

INTEGRAL UNIVERSITY, LUCKNOW
DIRECTORATE OF DISTANCE EDUCATION

BBA-504

Paper Code: IB

INTERNATIONAL BUSINESS

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UNIT-1 INTERNATIONAL BUSINESS: MEANING AND SCOPE

International Business

Meaning and Scope

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INTRODUCTIONS

In the post independence era, more than half-century Indian entrepreneurs concentrated on domestic operations and a surplus production was exported. The physical movement of goods, called EXPORT cannot represent International business. International business is defined as “any commercial transaction-taking place across the boundary lines of a sovereign entity”. It may take place either between countries or companies or both. Private companies involve themselves in such transactions for revenue, profit and prosperity. If governments are involved, they need to maintain their image, dependency and economic growth. Sometimes economic ties are strengthened through such transactions. These transactions include investments, physical movements of goods and services, transfer of technology and manufacturing. Today every company, whether small or large, single entity or partnership, joint stock or government owned, is determined to expand internationally. Earlier the slogan “export or perish” has now become “internationalize or perish”. Interdependency is a natural phenomenon; nations, living beings and companies cannot totally depend on themselves. It is the major driving force for international business.

International business has a wide spectrum of activities beyond mere exports. Currently Indian corporate acquire and takeover companies elsewhere. They invest a huge sum to find a right location for cost-effective production base. They are on the lookout for right joint-venture partners.

Hence International business operations extend their dimensions. The future success of company will depend upon its operations in many other countries through investment, manufacturing and marketing and not only on the revenue generated indigenously. In the same way nations success will depend on the businessman operating successfully in other countries and establishing their credentials there. In the 1950's and 60's, companies from United States built business operations throughout the world and brought image to the nation. In 1970's and 80's, Japanese

electronics and automobile companies made great revolution everywhere in the world.

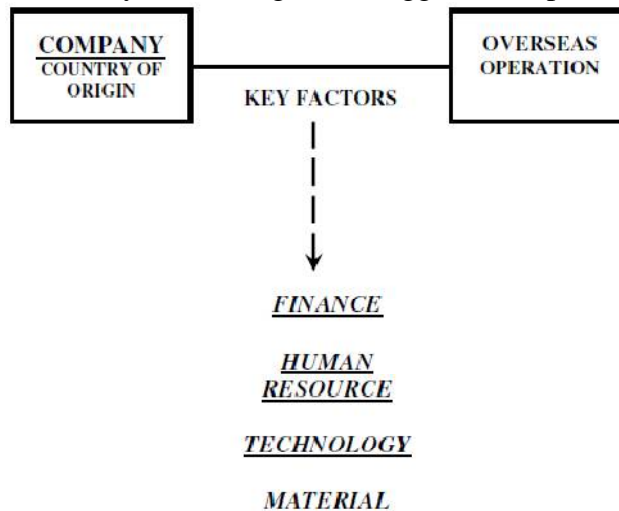
Why should we study International business?

Three decades ago very few companies ventured in to international arena, and most of them restricted themselves to physical movement of goods and services i.e. exports and imports. Restrictions, regulations and other barriers prevented them to take risks. Today, the whole world is open. Duties, license quotas and other investment limitations have gradually been eliminated. Anyone can do business in any part of the world. Risk factors are properly analyzed and evaluated and information about them is abundant. The aspiring international businessman can go to anywhere and explore opportunities.

In such a situation few key factors like finance flow or investment is a great force. To manage business internationally the right human resource is necessary and to manufacture goods, right technology is a pre-requisite. There should also be sizeable market to generate revenue. To manufacture goods in any country, raw material, components, consumables and capital items are required. Easy access to all the above is as easy as domestic procurement today. Hence scope of international business is widened.

REFORM PROCESS

Almost all countries are reforming their economy by LPG i.e. Liberalization, Privatization and Globalization. Many South East Asian nations, China, South Korea and a few Latin American countries were quick to introduce the reform process. India too, injected new vigour in to its economy and industry by introducing an open door policy, eliminating licenses, replacing foreign restrictions by other models and in general liberalizing procedures. It is clear that through reforming process, manufacturers in India are required to increase the production capacity and divert products to various destinations. Companies with surplus money should invest in different countries with motive of getting higher returns on their investment. Every business house such as Tatas, Birlas, Mittals, Mallayas have begin their aggressive operations abroad.



STRENGTH OF HUMAN RESOURCES

Countries like India have been endowed with efficient technical and nontechnical human resources. Companies with their origin in India have

proved themselves all over the world specially information technology, steel, healthcare, garments and jewellery.

International Business

Today international business is growing at a fast pace. Countries, which until now did not venture in to the international arena and untapped markets have emerged as potential ground for business. Latin America, sub-Saharan Africa and the Commonwealth of Independent States (CIS) are favourite destinations of future prosperity. Trade policies announced by various governments in the world are positive, proactive and pragmatic. Autocracy, authoritarianism and despotism are disappearing in all parts of the world. International bodies, such as World Trade Organisation strongly advocate elimination of barriers.

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It is mandatory for professionals to understand the whole network of political, legal, competitive and socio-cultural aspects wherever the business is setup. When E-Merck set up a business unit in India, there was a need for five hundred professionals who understood drug price control order, in process control system, food and drug administration and legal procedures, not only in India but in all countries in South Asia, Middle East and Africa. Hence, there will be an unprecedented demand for trained professional in the field of international business to handle business, investment, manpower, technology, services and marketing. To operate effectively, managers must understand modes, functions, means, environments, growth opportunities and risk factors. To this end they need to have access to a strong information base. To integrate all resources and produce a cost-effective product it in to revenue a strong professional force is directly involved at all stages. Thus a large force of trained manpower is required to handle future international business in all countries. Proper understanding of culture, economic indications, infrastructure, cost of operation, political scenario and working condition will make effective manager in international business in any country.

REASONS TO ENTER INTERNATIONAL BUSINESS

All organizations, irrespective of their size, are keen to enter in to international business. Established companies are expanding their business. Many countries encourage trade, and removal of strangulating trade barriers. It motivates companies to aggressively multiply their targets. The governments of various countries are also determined to make their economy grow through international business that has therefore become a inevitable part of their economic policy. The objective behind international business can be looked at:

1. From an individual company's angle.
2. From the government angle.

From an individual company's angle

1. Managing the product life cycle:

All companies have products, which pass through different stages of their life cycles. After the product reaches the last stage of the life cycle called the declining stage in one country, it is important for the company to identify other countries where the whole cycle process could be encashed. For example, Enfield India reached maturity and declining stage in India for the 350 cc motorcycle. The company entered Kenya, West Indies, Mauritius and other destinations where the heavy engine

two-wheeler became popular. The Suzuki 800 cc vehicle reached the last stage of its life cycle in Japan and entered India in the early 1980's, where it is still doing good business today. HP laptops are moving all the developing countries the moment they reached maturity in the U.S. market.

2. Geographic expansion as a growth strategy:

Even if companies expand their business at home, they may still look overseas for new markets and better prospects. For example, Arvind mills expanded their business by either setting up units or opening warehouses abroad. Ranbaxy's growth is mainly attributed to geographic expansion every year to new territories. Arabindo Pharma, Cipla and Dr. Reddys follow the same.

3. The adventurous spirit of the younger generation

The younger generation of business families has considerable International exposure. They are willing to take risks and challenges And also create opportunities for their business. Laxmi Mittal has Emerged as the steel king of the world and Vijay Mallya of the UB Group took a major risk in setting up operations in South Africa. Kumar Birla expands to Australia and Europe through acquisitions.

4. Corporate ambition:

Every corporate in the country has strategic plans to multiply its sales turnover. In case some of the ventures fail, others will offset the losses because of multi-location operations. For example, Coco Cola is still today not earning any profit in a number of countries. But this will not affect the company because more than a hundred countries are contributing to offset losses. Kellogge cannot think of profits in India for further five years. They are ambitious to be visible and then revenue.

5. Technology advantage:

Some companies have outstanding technology through which they enjoy core competency. There is a need for such technology in all countries. Biocon, Infosys, Gharda chemicals are known for their core competency in biotechnology, IT and pesticides respectively and a huge demand exists throughout the world for their technology. Thermax, Ion Exchange, Bharat Heavy Electricals and Larsen & Toubro have marched ahead in International business.

6. Building a corporate image

Prior to profits and revenue generation, many companies first build their corporate image abroad. Once the image is built, generating revenues is a comparatively easy task. Samsung and LG built their image in India for the first three years and generation of revenue and profits has been considerable, as they have expanded to semi-urban and rural India as well. Today their market share and penetration levels have gone far ahead of other players in India.

7. Incentives and business impact

Companies, which are involved in international business, enjoy fiscal, physical and infrastructural incentives while they setup business in the host country. The Aditya Birla Group enjoyed such incentives in Thailand and Indonesia. All such incentives contribute to the company to enjoy multiple advantages like economies of scale, access to import inputs, competitive pricing and aggressive promotion.

8. Labour advantage

Many companies have a highly productive labour force. Their unique skills may not be available throughout the world. Manufacturing units in India have consistently performed well, whether in a diamond industry, handicraft, woodwork or leather. Companies nurture the skills of the artisans and win world markets. Knitwear, handlooms, embroidery, metal ware, carpet weaving, cashew processing and seafood call for cost-effective labour force. India is endowed with such skills.

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9. New business opportunities

Many companies have entered in to business abroad, seeing unlimited opportunities. National foreign trade policy emphasizes focus markets. Enormous amount of growth potential is untapped in Latin America, Sub-Saharan Africa, CIS countries and China.

10. Emergence of SEZ'S, EOU'S, AEZ

Current approvals of Special economic zones, Agrizones and Technology parks by Ministry of Commerce & Industry give new dimensions to international business. The companies setting up units in SEZ's enjoy innumerable benefits and competitiveness.

From a Government Angle

1. Earning valuable foreign exchange

Foreign exchange earning is necessary to balance the payments for imports. India imports crude oil, defense equipments, essential raw materials and medical equipments for which the payments have to be made in foreign exchange. If the exports are high and imports are low it indicates a surplus balance of payment. On the other hand if imports are high and exports are low it indicates an adverse balance of payment, which all economies would want to avoid. A vast majority of the nations in the world are facing adverse balance of payment.

2. Interdependency of nations

From time immemorial, nations have depended on each other. Even during the era of Indus valley civilization, Egypt and the Indus Valley depended on each other for various items. Today, India depends on the Gulf regions for crude oil and in turn the Gulf region depends on India for tea, rice etc. Developed countries depend on developing countries for primary goods, whereas developing countries depend on developed countries for value added finished products. No single country is endowed with all the resources to survive on her own.

3. Trade theories and their impact

The theories of absolute advantage, comparative advantage and competitive advantage, which have been propounded by classical economists, indicate that a few nations have certain advantages of resources. The resources may be in the form of labour or infrastructure or technology or even a proactive policy of the government. Such theories are remaining foundations till today, for international business practices with few changes and trends.

4. Diplomatic relations

Diplomacy and trade always go hand in hand. Many sovereign nations send their diplomatic representatives to other countries with a motive of promoting trade besides maintaining cordial relations. Indian diplomats in Latin America have done a remarkable job of promoting India's

business in the 1990's. Indian embassies and high commissions in all the countries around the world play a catalytic role of promoting trade and investment.

5. Core competency of nations

Many countries are endowed with resources, which are produced at an optimum level. Such countries can compete well anywhere in the world. Rubber products from Malaysia, knitwear from India, rice from Thailand and wool from Australia are a few illustrations. Competing with a focused competency in any major resource or technology gives core competency status. India's core competency in IT is known throughout the world.

6. Investment for infrastructure

Over the years all countries have invested huge amounts of money on infrastructure by building airports, seaports, economic zones and inland container terminals. If the trade activities do not increase, the country cannot recover the amounts invested. Hence, the government fixes targets for every infrastructure unit and time frame to achieve it. Economies like Mauritius, Hong Kong, Singapore, Malta and Cyprus invest in trade related infrastructure in order to elevate themselves to be foreign trade oriented economies. Infrastructure and international business are the two eyes of a growing economy.

7. National image

A new era has emerged from conquering countries by sword to winning it by trade. A businessman gives priority to the image of the country he belongs to. We come across products with labels such as "made in China" and "Japan" & "made in India". Businessmen from India, China and Japan bring credentials to their country. When L.N.Mittal operates in Indonesia or Kazakhstan or Trinidad he is perceived by the people as Indian. The stigma cannot be detached.

8. Foreign trade policy and targets

All developing countries announce their trade policies. A clear road map is drafted and given to promotional bodies so that timely implementation is possible. Every trade policy in India, in the past had its agenda and action plans right from import control order in 1947. All the trade policies had three fold objectives in their agenda production promotion and competitiveness.

9. National targets

By the year 2010, India aims to have a 2% share of the global market from the current level of 1%. By the year 2009-10, our trade status should cross \$ 500 billion.

10. WTO and international agencies

The apex body of world trade, the WTO, a free, transparent and regulatory body upholds provisions related to the elimination of tariffs and non-tariff barriers. The International Bank for Reconstruction and Development (IBRD), popularly called the World Bank extends financial assistance on a soft loan basis in order to assist developing countries in their infrastructure and industrial development. The International Monetary Fund (IMF) maintains currency stability in various countries through regulatory mechanisms. Many more organizations like International Maritime Organization, International Standard

Organization, International Telecommunication Union, International Civil Aviation Organization are major catalysts to promote trade between nations. Over the past few years their role in promotion of trade, especially amongst developing economies is unprecedented.

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FUNDAMENTAL DIFFERENCES BETWEEN DOMESTIC BUSINESS OPERATIONS AND INTERNATIONAL BUSINESS OPERATIONS

Many well-known business units are highly successful in their home countries. However, they are not able to face the challenges abroad. On the other hand there are organizations that do very well in international business but they lose out in local arena. There are a number of organizations that do business, both domestic and international, successfully, by properly allocating right resources in right countries. These organizations are quick to see the advantages and disadvantages involved in both operations. If business is slow in the home country, they concentrate more on international business, and if risk is high in international business they focus their attention on the domestic front. Understanding differences and deciding policies and strategies enable organizations to succeed or fail. There are certain similarities between domestic and international business in terms of broad objectives and goals of the company, namely:

1. **Generating revenue**- either by creating opportunities or by optimizing strengths
2. Corporate image building
3. Customer satisfaction and building loyalty as patronage buyers
4. Carrying out their operations respecting and adhering to local regulations
5. Generation of employment opportunities
6. Both are subject to a set code of conduct and ethics that includes corporate governance.
7. Mass production through cost reduction and achieving economies of scale
8. Building a strong network in order to make product and services available in any part of the nation or world
9. Adapting new standards and change in style and function.

At the same time, there are major macro level differences. These are analyzed below, under various parameters.

DOMESTIC BUSINESS VERSUS INTERNATIONAL BUSINESS

Dimension	Domestic Business Operations	International Business Operations
1.Environment	The economic, political, legal, socio-cultural, competitive and technology environments are known	The environment is not fully known. Innumerable hidden factors which may emerge any time to pose as problems. They will lead to pitfalls.
2. Plan and strategy	Can be worked out for short terms and carried forward to long term	Only long term planning and strategy will work. Strategic inputs are required in multiples.
3. Competitive forces and their intensity	The maximum domestic competitive forces operate and one can understand their movements as they are visible	International competitive forces play a vital role and its difficult to understand their motive and movement
4. Currencies and their movements	Local currency is used for transactions. Costing, pricing, revenue and margins are computed in a single currency. Volatility may have a minimum impact in business in short term. One can overcome easily.	Transactions are carried out in various currencies. Fluctuations in cross currency movement and associated risks are common. Currency fluctuation influences pricing and costing and investment decisions.
5. Business risks	Comparatively one can predict future risks and shocks and they will not have a major impact on the businesses with strong background.	Very difficult to predict and risks may crop up at any time, due to the political situation, the society itself and several unknown factors.
6. Research	It is reasonable and easy to conduct business research, demand analysis and customer surveys. It is also reliable.	Very expensive and difficult to conduct. Reliability criteria depends on individual countries and there is no uniformity in the output and findings.
7. Human resources	Due to past laurels and established systems, corporates can succeed even if the human resources have minimum skills and knowledge. Team commitments is evaluated and appraised	Multilingual, multi-strategic and multi-cultural human resources and they should be able to withstand large risks. Every individual is profit center, hence, accountable.
8. Organizational vision and objective	Narrowed down to work in a single country with a steady growth objective. Each one will understand the vision and objective easily.	Broadened to cover many countries and geographic and cultural diversity may influence the vision and objective.
9. Product and usage	Adapted to the local environment, as per the requirements of the domestic customers affordability, beliefs, values, cultural elements and buying	Varies from country to country subject to regulations. This is especially true for consumer & medicinal items. Standardization, adaptability, usage
	behavior.	pattern & warranties are parts of product
10. Legal aspects	Only local regulations are fully applicable to conduct business. There is minimum adherence to international regulations related to IPR.	International regulations and host country regulations are applicable. Advanced countries impose strict regulations compared to LDCs. Strict adherence to contractual obligations is common.
11. Investment and Sourcing	Depending on the size of the business one can start with a minimum investment. Involvement of regulatory bodies is minimal. Individual ability and repayment terms determine the funds.	All overseas operations except exports, call for huge investments to set up and expand the business in many countries. Special regulatory bodies are involved in the process since foreign currency is transacted.
12. Pricing strategy	A majority of companies use cost plus margin pricing or competitive pricing.	Companies use marginal cost pricing or transfer pricing or competitive pricing to succeed.
13. Distribution channels	The business house can use its discretion to select any channel to reach the customer. No restriction exists here.	Government or market practice governs the distribution channel. Cash and carry, shopping malls and mail order services are becoming popular in international business.
14. Promotion	Advertising, personal selling and other promotional methods are not restricted through strict legal framework if they are not socially objectionable.	Different countries have different restrictions. For example, advertisements for liquor and cigarettes are not permitted in some countries and campaigns using female models are banned in others.
15. Logistics	Domestic players are involved in all the activities. The cost of logistics is very high locally.	International players with advanced technology and systems are involved. Proportionately, the cost is low for physical movements.

Some business groups like **Adanis** started only overseas operations without any linkage with domestic operation right from the beginning. **Tata group** established a good name at home country and gradually moved to other countries. For companies in IT, such as **Wipro or Infosys**, the major focus is on overseas operations. All the companies cited as examples above are successful in their own right, but the strategies and operation systems differ from country to country. Organizations like **RELIANCE INDUSTRIES** have inherent strength in indigenous business such as completing the project prior to stipulated time. This experience enables the company to grab any business opportunity in petrochemicals around the world and build reputation. **Gammon India, IRCON (Indian Railway Construction), Larsen & Toubro (L&T) and Saproorji Pallonji** are successful due to their meticulous way of understanding both operations.

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REVIEW QUESTIONS

Why should we study International business?

1. Discuss about reform process in business.
2. What are the strength of human resources required for international business?
3. What are reasons to enter into international business?
4. Describe the fundamental differences between domestic business operations and international business operations.
5. What is the difference between domestic business versus international business?

FURTHER READINGS

1. International Business- Stuart Wall, Bronwen Rees
2. International Business- Aswathappa
3. International Business Environment- Les Dlabay, James Calvert Scott
4. International Business- Thomas L. Friedman
5. International Business- Leslie Hamilton, Philip Webster

UNIT-2 METHODS OF ENTRY IN INTERNATIONAL BUSINESS

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- ❖ Introductions
- ❖ Different Modes Of Entry In International Business
- ❖ Foreign Entry Decision For MNCs
- ❖ Economic Environment
- ❖ Social Environment
- ❖ Political Environment
- ❖ Cultural Environment
- ❖ The Influence Of Culture On International Business
- ❖ Technology Environment
- ❖ Legal Environment :
- ❖ Competitive Environment:
- ❖ Review Questions
- ❖ Further Readings

INTRODUCTIONS

International business provides a wide range of advantages and opportunities. Companies in developing and less developed countries operate through physical exports, whereas those in advance countries operate through joint ventures, collaborations, franchises and other methods. Firms would prefer to go international only if the benefits surpass anticipated risks, and they carry out an in-depth analysis before entering international business. Generally, they give serious consideration on the following aspects:

- a. Current and potential size of the market.
- b. Level of completion for a specific product or service
- c. Economic growth of the country and reform process
- d. Purchasing power of the people
- e. Political and legal environments and their impact in business
- f. Infrastructures like banking, insurance, port facilities etc
- g. Socio-cultural background of the country
- h. Availability of technical and non-technical work force
- i. Foreign exchange reserve and repatriation facilities

For every human being or business unit, the origin is one, but, the laurels are built in multiples and that too, in various destinations. The vision, business models, right decisions and proper implementations have created business enterprises in the contemporary world.

DIFFERENT MODES OF ENTRY IN INTERNATIONAL BUSINESS

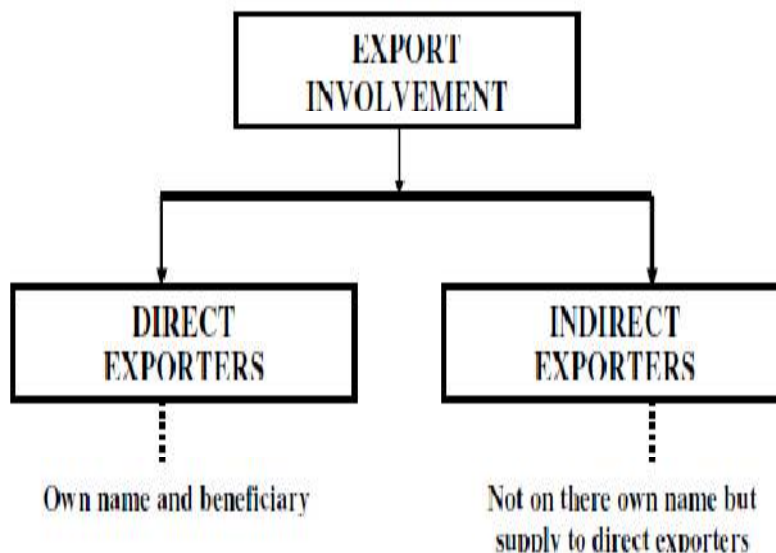
1. EXPORTS

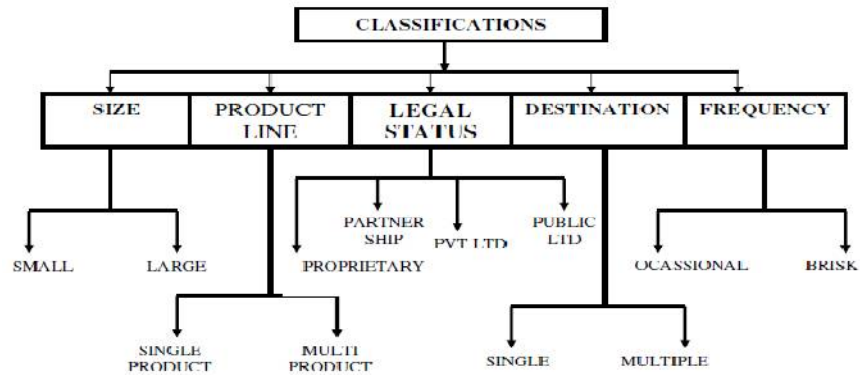
Export deals with physical movement of goods and services from one place to another through a customs port followings the rules of both the country of origin and country of destination. Depending upon the

involvement of the exporter, exports can be classified as direct or indirect. Direct exporters export their goods and services in their own name and the buyer directly remits proceeds, in a proper manner and through a proper channel. The proper channel means that the remittance is made through the banking channel in the currency, which is quoted in the invoice, and the proper channel means that the goods are legally exported through a customs port. Indirect exporters supply goods to direct exporters. Lack of expertise, international contacts and manpower cause them to depend upon direct exporters. Farmers rarely export grains on their own. Artisans cannot develop international contacts to clinch business deals.

Therefore, they become indirect exporters. Their products are to other countries but not in their names. Exporters can be classified in several ways:

1. Depending upon the size of business, they are classified as small and large exporters. Current national trade policy provides incentives and facilities to promote both small & large exporters in different ways that are status holders due to their performance in earning foreign exchange.
2. Depending upon the product lines exported, they are classified as single product and multiple product line
3. Depending upon their legal status, they are classified as proprietary, partnership, private limited and public limited companies
4. Depending upon the destination of their exports, they are classified as single destinations or multi destination exporters. Nowadays, the majority of the companies adopt the philosophy of multi product, multi location, multi strategic, and multi dimensional operations.
5. Depending upon the frequency of their exports, they are classified as occasional exporters and dynamic exporters.

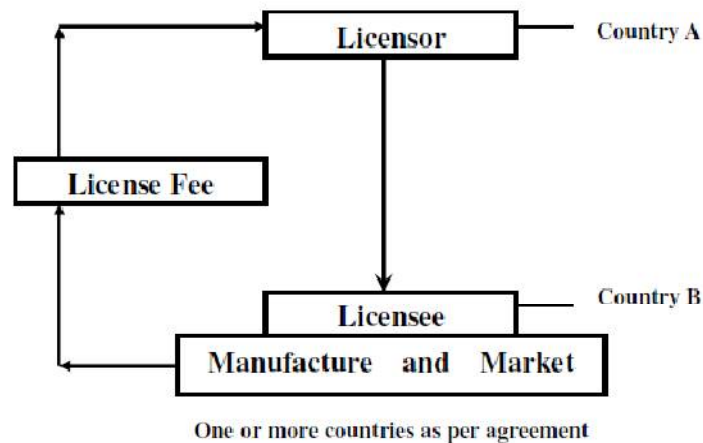




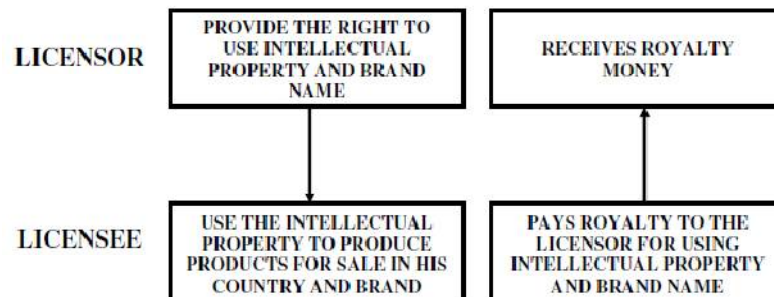
2. INTERNATIONAL LICENSING International licensing is an agreement between the licensor and the licensee over a period of time for the use of brand name, marketing, know-how, copyright, work method and trade mark by paying a license fee. For example, British American Tobacco Company (BATS) has given licenses in many countries for the manufacture of their brand of cigarettes “555”. In India, ITC is the licensed producer of “555”.

Pepsi cola licensed to Heineken of the Netherlands giving them the exclusive right to produce and sell Pepsi cola in Netherlands. The licensor has minimum involvement in day-to-day functions. Therefore the returns are also comparatively low. Licensing specifies the territory as well as period. The licensor gives such permission after establishing such a command-able position globally. It has a brand command.

Licensing Concept and Practice



Licensing Process

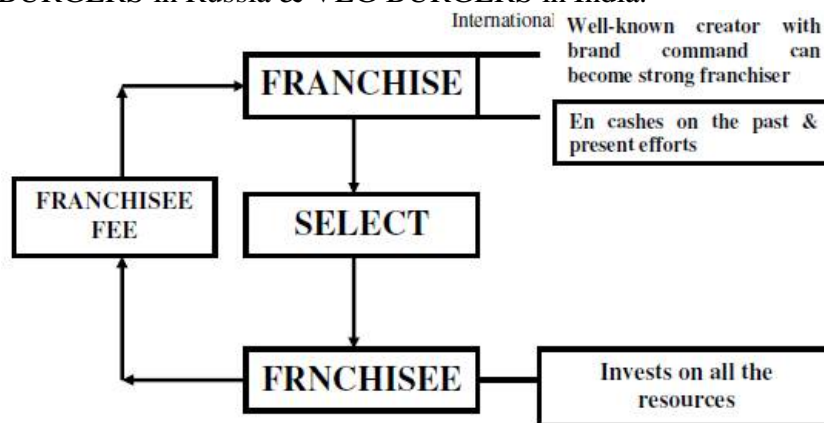


3. FRANCHISING

Franchising is a form of licensing wherein the franchiser exercises more control over franchisee. The franchiser supplies the main part of the product, and provides the following services to the franchisee:

1. TRADEMARKS
2. OPERATING SYSTEMS
3. PRODUCT, &
4. BRAND NAME

Company support systems like advertising, training of employees, quality assurance are also involved in franchising. McDonald, Dairy Queen, Domino's Pizza and KFC are the known franchise brands. NIIT & Aptech have appointed franchisees in Africa, south East Asia, Gulf countries and China. Hotels like The Hilton and Marriott are well known operators in hotel sector. Jaitia's in India are the national franchisees of McDonalds. All the investments on premises, HR, operations and promotions are totally borne by the franchisees. In practice the franchiser is determined to maintain a standard throughout the world in terms of quality brand logo and symbol. But the product is adaptable depending on the socio-cultural background of the country. McDonalds sells BEEF BURGERS in Russia & VEG BURGERS in India.

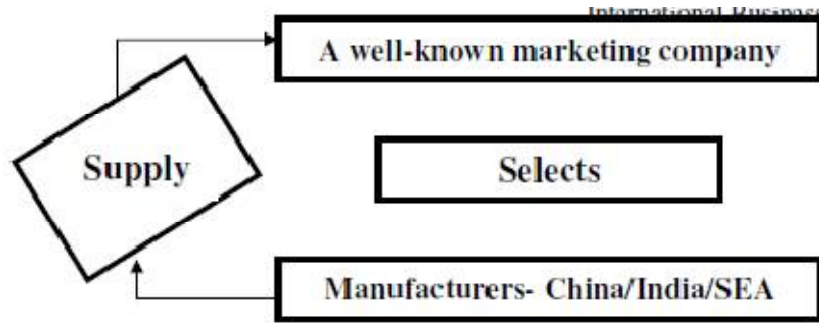


Sometimes the franchisers initiate the process where the economy is on boom. In many developing nations, franchisees initiate the process and they are forced to bear all the expenses.

4. CONTRACT MANUFACTURING

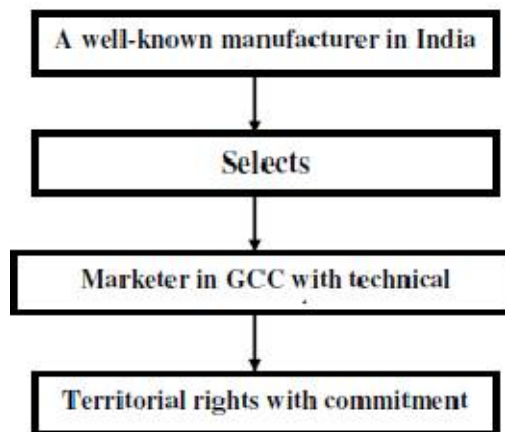
Many companies outsource their products and concentrate mainly on marketing operations. Contract manufacturing is the strategy of identifying a manufacturing unit to produce items at a competitive price in any part of the world. Nike is procuring its athletic footwear in a number of factories in South East Asia. Mega Toys is sourcing from China. Hundreds of international companies with their origin in European countries have selected manufacturing centers in India, China and South East Asia. Mark and Spencer, J.C. penny, Target and H & M have contract manufacturing arrangements in many parts of the world.

Contract manufacturing with a dimension in the service sector offer ample opportunities for Indian companies in the form of BUSINESS PROCESS OUTSOURCING (BPO) and KNOWLEDGE PROCESS OUTSOURCING (KPO). All the developed nations are becoming end user of outsourced products and services of developing nations.



5. CONTRACT MARKETING

All the companies, which are strong in production, may not have equal marketing strengths. However, they may be comfortable dealing with marketing outlets around the world such as TESCO, Maey's, 'K' Mart, Wal-Mart and Spinneys. Such manufacturing units enter in to a marketing agreement and concentrate more on production at lower costs. Thermax, Ion Exchange and Supreme industries have selected marketing firms in other countries, which have a good background with technology support. Majority of technology-based companies essentially have to identify competent organizations with marketing infrastructure to aggressively promote their products or projects. Many Indian companies are contract marketers for Germany based medical equipments, dental care items and hearing aids. Their contractual obligations include



6. MANAGEMENT CONTRACTS

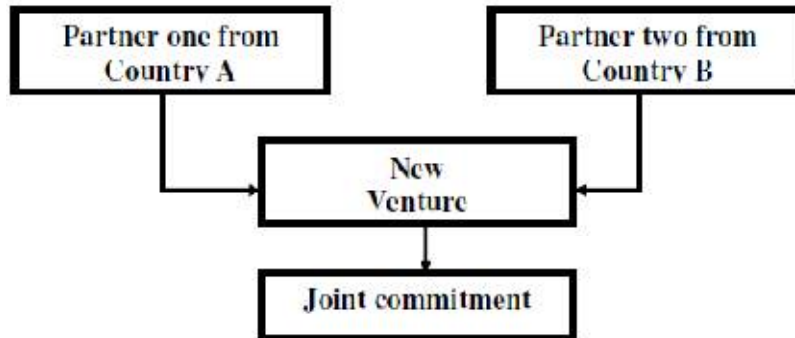
Companies with a low level of technology and managerial expertise may seek the assistance of foreign countries. A management contract is an agreement between two companies whereby one company provides managerial and technical assistance for which proper monetary compensation is given, either as a flat lump sum fee or a percentage on the sales or a share in the profits. Delta airlines, Air France and KLM offer such services in developing countries. Exxon is a major operator in Gulf region in the field of oil exploration.

7. JOINT VENTURE

VENTURE ORIGINATES FROM ADVENTURE, which means **NEW**, either market or technology or environment. A joint venture is a binding contract between two venture partners to set up a project either in home country or host country or a third country. In this case both parties are committed to joint risk taking and joint profit sharing. For example, The Taj group of hotels has a joint venture in Russia for setting

up Five Star Hotels. Mahindra & Mahindra has recently entered into a joint venture with Renault to manufacture cars.

A large number of joint ventures have been miserable failures in the past. In the initial stage every venture promises excellent opportunities to both the venture partners. However, when the operation actually starts, certain functional level grievances and issues become inevitable. Therefore, it is



absolutely necessary for both the venture partners to understand all the aspects of management, investment and regulations of the countries where they operate. The business units should have clear guidelines and operation manuals wherein the role of everyone should be clearly defined.

Hence, a joint venture is nothing but a “marriage binding” between two partners from different backgrounds with an understanding, commitment and mutually rewarding experience to work together.

8. COLLABORATION

While a joint venture deals with the project in totality, in financial terms and the proportionate partnership commitments, Collaboration deals with only a part of the functions. For example Bajaj Auto has technological collaboration with Kawasaki of Japan, who offers the technology for two wheelers. Others well known technological collaborations are Ind-Suzuki, Kinetic-Honda and Hero-Honda. All the developing countries encourage technology collaborations. The investors in the US, Japan, Germany and UK enjoyed the fruits by offering technical expertise to the developing nations. The world famous Kellogg Business School has collaborated with the Indian school of business (ISB) in Hyderabad, by offering teaching methodology. Likewise, there may be financial collaborations, HR collaborations, systems collaborations and strategic collaborations. The common term used for collaboration is TIE-UP.

9. FOREIGN DIRECT INVESTMENT

The flow of funds from one destination to another is called investment. Companies, which are constantly involved in international business, invest their money in manufacturing and marketing bases through ownership and control. Kellogg, Pepsi, Coca Cola and the Hyatt group of hotels are willing to invest even if the profits are expected after a long gestation period. Currently every developing country is formulating strategies by offering ample amount of incentives to attract investments.

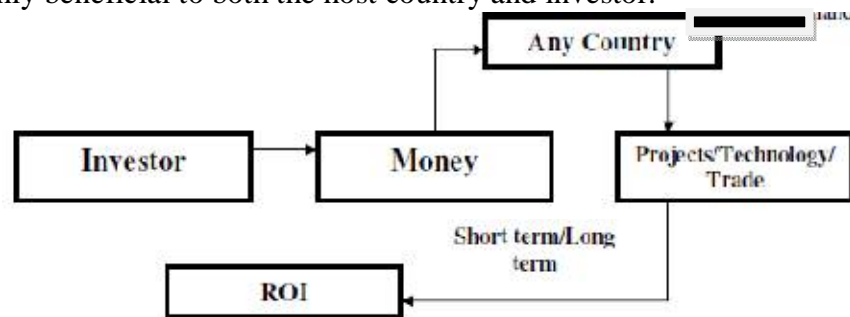
Foreign firms adopt certain methods as mentioned below:

- a. They control the operations through subsidiaries to achieve strategic synergies.
- b. They have control through technology, manufacturing expertise, intellectual property rights and brand name.

c. One permanent person or a team in the country of operation is appointed to monitor day to day operations.

The most attractive part of the operation is the direct investment, which contributes to optimization of resources in the host country, generating employment opportunities and enhancing the standard of living in the host country. The other major developments, which have taken place during the past two decades, are exposure of the host countries to advance technology and quality products. It is boon to the host country since capital is great resource it is coming through investment.

The main disadvantages are lack of clarity of repatriation of profits, imposition of restrictions by host countries and elimination of small and medium industries due to the financial power of the investor. A number of South American countries like Argentina and few South East Asian nations like Indonesia fell pray to the dominant forces of overseas investors. They feel that the old colonialism may re-emerge through investments. Generally, a foreign investment takes place on full swing in developing countries only in the past two decades. China, Taiwan, India, Brazil, Argentina and other developing countries have started attracting huge foreign investments. If it takes place in specific sectors like infrastructure, mining, marine technology and agro processing, it is highly beneficial to both the host country and investor.



10. MERGERS AND ACQUISITIONS

In this case the company in the host country selects a foreign company merges itself with it. The foreign company acquires the control of ownership. This mode of entry gives an outstanding competitive edge over others. Such companies strengthen their international manufacturing facilities and marketing network. Proctor & Gamble entered Mexico and became leaders in five years by acquiring Loreto. Tata bearing acquired Metal Box in India. It is an easy and fast method since the cost of acquisition is comparatively low. At the same time the disadvantages are:

- a. It is a complex task involving banks, lawyers, bureaucrats and obviously politicians.
- b. The host countries may impose restrictions on acquisitions.
- c. The labour problem is a big challenge to acquisitions specially in developing countries where unemployment is a critical issue.

The global STEEL-KING L.N.Mittal was successful right from the first acquisition of steel mill in Indonesia. Many other acquisitions followed in Trinidad, Kazakhstan, Hungary and others. The recent Aditya Birla Group Company Hindalco acquisition of Novelis has strengthened its production synergy and market access for non-ferrous category in the international market.

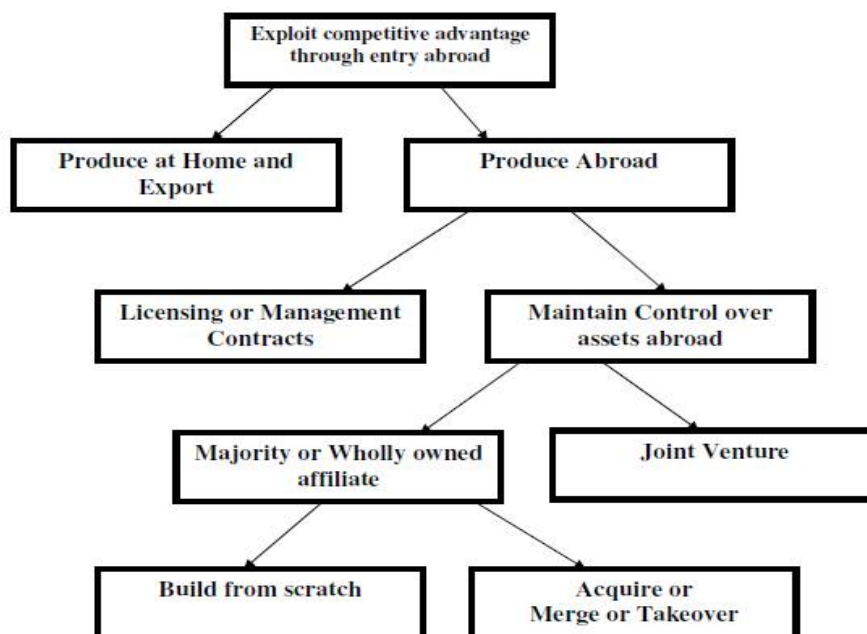
11. TAKE-OVERS

This is a strategy whereby a company identifies a healthy unit with strong brand name and network and brings it under the management of another unit in order to become a leader in the field and guarantee success. Since there may be many parties wanting to takeover a well-known company, competition becomes inevitable. It is obvious that only one entity will win and the winner has to withstand hostilities. Therefore, the process is called a “hostile takeover” and the winner is called the “take over tycoon”. Wellknown examples are the Hindujas who took over Ashok Leyland and Uniliver who took over Brook Bond and Lipton. Take-over is also on different levels, such as company takeover, business takeover, product takeover and brand takeover. Some takeovers in the past have made many corporate success stories. For example, Uniliver’s takeover of Brook Bond and Lipton enhanced its position as a leader in the tea industry in India. Always takeovers cost more as compared to acquisition but probability of success is high.

FOREIGN ENTRY DECISION FOR MNCs

For all the decisions the company has to analyse the opportunities and risk factors, future potential and long term prospects available in the destination. Once the entry is wrong, a major pitfall occurs in one country of the entry level, it may cause a major damage to the company. Entry of ENRON in INDIA was one such incident one cannot forget.

FOREIGN ENTRY DECISION FOR MNCs

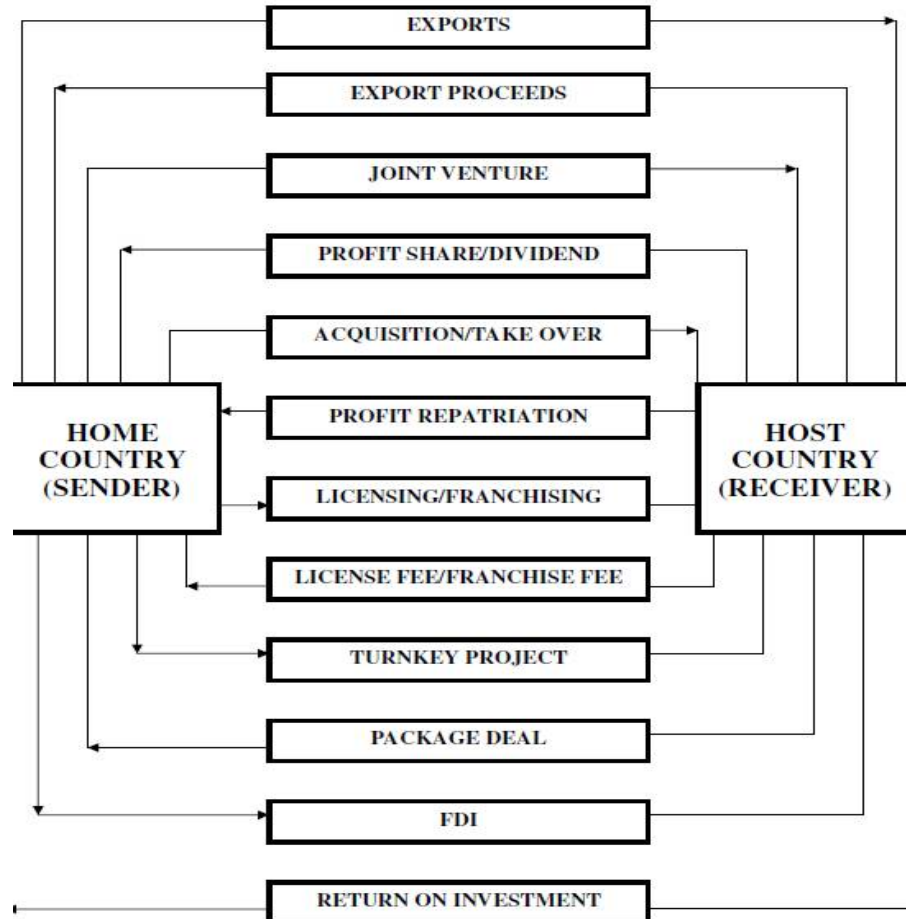


12. TURNKEY PROJECTS

A turnkey project is a contract under which a company is fully involved from concept to completion. It covers right from supply of manpower, capital, and erection of plant, installation and commissioning up to the trial operation of a project. The turnkey project contractors either get a fixed fee or the cost plus profits are collected over a period of time. Today, infrastructure projects like power plants, airports, refineries, railway lines, highways and dams are undertaken on a turnkey basis.

Bechtel, Brown Boveri, Hyundai, Mitsubishi, L&T and Daewoo are turnkey contractors for international projects. They use terms like BOT (Build, Operate and Transfer) and BOOT (Build, Own, Operate and Transfer) depending upon the level of involvement and obligations. Whenever turnkey project contractor is capable of cutting costs on material and manpower or finances or speed of completion: every component increases profitability.

Mode of Operation and Benefits to International Companies



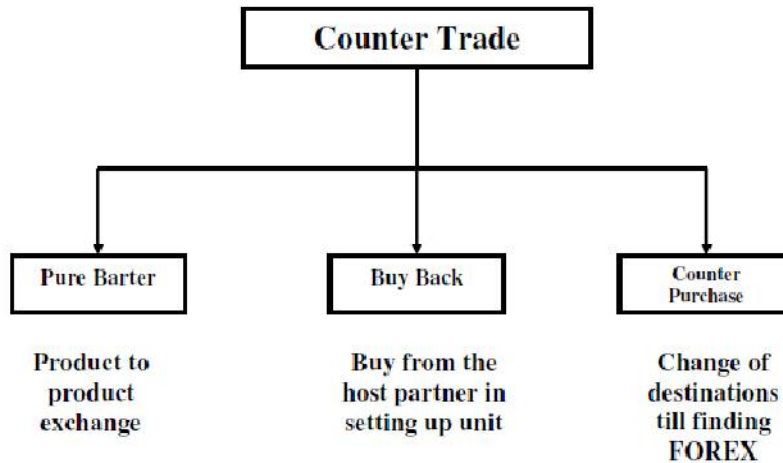
13. COUNTER TRADE

In all the above operations, foreign exchange is necessary for transactions. For exports, the supplier gets the proceeds in foreign exchange. For joint ventures, profits are shared in foreign exchange. For international licensing, the license fee is paid in foreign exchange. The current challenge to many international business organizations is to get payments in foreign currency. A vast majority of the countries in the world do not have the necessary reserves of foreign exchange to remit. However they can still be actively involved in international business, by using COUNTER TRADE mechanism. Counter trade came in to existence in the absence of foreign exchange reserves in a country. Sometimes the country is not willing to pay, though foreign exchange reserves are with it. Such unwillingness will lead to non-repatriation of payment. Ultimate solution is to enter in to counter trade practices.

Counter trade can be classified in to three categories:

1. Pure Barter
2. Buy Back

3. Counter Purchase



Pure Barter

In this system goods and services are mutually exchanged between two countries depending upon their bargaining strength. A country with surplus products can finalize deals with another country that has a shortage of the same range of products. At the same time, the second country may have a surplus of a different range of products, which are in short supply in the first country. Hence, both countries can exchange their products by fixing a price in advance for a given period of time. This age old system that was prevalent during the era of ancient civilizations is being practiced currently. The Indus Valley supplied timber for maritime activities to Mohenjadaro and Harappa. The same practice has re-emerged with sophisticated pre fixation of value. Pure barter is defined as “the mutual exchange of goods and services between two countries depending upon their bargaining strength, in order that both the countries enjoy the benefits”. For example Russia supplied newsprint and crude oil to India for decades, and in turn India supplied tea, garments, medicines and tobacco products to Russia at a comparatively low price, thus enabling both countries to enjoy the advantages.

Buy Back

A buy back is an arrangement by which the home country representative sets up a project in the host country, which does have sufficient foreign exchange reserves to fully pay for the project to the supplier. The project amount is partially paid in foreign exchange and the remaining amount is paid in kind. Usually, the home country representative comparatively at low price purchases the end product of the same project. This can be marketed in the home country or it could even be diverted to a third country in order to maximize the profit margin. Buy back arrangements have become popular since many turnkey project contractors get greater benefits by marketing the end product in any part of the world at a higher margin. Bharat Heavy Electricals (BHEL) sets up projects in other countries. Partially it gets the payment in foreign exchange. For the balance amount it takes back tankers from the host country and markets them in any other country and also brings them back to India to sell at a higher price. Such deals enable the home country businesses to get international exposure very fast. The host country is an ultimate

beneficiary since the project is located in and owned by it. At the same time, it need not have to pay the full sum of money necessary to invest in the project.

COUNTER PURCHASE

This is a method, wherein company A from country A supplies product X to country B. Country B, which has a surplus of product Y, compensates by supplying it to company A, which finds a market for product Y, say country C. Country C sells a product Z to a country D, which has sufficient foreign exchange to pay for it. Country D can then pay country C, and finally country A collects payment routed through company B and C. Thus purchasing takes place against supply until a country, which has sufficient foreign exchange reserves is found. He transaction. Many multinationals use this system to make large amounts of money at every stage of For example, Pepsi International supplies rice to South Africa from India. From South Africa it procures steel equivalent to the amount of rice collects and supplies it to Ghana. From Ghana, it procures coffee and cocoa equivalent to the steel imports and sells them to Canada, which has sufficient foreign exchange reserves to pay for them. By appointing one representative or employee the company can carry out routine functions deals in the Far East are Marubeni Corporation, Mitsubishi and Majuko.

The age-old economic theory of inter-dependency of nations has been redefined with the counter purchase mechanism. Today, to trade with other countries, it is not necessary that the country in question has to have sufficient foreign exchange reserves. Without foreign exchange reserve one can continue trade.

The model on the next page shows the benefits that both the home country and the host country enjoy on successful completion of the transactions undertaken. Today, anyone can do business with any country. Foreign exchange as a medium of transaction had a dominant role in all the countries in the past. Due to counter purchase mechanism very few countries with foreign exchange reserve can comfortably contribute to international business.

Key Factors Influencing International Business

Learning value:

This chapter highlights the major factors influencing the direction of international business;

- 1. Importance of environmental factors**
- 2. Economic environment**
- 3. Social environment**
- 4. Political environment**
- 5. Cultural environment**
- 6. Technological environment**
- 7. Legal environment**
- 8. Competitive environment**

A pilot has to check the atmosphere prior to take-off and landing his aircraft. A sailor has to understand waters & before sailing peacefully. A farmer has to plant seeds depending on the nature of the soil and monsoon.

On the same line, an international business entry or operation depends upon multiple environmental factors. They may change the direction, strategy and every moment of international business operations. Prior to going deep in to the topic, we can ask ourselves few questions and seek answers.

Analyzing similarities and dissimilarities prevalent in countries gives wisdom; selecting a country for business enkindles spirit and minimizing risks knocks the door of success.

- a. Why ENRON could not succeed in India?
- b. What is the major hindrance for success of Kellogg in India?
- c. Why KFC has not made any break through in India as it did in other countries?
- d. What made Whirlpool & Caterpillar stop business in India?

An international marketer is required to understand, evaluate and work out various parameters before venturing into any country. These Parameters are called environmental factors and they determine the direction and purpose of the international business operation. Many decisions depend upon environmental factors right from selection of the country, location of the plant, liaison with the government, and entry of investment from local bodies, product launch, channel management, promotion and opening of outlets. The first challenge for an organization is to navigate from its home country to the host country. Thereafter it has to develop a proper system so that the venture is successful in the host country; learn all about the regulatory bodies both in the host country and home country; understand the customer's changing tastes and attitude towards foreign goods and finally obtain revenue and make the business effective with right people. A majority of the multinational corporations and large business houses appoint a team of experts who are specialists in economies, political science, sociology, industrial psychology and policy matters, to advice the management on its strategic decisions. These experts are called risk analysts. Prior to entry or investing millions of dollars, the experts gather all the relevant information about the country and interpret those facts to facilitate the company. By such risk analysis, companies can safeguard themselves from future dangers. The major risks are:

1. Political
2. Economic
3. Exchange
4. Socio culture
5. Financial
6. Legal
7. Technological
8. Competitive
9. Infrastructural and
10. Labour.

An organization can overcome the effects of all the risks by taking into account the different environmental factors.

Since the home environment is known, one can understand and overcome the pitfalls in the event that any action goes wrong. The international business related environments vary from continent, country

to country and even from region to region. A detailed and comprehensive analysis of such fast changing environment is essential for formulating business strategies. Even well known companies with financial power, advance technology and an efficient management team have failed in other countries. Examples are

the Enron project which did not take off in India; American style of managing a sales force which never worked for Procter and Gamble in Japan; the multilayer marketing technique of Amway, which did not work in South Korea and Kentucky Fried chicken and McDonald's hamburgers, which failed in Brazil and Tashkent respectively. Thus, it is important for a company to have an international team to design strategies to suit varying environments of different countries.

In this chapter we discuss the environmental factors relevant to international business. The economic environment, political environment, cultural environment, technological environment, legal environment and competitive environment play a vital role in determining an international business operation. Certain environments are quite conducive to a company at the time of entry and later on they may pose major challenges. Argentina attracted huge investments before 2000. After 2002, they became detrimental to innumerable organizations. Hence environmental factors could be stimulant or detrimental. If it is stimulant, the business will flourish. But if it is detrimental, then the company has to be cautious.

ECONOMIC ENVIRONMENT:

The economic environment can be classified into three categories:

- a) Economy in the home country
- b) Economy in the host country
- c) Economy at a global level.

a) Home country Economy

Since 1940, hundreds of MNCs from the USA have ventured abroad, with the support of their home country. After 1990, many Indian companies started venturing into sub-Saharan Africa, South East Asia and Latin America due to the liberal policies adopted in India. In order to encourage the business community to venture overseas, it is necessary for a country to have liberal economic and trade policies.

1. Economic policies

The country's economic policies are formulated and the targets are fixed looking at business opportunities in other countries. It is made simpler for businessmen to invest or set up units abroad.

2. Trade and commercial policies:

The trade policy is announced by the ministry of commerce and industry and the target for national foreign trade is fixed. All the promotional bodies are geared to achieve the target. Many incentives are held out to overseas companies, so that they set up operations in the home country through local partners, Indonesia, Thailand and Brazil extend all facilities in their home country to promote their nationals.

3. Promotion and regulatory measures:

The home country should take the opportunity to do business abroad. It can do this by being proactive, encouraging persons to take risks and extending fiscal and promotional support. If restrictions are imposed and

bureaucratic hurdles are encountered at all stages the business community will not think of taking any risks. By removing exchange control restrictions and draconian codes of business and providing an environment conducive to foreign trade, small countries like Malta, Cyprus and Mauritius have today transformed themselves into foreign trade economies.

b) Host Country Economy.

When a firm from one country enters any other country, the following major criteria are taken into account:

1. Size of the market

Many multinational firms are thinking of entering India, China, Brazil and Indonesia, because of their large potential markets. Coca cola, Pepsi, Hewlett Packard and Samsung are looking to India as a future destination keeping in mind the size of population which represents the size of the market.

2. Gross Domestic Product (GDP)

GDP is an indicator of the health of the economy; it also determines per capita income. A country with a high GDP is an attractive destination for any international businessman. If a constant growth rate is maintained, such a country would always be a magnet for investors. Thailand, Malaysia and Indonesia were attractive during the 1990's due to a very high growth rate in GDP, until the currency crisis affected their economies.

3. Industrialization

Many firms in the developing world were interested in entering into Europe or the USA. The recent trend amongst companies in India is towards Latin America specially, Brazil, Argentina, Chile. This is due to the industrialization program, which is taking place in these countries. It is obvious that industrialization brings about prosperity and affluence.

4. Banking

Banking is the only channel through which remittances take place, and hence is a major infrastructure for international business. European, American and far East economies have highly effective banking systems. Sub-Saharan Africa and commonwealth Independent states (CIS) are not able to provide good banking services to the international business community. Thus, a firm which enters Africa or the CIS countries has to necessarily depend on other countries for banking services.

5. Purchasing Power

Another major determining factor for any international business unit is whether the people can afford to buy for a product is low. In other countries like Saudi Arabia, both the income and willingness to pay for the product are high. In the Scandinavian countries the per capita income is very high and they are ready to pay a premium price for highly sophisticated items. However, the low population is a limiting factor.

6. Foreign Exchange

Another determining factor in international business is whether foreign exchange facilities are available transactions. Although more than 70% of the countries in the world do not have foreign exchange reserves, the majority of them are becoming liberal in transacting foreign exchange as a long term strategy for their future economic development. Against this,

some countries with surplus foreign exchange reserves do not permit free movement of the currencies. Such countries that have restrictions in repatriation of foreign exchange will not be attractive to international business firms. Therefore, countries with sufficient foreign exchange reserves, a liberal policy on repatriation and which have a demand for the products and services are an ideal destination for any company to do international business.

7. Income Levels

Economies are classified into low income and high income economies. Industrialized nations are high income economies and enjoy a high per capita income. Companies manufacturing or marketing premium quality or high technology products have an easy entry into such advanced countries with the proper strategies. Developing countries, which are the low income economies, are price sensitive. Many of them are under pressure from high population, unemployment and lack the vision to industrialize fast. Still they need only primary goods and rated one amongst less developed countries. Differences in the income levels may limit the involvement and investments. Sometimes, in a densely populated country, a small percentage of the population can afford to buy premium products. Since this does not represent the purchasing power of the whole country, the revenue is minimum.

8. Economic diversity

In the same country, a few urban centers may offer outstanding business opportunities, while in remaining areas there is no demand at all. Nairobi I Kenya, Lusaka in Zambia, Johannesburg in South Africa, Sao Paulo in Brazil and Casablanca in Morocco are cities with the highest purchasing power and demand for refrigerators, air conditioners, TV sets etc. However in other parts of the country, there is hardly any opportunity to do business. In Madagascar, despite the fact that it is a highly resourceful country, one can not get even the basic item for survival, except in two cities, Tamatave and Antamarino.

c) ECONOMY AT A GOBAL LEVEL

Besides the home country and the Host country, there are certain other factors, which can influence the pattern of international business. Organizations such as the World Trade Organization, World Bank, International Monetary Fund, Asian development bank and the organization of petroleum Exporting countries (OPEC) can affect international business. The preferential treatment given to the members of NAFTA, ASEAN, the European Union and COMESA can have a negative impact on the trade between outside cartels and non-members. When shipments move from one destination to another, there are transit ports which charge huge sums as surcharge or transit charges.

SOCIAL ENVIRONMENT

The social environment encompassing religious aspects, language, customs, traditions and beliefs, influences buying consumption habits. Many companies face failure in foreign countries, due to their inability to understand the socio cultural environment. For example whenever any company establishes business in some African countries, the local population expects that many jobs will open up for them. Very few countries perceive tat they may be exploited.

Due to the entry of foreign firms the economic and hence the social environment of an area can completely change. An example is southern China, which has completely changed to an affluent society due to the fact that almost 2000 companies get their products manufactured in coastal south China.

1. National Taste

In Thailand, People prefer black shampoo; Nestle brews different varieties of instant coffee because people in those countries have different tastes, uncommon in other countries. Green is the favorite color of all the Arab countries; Red is still widely used in Russia, in banners, posters, and hoardings although communism is in no way relevant to modern Russia.

2. Language

Cross culture and cross border operations call for necessary language skills, e.g. South Koreans have learnt Indian languages to operate in India. One can see this in Hyundai or LG factories in India.

Companies also have to change their brand names and slogans in different countries. In Japan, General Motor's slogan "body by fisher" means "corpse by fisher", and Pepsi Cola slogan "come alive" means come out of the grave. Prior to promoting the brand, one has to take into account the sociocultural background of a specific nation and different interpretations of a name in the local language.

3. Values and beliefs

It is also important for companies to understand the significance of different designs and colors in different countries. For example, blue is perceived as feminine in Holland and masculine in widen. Green is favorite color in the Muslim world, but is associated with illness in Malaysia although it is a Muslim country. White indicated death in china and Korea but it is the color of bridal dresses in Europe. Red is associated with danger in many countries but it is a favorite in Russia. Another example is 'swastika', which is considered sacred in India, but has completely different connotations in the west.

4. Demography

A number of demographic factors such as age, sex ratio, family size and occupation influence the business of many companies. Different companies concentrate on different segments. For example, Barbie generates huge revenues through the children's segment of affluent countries.

5. Literacy rate

Countries with a high literacy rate experience a better standard of living. Here the need is for standardizes goods, supported by technical services. For a country with an educated population, the amount of training required for the staff will be far less than in the case of the country which has a low literacy rate. This is an important factor, as it influences the cost incurred. The ame argument holds in the case of educating the consumer about the products manufactured.

6. Female Workforce

The most spectacular change that has taken place in the current era is the empowerment of women throughout the world. In China, Indonesia, Russia and Thailand, women are major contributors to the GDP. With

economic independency, women no longer have to depend on men to make decisions about what to buy; they can make their own decisions about whether to purchase any consumer product or durable. Delux, a well known brand of paint in Europe was promoted through campaigns directed at women, because it was felt that women have an aesthetic taste for colors in the household paint segment. The performance of the i-pod of Apple hit the roof in terms of revenue generation due to female customers. The female work force is very strong in various sectors in many countries. Examples are: Indian women in IT enabled services and handicrafts, Chinese women in the soft toys and ceramics and Indonesian women in garments and paper work, who have brought great success to their countries.

7. Double Income Families

As the household income increases, the demand for the number of products increases proportionately. This is specially true for packaged food items, electronic gadgets, household appliances, health equipment, Japanese entertainment electronics and French perfumes dominate in the whole of Europe and North

America. Pizza Express, McDonald and Kentucky Fried Chicken invariably rule the households of double income families throughout the world.

8. Impulse buying

Benefit oriented buying is taking place everywhere. Preplanned shopping and scheduled purchases are gradually going away. Throughout the world, people need instant items. They see, ask and buy. It is a major challenge to international businessmen to provide benefits to lure impulse buying.

POLITICAL ENVIRONMENT.

The political environment in international business operates in different dimensions:

1. The home country political environment;
2. The host country political environment, and
3. The global political environment.

1. Home Country Political Environment

In an ideal world, one would not normally expect domestic policies to affect the firm's international activities. Some countries like the USA encourage their organization to establish activities abroad, especially in their core competency fields. Japan encouraged their electronics and auto companies to spread their activities outside Japan. Domestic firms that continue to invest and manufacture abroad while ignoring their home country are often accused of creating domestic unemployment problems and may be subject to political pressure, from the government. Indian government encourages business houses to go and perform outside in steel, healthcare, mining, textile and automobile.

2. Host Country Political Environment

If the actual benefits of foreign firms are shared in terms of employment, taxes and social security with the locals, political atmosphere tends to be hospitable. If it is felt that the foreign firms contribute nothing to the well being of the nation, it may produce a hostile reaction from the business community and labor organization, which in turn puts pressure on the

government. In extreme cases, this may lead to either political turmoil or the appropriation of the assets of the foreign firm.

Mc Donald had to face a change in the ruling party, in Israel. When the National Religious Party (NRP) came into the power it demanded that McDonald should change its practices or be shut down.

3. Global Political Environment

This may be describes as the combined politics of the home country, the host country and the other countries in the world. Multilateral agreements between international organizations, such as GAAT, the UNO and the Commonwealth, may constitute an impediment to free trade as well as to the nature and scope of the operation of international firms. Embargos, Cartels, free trade pacts and customs' unions allow a few nations to enjoy competitive advantages, whilst others lose their business prospects. However, there may also be advantages, e.g., the commonwealth generalizes Systems of Preferences (CWGSP) offers good opportunities to all commonwealth countries to supply and receive goods and services at concessional rates, which ultimately give them a competitive edge over non-commonwealth nations.

Global politics can influence business in vastly varying ways. For example the economic embargo on Iraq by the Security Council of the United Nations in 1991 meant that conducting trade with that country was illegal for all international firma. Another example is China Ordering Microsoft to stop selling. "Windows 95" as it contained politically offensive material including phrases like "communist bandits". Microsoft agreed to change the material for reentry.

CULTURAL ENVIRONMENT

The cultural environment for international business refers to the set of factors which shape the material and psychological development of a nation and represents the primary influence on individual lifestyle, attitude, pre-deposition and behavior as consumers in the market. The most important task of international business is to identify relevant similarities and differences among countries, and means and methods to match the organization's culture with that of the country of its operation. For example, when Toshiba gained 100 percent ownership of Rank-Toshiba in the Plymouth all the managers in charge learnt the British Style of working. Working it is the operation of a business or dealing with customers one cannot overlook cultural elements. The performance of a company in the international arena partly depends on how well the strategic elements fit into the culture of the host country. Culture may be described as the totality of the complex and learned behavior of members of a given society. Elements of culture include beliefs, art, morale, code of conduct and customs. Culture has the following three characteristics:

- **It is learned:** acquired by people over time through their membership in a group that transmits culture from generation to generation.
- **It is interrelated:** i.e. one aspect of the culture is connected with another part, e.g. religion and marriage, or business and social status.
- **It is shared:** i.e. tenets of a culture extend to other members of the group.

Culture is perhaps one of the most important determinants of human behavior. Food habits, social class, the family system, community units

and other cultural and sub-cultural elements influence the process of decision making in day to day dealings and the buying habits of customers.

Thus, there is a need for cross-cultural understanding because of the significant differences in attitude, belief, motivation, perception and life styles between nations. For example, branded products will move fast in Europe and America, but Africans perceive branded products as being very expensive.

The Influence Of Culture On International Business

1. The Utility value of a product may differ considerably from country to country because of differences in beliefs, values and lifestyles. Fast foods, such as Kentucky Fried Chicken, McDonalds, hamburgers and pizzas are more popular in modern societies than in traditional societies. Similarly, branding and packaging are very susceptible to cultural bias.

2. Products are launched in markets on the basis of either perceived or real utility value. Products from certain parts of the world such as Western Europe, Japan and United states command premium prices in developing countries because it is felt that they are of better quality than locally manufactures products. They have a higher value.

3. Culture is perhaps the most powerful influence in determining the acceptability of advertising copy, design and other elements in various countries. Advertisements released in France may not be acceptable in the United Kingdom. Many advertisements acceptable to the other parts of the world will not be accepted in the Saudi Arabia. Liquor advertisements are prohibited in many countries.

4. Holidays in different countries vary on religious grounds. Friday is a holiday in the whole of gulf region. In China, the offices and factories are closed for a week for the New Year celebrations. For companies having firms in different countries, it is therefore impossible to impose the rule of common business practices everywhere, as productivity would be very low during festive days. Any strict implementation of company policy will have direct repercussions, which may even lead to closure of the business in different countries.

5. Local norms and practices may affect certain distribution strategies. Eating in public places during Ramadan days is prohibited in Muslim countries. Therefore, eateries are not opened during the day at this time. In Spain, mail order shopping is very popular, whereas in the US and Europe chain stores are preferred, and door-to-door delivery is common in many Scandinavian countries. Shopping malls are coming up in urban India faster than in any other country in the world. Still small traditional shops near hometown are perceived as trustworthy suppliers when the customers need groceries.

TECHNOLOGY ENVIRONMENT

Technology and its applications are key factors in determining the international competitiveness of a firm in conducting international business. Multimedia using Pentium 4 is common in advanced countries whereas it will take at least another five years to introduce such products in Africa. Leadership in technology is achieved and maintained through a consistent program of intensive research and development, which can be

very expensive. Only those companies that are able to maintain their technological activities will remain competitive.

A Company may invest millions of dollars in R&D, despite the fact that the projected revenue in the home country would be very low. However other countries will generate huge revenues over a period of time. The Hoffkins, Bio Rad, Genen technology and Pfizer are examples of institutions and firms, who are investing huge sums of money in R&D, because they are sure of their returns on their investments over a period of time. In the late 20th century, Asian tigers, Japan, South Korea, Hong Kong, Singapore and Taiwan achieved a miraculous success due to their investment and implementation of the technology policies in specific sectors. Few countries, such as Japan for electronic equipment, Germany for medical equipment, and the USA for pharmaceuticals have remained leaders in their fields for decades. Other countries have remained behind them. The time between the innovation and its adoption and its adoption may vary from country to country. Innovating countries are few. Following countries are many. Technology leaders encash on skimming pricing strategies, wherein the margins are huge. Eriksson, Nokia, Motorola and LG have been successful since they manufactured cell phones. Currently, the business opportunities exist in every country in the world. The people around the world are adaptable to the technology too. While technology innovation is adaptable to the masses, the companies involved in such business prosper. Today Hewlett Packard, Fujitsn, Apple, Samsung and Lenova compete against each other by educating the workers on using their laptops and launch their new versions everywhere.

LEGAL ENVIRONMENT:

This relates to the laws and regulations governing the conduct of business activities in the country. Before entering any country, firms avail of the services of local legal firms to understand business interpretations pertaining to labor legislations, taxes, environment, pollution, investment, distribution, contracts, logistics etc. The international legal environment has three aspects:

- a) Home country laws
- b) Host country laws
- c) International laws.

a) Home Country Laws

These deal with two important issues:

- i) Conduct of the firm in the domestic territory.
- ii) Trade with the other countries

For international operators, the home country laws are not stringent. They are more of facilitating or regulating in nature, but not controlling in normal practice.

b) Host country laws

These include investment regulations, tariffs and duties, anti-dumping regulations and protection of local industries from unfair competition from industrialized countries. Tariffs and duties are used to discourage imports of non-essential products in order to conserve foreign exchange and maintain a favorable balance of trade and to generate revenue. Seven advanced countries impose laws against developing countries. Super 301

against Indian nylon skirts imposed by USA as inflammable fabric and ban on Indian sea food by Europe are the examples.

c) International Laws

These comprise treaties, conventions and agreement between nations, and have basically the same standing as laws. They are particularly in areas relating to patents and trademark protection and privacy laws. One has to understand the broad provisions of UN resolutions, and multilateral trade agreements such as the WTO. Disputes are solved by different means. Food and drug administration, health regulation, registration formalities are judiciously implemented in international business operations. Investment restrictions in some sector, promotion in others and the role of regulatory authorities are part of legal environment. For example, Nigerian government nationalized the assets of British petroleum, when it was revealed that the company as selling Nigerian crude oil to South Africa, despite an embargo.

COMPETITIVE ENVIRONMENT:

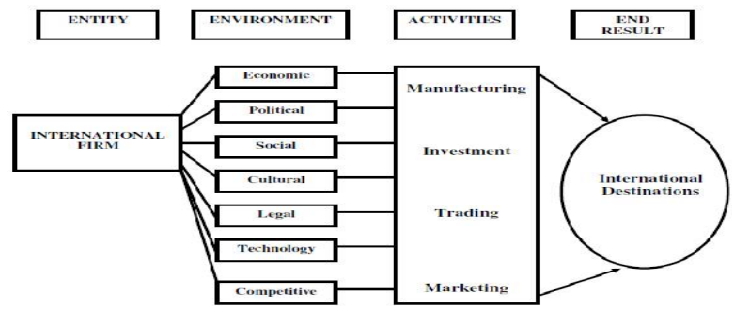
Competition is a threat imposed by an environment, which may effect or hamper or challenge the operation of an international business firm. Competition either could be from the firm’s home country or host country or third country. Some times product related competition may crop up through substitutes or low cost production process or technology or cost reduction through economies of scale. The current international business operation has to encounter competition as various levels such as entry, operation, production, administration, human resource, technical resource, and financial resource. Distribution and logistics.

Motorola had to face the face the competition from Nokia, soon Nokia concentrated in fast growing markets of India and China resulting the follower became leader in the world. Cuba based White Spirit Company; Havana club entered very late in the field and surpassed the erstwhile leader like Smirnoff.

Tusker and Phoenix – the major beer brands in COMESA countries (Common Market for East and South Africa) have been overtaken by King Fisher after UB group took over National Breweries of South Africa.

For international companies, facing competition is a way of life. According to them, competition keeps their mind alert, quality war is inevitable. Beyond theoretical models, they believe in learning competitiveness in streets, countries and production centers. They consolidate competitive advantages and succeed. Hyundai motors in India, Honda motors in Europe and Tata Motors in Africa withstood all the competitive forces and succeeded.

FACTORS INFLUENCING INTERNATIONAL BUSINESS



REVIEW QUESTIONS

1. Discuss about different modes of entry in international business in short.
2. Discuss about foreign entry decision for MNCs
3. What are key factors influencing international business?
4. Describe about economic environment in International business.
5. Discuss about the social environment in international business.
6. What are the influences of culture on international business?

FURTHER READINGS

1. International Business- Stuart Wall, Bronwen Rees
2. International Business- Aswathappa
3. International Business Environment- Les Dlabay, James Calvert Scott
4. International Business- Thomas L. Friedman
5. International Business- Leslie Hamilton, Philip Webster

UNIT-3 FOREIGN DIRECT INVESTMENT

CONTENTS

- ❖ Introductions
- ❖ Characteristics of FDI
- ❖ Investment Patterns
- ❖ Benefits and Costs Of FDI
- ❖ Strategies for Foreign Investors to Invest In India
- ❖ Strategies for Indian Investors to Invest In Foreign Countries
- ❖ Review Questions
- ❖ Further Readings

INTRODUCTIONS

Investment is “the flow of funds one destination to another”, for any activity, including industrial development, infrastructure and manufacturing. When the investment goes from the home country to another country it is defined as ‘investment outflow’ and when the foreign investment comes from other countries to home country it is termed as ‘investment inflow’. Both inward and outward movements are encouraged in majority of the countries. All developing countries produce primary goods, and to exploit them financial resources are necessary. Developed countries are also in need of FDI for further development of technology and modernization. The current Foreign Direct Investment (FDI) is related to investment in developing countries and Less Developed Countries (LDCs) require huge investments in other activities, such as infrastructure, healthcare, housing, power generation etc.

Financial resource is crucial, time bound and critical. If it is not available in right time from anywhere, the probable results are bankruptcy, decline and loss of status whether it is a nation or company or individual.

With the liberalization of the Indian economy, a large Indian market is being opened up to foreign investors. Practically, FDI represents foreign assets in domestic structures, equipment and organizations. It does not include foreign investment in the stock markets. Foreign direct investment is useful to a country if the focus is more on projects rather than investments in the equity of companies because equity investments are potentially “hot money” which can leave at the first sign of trouble. South Korean, South African and Argentinean crisis were partially due to such problems. When a firm invests directly in facilities in a foreign country it is said to be FDI. It involves the active control of the investment not really determined by level of stock ownership. Many multinational enterprises become involve in FDI with the ultimate objective of reaping short term as well as long term benefits. Ownership may become transnational, i.e., ownership in more than one country. Factors influencing FDI are related to increasing business opportunities across national borders and their involvement could be in the following functional areas.

- Production
- Marketing / services
- Research & development
- Raw materials or other resources

The parent company has direct managerial control, but the degree of control may depend on the type of country and company policy. Prior to their investment decisions it is necessary to carry out risk analysis and interpretations of the same. MNCs do not develop blind faith in any country. A team of experts analyse risks carefully and invest gradually.

CHARACTERISTICS OF FDI

FDI is an activity by which an investor, who is resident in one country, obtains a lasting interest in, and is a significant influence on the management of an entity in another country. This may involve either creating an entirely new enterprise, so-called “Greenfield” investment or, more typically, changing the ownership of existing enterprises via mergers and acquisitions. Other types of financial transactions between related enterprises, like reinvesting the earnings of the FDI enterprises or other capital transfers, are also defined as foreign direct investment.

INVESTMENT PATTERNS

- Follow Competitors – Oligopolistic industries and interdependence of a few major competitors force a strategic approach of following competitors:

American Motor Company (AMC) invested in Shanghai Motor Company in China. All others were on bee line including Japanese and South Korean companies besides other American companies.

- International Product Life Cycle – Reduces cost by shifting production to developing countries. Essel Propack moved to China for instance.
- Location – Specific advantages make FDI easier than exporting or licensing. Mahindra tractors are manufactured in North America.

1. POLITICAL RISKS

2. ECONOMIC RISKS

- Contract manufactures – brings down the cost of manufacturing and also contributes to consolidate competitive sourcing and competing in world market. Honda motors manufactures its vehicles in Europe.
- Assured return on investment – R & D centres and futuristic projects enable the investor to achieve great success through high revenue. Roseh products invest huge money in Genentech in California to get innovative products to their outlets around the world.

More than two thousand multinational from the USA and Europe have invested in Chinese Special Economies Zones and Export Processing Zones. Indonesia, Thailand, Philippines and Malaysia have also now become attractive destinations. In Latin America, Brazil, Argentina and Columbia are also attracting huge investments. Malta, Cyprus, Panama, Mans Island and Mauritius are growing only through Foreign Direct Investment, either in manufacturing, trading, or any other form. The reputation of such destinations depends on their ability to attract investments through their policies and hassle-free industrial climate.

BENEFITS AND COSTS OF FDI

Benefits for Host Countries

Notes

- **Capital:** Multinational enterprises invest in long-term projects, taking risks and repatriating profits only when the projects yield returns.
- **Technology:** Technology effects emerge especially when the liberalization of investment flows drives a more rapid rate of technology development, diffusion and transfer. Such processes may involve the transfer of physical goods and/or the transfer of knowledge. A vast majority of economic studies dealing with the relationship between FDI on the one hand and productivity and economic growth on the other hand, have found that technology transfer through FDI has contributed positively to productivity and economic growth in host countries.
- **Market access:** Investors can provide access to export markets. The growth of exports itself offers benefits in terms of technological learning, competitive stimulus, etc. They can transform normal customers to intellectual customers.
- **Increase in domestic investment:** The increase in FDI inflow is associated with a manifold increase in the investment by national investors.
- **Export promotion:** It seems that FDI could be related with export trade in goods, and the hosting country can benefit from an FDI-led export growth.
- **Generating employment:** It leads to generation of both direct and indirect employment opportunities in the host country.
- **Infrastructure:** In order to facilitate and enable the investors perform well, the host country studies other competitive destinations and enhance the level of infrastructure to match the requirements of the investors. India's silver valley in Bangalore, Hitch city in Hyderabad and Tidel Park in Chennai have revolutionized the areas through connectivity.
- **Social effects:** Closed economies have started to liberalize their economy through market reforms that are favourable to foreign investors through privatization, property rights and liberal labour policies. Society at large gets the benefit while employment, infrastructure, literacy and health care are bound to improve as an impact of FDI inflow.
- **Formation of Clusters:** Group of similar projects and manufacturing centres are formed in a specific location by way of providing common production , R&D, training and pollution control system to group competing companies. In Italy, Brazil and India, such clusters have made wonders.
- **Spillover:** Statistical evidences exist across the world to show that FDI's have a number of spillovers. Business history is replete with examples where persons trained in companies started their own ventures and became successful leaders in their respective fields. Silicon Valley in the U.S. provides many examples of such spin-offs. Intel is a spin-off of Fairchild. The main competitor to Intel today is its spin-off. Even in India, the machine tool industries of Ludhiana and Bangalore are spinoffs of yesteryears' popular companies like SKF, Bosch or MICO.

Cost for the Host Country

- The investing companies may not serve the host country's interests.

- There is an outflow of earnings as they are repatriated to their home country.
- Import of substantial inputs from the country of the investor.
- Hiring expatriate managers for management positions
- The investing country has controlling technology, for which it charges a huge technology fee.
- FDI can even wipe out the local firms. Infant industries and other home industries may suffer if they cannot compete. Home country producers do not have money power or technology to withstand the onslaught of the investors.

Benefits for Home Country

- Inwards flow of earnings on a long term basis.
- High salaries for employees.
- Exposure to foreign market.

Costs for the Home Country

- Initial capital outflow is extremely large.
- Exports may decrease.
- Imports may increase if FDI is intended to serve the home country.
- Employment loss to the home country population.
- Profits are repatriated abroad. They may not stay in the country for reinvestment.
- Major tax heavens will enjoy the money at the cost of home country.

MOTIVATIONS FOR FDI

- Exporting may not be feasible with high transportation costs and trade barriers.
- Companies, with operations only in the home country, have limited scope for prosperity and in order to grow fast investing in fertile grounds outside is a strategic move.
- Ownership advantages are used to benefit from global expansion.
- Location specific advantages are important at the time of selecting right destination:
 1. Availability of low cost labour force.
 2. Natural resources available in abundance and do not deplete.
 3. The cost incurred in research and development can be recovered at the earliest by identifying a suitable location.
 4. The cost of transportation and logistics is low in the specific as well as neighboring countries.

STRATEGIES FOR FOREIGN INVESTORS TO INVEST IN INDIA

There are several strategies by which foreign enterprises could be lured to set up Indian operations. Broadly, entry strategies for such organisations may be classified into two major types:-

1. A foreign investor may directly set up its operations in India through a branch office, a representative office, a liaison office or a project office to carry out business.
2. It may do so through an Indian arm i.e. through a subsidiary company set up in India under Indian laws.
3. It may invest in business units in SEZs and EOUs.

Generally, the second option of setting up operations through an Indian arm is advisable, especially if the investment is large. A foreign company

is one which has been incorporated outside India and conducts business in India. These companies are required to comply with the provisions foreign companies can set up their operations in Indian by opening liaison offices, project offices and branch offices. Such companies have to register themselves with the Registrar of Companies in New Delhi, within 30 days of setting up business in India.

Liaison Office/Representative Office

A foreign company can set up a liaison or representative office in India to test the Indian market. Once it is convinced about the potential of the Indian market, it can then bring in greater investment. There are, however, certain limitations regarding the type of work which can be done through a liaison or representative office. A liaison office is not allowed to undertake any business activity in India and therefore cannot earn any income in India. The role of such office is thus limited to collecting information about possible market opportunities and providing information about the company and its products to prospective Indian customers.

The Foreign Investment Promotion Board of the Reserve Bank of India is a regulatory body governing such operations. Foreign investors are required to follow the basic procedures prior to opening such offices. Permission is initially granted for a period of three years, and may be extended from time to time.

Project Office

Foreign companies planning to execute specific projects in Indian can set up temporary project/site offices for the purpose. Specific approval from the RBI is required for setting up a project office, which is generally given for Government approved projects, but the RBI can give approval for setting up project offices even for executing private sector projects. Approval for setting up project offices is specific to a particular project that is to be executed and lasts only till the completion of the project.

Branch Office

The Government has allowed foreign companies engaged in manufacturing and trading activities abroad to set up branch offices in India for the following purposes:-

1. To represent the parent company/other foreign companies in various matters in India e.g. acting as buying/selling agents in India.
2. To conduct research work in the area in which the parent company is engaged, provided the results to the research work are made available to the Indian companies.
3. To undertake export and import trading activities.
4. To promote possible technical and financial collaborations between the Indian companies and the overseas companies. A branch office is not allowed to carry out manufacturing activities on its own but is permitted to subcontract them to an Indian manufacturer.

Permission for setting up branch offices is granted by the Reserve Bank of India on a case-to-case basis. The RBI normally considers the operating history of the applicant worldwide and its proposed activities in India for granting the approval.

Through an Indian Arm

The entry strategies through an Indian entity are given below. The Indian entity may be a subsidiary of the foreign company in India or it may be joint venture.

As an Indian company

A foreign company can commence operations in India through incorporation of a company under the provisions of the Indian Companies Act, 1956. Foreign equity in such Indian companies can be up to 100% depending on the business plan of the foreign investor subject to the prevailing investment policies of the Government and receipt of requisite approvals. For registration as an Indian company and its incorporation, an application has to be filed with the Registrar of Companies. Once a company has been duly registered and incorporated as an Indian company, it will be subject to the same Indian laws and regulations that are applicable to other domestic Indian companies.

Joint venture with an Indian partner

Foreign companies can set up their operations in India by forging strategic alliances with Indian partners. Setting up operations through a joint venture may entail the following advantages for a foreign investor:-

1. Established distribution/marketing set up of the Indian partners.
2. Available financial resources of the Indian partner.
3. Established contacts of an Indian partner, which help the process of setting up operations.

Wholly owned subsidiary company

The other investment option open to foreign investors is the setting up of a wholly owned subsidiary. This implies that the foreign company can own 100% shares of the Indian company. All such cases are subject to prior approval from the Foreign Investment Promotion Board (FIPB).

The FIPB considers cases on a flexible basis and grants permission for 100 percent ownership based on the following criteria:-

1. Where only a "holding" operation is involved and all subsequent/downstream investments to be carried out would require prior approval of the Government;
2. Where proprietary technology is sought to be protected or sophisticated technology is proposed to be brought in.
3. Where at least 50% of the production is to be exported.
4. Proposals for consultancy.
5. Proposals for power, roads, ports and industrial model towns/industrial parks or estates.
6. Business units in SEZs, AEZs, Techno-Parks and EOUs:

The investor who invests to setup units in the above categories does not need mandatory permission from Foreign Investment Promotion Board of Reserve Bank of India. It is called automatic route. Such units can enjoy 100% profit repatriation to their home countries.

STRATEGIES FOR INDIAN INVESTORS TO INVEST IN FOREIGN COUNTRIES

Foreign Investment through GDRs (Global Depository Receipts), ADRs (American Depository Receipts) and FCCBs (Foreign Currency Convertible Bonds).

Foreign Investment through ADRs and GDRs and FCCB's is treated as Foreign Direct Investment. Indian Companies are allowed to raise equity capital in the international market through the issue of GDRs/ADRs/FCCBs. These are not subject to any ceilings on investment. An applicant company seeking the Government's approval in this regard should have a consistent track record of good financial performance for a minimum period of 3 years. This condition can be relaxed for infrastructure projects such as power generation, telecommunication, petroleum exploration and refining, ports, airports and roads.

There is no restriction on the number of GDRs/ADRs/FCCBs to be floated by a company or a group of companies in a financial year. The reason for this is that a company engaged in the manufacture of items covered under automatic route is likely to exceed the percentage limits under automatic route, whose direct foreign investment after the proposed GDRs/ADRs/FCCs is likely to exceed 50 percent / 51 percent / 74 percent as the case may be. There are no end-use restrictions on GDRs/ADRs/ issue proceeds, except ban on investment in real estate and stock markets. The FCCB issue proceeds need to conform to external commercial borrowing end use requirements. In addition, 25 percent of the FCCB proceeds can be used for general corporate restructuring.

Use of GDRs

The proceeds of the GDRs can be used for financing capital goods imports, capital expenditure including domestic purchase/installation of a plant, equipment and building and investment in software development, prepayment or scheduled repayment of earlier external borrowings, and equity investment in joint ventures and wholly owned subsidiaries, in India.

Restrictions

However, investment in stock markets and real estate will not be permitted. Companies may retain the proceeds abroad or may remit funds into India in anticipation of the use of funds for approved end uses. Any investment from a foreign firm into India requires prior approval of the Government of India.

FDI POLICY

The Government has put in place a liberal, transparent and investor-friendly FDI policy, wherein FDI up to 100% is allowed on the automatic route in most of the sectors except in:

- Activities that attract industrial licensing.
- Proposals where the foreign collaborator has previous/existing ventures in India.
- Proposals for acquisition of shares in an existing Indian company in favour of non-residents.
- Activities where the automatic route is not available under the notified sectoral policy.

Salient Features of FDI Policy

In view of sectoral policies, security concerns and other strategic considerations, restrictions, such as equity cap, divestment condition, minimum capitalization and lock-in period have been imposed on FDI in a few sectors, which are given below.

1. Agriculture and plantations excluding tea plantations.
2. Real estate business excluding integrated township development. However, NRI/OCB investment is allowed for real estate business.
3. Retail trade in any form.
4. Lottery, betting and gambling activities.
5. Security services.
6. Atomic energy.

Non-resident Indians' Scheme

The general policy and facilities for Foreign Direct Investment as available to foreign investors/companies are fully applicable to NRIs as well. In addition, the Government has extended some concessions for NRIs and Overseas Corporate Bodies in which NRIs have invested more than 60%.

These include:

- NRI/OCB investment in the real estate and housing sectors up to 100%:
- NRI/OCB investment in the domestic airline sectors up to 100%;
- NRI/OBC investment up to 74% in the banking sector.

Since 2001, the investments of NRIs in India have grown 20% every year till 2007 due to liberal policies. Few NRIs from the Middle East and Europe invest in huge amounts in real estate and SEZs. The confidence level has increased on India amongst NRIs resulting huge investments in India.

FDI Policy Initiatives

The FDI policy is reviewed on an ongoing basis and suitable liberalization measures are taken. Some of the main initiatives undertaken are mentioned below:

- Issue of equity shares has been allowed against a one-time fee or royalty and External Commercial Borrowings received in convertible foreign currency, subject to meeting all tax liabilities and procedures.
- The policy governing the payment of royalties under foreign technology collaboration has been further liberalized by allowing all companies, who have entered into foreign technology agreements, to pay royalties on the automatic route to the extent of 8% on exports and 5% on domestic sales without any restriction on the duration of the royalty payments. This is irrespective of the extent of foreign equity in the shareholding.
- The foreign investment in the banking sector has been further liberalized by allowing a FDI limit in private sector banks up to 74 percent under the automatic route including investment by FIIs.
- The foreign banks regulated by a banking supervisory authority in the home country and meeting the Reserve Bank's licensing criteria have been allowed to hold 100 percent paid up capital to enable them to set up a wholly-owned subsidiary in India.
- FDI up to 100% has been permitted in printing scientific and technical magazines, periodicals and journals subject to compliance with all legalities and with the prior approval of the Government.
- FDI up to 100% has been permitted on automatic route on marketing of petroleum products, subject to the existing sectoral policy and regulatory framework in the oil marketing sector.

- FDI up to 100% has been permitted on automatic route in oil exploration in both small and medium sized fields subjects to, and under the policy of the Government on private participation in:

1. Exploration of oil.

2. The discovered fields of national companies.

- FDI up to 100% has been permitted on automatic route for petroleum product pipelines subject to, and been permitted for Natural Gas/LNG pipelines with prior Government approval.

- 100% FDI is permitted in any venture related to Special Economic Zones and 100% export oriented units either as a developer or as a unit holder or service provider. The same scheme is applicable to agricultural zones and technology parks.

Country-wise distribution of approvals

In terms of the quantum of investment, Mauritius with 22.61% of the total approvals is the highest, followed by the U.S.A. (12.62%), the Netherlands (9.78%), the U.K.(8.28%), Japan (5.68%), Singapore (3.59%), Germany (3.53%), Hong Kong (1.64%), Switzerland (1.39%) and Belgium (1.27%). Other countries constitute the remaining 29.61% of approvals.

Sectoral distribution of approvals

Drug & pharmaceuticals sector has a major share of the approvals followed by the services sector, both financial & non-financial, electrical equipment including computer software & electronics, the food processing industry, telecommunications and automobiles. All put together account for 60%. Other sectors account for 40% of the approvals.

Country-wise distribution of approvals

In terms of quantum of investment, Mauritius with 24.10% of the total approvals is the highest, followed by the U.S.A. (12.53%), Singapore (11.955%), U.K. (7.93%) and U.A.E. (3.52%). Other countries constitute the remaining 39.97% of approvals.

State-wise distribution of approvals

The choice of location of projects depends on the commercial judgment of investors and is based on factors such as market size and growth potential, availability of skilled man-power; availability and reliability of infrastructure facilities; fiscal and other incentives provided by State Governments. The Central Government supplements the efforts of the State Government by providing fiscal incentives for investments in the infrastructure sector as also high priority industries such as information technology, through specific schemes such as the Growth Center Schemes, Transport Subsidy Schemes, New Industrial Policy for the North-East and other hill States, Electronics Hardware Technology Park (EHTP), Software Technology Park (STP), Export Promotion Zones (EPZs), Special Economic Zones (SEZs). Maharashtra, Delhi, Tamil Nadu, Karnataka, Gujarat, Andhra Pradesh, Madhya Pradesh, West Bengal, Orissa and Uttar Pradesh accounted for a major portion of FDI investment approvals during the cumulative period i.e. from August 1991 to March 2004.

FDI Promotion Initiatives

Several steps have been initiated during the year to facilitate increased FDI inflows, which include, inter alia, the following:

- On the policy front: While our FDI policy is already very liberal, it is being further progressively liberalized. Equity caps in the banking sector, the petroleum sector and printing of scientific/technical magazines/periodicals & journals have recently been raised as a measure of further liberalisation of policy.
- On the investment promotion front: The Government organized “Destination Authority has been actively involved to ensure speedy resolution of investment related problems, which has been widely acknowledged as an effective problem-solving platform.
- On the competitiveness issue: The Government has received reports on various studies on current potential and risks involved in various business activities in India. Different sectors with competitive advantages have been enlisted to attract foreign investment.
- An exclusive website is hosted by the promotion authorities is comprehensive and informative with online chat facilities. About 2000 investment related queries were replied to during the year.
- The Committee on Reforming Investment Approval and Implementation Procedures submitted its reports on simplification of investment procedures. Steps have already been initiated to implement these recommendations. The Department is coordinating with other ministries to implement the same at all levels in the Central Government.
- Every state government takes a major initiative like Vibrant Gujarat to bring all the investors around the world and show cause their advantages and encourage them to invest.

The advantages of India as an investment destination rest on a number of factors, which include a large and growing market; world-class scientific, technical and managerial manpower; cheap labour; an abundance of natural resources; a large English speaking population; independent judiciary, etc. This has now been recognized by a number of global investors who have either already established a base in India or are in the process of doing so. Ongoing initiatives such as further simplification of legislation, de-licensing, setting up of regulatory authorities such as Central/State Electricity Regulatory Commissions, etc. is expected to provide the necessary impetus to increase FDI inflows in the future. Inflows of FDI would depend on domestic economic conditions and the FDI policy, world economic trends, and strategies of global investors.

The Government, on its part is fully committed to creating strong economic fundamentals and an increasingly proactive FDI policy regime. The positive efforts of the Government to improve the investment climate, including sustained improvement of infrastructure, have led to renewed optimism about India as an emerging investment destination.

Criteria considered by investors prior to selecting a destination.

1. Political stability and a strong policy to protect investors.
2. Safety and security for life, money and output.
3. Investment protection through legal provisions.
4. Good governance as compared to other countries.

5. Proactive government policies and implementing authorities, bureaucrats.
6. Continuous infrastructural development..
7. Banking system with updated technology.
8. High productivity of the labour force and unhindered working conditions.
9. Clear and simple tax procedures without any ambiguity.
10. Availability of raw material, components and consumables.
11. Hospitable society, especially secular approach towards investors.
12. Demand for the products the investor manufacturers.
13. Ample potential opportunities for products in the neighboring countries.

Even though the developed and developing countries are extending schemes of tax holidays and many other incentives, very few countries are capable of attracting FDIs. Still, China is an attractive destination because it ranks on a higher scale as compared to others on all the parameters mentioned above. India, could not attract an expected investment in the last and early part of current decade though the scenario is changing gradually now.

The reasons are:

1. Poor infrastructure, which does not match international standards.
2. Political instability, but now it is not a major constraint.
3. High levels of corruption, which are deep-rooted at all levels.
4. Bureaucratic red tape, which the investor does not have to face in other destinations in the world.
5. Interpretation of policies and their implementation are quite complex.
6. Heterogeneous society with different states, cultures and languages.
7. Inordinate delay in projects.
8. Draconian labour legislation.
9. Lack of transparency in regulatory bodies.
10. High cost of production due to expensive power and other inputs and transportation.

REVIEW QUESTIONS

1. Describe the characteristics of FDI.
2. What are benefits and costs of FDI for host countries?
3. Discuss about motivations for FDI.
4. Discuss about strategies for foreign investors to invest in India.
5. Discuss about strategies for indian investors to invest in foreign countries.
6. What are the salient features of FDI policy?

FURTHER READINGS

1. International Business- Stuart Wall, Bronwen Rees
2. International Business- Aswathappa
3. International Business Environment- Les Dlabay, James Calvert Scott
4. International Business- Thomas L. Friedman
5. International Business- Leslie Hamilton, Philip Webster

UNIT-4 OFFSHORE BANKING

OFFSHORE BANKING

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- ❖ Introductions
- ❖ Establishment of Offshore Banking Units
- ❖ Operations of Offshore Banks
- ❖ Role of Offshore Banks and Investments
- ❖ Offshore Financial Centres and Implications for India
- ❖ Review Questions
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INTRODUCTIONS

Any international business unit, whether manufacturing or trading is always looking for funds for their operations. Every company cannot take funds from its home country due to strict regulations or interest cost or taxes. All over the world the business community is in search of locations where their investments are safe and the funds can be taken out without any barriers and invested comfortably for any ventures in any part of the world. Currently, Mauritius, Malta, Panama, Man's Island, Cyprus, Seychelles and Hawaii are a few centres attracting offshore banks. Since 2003, the Government of India has permitted banks to set up offshore banking operations in Special Economic Zones. Hence, the system of offshore banking has become part of international business. Offshore banks are banking units set up by foreign banks in territories where the restrictions and regulations are limited and the intervention of the country of location is minimal. Offshore banking units bring foreign No other resources will be effective in the absence of financial resources and that too, at the right time. Non-availability can cause major damage to international operations. The purpose of offshore banking is to provide international business firms funds at cheaper cost, at a high place and at right time.

Currency funds from non-residents and the international money market, and invest them in the host country or in projects set up by the host country in a third country. In short, it is a hassle free and safer banking system for saving and borrowing funds for business.

ESTABLISHMENT OF OFFSHORE BANKING UNITS

The origin of offshore banking units can be traced to the growth of financial activity in tax havens. A "tax haven" is a place where non-residents can receive income or own assets without paying high taxes. Some such places are Bahamas, Bermuda, Hong Kong, the Netherlands, Panama and Switzerland.

Some features of these tax havens are:

1. Low rate or complete absence of income tax on foreign investment and income.
2. High degree of economical and political stability and a political system, which directly or indirectly encourages and fosters business activity at the center.
3. Strict and well enforced rules of banking secrecy.
4. Absence of exchange control

5. Availability of supporting infrastructure such as an efficient communications and transportation network.

6. Presence of well developed legal system and professional accounting expertise.

7. Investor's confidence due to past credential.

8. No incidence of violence or criminal activities.

These features encourage various types of business operations some of which are bona fide but most of them generate what has been termed as 'dirty offshore funds'.

OPERATIONS OF OFFSHORE BANKS

Offshore banking centres are an integral part of the foreign currency markets. Therefore, the operations of banking units set up at these centers comprise foreign currency transactions, in the form of accepting and placing of funds in foreign currency outside the country of issue. The functional offshore centers engage in the issue and placement of foreign currency certificates of deposits, loan/credits and bonds.

These centers contribute to the economic development of the host country in the following ways.

1. The offshore banking units can raise foreign currency loans and bonds for the host country at reasonable interest rates, due to their connections with well known international banks. These foreign currency funds can be lent to the host countries or invested in onshore projects or even projects in a third country. Indirectly, the host country gains better access to international capital markets.

2. The functional offshore centers contribute to the foreign exchange income of the host country through local operating expenditures, such as rent paid on leased property, salary paid to local staff, and license fees/taxes recovered from the offshore units.

3. The presence of functional units speeds up the communication and transport network in the host country, which helps to upgrade local skills and technology and constitutes productive assets to the host country.

4. The onshore banking industry in the host country is compelled to improve its efficiency and skills in order to retain its competitive edge.

5. The local staff employed at the centre develops sophisticated international banking skills and this pool of highly trained personnel can be brought in to the host country to attain a faster growth level. Once an offshore centre consistently offers an attractive package of incentives, the above benefits will accrue to the host country, which will be able to induce more and more reputed foreign banks to set up banking units in its territory.

ROLE OF OFFSHORE BANKS AND INVESTMENTS

In today's highly integrated global network international Offshore Financial Centers (OFCs) have come to play a vital role in facilitating investment worldwide. An offshore centre exists for comfort and convenience. OFCs are jurisdictions where offshore banks are exempted from a wide range of regulations, which are normally imposed on onshore institutions. Specially, deposits are not subject to statutory reserve requirements. Bank transactions are mostly exempted from tax or treated under a favourable fiscal regime.

and they are free of interest and exchange control restrictions. In many cases, offshore banks are exempted from regulatory scrutiny with effect to liquidity or capital adequacy.

An important activity in OFCs is offshore banking, which is the cross border intermediation of funds and provisions of services by banks residing in OFCs to non-residents. Offshore banking is an increasingly attractive alternative to heavily regulated financial markets of emerging economies. They exploit the risk return trade off by being more profitable than onshore banks and in many instances they have more leverage.

OFFSHORE BANKING – METHOD OF OPERATION

Offshore banks deal mostly with other financial institutions and transact wholesale business in currencies other than that of the country hosting the OFC. Offshore banking is carried out typically through offshore establishments that are offshore branches. Offshore branches are legally indistinguishable from parent banks onshore, which facilitate intra-branch transfers. Offshore activities may also take place through what are called parallel-owned banks. These are banks established in different jurisdictions having the same owner(s), but at the same time they are not subsidiaries. Offshore banks are mainly engaged in three types of transactions; Foreign currency loans and deposits, the under writing of bonds, and Over the Counter (OTC) trading in derivatives for risk management and speculative purposes. Foreign currency transactions form the bulk of offshore banking operations. They include transactions between banks and original depositors, between banks and ultimate borrowers, and between banks themselves on the interbank market. Underwriting of bonds floated in international capital markets is also a significant part of offshore banking activities.

OFCs IN DEVELOPED COUNTRIES AND EMERGING ECONOMIES

In the developed countries, OFCs appear to be losing their attractiveness and appeal for financial institutions, which are operating in liquid, increasingly competitive and well-regulated financial markets. With competition under prudential supervision and capital account convertibility being increasingly adopted, the distinction between onshore and offshore banking is progressively disappearing in industrialized countries.

In Asia, offshore interbank markets developed after 1968 when Singapore launched the Asian Dollar Market (ADM) and introduced the Asian Currency Units (ACUs) and Japan established the Japanese Offshore Market (JOM). The ADM was an alternative to London Eurodollar market for the investment of oil surpluses from Indonesia and Malaysia and ACUs enabled local banks to engage in international transactions under a favourable tax and regulatory environment.

OFFSHORE FINANCIAL CENTRES IN SINGAPORE, MALAYSIA AND MAURITIUS

Singapore

Singapore is an established financial centre. The financial service sector is supported by sound economic and financial fundamentals and attractiveness as a base for financial institutions. This has been aided by

its geographical location in a fast growing area that bridges the gap between the time zones of the North American and European financial markets, political and financial stability, a skilled labour force and significant government incentives.

Singapore is the fourth largest foreign exchange trading centre in the world, the fifth largest trader in derivatives and the ninth largest offshore lending centre. The Asian Dollar market (ADM) is one of the premier offshore banking centres in Asia. The STOCK Exchange of Singapore (SES) is a leading stock market in Asia, and the Singapore International Monetary Exchange (SIMEX) has grown into one of the world's leading derivatives exchanges.

There are three categories of commercial banks in Singapore:

I. Full banks II. Restricted banks III. Offshore banks

Full banks are allowed to carry out the full range of banking services under the Banking Act. Restricted banks may engage in the same range of domestic branch and cannot accept Singapore dollar savings accounts and Singapore dollar fixed deposits of less than Singapore \$ 250,000 from nonblank customers.

In 1973, with a view to facilitate Singapore's goal to become an international financial centre through the entry of more foreign banks, another category of same opportunities as the full and restricted banks in business transacted, their scope of business in the Singapore dollar retail market is slightly more limited. In the domestic market, offshore banks cannot accept any interest-bearing deposits from persons other than approved financial institutions, nor can they open more than one branch. By the end of November 1998, there were 104 offshore banks in Singapore, all of which were branches of foreign banks. By 2003 the number of banks crossed 120.

In Singapore, offshore banking is carried out by separate bookkeeping entities known as Asian Currency Units. ACUs do not have the right to incur assets and liabilities in Singapore dollars but can engage in all types of banking transactions in other currencies. Various incentives have been given to encourage the development of ACUs, the most important of which is that ACUs face a tax on profits of only 10% compared with the standard corporate rate of 27% and are not subject to reserve and liquidity requirements. ACUs have functioned in the region primarily as a centre for routing capital from markets in Europe, North America and the Middle East to the fast growing regions of Asia.

Important measures to promote offshore banking in Singapore include:

- 1973 – Offshore banking licenses issued to seven foreign banks; corporate tax of ACU on interest earnings from overseas loans reduced from 40% to 0%; interest received by non-resident holders of approved Asian dollar bonds exempted from tax.
- 1976 – Non resident deposits with ACUs and approved Asian dollar bonds held by non-residents exempted from Singapore estate duty.
- 1979 – Income earned from offshore general reinsurance business granted 10% concessionary tax rate.
- 1980 – Stamp duty on ACU offshore general reinsurance business granted 10% concessionary tax rate.

- 1980 – Stamp duty on ACU offshore loan agreements and Asian dollar bond certificates abolished.
 - 1983 – ACUs granted 5 year tax holiday for all income derived from syndicated offshore loans arranged in Singapore.
 - 1989 – A concessionary 10% tax rate was granted on income from international oil trading activities.
 - 1990 – Monetary Authority of Singapore (MAS) raised the ceiling on foreign ownership of shares in local banks to 40% from 20%.
 - 1992 – Stock Exchange of Singapore (SES) granted membership to seven foreign brokerage houses, allowing them to trade directly on the local market.
 - 2002 – Offshore transactions became equivalent to domestic transactions.
 - 2006- offshore banks started investing huge money in other Asian countries like India, Sri Lanka, Indonesia, Thailand and Vietnam.
- With a view to creating a more level playing field for local and foreign banks, the maximum limit for offshore banks for Singapore dollar credit facilities at any one time to non-bank residents was raised from S\$ 200 million to S\$ 300 to S\$ 1 billion, with a view to boosting Singapore as a financial centre. In 2004, many of the investors and joint venture partners avail of offshore facilities to invest in the mega projects of South Asia and South East Asia.

Malaysia

Malaysia established an International Offshore Financial Centre (IOFC) in Labuan in 1991. The Offshore Banking Act 1990 provides a regulatory framework for offshore banking operations in Labuan. As confidentiality is the hallmark of an offshore financial centre, an offshore bank has to maintain strict secrecy in the affairs of its customers. Offshore banks are expected to observe a strong self-regulatory code of conduct which places emphasis on ‘knowing your customer.’

The Labuan Offshore Financial Services Authority (LOFSA) established in 1996, is the single regulatory authority with the following roles and functions:

- To be responsible for setting national objectives, policies and priorities for the orderly development and administration of the Labuan IOFC.
- To be responsible for the promotion and development aspects and recommend new measures to the government to speed up growth and development of the Labuan IOFC.
- To supervise the activities and operations of the offshore financial service industry in Labuan and to process applications to conduct business in the Labuan IOFC, specially in offshore banking, offshore insurance and insurance related business, offshore trust and fund management, incorporating and registering of offshore companies as well as for setting up of Labuan trust companies.
- To administer and enforce offshore financial services legislation and work with the offshore players in Labuan to promote offshore financial services.

The Labuan IOFC operates in a free exchange control environment. Offshore companies are given a non-resident status for exchange control status. Offshore companies can continue to transfer funds freely to and

from their accounts outside Malaysia without approval from the central bank of Malaysia. The foreign currency accounts held with the offshore banks are not considered as external accounts and are not subject to exchange control measures. The offshore banks are also allowed to issue financial and nonfinancial guarantees to residents in Ringgit. They can receive fees and commissions related to guarantee in Ringgit. The holding requirement of one year is not applicable to assets in Ringgit held in collateral by the offshore banks for credit facilities granted to residents. The payments of existing loans and guarantees in foreign currency by Malaysian residents to the offshore banks do not require prior approval from the Central Bank.

In Labuan no tax is imposed on the income of offshore companies that are non-trading companies, and offshore trading companies enjoy a low tax regime with a rate of only 3% of their net income of RM 20,000 (USD 8000). Other benefits and incentives include:

- No tax on offshore companies carrying out offshore non-trading activities such as holding of securities, shares, immovable properties and taking of loans and placing of deposits.
- No withholding tax for dividends paid by an offshore company, distribution from an offshore trust, royalties received from an offshore company by a non-resident, interest earned on deposits with offshore banks, and interest earned on loans to Malaysians.
- No inheritance, death, or estate duty.
- Exemption from paying stamp duty on all offshore business transactions.
- Double tax treaty agreements signed with over 40 other countries and investment guarantee agreements with 50 countries.

Mauritius

Mauritius is fast becoming an international financial and business centre. Offshore transactions are normally conducted with non-residents and in currencies other than the Mauritius Rupee. Mauritius has focused its offshore business on specific areas such as investment funds, investment holdings and international trading. The island is becoming an attractive destination for offshore fund structuring and investment vehicles. Mauritius enjoys international exposure as a domicile for emerging market funds, and

is being considered as a gateway for investment into India, the Indian subcontinent and the African region.

In 1989, offshore banks were allowed to be set up in Mauritius and subsequently the incorporation of offshore companies was allowed. In 1992, the offshore financial services sector was officially set up with the proclamation of two acts of parliament, namely the Mauritius Offshore Business Activities Act and the Offshore Trusts Act.

Offshore business can be conducted through the following entities: an ordinary status company, an international company, a trust, or a partnership. The Mauritius Offshore Business Activities Authority (MOBAA), set up in 1992 under the Mauritius Offshore Business Activities (MOBA) Act 1992, is entrusted with the task of licensing, supervising and developing non-banking offshore business in Mauritius. The MOBA Act 1992 sets out the broad parameters for the conduct of

offshore business. An offshore business activity is defined as an activity carried on from within Mauritius with non-residents and in foreign currencies. The MOBA Act of 1992 provides for a whole range of approved offshore activities which include Offshore Funds Management; International Financial Services; Operational Headquarters; International Consultancy Services, Shipping and Ship Management; Aircraft Financing and Leasing;

International Licensing and Franchising; International Data Processing and Information Technology Services; Offshore Pension Funds; International Trading; International Employment Services; International Assets Management; and Offshore Insurance. Currently, eleven offshore banks of international standing operate in Mauritius. Both the volume and range of business undertaken by offshore banks have registered sustained progress. Various factors have contributed to the attractiveness of Mauritius as an OFC which include:

- Exemption from compliance with the Exchange Control Act.
- Freedom to conduct all legitimate banking and other financial business with non-residents.
- Exemption from credit, interest rates and other restrictions normally applied to business of domestic banks.
- Low income tax rate of 5 percent on all offshore profits.
- Free repatriation of profits without further taxation.
- Exemption from stamp duty on documents relating to offshore business transactions.
- Exemption from stamp duty on documents relating to offshore business transactions.
- Exemption from customs duty on imported office equipment.
- No withholding tax on interest payable on deposits raised from non residents by offshore banks.
- Double taxation avoidance treaty with a number of countries.
- Expatriate staff is subject to a concessionary personal income tax rate.
- No estate duty or inheritance tax is payable on the inheritance of shares in an offshore entity.
- No capital gains tax.

OFFSHORE FINANCIAL CENTERS AND IMPLICATIONS FOR INDIA

A synthesis of the role and evolution of OFCs in select countries, their operative mechanisms, regulatory framework and privileges delineated in the preceding sections highlight various factors that contribute to the attractiveness of OFCs. Certain common facilities/exemptions/concessions have been worked out to form offshore banking in India.

With the Government having announced the policy of promoting Special Economic Zones (SEZs) which would, inter alia, serve to attract world class investors, and at the same time contribute towards the country's export efforts, it is pertinent to take into account the factors highlighted above that have contributed to successful OFCs around the world. This is very important, as it is necessary to create a policy environment relating to finance and banking which is conducive as also internationally

competitive. The main requirements of such a policy are given below. •
Conducive fiscal regime, such as minimal taxation or low tax jurisdiction with an extensive web of bilateral tax treaties; no income tax, capital gains or wealth taxes on individuals, stamp duty, customs duty, estate tax, inheritance tax, etc.

- No withholding of income tax on non-resident depositors in OFCs.
- Stringent banking secrecy rules.
- Absence of exchange control or minimal control.
- Exemption from several prudential regulations including reserve requirements limitations on investments, limitations on acquisitions of immovable property, etc.
- Minimum formalities for incorporation.
- Adequate legal framework that safeguards the integrity of principal agent relations.
- Conducive regulatory framework – a separate banking act to provide a regulatory framework covering the operations of banks and financial institutions in the SEZs. For instance, the Offshore banking licence for the setting up of a branch or subsidiary.

India as offshore banking, an emerging sector

The concept and practices are not new to Indian banks. Indian public sector banks such as Bank Of India, State Bank Of India, Punjab National Bank and Bank Of Baroda already had operations in other countries. They have developed systems and expertise to handle offshore operations. The customers, both investing and borrowing segments are also aware of the mechanism. But in real terms, the awareness has been created while news items started appearing on overseas banking units (OBU) could be set up in special economic zones (SEZ) without mandatory requirements of SLR (Statutory Liquidity Ratio).

REVIEW QUESTIONS

1. Discuss about establishment of offshore banking units?
2. What are the operations of offshore banks?
3. Describe the role of offshore banks and investments.
4. What are the important measures to promote offshore banking?
5. Describe the offshore financial centres and implications for India
6. Discuss about India as offshore banking, an emerging sector.

FURTHER READINGS

1. International Business- Stuart Wall, Bronwen Rees
2. International Business- Aswathappa
3. International Business Environment- Les Dlabay, James Calvert Scott
4. International Business- Thomas L. Friedman
5. International Business- Leslie Hamilton, Philip Webster

UNIT-5 ESSENTIALS OF TRADE FINANCE

Essentials of Trade
Finance

Notes

CONTENTS

- ❖ Introductions
- ❖ Types of Exchange Rates
- ❖ Fixed and Floating Exchange Rates
- ❖ Principle Types of Merchant Rates
- ❖ Correspondent Banking
- ❖ International Organizations as facilitators of International Business
- ❖ Letter Of Credit
- ❖ Types of Letter of Credit (L/C)
- ❖ INCOTERMS- A General Guide
- ❖ UCPDC ICC (2007) – 600 – Important
- ❖ Provision
- ❖ Review Questions
- ❖ Further Readings

INTRODUCTIONS

Different countries have different currencies. All the currencies are neither equivalent in value nor stable. Whether the company is involved in trading or manufacturing or investing there is a need for expertise in managing currencies at all the stages of operation.

Exchange Rate is defined as the rate at which one currency is exchanged for another currency. Foreign Exchange trading is a sale or purchase of one currency and traded with another. In a foreign exchange transaction:

- The transaction is always talked of from the banks point of view.
- The item referred to is the foreign currency. When we say “Purchase” we mean (buying rate):
 - The bank has purchased and
 - It has purchased foreign currency. Similarly, “Sale” means (selling rate):
 - The bank has sold and
 - It has sold foreign currency.

Direct Quotation: A given number of units of domestic currency per unit of foreign currency, e.g., \$1 = Rs.40.00. With effect from 2nd August 1993 direct quotations are being used in India.

Indirect Quotation: A given number of foreign currency per unit local (domestic) currency, e.g., Rs.100 = \$2.5.

Two-Way Quotation

The foreign exchange quotation by the bank has two rates- one at which quoting bank is willing to buy and the other at which it is willing to sell. For example US \$1 = Rs.45 – Rs.45.20. Here, the bank will enter into purchase transaction at Rs.45.00 and sell transaction at Rs.45.20. Hence the principle in case of direct quotation is BUY LOW & SELL HIGH. From the Ads point of view, conversion of foreign currency on behalf of an exporter into Indian Rupees would be a purchase transaction, and

conversion of domestic currency into foreign currency on behalf of an importer would be a sale transaction. Likewise, outward remittance would involve sale of foreign currency while inward remittance would involve purchase of foreign currency. In case of Indirect Rate Quotation the principle is BUY HIGH & SELL LOW.

Types of Exchange Rates

Ready of Cash: Refers to transaction to be settled on the same day e.g., transaction done on 3rd June to be settled on 3rd June.

Tom: Refers to transaction where delivery of foreign currency to be done on the next day tomorrow, e.g., transaction done on 3rd August to be settled on 4th August.

Spot: Refers to transaction where delivery of foreign currency to be done on the second working day (day after tomorrow) from the date of contract e.g., transaction done on 3rd June to be settled on 5th June.

Forward: Refers to transaction where delivery of foreign currency to take place on a date farther than the spot date e.g., transaction done on 3rd June to be settled on any date after 5th June, normally.

Cross Rates: If the quotation for a particular currency is not available, we can obtain it through the rate of that currency, of which the rate is available.

Value Date: The date on which payment, delivery of funds or an entry to an account becomes effective.

Cover Rate and Base Rate

The rate at which the banks can cover the merchant transactions in the inter-bank market without any profit or loss is called the Cover Rate. That is, the rate at which the bank can buy the dollars to cover import transactions in US\$ and the rate at which it can sell the Dollars to cover an export transaction in Dollars is called the Cover Rate. The base rate is arrived from the cover rate after allowing for some cushion for adverse movement of the rates. In practice there are instances where the cover rate and the base rate are the same.

Fixed and Floating Exchange Rates

- In a fixed exchange rate regime, the rate of the domestic currency vis-à-vis a foreign currency is fixed. In Hong Kong the HK dollar rate is fixed i.e. \$1 = HK\$ 7.80. In case of higher demand of the foreign currency viz. the dollar, the central bank of the country sells dollar from its reserve to maintain the rate.

- In a floating exchange rate regime, the rate of the domestic currency vis-à-vis foreign currency depends on supply and demand and market forces. Most major currencies viz. US Dollar, British Pound, Euro Japanese Yen etc. are floating ones.

Principle Types of Merchant Rates

As mentioned above, in a purchase transaction the bank buys foreign currency from the customer and pays him in rupees. Some transactions result in the bank getting the foreign exchange immediately, while some involve delay in getting the foreign exchange.

Depending upon the time of realization of foreign exchange by the bank, two types of buying/selling rates are quoted in India.

- TT buying rate is applied when the transaction does not involve any delay in realization of foreign exchange by the bank i.e. the nostro a/c of

the bank has already been credited. For example, purchase of drafts, MT's, TT's etc. and/or cancellation of drafts sold earlier.

Essentials of Trade Finance

Notes

- Bills buying rate is applied when a bill is purchased. The proceeds will be realized by the bank after the bill is presented to the drawee and he makes payment. The rate is loaded with transit/usance period interest.
- TT selling is applied when the correspondent bank's account is credited immediately. For example, issue of drafts, TT's drawn on a correspondent bank and/or cancellation of foreign exchange purchased earlier.
- Bills selling rate is used for all other transactions involving handling of documents by the bank e.g. payment against import bills etc.

SELLING RATES	TRANSACTIONS
TT Selling Rate Exchange Margin: 0.125% to 0.150%	A. Outward remittance in foreign currency (TT,MT, PO,DD) B. Cancellation of purchase, e.g. <ul style="list-style-type: none"> • Bill purchased returned unpaid. • Bill purchased transferred to collection amount • Earlier inward remittance (converted into rupees) is refunded to the remitting bank. C. A forward purchase contract is cancelled.
Bill Selling Rate Exchange Margin: 0.175% to 0.200%	Transaction involving transfer of proceeds of import bills. {Even if proceeds of import bills are remitted in foreign currency by way of DD, MT, TT, PO, the rate to be applied is the Bill Selling Rate(and not TT Selling Rate)}.
Foreign – TCs/ Currency Notes Selling Rates	At the option of Ads.
BUYING RATES	TRANSACTIONS
TT Buying Rate Exchange Margin: 0.125% to 0.180%	A. Clean inward remittance (PO, MT, TT, DD) for which cover has already been credited to Ads account abroad. B. Conversion of proceeds of instruments sent for collection. C. Cancellation of outward TT, MT, PO etc. D. Cancellation of a forward sale contract.
Bill Buying Rate Exchange Margin: 0.125% to 0.150%	A. Purchase / Discounting of Bills and other instruments. B. Where banks has to claim cover after payment. C. Where drawing bank at one centre remits cover for credit to a different centre.
Foreign-TCs / Currency Notes Selling Rates	At the option of Ads.

Persons residing in India:

Section 2 of FEMA, 1999 defines the term resident in India as a person residing in India for more than 182 days during the course of a financial year.

Persons residing outside India:

Section 2 of FEMA, 1999 defines person residing outside India as a person who is not resident in India (NRI).

Non-resident Indians generally fall under one of the following broad categories:

- **Non-Resident Indian (NRI)**

- An NRI is a person holding an Indian passport:

- o Who has gone abroad for a gainful employment or business or vacation, or for any other purpose indicating an indefinite period of stay outside India.

- o Who are working abroad on foreign assignments persons employed by IMF/IBRD/UNO/UNESCO etc.

- o who are employed in Central/State Government and Public Sector Undertakings and deputed abroad on temporary period.

- **Persons of Indian Origin (PIO)**

- o For the purpose of being eligible for the facilities of opening and maintenance of various types of bank accounts and making investments in shares and securities in India, a PIO means a citizen of any country other than Bangladesh or Pakistan, if:

- He held an Indian passport at any point of time, or

- Whose parent/s or grand parent/s was citizen of India (undivided India), or

- Spouse of a non-resident Indian.

Overseas Corporate Bodies (OCBs)

Overseas firms, trusts or companies, predominantly owned by non-resident Indians are called Overseas Corporate Bodies. The level of ownership of NRIs in such bodies should be minimum 60%, by one or more NRI owners. The facilities for investment into India, granted to OCBs were almost similar to those granted to individual non-resident Indians.

However, with effect from 16.08.2003, OCBs have been completely derecognized as an investor class by the RBI. Now they are not allowed to make fresh investments in India.

Correspondent Banking

Nostro Account: A foreign currency account maintained by a bank in India with a bank abroad. “Our account with you”. E.g., State Bank of India, Kolkata.

Vostro Account: A rupee account of a foreign bank with an Indian bank. “Your account with us”. E.g., Citibank’s rupee account with State Bank of India, Kolkata.

Loro Account: A bank’s account with another bank. “Their account with you”. E.g., Citibank’s HK \$ account with Hong Kong Bank, Hong Kong.

Mirror Account: These are dummy accounts maintained by banks to know the actual position of their accounts with the foreign correspondent

banks. We may call it a pass-book of our accounts maintained with the correspondents.

Escrow Account: These accounts are maintained by citizens outside the country or by the citizens residing outside the country, but accounts maintained in the parent country. These accounts are being maintained exclusively for business purposes and like current accounts, do not carry any benefit of interest, overdrafts etc. Basically, such accounts are opened to carry merchant trading activity with prior approval from the RBI and general transactions are not permitted.

International Organizations as facilitators of International Business:

International Organizations like the World Bank were set up to maintain orderly international financial conditions and to provide capital and advice for economic development, particularly of developing countries. International Business Organizations are required to understand the system and lending criteria of such institution, so that it would be easy to avail their funds to develop business.

World Bank Group

- International Development Association
- International Finance Corporation
- Multilateral Investment Guarantee Agency

Other International Organizations

- International Monetary Fund
- Bank of International Settlements
- Asian Development Bank
- African Development Bank

Asian Clearing Union

- Established in 1974
- Members- Central Banks of India, Iran, Bangladesh, Nepal, Pakistan, Sri Lanka and Myanmar (Burma).
- To provide facility to settle payments for current international transactions.
- Promote use of participant's currencies in current transactions.
- Promote monetary cooperation.
- Exempted categories:
 - _ Travel between India and other countries.
 - _ Foreign trade financed by World Bank, ADB etc.
 - _ Payments between India and Nepal, Pakistan and Iran individually.
- With effect from 1.1.1996, 1 A.C.U. \$ = 1 U.S. \$.
- ACU accounts are settled at the end of every two months.
- The balance outstanding in ACU Vostro account with the Authorized Dealers is subject to CRR and SLR.

Offshore Banking Unit (OBU)

An Offshore Banking Unit (OBU) of a bank is a deemed foreign branch of the parent bank situated within India, and shall undertake international banking business involving foreign currency denominated assets and liabilities. The Reserve Bank of India (RBI) has given permission to certain select banks in India, fulfilling certain criteria, to set up OBUs in "Special Economic Zones" (SEZ), for facilitating exports from India. Offshore Banking Units can accept Multi Currency Deposits from NRIs

and Eligible Resident Indians as per FEMA. Companies/Units within the “SEZs” in India as well as companies outside “SEZs” as per existing FEMA guidelines can go for Multi Currency Borrowing from OBU.

E-Money India

This is a completely online mode of sending money from US to India. Any person/organization who wishes to make a payment (in foreign currency) to an individual/organization in India (in Indian rupees) can use e-Money India. The customer needs to follow three simple steps to send money to India:

- Register on the e-money India site by providing elementary details.
- Provide his bank details.
- Provide the receiver’s details in India.

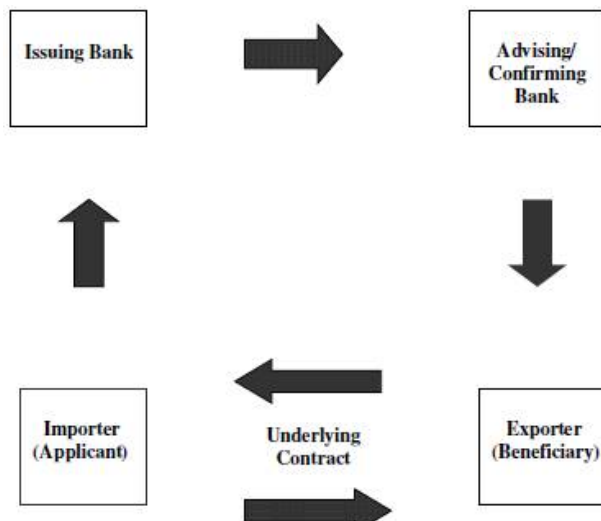
Presently, a customer can make an inward remittance in US Dollars only for family maintenance, purchase of property, investments, or transfers to NRE accounts.

Remittances from foreign tourists visiting India and traderelated remittances can also be sent. The remittance will be delivered to his/her beneficiary’s doorstep as a locally payable demand draft or deposited directly into the receiver’s account in India in Indian Rupees only.

LETTER OF CREDIT: Short term transactions for goods and services.

The concept:

In simple terms, a letter of credit is an undertaking by a bank to make a payment to a named beneficiary within a specified time, against the presentation of documents which comply strictly with the terms of the letter of credit. A letter of credit is opened by an importer (applicant), to ensure that the documentation requested reflects and proves that the seller has performed under the requirements of the underlying sales contract, by the exporter by making them conditions of the letter of credit (N.B. The sales contract is not an inherent part of the Letter of Credit, although the Letter of Credit may contain a reference to such contract). For the exporter, a letter of credit, apart from cash in advance, is the most secure method of payment in international trade as long as the terms of the credit are met. The following diagram shows those involved in a Letter of Credit transaction:



Its main advantage is providing security to both the exporter and the importer. The security offered, however, comes at a price and must be weighed against the additional costs resulting from bank charges.

The exporter must understand the conditional nature of the letter of credit and the fact that payment will not be made unless the terms of the credit are met precisely.

When an exporter asks for payment by letter of credit, he is transferring the risk of non-payment by the buyer to the issuing bank (and the confirming bank if the letter of credit is confirmed), providing the exporter presents the required documents in strict compliance with the credit.

An importer should only be thinking of opening a letter of credit if his country's exchange control regulations require it or if his supplier insists upon it. It is worth noting that over 50% of letters of credit are rejected on first presentations, which can cause expensive delays for both the exporter and importer. Up to one half of these rejections could have been avoided if more care was taken to ensure the credit properly represented the sales contract.

Exporter will need to be certain that it is necessary to use a letter of credit. Typical considerations include:

- Is it a legal requirement in the importing country?
- What is the value of the order will the bank charges be out of proportion to the value?
- 'Always Traded This Way' always using letter of credit for a particular customer or region without periodically reassessing the reasons for requesting this method of payment.
- What is the credit rating of the importer and are they a new customer or has a trading relationship already been established?
- What is the country risk of the issuing bank? Would a confirmed letter of credit be more suitable?
- What is the standing of the issuing bank? Would a confirmed letter of credit be more suitable?
- What is the usual practice in trading with that country and in that particular commodity?
- Are there any other measures that could be taken to protect the exporter such as credit insurance?
- Insistence by a Credit Insurer to trade on letter of credit terms with buyers in certain markets.
- Recommendation by banks who may advise that the best method of payment is a 'confirmed irrevocable letter of credit' irrespective of the country, strength of issuing bank and without much regard to the value of the consignment.
- Strategic decision made by the exporter however, this strategy should be flexible to adapt to the changing risk profile of both the country and the buyer. It is important to remember that all parties in the letter of credit transaction deal with documents, not goods.

Types of Letter of Credit (L/C)

Revocable: A revocable letter of credit can be amended or cancelled at any time by the importer without the exporter's agreement unless

documents have been taken up by the nominated bank. Little protection is offered to the exporter with a revocable credit and they are rarely seen.

Irrevocable: An irrevocable letter of credit can neither be amended nor cancelled without the agreement of all parties to the credit. Under UCP 600, all letters of credit are deemed to be irrevocable unless otherwise stated. Here, the importer's bank gives a binding undertaking to the supplier provided all the terms and conditions of the credit are fulfilled.

Unconfirmed: An unconfirmed letter of credit is forwarded by the advising bank directly to the exporter without adding its own undertaking to make payment or accept responsibility for payment at a future date, but confirming its authenticity.

Confirmed: A confirmed letter of credit is one in which the advising bank, on the instructions of the issuing bank, has added a confirmation that payment will be made as long as compliant documents are presented. This commitment holds even if the issuing bank or the buyer fails to make payment. The added security to the exporter of confirmation needs to be considered in the context of the standing of the issuing bank and the current political and economic state of the importer's country. A bank will make an additional charge for confirming a letter of credit.

Confirmation costs will vary according to the country involved, but for many countries considered a high risk will be between 2%-8%. There also may be countries issuing letters of credit which banks do not wish to confirm they may already have enough exposure in that market or not wish to expose themselves to that particular risk at all.

Standby Letter of Credit: A standby letter of credit is used as support where an alternative, less secure, method of payment has been agreed. They are also used in the United States of America in place of bank guarantees. Should the exporter fail to receive payment from the importer he may claim under the standby letter of credit? Certain documents are likely to be required to obtain payment including: the standby letter of credit itself; a sight draft for the amount due; a copy of the unpaid invoice; proof of dispatch and a signed declaration from the beneficiary stating that payment has not been received by the due date and therefore reimbursement is claimed by letter of credit. The International Chamber of Commerce publishes rules for operating standby letter of credit ISP98- International Standby Practices.

Revolving Letter of Credit: The revolving credit is used for regular shipments of the same commodity to the same importer. It can revolve in relation to time or value. If the credit is time revolving once utilized it is reinstated for further regular shipments until the credit is fully drawn. If the credit revolves in relation to value once utilized and paid the value can be reinstated for further drawings. The credit must state that it is a revolving letter of credit and it may revolve either automatically or subject to certain provisions. Revolving letters of credit are useful to avoid the need for repetitious arrangements for opening or amending letters of credit.

Transferable Letter of Credit: A transferable letter of credit is one in which the exporter has the right to request the paying, or negotiating bank to make either part, or all, of the credit value available to one or

more third parties. This type of credit is useful for those acting as middlemen especially where there is a need to finance purchases from third party suppliers.

Back to Back Letter of Credit: A back to back letter of credit can be used as an alternative to the transferable letter of credit. Rather than transferring the original letter of credit to the supplier, once the letter of credit is received by the exporter from the opening bank, that letter of credit is used as security to establish a second letter of credit drawn on the exporter in favour of his importer. Many banks are reluctant to issue back-to-back letters of credit due to the level of risk to which they are exposed, whereas a transferable credit will not expose them to higher risk than under the original credit.

Uniform Customs and Practice for Documentary Credit (UCPDC): Most letters of credit are subject to UCP 600 which are the universally recognized set of rules governing the use of the documentary credits in international trade. UCP were originally formulated in 1993 by the International Chamber of Commerce (ICC) and last updated in 2003 ICC publication. All definitions and general documentary requirements referred to in this briefing are in accordance with UCP 600 unless otherwise stated (it should be remembered that in some instances this may differ from national law). SITPRO would only recommend using letters of credit which are subject to UCP 600. It is important to negotiate, at contractual stage if possible, which party will bear bank charges. It is worth remembering that on a small transaction these may be totally out of proportion and if these costs are not included in the pricing any profit may be completely eroded.

Essential checks when the Letter of Credit is received

Even when the above steps are followed, it is essential to check the Letter of Credit as soon as it is received. The following is a checklist to be reviewed immediately on receipt of a Letter of Credit.

- Is the credit subject to UCP 600?
- Are there any terms or conditions within the credit which cannot be met? If so immediate arrangements must be made with your importer for the credit to be amended.
- Can the goods be shipped within the period set by the Letter of Credit?
- Do any documents need to be legalized?
- Can the mode of transport specified be used?
- Can shipment be made from the port/airport specified?
- Are the prices correct?
- Do the credit terms confirm with the underlying sales contract?
- Are drawings under the credit negotiable or payable in the exporter's country rather than abroad?
- Are the description, price and quantity of the goods are in accordance with the terms of the contract? (Remember that under-drawing a credit may sometimes cause problems, e.g., if trade discount has been forgotten when the opener instructed his bank).
- Are the insurance requirements of the credit acceptable?
- Can the required documentation be obtained?
- If part shipments and trans-shipment of goods are

prohibited, can the full quantity of the goods be exported on a vessel direct from the port of loading to the port of destination?

- Can the goods be shipped within the period specified and documents presented to the bank within 21 days from the date of shipment (unless a shorter time is stipulated) but, in any case before the credit expires?

Checklist for preparing documents Amount Payable:

- Do not overstate of the amount to be drawn as this could lead to the rejection of documents when presented.
- The words “circa” or “about” relating to the quantity or unit price of the goods or to the amount of the credit allow a tolerance of 10% either way.
- Unless a credit stipulates that the quantity of the goods specified must be exceeded nor reduced, a tolerance of 5% either way is permissible, always providing that the total amount of the drawings does not exceed the amount of the credit. However, this tolerance does not apply when the credit specifies quantities in number of packing units or individual items.

Shipment:

- Can specified shipping documentation can be obtained?
- If the seller is chartering a vessel or shipping on deck, does the credit specifically permit such methods?
- Do the ports of shipment and discharge, if specified, conflict with the price quotations?
- If partial shipment or transshipments have to be made, does the credit allow this? Any installments not shipped within a stipulated period will effectively cancel the credit.
- Is the time available for shipment sufficient and the period allowed for presentation of documents after shipment also sufficient?
- If a credit on a day when banks are not open, the validity is usually extended to the next working day. However, this does not apply to the stipulated time after shipment allowed for the presentation of documents, usually 21 days.

Individual Documents

Draft: The draft must be drawn by the beneficiary on the party specified in the credit or as requested by the advising bank. It must be drawn in accordance with the terms of the credit. One should check that it is:

- Correct in words and figures.
- Drawn payable at sight or sometimes at a given future time.
- Clause in accordance with the credit terms.
- Correctly dated.

Bill of Lading: It is a transport document issued by the shipping company to prove that the consignment has left the port of despatch. A traditional bill of lading has a threefold purpose:

- Formal receipt by the ship owner for goods.
- Evidence of the contract of carriage.
- Document of title to goods.

They should:

- Be issued by a shipping company or its accredited agent.
- Not be issued by a forwarding agent nor under a charter unless specifically authorized by the Letter of Credit.

- Be shipped on board, unless the credit provides otherwise.
- Bear a proper amendment, duly dated and signed by the shipping company, if a “received for shipment” item has been converted into a “shipped” document. The same applies to any other alteration.
- Be in a complete set (unless otherwise indicated in the Letter of Credit) with any required number of non-negotiable copies, each negotiable copy being signed by the shipping company.
- Be free from any detrimental clauses added by the shipping company indicating damage to goods or packing.
- Cover an ocean voyage. Bills of lading evidencing shipment by a local vessel are not normally acceptable if transshipment is not allowed.
- Bear a precise notation concerning payment of freight, i.e. either “freight paid” or freight payable at a given destination.
- Bear goods description either in general or particular terms: however, the wording chosen must not conflict with the credit or other documents.
- Bear shipping marks, number of packets and weights, consistent with all other documents. In particular, care should be taken that details on the bill of lading (often the last document to become available) do not contradict details typed on earlier documents.
- Show ports of shipment and discharge in agreement with credit terms.
- Be endorsed on the reverse if made out to the shopper’s order.
- Be presented within the time limit specified in the credit for presentation of documents. If no such period is stipulated, banks will refuse documents presented later than 21 days from the date of the bill of lading.
- Must bear a shipment date on or before the last stipulated shipment date but, in any event, within the validity of the credit.
- Unless otherwise stipulated in the credit, banks will accept short form bills of lading issued by shipping companies or their agents or combined transport bills of lading issued by shipping companies or their agents.

Insurance Documents Check that:

The extent of the cover agrees precisely with the credit terms, bearing in mind that Institute Cargo Clauses (all risks) do not always cover special risks.

The date of the insurance document is not later than the shipment date or, if dated after shipment, it bears a clause to the effect that cover commences not later than the date of shipment. Claims are payable in the place specified in the credit. The amount payable in the accordance with the credit terms plus any specified percentage and is in the currency of the credit. Marks, weights and description of the goods agree with the bill of lading and all other documents.

The policy or certificate required by the terms is signed by the insurance company, agents or underwriters and endorsed as necessary.

Cover is not by means of a broker’s cover note, unless this is specified in the credit.

Any insurance policy or certificate made out to the order of the shippers has been blank endorsed.

Invoice

Check that:

- These have been completed by the exporter in the name of the importer unless the credit specifies otherwise.
- Totals of all invoices agree with the amount of the drawing.
- Prices and shipment terms (FOB and CIF etc) agree with the credit.
- If a combined invoice and certificate of origin is called for, the certificate of origin is duly completed and signed.
- If invoices have to be visaed, this has been done by the authority stipulated in the credit. Also remember the time lag between forwarding documents to a consulate and their return.
- The full and exact description of the goods as shown on the credit appears on the invoice and that the quantity and specifications are as called for. If goods are described as being “.....in accordance with Performa invoice number.....dated.....” this can reduce superfluous, error producing, detail.
- There are no additional goods, charges or deductions not authorized in the credit. However, a deduction of normal trade discount is allowed as long as the final amount is correct-neither overdrawn nor under drawn.
- If both an invoice and a packing list are called for, no “combined invoice and packing list” should be offered. An appropriately detailed extra invoice may often satisfy the packing list need, if suitably headed.
- Performa invoice numbers or references numbers are required by the credit are shown.
- Marks and weights net unless the credit states otherwise, number of cases and name of vessel agree with the bill of lading and other documents.

Certificate of Origin

An exporter’s own certificate on a separate sheet is acceptable unless the credit states otherwise.

Check that:

All details quoted, shipping marks and description of goods, agree with the Letter of Credit, bill of lading and other documents. The certificate does not conflict with other documents with regard to value and country of origin.

Weight Note/List Check that:

- Certificates of weight must bear an authorized signature of the person/firm/company issuing the certificate in the detail required.
- If a weight lists is called for by the credit, this requires the individual weight of each parcel or package together with the total weight.
- If a weight note is called for by the credit it can merely state the weights concerned in general terms, perhaps one total.

Other Documents which provide evidence of the movement of goods

Airway Bill or Air Consignment Note:

- These should be issued and stamped by an airline on standard forms and should appear to be the original for the shipper, usually in 3 copies, this shows: name of consignee, goods, which must agree with the credit and all other documents, flight number and date, freight paid or to be paid at destination again in accordance with the terms of the credit.

- Ensure that the correct copy is submitted, bearing a clear reception stamp with signature of the carrier or his agent.
- Airway bills issued by freight forwarders and referred to master Airway Bill are not acceptable unless a certificate is presented stating that the forwarders are acting as agents for the carriers.

Parcel Post Receipt Check that:

- The receipt shows evidence of dispatch to the party named in the credit.
- The Post Office stamp shows a dispatch date on or before the last stipulated date for shipment.
- The credit does not call for postal dispatch on a FOB basis; these are not acceptable as postal charges to destinations have to be prepaid.

Forwarding Agent's Receipt

It is very important to establish at the outset whether there's a requirement for:

- A forwarding agent's receipt showing goods received for shipment or;
- A forwarding agent's receipt showing goods received and dispatched, as in the case of the CMR note. Normally, one set of documents accompanies the goods on this type of journey.

INCOTERMS- A GENERAL GUIDE

A set of common and understandable terms with commitment amongst the business community is to be implemented by every entity in trading such as, shipper, receiver, shipping company, banker clearing houses and insurance company. Incoterms are a set of rules for the interpretation of the most commonly used trade terms in international trade- International Commercial Terms. They were first published by the International Chamber of Commerce (ICC) in 1936 and since then have been updated I 1953, 1967, 1976, 1980, 1990 and the current revision 2000. Parties to a contract are often unaware that there are different trading practices in their respective countries, for example, FOB for an American company may have a different meaning than FOB for a UK trader. This can lead to misunderstanding and, in the worst scenario, costly litigation. Incoterms set out to avoid this problem by giving a set of standard rules that are recognized throughout the world.

The basic purpose of each Incoterm is to clarify how functions, costs and risks are split between the buyer and seller in connection with the delivery of the goods as required by the sales contract. Delivery, risks and costs are known as the critical points. Each term clearly specifies the responsibility of the buyer to the other extreme where everything is fundamentally the responsibility of the seller.

The Obligations of the Seller and Buyer

The main purpose of Incoterms is to clearly set out the obligations of the seller and the buyer in relation to the delivery of the goods and the division of functions, costs and risks related to the delivery. The way this is presented in each Incoterms is under ten clauses each for the seller and the buyer, where each clause on the seller's side "mirrors" the obligations to contract for carriage and insurance and clause B3 deals with buyer's obligations to contract for carriage and insurance.

Incorporating Incoterms

It is important to ensure that where the protection of Incoterms is intended to be incorporated into a contract of sale that an express

reference to the current edition of Incoterms is always made. For example, it is not enough to quote just “FOB Southampton” but instead “FOB Southampton Incoterms 2000” should be used. Alternatively, suitable wording can be included in the contract stating that the contract is subject to Incoterms 2000. However, if this is the case, you should be careful to ensure that standard contracts, and any other standard paperwork mentioning Incoterms, are updated to quote “Incoterms 2000” rather than Incoterms 1990. Failure to incorporate the correct version of Incoterms could result in dispute as to which version is intended or indeed, if Incoterms were intended to be incorporated at all.

The Incoterms

The thirteen Incoterms are split into four distinct groups:

Group E- where the goods are made available to the buyer at the seller’s premises;

Group F- where the seller must deliver the goods to a carrier appointed by the buyer;

Group C- where the seller must contract for the carriage of the goods without assuming risk of loss of, or damage to the goods or additional costs due to events occurring after shipment;

Group D- where the seller has to bear all costs and risks required to bring the goods to the place of destination.

The following is a list of all of the Incoterms, the group to which they belong and a brief outline of responsibilities under that Incoterm. However, it should be remembered that this is just a brief outline and is not a substitute for reading and understanding Incoterms 2000 itself. Additionally it has been noted whether the term is suitable for any mode of transport or just conventional maritime and inland waterway transport.

Group E Departure

EXW- Ex Works (named place) (any mode of transport). The seller must place the goods at the disposal of the buyer at the seller’s premises or another named place not cleared for export and not loaded on any collecting vehicle.

Group F Main Carriage Unpaid

FCA- Free Carrier (named place) (Any mode of transport). The seller must deliver the goods, cleared for export, to the carrier nominated by the buyer at the named place.

FAS- Free alongside Ship (named port of shipment) (Maritime and inland waterway transport only). The seller must place the goods, cleared for export, alongside the vessel at the named port of shipment.

FOB- Free on Board (named port of shipment) (Maritime and inland waterway transport only). The seller delivers the goods, cleared for export, when they pass the ship’s rail at the named port of shipment.

Group C Main Carriage Paid

CFR- Cost and Freight (named port of destination) (Maritime and inland waterway transport only).

The seller delivers the goods when they pass the ship’s rail in the port of shipment and must pay the costs and freight necessary to bring the goods to the named port of destination. The buyer bears all additional costs and

risks after the goods have been delivered (over the ship's rail at the port of shipment).

CI- Cost, Insurance and Freight (named port of destination) (Maritime and inland waterway transport only). The only obligations are the same as under CFR with the addition that the seller must procure insurance against the buyer's risk of loss of, or damage to the goods during carriage.

CPT- Carriage Paid to (named place of destination) (any mode of transport). The seller delivers the goods to the nominated carrier and must also pay the cost of carriage necessary to bring the goods to the named destination. The buyer bears additional costs and risks after the goods have been delivered to the nominated carrier.

CIP- Carriage and Insurance Paid To (named place of destination) (any mode of transport). The obligations are the same as under CPT with the addition that the seller must procure insurance against the buyer's risk of loss of, or damage to the goods during carriage.

Group D Arrival

DAF- Delivered at Frontier (named place) (Any mode of transport). The seller must place the goods at the disposal of the buyer on the arriving means of transport not unloaded, cleared for export but not cleared for import, at the named point and place at the frontier.

DES- Delivered Ex Ship (named port of destination) (Maritime and inland waterway transport only). The seller delivers when the goods are placed at the disposal of the buyer on board the ship, not cleared for import, at the named port of destination.

DEQ- Delivered Ex Quay (named port of destination) (Maritime and inland waterway transport only). The seller delivers when the goods are placed at the disposal of the buyer, not cleared for import, on the quay at the named port of destination.

DDU- Delivered Duty Paid (named place of destination) (any mode of transport). The seller must deliver the goods to the buyer, not cleared for import, and not unloaded at the named place of destination.

DDP- Delivered Duty Paid (named place of destination) (any mode of transport).

The seller must deliver the goods to the buyer, cleared for import, and not unloaded at the named place of destination. As can be seen, this list runs from the term where the buyer has most of the responsibility (EXW) through that where the seller has the majority of the responsibility (DDP). It is worth noting that in

Incoterms 2000 the only term that requires the buyer to clear the goods for export (including obtaining any export license necessary) is EXW and the only term that requires the seller to clear the goods for import (including obtaining any import license necessary) is DDP.

UCPDC ICC (2007) – 600 – IMPORTANT PROVISION

Background

In May 2003, the International Chamber of Commerce (ICC) authorized the ICC Commission on Banking Technique and Practice to bring a revision of the Uniform Customs and Practice for Documentary Credits.

The commission has framed ICC-600 which will be applicable from 1st July 2007.

Meaning

The Uniform Customs and Practice for Documentary Credit (UCPDC) is a set of rules on the issuance and use of letters of credit. It is being utilized by bankers and commercial parties for more than 175 countries.

Essential Articles for Trading Operations

Article 2: Definitions of advising bank, applicant, confirmation, beneficiary etc. As per the definition of credit, credit is an arrangement which is irrevocable and constitute a definite undertaking of the issuing bank to honour a complying presentation. Means there is no revocable credit.

Article 3: Interpretations of various commonly used words in credit are given. Important of which is that if on or about or similar will be interpreted as a stipulation that an event is to occur during a period of 5 calendar days after the specified date, both start and end dates included.

Article 4: A credit by nature is a separate transaction from the sale or other contracts on which it may be based. Banks are in no way concerned or bound by such contracts even if any reference is given in the credit.

Article 5: The bank deals in documents and not with goods, services or performance to which the documents may relate.

Article 6: A credit must state availability of the bank, expiry date and place of presentation.

Article 7: Issuing Bank undertaking for making payment as per terms of LC or reimbursing to nominated bank having made the payment by way of negotiation as per the terms of LC.

Article 8: Confirming Bank undertakings for reimbursement to another nominated bank that has honored or negotiated a complying presentation.

Article 14: A presentation must be made by or on behalf of the beneficiary not later than 21 calendar days after the date of shipment but not later than the expiry date of the credit. Further, a nominated bank acting on its nomination, a confirming bank, if any, and the issuing bank shall each have a maximum of 5 banking days (7 in earlier UCP - 500), following the day of presentation to determine if presentation is complying. This period is not curtailed or otherwise affected by the occurrence on or after the date of presentation of any expiry date or last date for presentation.

Article 20: Clause in Bill of Lading stating that the carrier reserves the right to transship will be disregarded.

Article 22: In case of Charter Party Bill of Lading, banks will not examine the Charter Party contract, even if they are required to be presented by the terms of credit.

Article 23: In case of air transport document indicating that transshipment will or may take place is acceptable, even if credit prohibits transshipment.

Article 28: If there is no indication in the credit of the insurance coverage required, the amount of insurance coverage must be at least 110% of the CIF or CIP value goods.

Article 29: If the expiry date of a credit or the last day for presentation falls on a day when bank is closed for reasons other than Force Measures

(Article 36), the expiry day / presentation day will be extended to the first following banking day. But the latest date for shipment will not be extended as a result of this.

Article 30: If the word 'about', 'app' etc is mentioned in the credit it will be construed as + or – 10% for amount and + or – for quantity. The tolerance of 5% in quantity is allowed even if partial shipment is not allowed.

Article 31: Partial drawings or shipment are allowed.

Article 33: A bank has no obligation to accept a presentation outside its banking hours.

Article 36: Force Majeure- A bank assumes no liability or responsibility for the consequences arising out of the interruption of its business by acts of God, riots, civil commotions, insurrections, wars acts or terrorism, or by any strikes or lockouts or any other causes beyond its control. A bank will not upon resumption of its business, honour, or negotiate under a credit that expired during such interruption of its business.

Article 38: For the purpose of this article, transferable credit means a credit that specifically states that it is transferable. A credit may be transferred in part of more than one second beneficiary provided partial drawings or shipments are allowed. But a transferred credit cannot be transferred at the request of a second beneficiary to any subsequent beneficiary i.e. it can be transferred only once.

International business organizations are relocating their manufacturing units. Destinations are changing for their goods. Companies like Mitsubishi and support their goods through ship liners. Obviously, trade finance transactions are integral parts of their business.

REVIEW QUESTIONS

1. Describe various types of exchange rates.
2. What are the principle types of merchant rates?
3. What is correspondent banking?
4. Discuss about international organizations as facilitators of international business.
5. Define letter of credit. Also describe short term transactions for goods and types of letter of credit .
6. What are essential checks when the letter of credit is received?

FURTHER READINGS

1. International Business- Stuart Wall, Bronwen Rees
2. International Business- Aswathappa
3. International Business Environment- Les Dlabay, James Calvert Scott
4. International Business- Thomas L. Friedman
5. International Business- Leslie Hamilton, Philip Webster

UNIT-6 MULTINATIONAL CORPORATIONS

CONTENTS

- ❖ Introductions
- ❖ Classification of Multinationals
- ❖ Basic Philosophies of Multinationals
- ❖ Strategic Approach to Multinationals
- ❖ Reasons for the Growth of MNCs
- ❖ Multinationals: Creatures of Market Imperfections
- ❖ Transfer Pricing
- ❖ Country Risk
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- ❖ Review Questions
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INTRODUCTIONS

If we ask any employee of a multinational company in a developing country, he is proud of his status, sense of achievement and affluence as compared to his peers. The system, style, technology and working style elevate his position little higher than others.

What is Multinational Corporation?

“The multinational is a business unit which operates simultaneously in different parts of the world. In some cases the manufacturing unit may be in one country, while the marketing and investment may be in other countries. In other cases all the business operations are carried out in different countries, with the strategic head quarters in any part of the world.” For example, the Manhattan based company, Colgate Palmolive Inc., which manufactures and markets dental care, health care, hair care and skin care products, in more than 120 countries. Procter and Gamble, based in Cincinnati also has similar product lines and operates in more than 150 countries. Their logo, symbol, products and brands are easily identified in the malls, outlets and media.

There are multinationals that have a total turnover exceeding the GDP of many small or less developed nations. The Minnesota Mining and Manufacturing Company, called for short, 3M, have more than a thousand product lines. The top three multinationals in the world today could combine to purchase a small nation. Few multinationals in the total employee force that is larger than the population of a country and may even have the power to bring down governments. Therefore, multinationals have money power, muscle power, managerial power, technology power and political power through which they influence many economies in the world.

At one time American based multinationals ruled the world. Today, many Japanese, Korean, European and Indian multinationals have spread

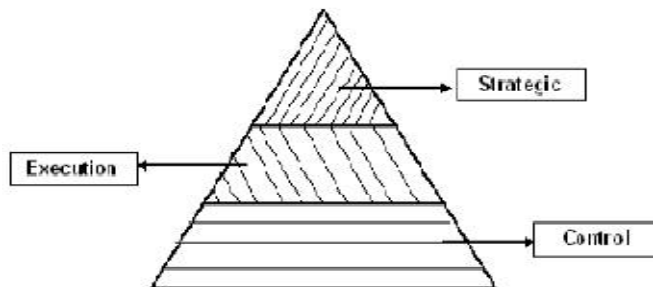
their wings in many parts of the world. Few nations have created specific product based MNCs such as General Motors, Ford Motors and AMC in case of U.S.A and Sony, Sharp, Hitachi and Casio in case of Japan. Germany concentrated on technology based items like dental equipments and telecommunications. From the centre they started moving to various countries and established their empires.

The strategic nerve centre is the company's headquarters, where major decisions are taken and policies are formulated. The main roles of a typical multinational at headquarters are:

1. Strategic role: It is a policy making entity for operations worldwide.
2. Execution: Decisions on implementation of policies, methods and means of operations, in different countries.
3. Control: Since the operations are vast it is necessary to maintain control over global strategic, costs, systems and operations.

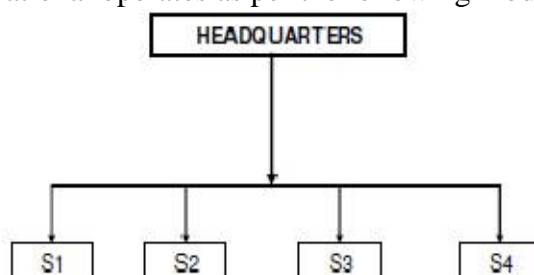
All the three roles are played by the head quarters after completing major five pre-requisites:

1. The business opportunity has been explored in a specific area.
2. Sufficient investment has been made in tangible and intangible assets.
3. The production facility has been already developed.
4. The key persons are taking responsible positions.
5. The location is ideal and conducive for further expansion.



Every multinational has to operate through its satellite units in many countries, called subsidiaries. Therefore, multinationals have headquarters and a number of subsidiaries that are scattered throughout the world.

As an expansion process, few multinationals are fast expanding their operations in developing countries. While doing so the headquarter is involved in a serious risk analysis and finally select the country where they are comfortable to do business. At the headquarters, the experts from political science, economics, accountancy, sociology and diplomacy are advising the top management on different issues prior to entry into any country. The entry decision is crucial for any MNC and it is an outcome of many brains and not a daring decision of a single mind. A typical multinational operates as per the following model:

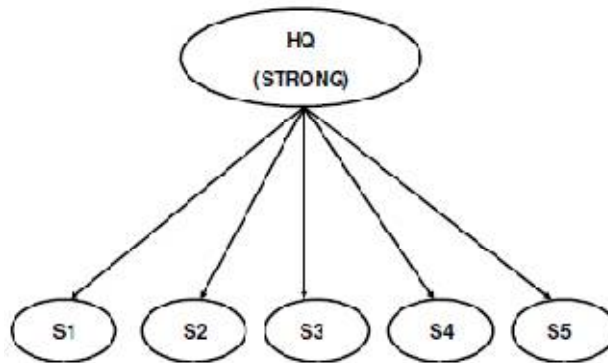


In most cases the power rests with the main company at its head quarters. However, a few multinationals do give considerable powers to their subsidiaries. Currently, multinationals are motivated solely by revenue wherein profits are the main criteria.

CLASSIFICATION OF MULTINATIONALS

Depending upon the relationship between the headquarters and subsidiaries, multinationals can be classified into three broad categories:

1. Pyramidal Model Multinationals



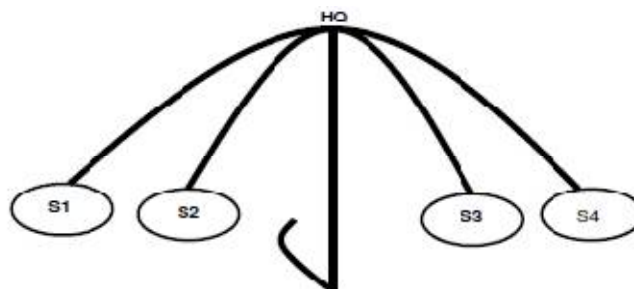
A pyramid indicates a broad bottom and narrow top. According to the typical pyramid model, the multinational operates as follows:

- a) It has strong headquarters and weak subsidiaries.
- b) All decisions are made at the headquarters and imposed on the subsidiaries,
- c) Major decisions related to new product development, plant location and managerial decisions are taken only at the headquarters. At times, the head-quarters may be quite autocratic towards its subsidiaries.
- d) They may be quite old fashioned in their day-to-day functioning.
- e) They do not bring sentiments and emotions for the local population into their dealings.
- f) They exercise complete control in their deals.
- g) They run their business through power.

Sympathy, compassion and human approach are generally far off in their approach. Lower is the prime motive in their style. Age old colonialism and imperialism got percolated to follow such style.

Due to rigidity in their style of functioning, such organizations may invite opposition from citizens in developing countries at any time. Fortunately, such multinationals changed became adaptable to local environment.

2. Umbrella Model Multinationals



Here the headquarters acts as a facilitator. Such MNCs believe in

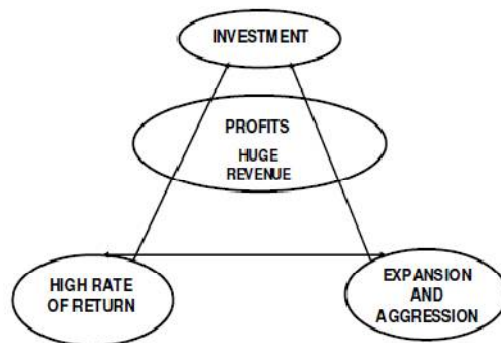
- a) Mutual exchange of knowledge and technology.

- b) Constant motivation of subsidiaries.
- c) Building an image for both headquarters and the subsidiary.
- d) Harmony between employees at different levels, and between employees and employers.
- e) High respect for the sovereignty of the county where they operate.

Such organizations are concerned about their image, goodwill and reputation. For them doing business is a way of life. They invite representatives from the subsidiaries to the headquarters for strategic decisions. They do not practice favoritism, nepotism, parochialism and racial superiority. Merit is the only consideration for growth and career enhancement. An Indian is the CEO of Mc.kinsey, Afghani is the head of HR in Yahoo, Indonesian is the research head in Biorad and Indian woman is heading Pepsi world-wide operations.

3. Inter-conglomerate Multinationals

Conglomerate indicates grouping of business activities aiming at high profits and revenue generations, whether it is related to existing core business or not. Inter –conglomerate multinationals are aggressive in expansion and achieving a high turnover. Such multinationals enter into any business where the profits are exponentially high. They generally do not consider any other aspect, except high profits, as a performance indicator.

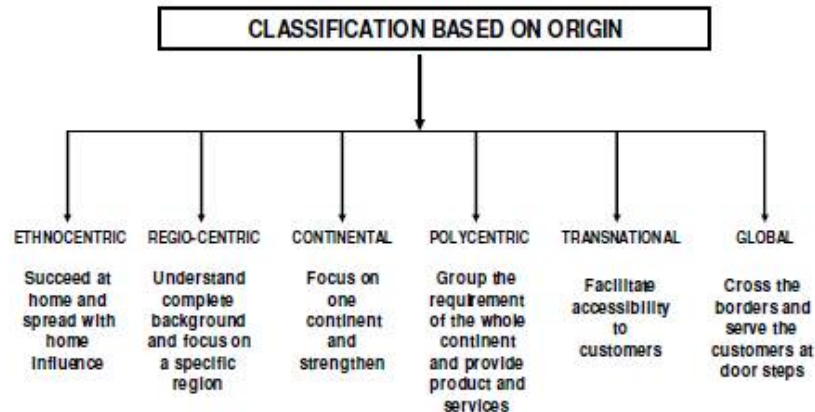


- a) High profit motivation.
 - b) They do not restrict themselves to their core competency.
 - c) A 'hire and fire' policy is very common.
 - d) They set high targets for themselves.
 - e) No social consideration in the country of their operation.
 - f) Growth, expansion, takeovers and aggression are constant endeavours.
- The investments are high and are made with expectations of high returns, which will be used for aggressive expansion, diversification and takeovers?

Although multinationals can be classified on the above basis, today the classification is not rigid. Hence, multinationals have become flexible over the past two decades. As the indigenous forces become strong in any developing country, the pure pyramidal model will not work. Organizations, which work under a pure umbrella model cannot generate sufficient revenue to sustain itself and it is also difficult for such organizations to face stiff competition. Organisation, which functions under the inter-conglomerate model, cannot focus only on profit, considerations for social causes and sensitivity towards the host country

have to be maintained or else the nationals in the host country pose major challenges and pull down the operations.

Classification of Multinationals Depending upon their Origin



1. **Ethnocentric:** Such multinationals concentrate more on their place of origin. Since they understand their own socio-cultural background it is easy for them to succeed in their home country. Instead of taking high risks in other countries they first succeed in their home country and then slowly move abroad with few changes in the product and mode of functioning. Mitsukoshi Super Market practices ethnic touch of Japan in its malls wherever it operates.

2. **Regio-centric:** Few multinationals focus their activities only in a particular region like South East Asia or the Gulf region. There are certain practices that are uniform in nature in a specific region, and hence they succeed. A region covers many nations; hence the organization operates in all parts of the region to get the title 'multinational'. "Continent", the French super market chain has an influence in the whole of Indian ocean rim countries.

3. **Continental:** There are multinationals that are very successful in particular continent for their specific product ranges. The cost of storing and warehousing can be brought down if the product is distributed in the whole continent. There are hundreds of multinationals doing exceedingly well only in Europe, but are not able to face cross-cultural challenges in other continents. Therefore, they remain as continental multinationals. TESCO serves the whole European continent by understanding the need of every European community.

4. **Polycentric:** The majority of multinationals have to simultaneously enter different countries. It is not possible to adopt a 'wait and watch' policy to enter different countries and commence operations. Once a company invests in an innovation, it has to spread its activities everywhere, otherwise it will lose the opportunity, and competitors will step in to get the business. Therefore, companies like Proctor & Gamble, Unilever, Sony, Electrolux, Henkel and Colgate-Palmolive are present in almost every part of the world.

5. **Trans-national:** Multinational like Hewlett Packard has set up subheadquarters close to the subsidiaries for easy accessibility. The subheadquarters are located in Singapore or Hong Kong but the main office remains in California. The trans-national multinationals' sole problems

arising from nearby countries through their sub-headquarter. It is serving the purpose of administrative convenience.

6. Global organizations: These organizations have a physical presence in other parts of the world and cater to customers in different countries through standardized products by consolidating resources from any part of the world. Today, every company dreams of becoming a global company. Companies shift their manufacturing bases to more profitable locations, open up warehouses in special economic zones and train people to be multilingual, multi-strategic and multi-functional in order to manage the business successfully.

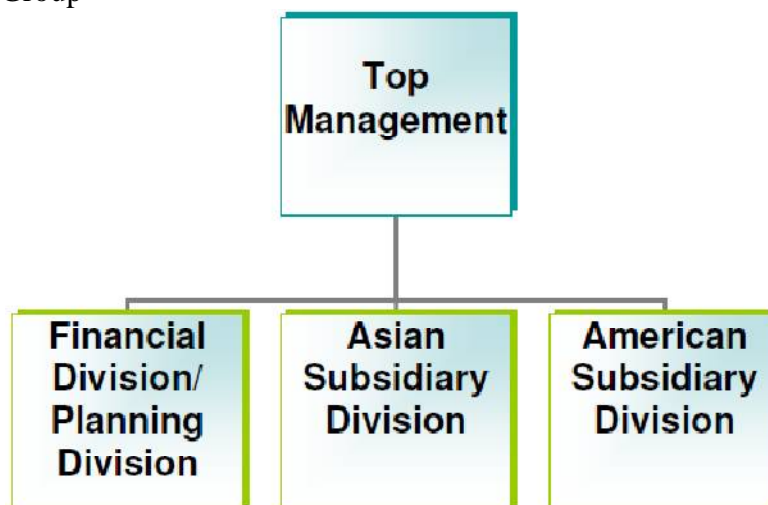
The difference between polycentric and global multinationals is that the latter is very closed to customer and does not give extra weightage to the headquarters. Global organisations take into account customer tastes and preferences. They employ cost cutting techniques and are able to provide customers with good quality, low-priced items. They have enormous respect for the country in which they operate and integrate themselves into the society.

BASIC PHILOSOPHIES OF MULTINATIONALS

MNCs will always look out for opportunities. They carry out risk analysis, and send their personnel to learn and understand the business climate. They develop expertise in understanding the culture, politics, economy and legal aspects of the country that they are planning to enter. They look at the global, rather than only local potential. The essential element that distinguishes the true multinational is its commitment to manufacturing, marketing, developing R&D, and financing opportunities throughout the world, rather than just thinking of the domestic situation.

STRUCTURE OF MULTI-NATIONAL CORPORATIONS MNCs can be categorized in 3 main structures:

1. Attachment of Subsidiaries with General (or Top) Management of the Parent Company and with the CMD
2. Creation of an International Division
 1. Attachment of Subsidiaries with Top Management of the Group

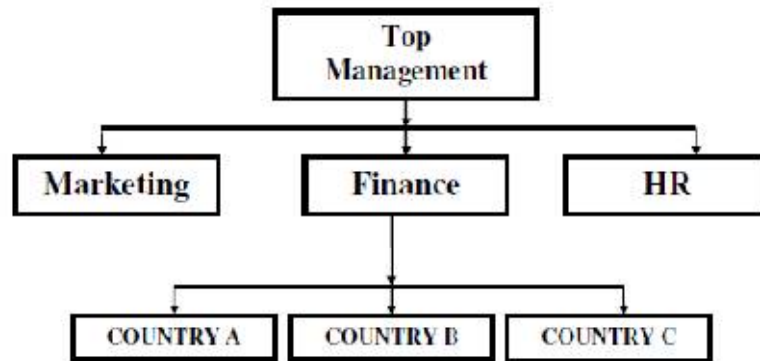


Organizations with an International Division

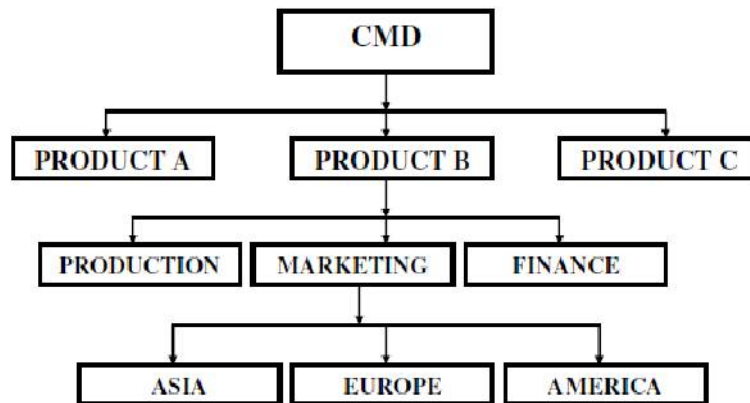


Creation of a Group Structure

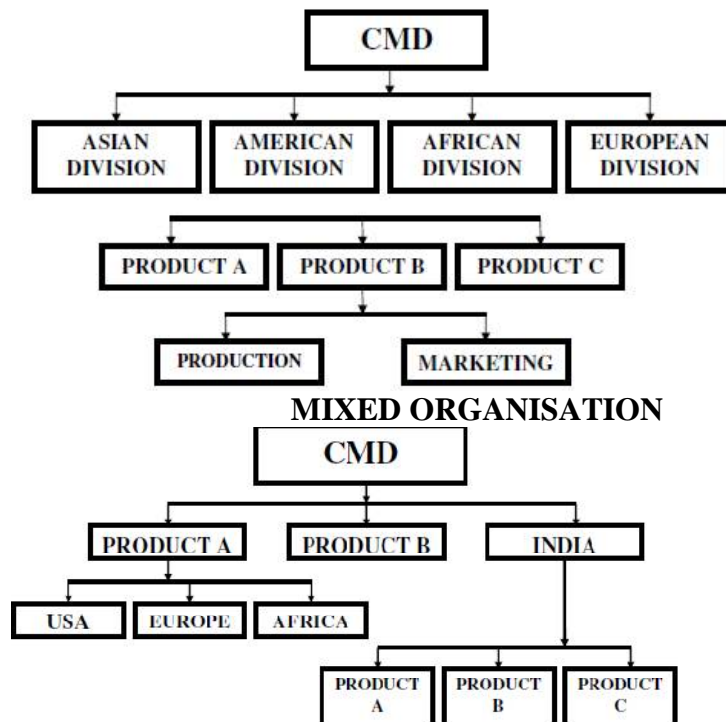
- Organization according to functions
- Organization according to products
- Organization according to geographical zones
- Mixed organization



FUNCTIONAL ORGANISATION PRODUCT ORGANISATION



Organization according to Geographical Zones MIXED ORGANISATION



Mode of Transfer (as per convenience)

An MNC has considerable freedom in selecting the financial channel through which funds or profits or both are moved. For example, patents and trademarks can be sold outright or transferred in return through contractual binding or royalty payments. Similarly, the MNC can move profits and cash from one unit to another by adjusting transfer prices on intercompany sales and purchases of goods and services. MNCs can use these various channels, singly or in combinations, to transfer funds internationally, depending on the specific circumstances encountered.

Timing Flexibility

Some of the internationally operating companies have to comply with strict payment schedule; others can be accelerated or delayed. MNCs can extend trade credit to their other subsidiaries through open account terms, say from 90 to 180 days. This gives a major leverage to financial status. In addition, the timing for payment of fees and royalties may be modified when all parties to the agreement are related. In the same way while price of raw material is low then they can procure a huge quantity and stock for usage.

Value addition through tax reduction

By shifting profits from high-tax to low-tax nations, MNCs can reduce their global tax payments. In additions, they can transfer funds among their various units, which allow them to circumvent currency control and other regulations. Cyprus, Panama and Malta are safe destinations for such operations.

STRATEGIC APPROACH TO MULTINATIONALS

In order to explain new and potentially profitable projects, a good understanding of multinational strategies is necessary. The three broad

categories of multinationals and their associated strategies are examined below.

A. Innovation Based Multinationals

Firms such as IBM, Philips and Apple create barriers to entry for others by continually introducing new products and differentiating existing ones, both domestically and internationally. Firms in this category spend large amounts of money on R&D and have a high ratio of technical to factory personnel. Their products are typically designed to fill a need perceived locally that often exists abroad as well. In the field of chemical and pharmaceuticals Hopkins and E. Merck adopt the same strategy.

B. The Mature Multinationals

The principal approach in such firms is the presence of economies of scale. It exists whenever there is an increase in the scale of production, marketing and distribution costs could be increased in order to retain in existing position or more aggressive. The existence of economies of scale means there are inherent cost advantages of being large. The more significant these economies of scale are, the greater will be the cost disadvantage faced by a new entrant in the same field in a given market. Philip Morris, Toshiba and Whirlpool are falling under this category.

Reduction in promotion costs

Some companies such as Coca Cola and Proctor & Gamble take advantage of the fact that potential entrants are wary of the high costs involved in advertising and marketing a new product. Such firms are able to exploit the premium associated with their strong brand names. MNCs can use single campaign and visual aspects in all the countries simultaneously with different languages like Nestlé's Nescafe.

Cost advantage through multiple activities

Other firms take advantage of economies of scope. Economies of scope exist whenever the same investment can support multi-profitable activities, which are less expensive. Examples abound of the cost advantages of producing and selling multiple products related to common technology, production facilities and distribution network. For example, Honda has increased its investment in small engine technology in the automobile, motorcycle, lawn mower, marine engine, chain saw and generator business. Mitsubishi enjoys this advantage of steel trading, lifts and escalators, vehicles and power generation.

C. The Senescent Multinationals

There are some product lines where the competitive advantages erode very fast. The strategic followed in such cases are given below.

1. One possibility is to enter new markets where little competition currently exists. For example Crown Cork & Seal, the Philadelphia-based maker of bottle tops and cans, reacted to the slowing of growth and heightened competition in business in the United States by expanding overseas. It sets up subsidiaries in such countries as Thailand, Malaysia, Zambia and Peru, estimating correctly that in these developing and urbanizing societies, people would eventually switch from home grown produce to food in cans and drinks in bottles.

2. Another strategy often followed when senescence sets in is to use the firm's global scanning capability to seek out lower cost production sites. Costs can then be minimized by integration of the firm's manufacturing

facilities worldwide. Many electronics and textile firms in the US shifted their production facilities to Asian locations such as Taiwan and Hong Kong, to take advantage of the lower labour costs.

REASONS FOR THE GROWTH OF MNCs

1. Non-transferable knowledge

It is often possible for an MNC to sell its knowledge in the form of patent rights and to license a foreign producer. This relieves the MNC the need to make foreign direct investment. However, sometimes an MNC that has a production process or product patent can make a larger profit by carrying out the production in a foreign country itself. The reason for this is that some kinds of knowledge cannot be sold and which are the result of years of experience.

2. Protecting Reputations

Products develop a good or bad name, which transcends international boundaries. It would be very difficult for an MNC to protect its reputation if a foreign licensee does an inferior job. Therefore, MNCs prefer to invest in a country rather than licensing and transfer expertise, to ensure the maintenance of their good name.

3. Building Reputations

Sometimes, MNCs invest to build their image and reputation rather than protect their reputation. This motive is of particular importance in the case of foreign direct investment by banks, because in the banking business an international reputation can attract deposits. If the goodwill is established the bank can expand and build a strong customer base. Quality service to a large number of customers is bound to ensure success. This probably explains the tremendous growth of foreign banks such as Citibank, Grindlays and Standard Chartered in India and other developing countries.

4. Protecting Secrecy

MNCs prefer direct investment, rather than granting a license to a foreign company if protecting the secrecy of the product is important. While it may be true that a licensee will take precautions to protect patent rights, it is equally true that it may be less conscientious than the original owner of the patent.

5. Product Life Cycle theory and impact

It has been argued that opportunities for further gains at home eventually dry up. To maintain the growth of profits, a corporation must venture abroad where markets are not so well penetrated and where there is perhaps less competition. This hypothesis perfectly explains the growth of American MNCs in other countries where they can fully exploit all the stages of the life cycle of a product. A prime example would be Gillette, which has revolutionized the shaving systems industry. HP laptop, Sony Walkman and

Xerox face various stages of their life-cycle in their home country.

6. Availability of Capital

The fact that MNCs have access to capital markets has been advocated as another reason why firms themselves move abroad. A firm operating in only one country does not have the same access to cheaper funds as a larger firm. However, this argument, which has been put forward for the growth of MNCs, has been rejected by many critics.

7. Invest and prosper “out” and not “in”

The strategic motive for making investments has been advocated as another reason for the growth of MNCs. MNCs enter foreign markets to protect their market share when this is being threatened by the potential entry of indigenous firms or multinationals from other countries. Fast growing countries like India and China give a great boost to MNCs originated in U.S, Japan and Europe.

8. Avoiding Tariffs and Quotas

MNCs prefer to invest directly in a country in order to avoid import tariffs and quotas that the firm may have to face if it produces the goods at home and ship them. For example, a number of foreign automobile and truck producers opened plants in the US to avoid restrictions on selling foreign made cars. Automobile giants like Fiat, Volkswagen, Hyundai, Honda and Mazda are entering different countries around the world not with the products but with technology and money.

9. Symbiotic Relationships

Some firms have followed clients who have made foreign direct investment. This is especially true in the case of accountancy and consulting firms. Large US accounting firms, which know the parent companies’ special needs and practices, have opened offices in countries where their clients have opened subsidiaries. These US accounting firms have an advantage over local firms because of their knowledge of the company and because the client may prefer to engage only one firm in order to reduce the number of people with access to sensitive information. Templeton, Goldman Sachs and Ernst and Young are moving with their clients even to small countries like Panama, Mauritius, Malta and Sri Lanka.

MULTINATIONALS: CREATURES OF MARKET IMPERFECTIONS

Broadly, two kinds of imperfections are relevant.

1. **Structural imperfections:** These may be natural or manmade. Government regulations on investment, taxes and subsidies, capital markets and monopoly aspects create imperfections. This kind of imperfection is now disappearing from industrial countries, but is still appearing in developing countries.

2. **Imperfections in transactions and markets:** Uncertainty in delivery, the volatility of exchange rates; the difficulty that customers face in evaluating unfamiliar products; the costs of negotiating deals, economies of scale in production, purchasing, research and developments and distribution give advantages to existing firms and impose barriers against newcomers.

Due to these and other imperfections, firms locate their production and other operations internally. As these market imperfections disappear, the importance of MNCs may diminish. The days for this may not be far off due to the international apex body, WTO and its regulatory norms are strictly implemented in near future.

TRANSFER PRICING

Transfer prices are the charges made when a company supplies goods, services or finance to another company to which it is related. It is an

internationally accepted principle that transactions between related parties should be based upon the same terms as those between unrelated parties. Thus both tax treaties entered into between countries and domestic tax legislation of various countries have adopted the arm's length principle.

Abuse of Transfer Pricing

In the era of global competition transfer pricing has become an unwanted reality. The price charged by a company in Country A to another company in Country B is reflected in the profit and loss account of both the companies, either as income or expenditure, and impacts the tax paid by the two related companies. By resorting to transfer pricing, related entities can reduce their total taxation by transferring higher income to low-tax jurisdictions and greater expenditure to those jurisdictions where the tax rate is very high. For example, the current tax rate on domestic companies in India is 33.3%. Take an example, the Company A is located in India and Company B in Singapore, and that both belong to the same group. If the tax rate in Singapore is 15% then Company B will transfer raw material to Company A at slightly higher prices. This will enable Company A to show a higher expenditure and reduce its taxable profits. On the other hand, a slightly higher income will not harm Company B much as the tax rate in its country is very low, thus the global group as a whole will benefit from tax savings. In this game, the first country is the major loser and due to low profits employees may struggle for their incentives.

Detection of Transfer Pricing

Globally, there are several methods of detecting transfer pricing to check whether transactions between related parties have been at an 'arm's length'. The transaction method relies directly or indirectly on information about the prices at which similar transactions have been entered into by unrelated parties. This method is further divided into the Comparable Uncontrolled Price (CUP) method and cost plus (C+) method.

Prices charged in similar business transactions between two independent parties is the yardstick adopted under the CUP method. Whereas under the C+ method, an arm's length price is determined by applying an appropriate mark-up on the costs incurred. The transactional profit method, as the name indicates, is transaction-specific; it examines whether or not profits from a particular deal are reasonable.

Importance of Transfer Pricing Regulations in Developing Countries

Import of raw material, semi-finished goods for assembling and most important of all, intellectual property such as know-how and technology are areas prone to transfer pricing. Such goods or services can be sent to associate companies in India at a higher or lower rate than the prices charged to unrelated parties, to secure a global tax advantage. In today's high-tech age, Indian companies often rely on technology and know-how from their foreign joint venture partners; thus strict regulations are very important.

Regulations in Dealing with Transfer Pricing

The important sections relating to transfer pricing in the Income Tax Act 1961 are Section 40A (2), Section 80 1A (9) and Section 1A (10). The

first enables tax authorities to disallow any expenditure made to a related party, which they feel is excessive. Certain tax benefits are available under Section 80 1A such as a tax holiday for a certain number of years. If transfer pricing is suspected then the tax authorities can deny such tax holidays. The most important provision in the tax laws is in Section 92. This allows the Indian tax authorities to adjust the taxable income of the Indian party, if they feel that the prices charged in a transaction are not at an arm's length due to close connection between the Indian entity and a foreign party.

COUNTRY RISK

When making overseas direct investments it is necessary to allow for risk due to the investment being in a foreign country. Country risk is one of the special issues faced by MNCs when investing abroad. It involves the possibility of losses due to country-specific economic, political and social events. Among the country risks that are faced by MNCs are those related to the local economy, those due to the possibility of confiscation i.e. government takeover without any compensation, and those due to expropriation i.e. government takeover without any compensation, and those due to expropriation i.e. government takeover with compensation which at times can be generous. In addition there are the political/social risks of wars, revolutions and insurrections. Even though none of these latter events are specifically directed towards an MNC by the foreign government, they can damage or destroy an investment. There are also risks of currency non convertibility and restrictions on the repatriation of income. International magazines like Euro Money and The Economist regularly conduct country risk evaluations in order to facilitate MNCs.

Methods of Reducing Country Risk and Control

1. Controlling crucial elements of corporate operations

Many MNCs try to prevent operations in developing countries by other local entities without their element of operations. For example, food and soft drink manufacturers keep their special ingredients secret. Automobile companies may produce vital parts such as engines in some other country and refuse to supply these parts if their operations are seized.

2. Programmed stages of planned disinvestment

An alternative technique for reducing the probability of expropriation is for the MNC to promise to hand over ownership and control to local people in the future. This is sometimes a requirement of the host government. There is a calculative move to involve themselves in stages.

3. Joint ventures

Instead of promising shared ownership in the future, an alternative technique for reducing the risk of expropriation is to share ownership with private or official partners in the host country from the very beginning. Such shared ownerships, known as joint ventures rely on the reluctance of local partners, if private, to accept the interference of their own government as a means of reducing expropriation. When the partner is the government itself, the disincentive to expropriation is concerned over the loss of future investments. Multiple joint ventures in different countries reduce the risk of expropriation, even if there is no local participation. If the government of one country does expropriate the

business if faces the risk of being isolated simultaneously by numerous foreign powers.

PROBLEMS FROM THE GORWTH OF MNCs

Much of the concern about MNCs stems from their size, which can be formidable. MNCs may impose on their host governments to the advantage of their own shareholders and the disadvantage of citizens and shareholders in the country of operation. Even in India, MNCs have neglected the interests of the minority shareholders in the past. It can be difficult to manage economies in which MNCs have extensive investments. Since MNCs often have ready access to external sources of finances, they can blunt local monetary policy. When the host government wishes to constrain any economic activity, MNCs may nevertheless expand through foreign borrowing. Similarly, efforts at economic expansion elsewhere. Although it is true that any firm can frustrate plans for economic expansion due to integrated financial markets, MNCs are likely to take advantage of any opportunity to gain profits. As we have see , MNCs can also shift profits to reduce their total tax burden by showing larger profits in countries with lower tax rates.

Concern has been expressed, especially within the US, that their MNCs can defy the foreign policy objectives of the government through their foreign branches and subsidiaries. MNCs might break a blockade and avoid sanctions by operating through overseas subsidiaries. This has led to greater concern in some host countries, as they feel that companies operating within their boundaries may follow orders of the US or any other foreign government, and even within international trade unions. For example, in 1981 Chrysler Corporation was given loan guarantee to continue its operation. The US government insisted on wage and salary roll backs as a condition. Chrysler workers in Canada did not appreciate the instructions from the US Congress to accept a reduced wage. The examples below illustrate some of the controversies faced by MNCs.

Parke-Davis

Parke-Davis India is a 40% subsidiary of Parke-Davis Inc, USA which in turn is a division of the US-based company, Warner-Lambert. In 1995 the latter set up a 100% subsidiary. Among other products, it planned to manufacture and market confectionary products, although Parke-Davis India was already operating in this field. Later the parent company bought the brands of 'Halls' and 'Chiclets' from Parke-Davis India for about Rs.10 crores, which according to analysts was low price in relation to growth prospects and sales. Post-transfer, the sales of Parke-Davis grew just 3% in 1995-96 and then fell 1.5% the following year. And revealingly while the Sensex dropped 39% in 17 months from September 1994, Parke-Davis shares plunged almost 70% in the same period. Practically, a loss of about Rs.285 crores in market capitalization was witnessed during the same period.

Pfizer

There is undeniable attraction for an MNC to retain all the profits of a venture, rather than sharing them with minority shareholders. Obviously such a prospect is attractive to the MNC and alarming to the retail investor, especially since the regulatory framework cannot control corporate action in this matter. Although not having to share the profits

may be the real reason. MNCs cite other factors, including lack of stringent patent and copyright laws in India for their actions. Often it is also the high cost of acquiring the additional shares to take the parent company's holding above 51%. For example the additional 11% equity stake required for Pfizer would set the parent company back some Rs. 290 crore at the current valuation, and to buy out the remaining 60% from the other shareholders, would cost it Rs.775 crore. Setting up a 100% subsidiary is possible.

SmithKline Beecham

This case gives us an insight into the royalty issues. In 1997, SmithKline Beecham India announced its plan to pay 5% of net revenues earned from the sale of Horlicks to its parent company for using the brand name. At that point Horlicks accounted for 80% of the company's Rs. 430 crore net sales. Although it paid about Rs.5 crore in 1996, the estimated annual outgoings worked out to about Rs.20 crore, against a net profit of Rs.45.6 crore in the same year.

The immediate impact on the SmithKline Beecham Consumer Healthcare stock was drastic, as the stock price fell by almost Rs.100 from Rs.365 in Feb 1997 in just 10 days, reflecting a loss of about 27% or about Rs.275 crore in terms of market capitalization.

Here, the main issue for investors was whether royalty payment needed to be paid to the parent company at all. Although the Indian company does not own the brand and is only its licensed user, it has nevertheless spent a huge amount on brand promotion and advertisement expenses for Horlicks, over the last four decades, and approximately Rs, 175 crores over the past 10 years. Critics feel that the company could have used this money to promote a brand of its own, with considerable success.

Philips

On 1st December 2001, the parent company of Philips announced that it wanted to buy out the other shareholders of its 51% subsidiary Philips India, and delist it from the stock markets. It offered to pay Rs. 105 for each share. The deadline for accepting the offer was 14th December. The beauty of the strategy was that Philips did not need to persuade every individual shareholder to sell to achieve its goal. According to the SEBI regulations, Philips needed to increase its shareholding to 90% in Philips India to apply for delisting the latter. Since Philips owned 51% shares, it needed to pick up only 39% more.

When the offer opened, three financial institutional – GIC, LIC and UTI – together held 22% of the shares, while another 27% were held by the minority shareholders. Within days of the announcement, most minority shareholders started worrying about what would happen to anyone who did not sell their entire stake, Philips would need to pick up only another 17% of the shares to reach a level of 90%. So, if Philips managed to pick up only 90% of the shares, all those who held out would be trapped. They would agree to buy them after the deadline was over, provided it already had the 90% it needed.

This fear reportedly led to many minority shareholders selling out, even though the FIs had not announced their decision. Finally the FIs did announce that they too were taking up the offer. A major factor influencing their decision was that, if enough minority shareholders sold

out, the liquidity of the Philips India stock would be drastically reduced. In that case, they would find it impossible to sell later because there would not be enough buyers.

For a majority of the shareholders, the offer price was not the critical factor in their decision to sell. In fact, many of them thought the price was too low and that Philips had timed its offer cleverly. Royal Philips had strictly followed SEBI guidelines which state that the offer price should not be less than the average price of the past six months, Philips made sure that most shareholders would sell out even if it was not the most attractive option.

CRITICISM OF MULTINATIONALS IN DEVELOPING COUNTRIES

1. They do not give enough importance to the society in which they operate. An example in Union Carbide, which did not show concern for the people of Bhopal. In South Africa, HIV medicines are sold at an expensive price irrespective of the cost. When people die out with these dreaded diseases in some region then MNCs consider that place as a huge potential for business prosperity.

2. While many Indian companies, such as the Tatas and Birlas allocate funds for charitable works like hospitals, temples and scholarships for higher studies, not many MNCs do so, though they generate huge revenue.

3. They generate profits when the situation is favourable, but will close their business if any risk is anticipated. E.g., many multinationals pulled out of South East Asia during the currency crisis, especially in Thailand and Indonesia.

4. Active participation is needed in developing countries for infrastructure, especially roads, ports, power plants etc. They enjoy but do not contribute.

However, most multinationals in India deal in non-essential products such as soaps, shampoos, lotions and other consumer products. Whether Unilever, Johnson & Johnson, Colgate or Ricket & Coleman, their contribution is not for the welfare except revenue generation. Hardly any multinational is getting involved in developing activities such as infrastructure.

5. There is a misconception that MNCs generate employment. However the managerial cadre and the sales force personnel do not represent real employment in developing countries.

6. Due to aggressive promotion and money power, MNCs can venture into small towns in all parts of the country, leading to the decline of small industries.

7. One Union Carbide could cost the life of thousand of living beings in Bhopal due to sheer negligence and disrespect for the pollution control norms. It shows that just for earning money such a multinational never had a concern for valuable human lives.

FOREIGN COMPANIES

A foreign company is one that has been incorporated outside India and conducts business in India. These companies are required to comply with the provisions of the Indian Companies Act, 1956 as far as the Indian

operations are concerned. Foreign companies can set up their operations in India by opening liaison offices, project offices and branch offices. Such companies have to register themselves with the Registrar of Companies (ROC), New Delhi within 30 days of setting up a place of business in India. The Indian entity may be a subsidiary of the foreign company in India or it may be a joint venture company with an Indian partner.

As an Indian Company

A foreign company can commence operations in India by incorporating a company under the provisions of the Indian Companies Act, 1956. Foreign equity in such Indian companies can be up to 100% depending on the business plan of the foreign investor, the prevailing investment policies of the Government and receipt of requisite approvals. For registration as an Indian company and its incorporation, an application has to be filed with the Registrar of Companies (ROC). Once a company has been duly registered and incorporated as in Indian company, it will be subject to the same Indian laws and regulations that are applicable to other domestic Indian companies.

Joint Venture with an Indian Partner

Foreign companies can set up their operations in Indian by forgoing strategic alliances with Indian partners. Setting up operations through a joint venture entails the following advantages for a foreign investor:-

1. The Indian partners have an established distribution/marketing setup.
2. The Indian partner has available financial resources.
3. The established contacts of the Indian partner help to smoothen the process of setting up of operations.

Even before independence, India had so many multinationals in the field of engineering, chemicals, Pharma and consumer goods. Metal Box, Spencer, Uniliver, Colgate Palmolive, Sandoz, Pfizer, Siemens and Bayer entered and prospered due to their monopoly in their respective field. Currently indigenous organizations have proved that they are nowhere inferior to them. The current decade is the era of Indian MNCs to operate every part of the world.

REVIEW QUESTIONS

1. Describe about Classification of Multinationals in short.
2. Discuss about Basic Philosophies of Multinationals.
3. What is the Strategic Approach to Multinationals.
4. What are the Reasons for the Growth of MNCs
5. What are the Problems from the Growth of MNCs
6. Discuss about Criticism of Multinationals in Developing Countries.

FURTHER READINGS

1. International Business- Stuart Wall, Bronwen Rees
2. International Business- Aswathappa
3. International Business Environment- Les Dlabay, James Calvert Scott
4. International Business- Thomas L. Friedman
5. International Business- Leslie Hamilton, Philip Webster

UNIT-7 GLOBALISATION- CONCEPT AND PRACTICE

GLOBALISATION- CONCEPT
AND PRACTICE

Notes

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- ❖ Introductions
- ❖ What is Meant By Globalisation?
- ❖ Globalisation Trends
- ❖ Some Lessons from Global Companies
- ❖ Driving Forces of Globalisation
- ❖ Organisation and Globalisation
- ❖ Criteria for Global Organisations
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INTRODUCTIONS

Globalization is a way of life. The countries are not far off, business partners are not away, goods could be manufactured anywhere, and barriers are broken. The whole world is on the table. What is required for global players is a “global mindset”. The global village has now shrunk to global table.

WHAT IS MEANT BY GLOBALISATION?

Globalisation is the “strategy of optimizing” the resources available in various countries and catering to customers throughout the world with internationally standardised products, at competitive prices. It advocates that the nation or a company or product involved should be global. A global man is one who is born in India, studies in the UK, wears Reid & Taylor, shops in Marks & Spencer, drives a Lexus, acquires a steel plant in Kazakhstan

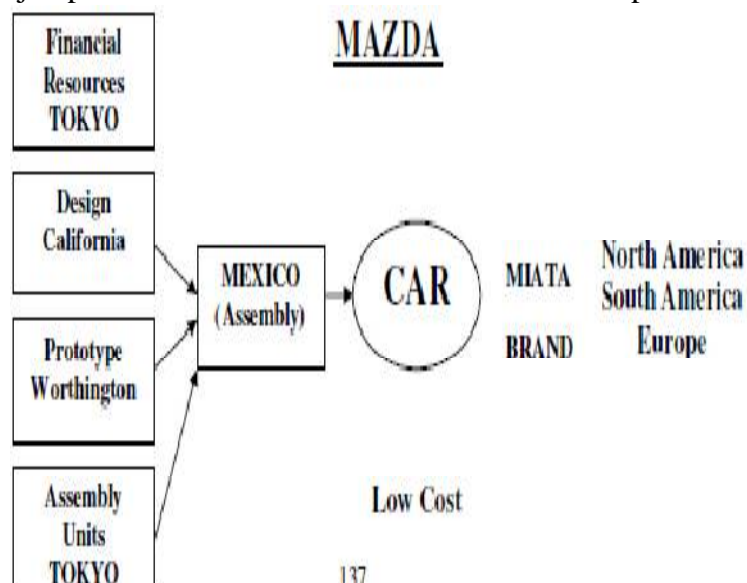
Soon after the independence the slogan of the business community was “export or perish”, after 50 years of independence, we have modified it as “globalize or perish”. It is ringing on the ears of every corporate board room right from the TATAS, BIRLAS, MITTALS, MALLYAS and MAHINDRAS.

And ships his hot rolled coil to China. Thus, he becomes a part of globalisation process.

Liberalisation, the rise of developing countries, new technology and falling trade barriers are changing the economic landscape profoundly, and contributing to fast track globalisation in many countries. Increasingly we are living in a global world. In practical terms, this means that a steel company in the United States will consider other countries as well as the US when deciding where to locate a new \$ 1 billion steel mill. Other examples are automobile manufacturers such Fort Motors, who entered emerging markets such as China or India with modified versions of existing cars, rather than designing a new car from

scratch and Mazda, which designs its sports car in California, produces components in Tokyo, makes prototypes in Worthington, and finally assembles the car in Mexico in order to market it in North America at a very low price. China sources its fibre from South Korea, uses funds from Macau and a labour force in Beijing and finally markets its soft toys all over the world.

The economic landscape is not the same as it was twenty years ago, nor is the pace of global economic change expected to slacken in the next twenty years. This will have an effect on everybody from the highest to the lowest. India's finance minister will have to view the integration of India's economy with the rest of the world as fundamental to the country's transformation into an economic superpower, and a junior manager in a firm will have virtually no chance of making it into the top ranks of the company unless he or she combines superb qualities and skills in job performance with extensive international experience.



GLOBALISATION TRENDS

Globalisation can be defined in several different ways depending on the level we choose to focus on. The philosophy is “the whole world is my market; wherever the opportunity arises I will tap it irrespective of location, standard of economy, ethnic relations and all other parameters.” “Cross border customers are my neighbours; I will be close to them at any time” – a slogan of a global manager. “Globalisation is a mindset rather than physical pharmaceutical giant in India.

At a worldwide level globalisation refers to the growing economic interdependence among countries, which is reflected in the increasing cross border flow of goods, services, capital and know-how. Clear evidence of this is offered by the following trends:

Between 1989 and 2000, cross-border trade in goods and services grew at an average annual rate of 6.4 percent. This is almost twice as fast as the average annual growth rate of 3.2 percent in the world's GDP during the same period.

From 1980 to 2000 foreign direct investment grew from 4.8 percent to 10 percent of the world's GDP. Destinations for flow of funds have changed drastically. It has increased to 18% till the first half of 2007.

In 1970 cross-border transactions in bonds and equities, as a ratio of GDP, stood at under 5 percent in the US, Germany and Japan. By 2001, the respective figures for these countries had soared to 152 percent, 197 percent and 83 percent respectively. After 2001 every year it witnesses more than 15% in all those three countries.

At the level of a specific country, globalisation refers to the ability of the country to expand its trade and aggressively dominate in other parts of the world; by motivating its entrepreneurs by investing, manufacturing and marketing.

Despite the fact that globalisation is taking place very rapidly, all the countries are not equally integrated into the global economy still. Some key indicators to measure the global integration of any country's economy are exports and imports as a ratio of GDP, inward and outward flow of foreign direct investment and portfolio investment, and flow of royalty and know-how payments associated with technology transfer. The growths of China and India with respect to some of these indicators during the last two decades ensure that they will emerge as major global players. At the level of a specific industry globalization refers to the strength of a company in the face of international competition. The more global an industry, the greater is the advantage that a company can derive from leveraging technology, manufacturing and brand names. Specific industries which are on the verge of globalization co-ordinate their strategic actions across countries. For example, the athletic footwear industry is dominated by the firms of Nike, Reebok and Adidas. In the same way Armani, Versace and Vanity Fair are looking at global markets and strategizing their activities with new vigour. Currently Wal-Mart, Mark & Spencer and TESCO chains are integrating by cost effective sourcing. The current aggressiveness of Vodafone to dominate in the communication area especially in Asia is daring and expensive globalization in non conventional sector.

SOME LESSONS FROM GLOBAL COMPANIES

Toyota is a good example of a highly globalised company. At the end of 1995 one-third of Toyota's global output came from wholly or partially owned affiliates located in twenty-five foreign countries spread over North and South America, Europe and Asia.

Furthermore, Toyota exported 38 percent of its domestic production from Japan to foreign markets and engaged in significant intra-firm flows among its affiliates. Within its South East Asian regional network Toyota exported diesel engines from Thailand, transmissions from the Philippines, steering gears from Malaysia and engines from Indonesia. In effect units were set up by Toyota in the whole of South East Asia, to assemble different automobile parts, depending on the competency and resources of the country.

Key indicators of the globalisation of a company are international dispersion of its sales revenue and asset base, intra-firm trade in intermediate and finished goods, and intra-firm flows of technology. These all lead to its physical presence, scattered investments, global image, brand promotion and building borderless customer patronage.

DRIVING FORCES FOR GLOBALISATION

Globalisation occurs because specific managers in specific companies make decisions that result in increased cross-border flow of capital, goods and know-how. Managers are increasingly making such decisions because globalization is becoming more feasible and desirable. The following trends lie at the core of these developments.

1. An ever-increasing number of countries are embracing the free-market ideology. Economic policy makers in industrialized and industrializing nations have shifted from a 'planning' mentality to a 'market' mentality, which has been well documented. Since the end of the second world war, the rising tide of free-market ideology that started with developed economies has swept up South Korea, Taiwan, Hong Kong, Singapore and other South East Asian economies, and is now moving into China, India, Brazil, parts of Africa and central and eastern including Russia. As per BRIC report, four countries will surpass the developed nations in terms of growth and prosperity.

2. The economic centre of gravity is shifting from the developed to developing countries. Economic liberalization promotes competition, efficiency, innovation, new capital investment and faster economic growth. Today's market mechanisms have allowed the developing economies to start catching up with the advanced economies, so that China, India, South Korea, Taiwan, Indonesia and Thailand are emerging as major players in the global market. In fact Taiwan, Hong Kong and Singapore, which were amongst the world's poorest countries in the

DRIVING FORCES OF GLOBALISATION

1950s are already listed as advanced economies. Despite short-term growth for the region are still valid. Their shares in global markets are eating slowly the shares of developed countries especially in plastic, rubber, medical and electronic components. Larger economies, notably China are advancing rapidly. Having sustained an annual GDP growth rate above 10 percent since 1980, China has already transformed itself into the third largest economy in the world at least on a purchasing power parity basis and seems poised to overtake Japan in the near future. These numbers indicate that the world's economic centre of gravity is shifting. Today, any company that seeks to grow has little choice but to go where the growth is. For the vast majority of the world's top 500 industrial corporations, such growth can only take place globally as the home markets are saturated.

3. Technological advances are constantly improving. The cost of air transportation, telecommunications and computers has declined sharply over the past two decades. The decline in transportation costs, especially, has motivated companies to explore new avenues and new countries. In the case of computers and telecommunications, the consistent decline in costs, and the recent widespread adoption of technologies such as video conferencing and electronic mail have made operations simple, effective and fast. By combining these trends with mobile telephones, video telephones, the Internet and increasingly powerful computers, one can optimize a real-time coordination of globally dispersed activities. This will lead to a further increase in the intensity of global competition and

an even greater search for the best locations for the discrete activities in company's value chain.

4. The main hidden principle of WTO is to generate new business opportunities throughout the world. The opening of borders to trade, investment and technology transfers not only creates new market opportunities for companies but also enables competitors from abroad to enter the home markets.

5. The availability of cheap labour has caused many companies to shift their manufacturing units to locations where a competent work force is available at much lower rates. Increasing competition forces competitors to offer better global services, to capture economies of scale, to exploit the cost reducing or quality-enhancing potential of optimal locations and to tap technological advancements wherever they may occur. This has resulted in an accelerated growth of globalization.

6. All the countries are vigorously developing their airports, seaports, energy sources and social amenities. Singapore, Malaysia, South Korea and India facilitate companies by assuring.

ORGANISATION AND GLOBALISATION

Due to the increased rate of globalization, the global economic landscape will undoubtedly look very different 20 years from now. Companies will need to adapt to this changing landscape and those that choose to move first will have a better chance of turning these changes into competitive advantage. The author regards three fundamental changes in the global economic landscape as inevitable. These are described below.

Developing countries will essentially dominate the world economy in the future

Given the commitment of the post-Deng Chinese leadership to economic reform, China is likely to remain in the most successful economic story. Its status as a super power is visible in innumerable fields like textiles, garments, chemicals, silk, soft toys and ceramics. Despite its rapid growth since 1979, China's economy has attracted attention, only during the last few years.

China is not alone. As the economies of other countries such as India, Brazil, Mexico and Russia continue to gather momentum, they will increasingly become major contributors to the creation of new wealth. It is expected that in 20 years, China's economy will be larger than that of the U.S. and India's will be as big as that of Japan. The regional composition of the world's largest corporations will change radically, spreading, over the developing countries, rather than just being limited to the U.S. and Europe, where the majority of them are situated today. As a consequence intraindustry competition will intensify. As an example from India, consider the case of the loosely held Tata Group, a group of companies involved in a number of businesses, such as steel, cement, engineering, chemicals, tea, construction, IT, hotels and trucks. The group's intention is to triple its sales by 2010 and to achieve this target it has narrowed down the group's portfolio and increased control over the individual companies. It is inevitable that the Tata Group will emerge as a global power through cross border alliances and strategic moves. In the field of steel it acquired larger unit, Corus as compared to its own Tata steel. Similar strategic moves are taking place in many business houses

in India, like Reliance, the Aditya Birla group and Murugappa. The same trend is visible in the economies of Indonesia, Brazil, Mexico and Malaysia. Ranbaxy, a pharmaceutical major has multiplied its operations in all the continents in the world and aiming at achieving Rs.20, 000 crores by 2008. LN Mittal group has emerged as a global steel giant, probably one amongst the top richest three in the world in near future.

CRITERIA FOR GLOBAL ORGANISATIONS

Assuming that the trends described here are inevitable the following issues need serious consideration by any medium-sized or large company that is inclined to go global.

1. **Size of the market:**

How extensive do you want your markets to be, particularly the major emerging markets for your products and services? How should you build a necessary global presence?

2. **Location advantage:**

To what extent do you want to capture the cost reducing and quality enhancing potential of locations around the world for the execution of various activities in your company's value chain? How should you deal with the problem of suboptimal locations currently in use?

3. **Global competitiveness:**

How effective do you want to be in exploiting global presence and turning it into a true global competitive company as opposed to global mediocrity? How should you eliminate the existing shortcomings and impediments?

4. **Management efficiency and mindset:**

Is the mindset of your company's top management sufficiently global? As the world around you changes and new opportunities open up in various parts of the world, is your company generally a leader or a laggard in identifying and exploiting these opportunities? How should you create the needed global mindset?

5. **Vision and long term objective:**

Does your company have vision? Is it there with everyone? Whether proper road-map is in place. Is it only for generation of money or for leadership?

6. **Right human resource to handle:**

Do you have sufficient HR, especially technical? Or yet to be appointed in the location of operation?

Once a company has selected the country or countries that will serve as a launch vehicle for its products, it must determine the appropriate mode of entry. This issue rests on two fundamental questions:

- To what extent will the company rely on exports versus local production in the target market? Here the firm has a range of choices as follows. (i) 100 percent export of finished goods, (ii) export of components but localized assembly, (iii) 100 percent local production.
- To what extent will the company exercise ownership and control over the activities carried out locally in the target market? Again, it faces a range of choices as follows: (i) 0 percent ownership by licensing or franchising, (ii) partial ownership such as joint ventures or collaboration, (iii) 100 percent ownership as a wholly owned subsidiary.

Local production would be appropriate under the following conditions:

1. **Longer local production:** The local market is larger than the minimum efficient scale of production. The larger the local market, the more local production will translate into scale economies while holding down tariff and transportation costs. An example is the entry of the Japanese tyre group Bridgestone into the US market by acquiring the local production base of Firestone instead of exporting tyres from Japan.
2. **Cost of logistics and tariffs:** Shipping and tariff costs of exporting to the target market are so high that they neutralize any cost advantages of manufacturing the product at any place other than the target market. This is the main reason why cement companies such as Cemex and Lafarge Coppe engage heavily in local production in all the countries they enter.
3. **Localization and customization of products:** The need to customize the product to suit local requirements is high. Customization of a product requires a deep understanding of local market needs and the ability to incorporate this understanding into which products to market and their design. Localising production in the target market area significantly enhances a firm's ability to respond to local market needs.
4. **Requirement for local production:** There is a strong requirement for local production by the host country. This is one of the major reasons why foreign automobile companies rely heavily on local production in markets such as the European Union, China and India. The Hyundai Corporation has strengthened its production base in India and components are procured in India. Besides the above criteria, the strategic approach for successful companies could be on the following lines:
 - a. Product focus, i.e. Bic pens and Ray ban.
 - b. Human Resource focus, i.e. Infosys and Wipro.
 - c. Technology focus, i.e. Microsoft and Singapore airlines.
 - d. Service focus, i.e. FEDEX and Singapore airlines. They are going in their respective business with complete focus.

The Extent of Ownership Control over Locally Performed Activities
Entering the market via an alliance permits a company to share the costs and risks associated with market entry and allow rapid access to local know how. However it also has the potential for various types of conflict. Alliance based entries are often more appropriate under the following conditions:

1. The company is short of capital. In the 1950s, Xerox Corporation decided to enter the European market through an alliance with the United Kingdom's Rank Organisation. Rank's goodwill and presence in the UK benefited the Xerox Corporation immensely.
2. There are large physical, linguistic and cultural differences between the host and the home country. The more dissimilar and unfamiliar the target market, the greater is the need for a firm to rely on a local partner to network and provide local know how. Given a choice the company would prefer to obtain these assets through an acquisition. However, in unfamiliar markets, a firm's ability to manage an acquired subsidiary is often very limited, and hence the involvement of a local partner becomes inevitable.

3. A subsidiary would not be able to integrate its operations easily with the other multinational operations and hence puts major constraints on a firm's ability in the initial stages of operations.

4. In a typical joint venture, the two partners pool different but complementary know-how. They interact regularly through their core operations and understand each other's working. Both partners learn the other's know-how and often if one firm learns faster than the other it may sooner or later seek to dissolve the alliance.

5. Government regulations stress upon local equity participation. Historically, several countries with a very large market potential such as China and Brazil have been successful in imposing joint ventures.

STAGES OF GLOBAL ORGANISATIONS

Globalization process does not take place instantly. It is a deliberate and cautious move for several companies. Nike and Addidas took more than a decade to move to other countries from their origin. Apple, HP and Dell are fast globalizing their operations due to technology advantages. if they are not quick then technology obsolescence will crop up and finally they have to lose their current status to their competitors. However, in the normal process, a complete globalization has to pass through several stages as described in the following table:

Stages	Purpose	Action	End Result
Stage # 1	Make the presence feel - the move for product or service	Physically export and establish one strong contact overseas	One market established. Trial and errors are overcome, confidence is built
Stage # 2	Study the whole nation and explore the avenues for production	Find out a right partner. Jointly promote the product/s, establish brand in one market.	Awareness is created in one territory. The demand level is known for the production.
Stage # 3	Set up production facility with a local or alone	Identify location or develop a complete network. Reduce the cost and service the market.	Becoming close to the customer at a reduced cost and part of the local
Stage # 4	Expanding to neighboring areas	Take the products from the unit and spread in	The whole region is aware. Loyalty is built.
	through production	nearby countries and build brand name	The network members become patrons.
Stage # 5	Review all the pitfalls and gear up to other regions	Analyse the potential in various regions. Evaluate the partners, investment climate and Socio-Cultural background	Comparing and selection of right locations, right partners and right markets
Stage # 6	Emerging as global enterprise	Produce, distribute, invest and build corporate image and face competition	Global production Global investments Global brand name Status of global company

SPEED OF GLOBAL EXPANSION

Having begun the journey towards globalization, a company must still address the question as to how fast it should expand globally. Rapid globalization enables a firm to grow aggressively but it can also spread managerial, organizational and financial resources quickly. The absence of one of these resources can jeopardize a company's ability to perform. Faster global expansion is more appropriate under the following condition:

A. It is easy for competitors to replicate a firm's recipe for success. This possibility is obvious for fast food and retailing companies such as Kentucky Fried Chicken and Starbucks. Once the concept has been created in a market, competitors can come in and easily replicate it with relatively low investment.

B. The scale of economies is extremely important. Mass production through cost reduction leads to rapid success. Firms which come in later may lose out in a specific sector. This is the reason why tyre manufacturers such as Goodyear, Michelin and Bridgestone, which went global at rapid rate now have considerable advantage over other firms such as Pirelli and Continental, which were slower in entering the global market.

C. The management is highly capable of managing global operations. For example, consider the case of global companies such as Anglo Dutch conglomerate Unilever or the Swedish-Swiss company ABB. If these companies successfully introduce a new product line in one country, it is relatively easy, and also logical, for them to globalize this line rapidly.

THE ROLE OF GLOBAL MANAGERS – CRITERIA FOR SUCCESS

The management, which may be very successful domestically, may not be able to maintain the same level of performance level in its global operations. Global operations require the investment of extremely large sums of money and the managers have to live up to high expectations. To handle business in a global context and make an organization successful, the managerial team requires certain unique qualities.

1. They should have a strong information base.
2. They should possess multi-lingual skills.
3. The managerial cadre should be adaptable in its approach.
4. They should understand the strategies of their competitors.
5. Cost management should be meticulous.
6. The persons should be highly innovative and be able to identify new avenues.
7. They must be able to understand and implement all the organizational policies.
8. The leader must be acceptable, not only to his team, but also to institutions like banks, which support the company. In short, the managerial team should consist of personnel who are multilingual, multi-cultural, adaptable, informative, multi-functional, efficient and enthusiastic. Only then will a company be able to succeed in its global operations.

STAGES FOR GLOBALIZATION FOR AN ENTERPRISE

Stages	Objective	Action Plan	Anticipated risks and hurdle	End Result
Stage:1	"Physical movement of goods and services from the country of its origin".	(i) Identify one country. (ii) Focus on one product or services. (iii) Explore opportunity for exports.	(i) Local resistance for bringing. (ii) Technical and commercial barriers. (iii) Competitive forces from local and imported goods.	(i) Entry into one country- successful. (ii) Learning experience in a country outside.
Stage:2	"Strengthen and stabilize one overseas market."	(i) Build a strong relation in one market. (ii) Promote brand name with customers and channels.	(i) Local competitors pose threats. (ii) Price war is inevitable.	(i) Strengthen one country by overcoming all the hurdles. (ii) One or few importers extend cooperation and support for constant flow of goods.
Stage:3	"Establish manufacturing base in the importing country".	(i) Narrow down to one local partner. (ii) Locate an ideal place for production. (iii) Workout for financially together.	(i) Competitors increase their production capacity. (ii) Local regulations on labour, transaction and infrastructure may trouble the operation.	(i) Local production brings down the cost. (ii) The enterprise becomes close to the customers. (iii) Brand loyalty is built.
Stage:4	"Spread the distribution and increase production in the region".	(i) Develop fast network in the neighbouring countries. (ii) Setup warehouses / sub-dealer network in the region.	(i) Every part of the region works differently. (ii) Rules are not uniform. (iii) Demand level is not similar in every country.	(i) Access in the whole region. (ii) Easy to experiment in other regions. (iii) Revenue is increased.
Stage:5	"Move to other regions by investing and producing".	(i) Set up subsidiaries. (ii) Develop strong systems. (iii) Induct right people with performance. (iv) Flexible to local environment.	(i) Cross cultural complexities. (ii) Local adaptability. (iii) Promotional barriers.	(i) Global take off assured. (ii) The enterprise has a competency in skill and knowledge to go global.
Stage:6	"Global mindset, customer orientation and constant innovation".	(i) Organization to be global. (ii) Investment to be global. (iii) Technology to be global. (iv) Real optimization of resources takes place.	(i) Challenge on governance. (ii) Ethical standards. (iii) Concern for the locals. (iv) Human Resources.	(i) Global investment. (ii) Global competency. (iii) Global branding. (iv) Global Organization.

REVIEW QUESTIONS

1. What is meant by globalisation?
2. What are the driving forces for globalisation?
3. What are the criteria for global organisations?
4. What are stages of global organisations?
5. Discuss about the role of global managers.
6. Discuss about stages for globalization for an enterprise

FURTHER READINGS

1. International Business- Stuart Wall, Bronwen Rees
2. International Business- Aswathappa
3. International Business Environment- Les Dlabay, James Calvert Scott
4. International Business- Thomas L. Friedman
5. International Business- Leslie Hamilton, Philip Webster

UNIT-8 WORLD TRADE ORGANISATION (WTO)

WORLD TRADE ORGANISATION (WTO)

Notes

Contents

- ❖ Introductions
- ❖ Difference between GATT and the WTO
- ❖ WTO: The Organisation
- ❖ Contributions of the WTO
- ❖ Review Questions
- ❖ Further Readings

INTRODUCTIONS

The roots of the World Trade Organisation (WTO) lie in the General Agreement on Tariffs and Trade (GATT) which was established in 1948 by 23 original founders, India being one of them. The 8th round of talks under GATT (1986-1994), KNOWN AS THE Uruguay Round, led to the birth of the WTO on 1st January 1995. In the Uruguay Round, new agreements such as the General Agreement on Trade in Services (GATS) and the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS) and Trade Related Investment Management System (TRIMS) were negotiated. All the three major agreements along with their associate agreements now rest under the umbrella organization, namely the WTO.

The WTO, which has its headquarters in Geneva, Switzerland, has a membership of 150 countries. More than 98% of the global trade is transacted among the members.

As the only regulatory body of world trade, the WTO's objective is to ensure a freer, more transparent and more predictable trading regime in the world. The WTO is based on a sound legal system and its agreements are ratified by the parliaments of member countries. No one country controls the WTO; wherein the top decision makers are the designated ministers of member countries.

The WTO agreements cover:

- Goods, e.g., all industrial products, FMCGs etc.
- Services, e.g., banking, insurance, consultancy etc.
- Intellectual property, e.g., patents, copyrights, designs and trademarks etc.

Two important principles that underline most agreements are:

- a) Most Favoured Nation Clause: No discrimination among member countries.
- b) National Treatment Clause: Equal treatment to imported and domestic products.

These agreements broadly address three concerns:

Same rule for all: It restricts governments or organisations from 'distorting' normal trade by way of subsidising, dumping or discriminatory licensing policies. Government policies are framed to eliminate distorting effects. The WTO allows exports to be relieved of all indirect taxes such as excise, sales tax etc. since they have a cascading effect on the cost of the product.

Administration of agreements: It has detailed guidelines as to how the agreements should be administered at a national level. These apply to antidumping proceedings, standardization, sanitary and phytosanitary measures, or settlement of disputes.

Fair deal to businesses: It ensures rights for the business community e.g., the right to information, the right to present evidence etc. For example, the Agreement on Customs Valuation allows the importer to justify the value of imported goods or requires the customs to give written reasons for rejecting the value disclosed.

DIFFERENCE BETWEEN GATT AND THE WTO

- GATT signifies two aspects – GATT as a body and GATT as a formulator of agreements.
- GATT – the body no longer exists; it was merged with the WTO on 1st Jan, 1995.
- GATT – the agreement rests in the WTO along with other agreements.
- The WTO now includes GATT, GATS, TRIPS and the Dispute Settlement body. GATT covered trade in goods only, whereas the WTO covers trade in goods, services, and intellectual property rights as well.
- Throughout its duration, from 1948 to 1994, GATT was ad hoc and provisional; WTO and its agreements are permanent.
- GATT has contracting parties, whereas the WTO has member nations.
- The WTO is an inherently superior system as compared to GATT, as it has a sound legal basis; even its agreements are ratified in the members parliament.
- WTO has two significant functions, which GATT did not have. These are:
 - (i) Trade Policy Review Mechanism – a periodic process to examine a country's trade policies and to note changes and (ii) an in-built mechanism to settle disputes, which cannot be overlooked by anyone.
- The WTO is more democratic in character. If decisions cannot be reached by consensus, the matter is decided by putting it to vote; each WTO member having one vote. In the case of GATT, it was controlled by a power lobby.

WTO: THE ORGANISATION

The World Trade Organisation (WTO) monitors global trade. Its decisions are absolute and every member must abide by its rulings. Extra powers given to the WTO are supposed to ensure that disputes are settled in harmony with international trade principles. It is located in Geneva, Switzerland. At its head is the Director General, who serves a term of four years. Its staff is made up of 500 persons of varying nationalities.

The Decision Making Process

The Ministerial Conference, comprising designated ministers of the member nations is the supreme decision making forum. The ministers meet at least once in two years. The Ministerial Conference can take decisions on 'all matters' under any of the multilateral agreements.

Second level

The day-to-day work is handled by the General Council, which also acts as The Dispute Settlement Body and The Trade Policy Review Body. The General Council acts on behalf of the Ministerial Conference and meets under these three different terms of reference.

Third level

Three more councils, each handling a different broad area of trade, report to the General Council: the Council for Trade in Goods, the Council of Services and the Council for TRIPS.

Fourth level

Each of the higher-level councils has subsidiary bodies. The Council for Trade in Goods, for example, has 11 committees dealing with specific subjects such as agriculture, subsidies etc.

Four Principles

The WTO has 145 members and makes decisions on a basis of unanimity.

No country has a power of veto.

The four principles which members abide by are:

1. Extending trade concessions equally to all WTO members.
2. Aiming for a freer global trade with lower tariffs everywhere.
3. Making trade more predictable through the use of rules.
4. Bringing about more competition by cutting subsidies.

The definition of 'trade' has steadily expanded and now includes intellectual protection, investment, trade in services and agriculture as well as trade in manufactured goods.

In its short life the WTO has already become the focus of intense controversy. Heralded by the richer nations as the ticket to world prosperity, to many others it's looking more and more like another Trojan horse in the citadel of international development.

'Freeing up' trade- GATT's Uruguay Round concluded at the end of 1993, basically 'freed up' world trade. This meant doing away with barriers which had prevented developing countries from exporting their goods to the richer countries of the North. It also opened up all countries to foreign penetration in completely new areas, such as service industries and intellectual property rights. This offered richer nations and multinational corporations a golden opportunity to take over new sectors in countries that were previously able to protect their own smaller industries.

The WTO has the task of policing this new world order, and is beginning to make its presence felt. Fairer trading provisions, which guarantee protection to producers in the developing world, have already come under fire. The USA, on behalf of the American MNC Chiquita, has challenged arrangements whereby bananas from the Windward Islands are marketed in Europe under the protection of the European Union's Lome Treaty.

Dismantling such arrangements would bring Chiquita greater profits, but would prove disastrous to the farmers and the economies of the Eastern Caribbean. The WTO has upheld the US complaint.

It was perceived that the WTO is controlled by the industrialized nations, just as they control the World Bank and the IMF. At the conference held in Singapore in December 1996, delegates from developing countries complained at being excluded from 'behind the scenes' discussions. The charge was accepted by Renato Ruggier, who was the WTO's Director General at that time. While the WTO claims that its rules-based system is a means of protecting smaller nations from the larger trading powers,

many of those smaller nations have complained of being bullied by the very countries, which set the rules in the first place.

International resistance - While some developing countries, particularly Latin America and East Asia, may be able to compete in the world trade, the world's least developed countries are predicted to lose out. Even in richer countries, the expansion of MNCs has a negative impact on smaller businesses, labour standards and basic freedom. A growing international movement is forming in protest against the WTO and its expanding 'free trade' agenda. Multilateral negotiations, known as 'rounds', held in Seattle and Doha. Qatar made the representation of developing countries stronger than before especially regarding issues related to agricultural subsidies and labour legislation. In many ways the advanced countries appear to have double standards. This approach has been challenged and the influence of the advanced countries in the WTO is gradually diminishing.

Developments

- The agenda of the WTO, the implementation of its agreements, and the much-praised dispute settlement system all serve to advance interests of developed countries, sidelining those of the developing countries.
- The Least Developed Countries (LDCs) are marginalized in the world trade system, and their products continue to face tariff escalations.
- Rules uniformly applied to WTO members have brought about inequalities because each member has different economic circumstances. Compared to GATT, the WTO is much more powerful because of its institutional foundation and its dispute settlement system. Countries that do not abide by its trade rules are taken to court.

Historically, GATT enforced phased-in tariff reductions worldwide. Until the Uruguay Round, which ended in 1994, the trade negotiations focused on non agricultural goods, mainly because the U.S. wanted to protect its farm sector. Over the years, as the corporate interests of the developed countries expanded, they also lobbied for more issues to be incorporated into the WTO.

Changes in rules come about mainly through multilateral negotiations or "rounds". Each round offers a package approach to trade negotiations, in which many issues are negotiated together and trade-offs between different issues are made. Between the rounds, negotiations on single issues take place.

One of the commonly used yardsticks to measure the success of the WTO is the volume of world trade. The results seem excellent in this respect, with world trade up by 25% in the last four years. But the benefits of increased trade are not widely shared. For example, the LDCs represent 20% of the world's population, but they generate a mere 0.03% of the trade flows. Developing countries have little power within the WTO framework for the following reasons:

1. Although developing countries make up three-fourths of the WTO membership and can in theory influence the agenda and outcome of trade negotiations, they have never used this to their advantage. Most developing country economies are in one way or another dependent on the U.S., the EU, or Japan in terms of imports, exports, aid, security, etc.

Any obstruction of a consensus at the WTO might threaten the overall well-being and security of dissenting developing nations.

2. Mutual give and take policies with tariff reduction exist between countries. This type of bartering benefits the large and diversified economies, because they can get more by giving more. For the most part, negotiations and trade-offs take place among the developed countries and some of the richer or larger developing countries.

3. Developing countries have discovered that seeking recourse in the dispute settlement system is costly and requires a level of legal expertise that they may not have.

Nelson Mandela, commenting on the negotiations said: “The developing countries were not able to ensure that the rules accommodated their realities. It was mainly the preoccupations and problems of the advanced industrial economies that shaped the agreement.” He added that rules applied uniformly are not necessarily fair because of the different circumstances of members.

“Trade and labour standards” is a highly sensitive issue. To date, a clause of labour standards has not been included in the policies framed by the WTO. The issue has been raised by some industrial nations, who feel that the subject should be studied by the WTO as a first step towards bringing the matter of “core labour standards” into the organizations. There is a great divide between most of the industrialized nations and the developing countries on the subject. Developing countries like India are most very vocal on labour issues. They feel that developed nations try to annihilate the comparative advantage they have of cheaper labour, and argue that the International Labour Organisation (ILO) is the right platform to discuss the issue and not the WTO.

Environmental Issues

The WTO has no specific agreement on environment; it has a “Trade & Environment Committee”, which plays a limited role. There is increasing pressure by environmentalists on the WTO to take proactive measures to protect the environment. The US banned import of tuna fish from Mexico in accordance with its Marine Mammals Law, which has the mandate like dolphins. At that time Mexico appealed to GATT whose verdict went against the USA.

Trade experts fear that free trade will be undermined in the guise of protecting the environment, if such issues find a place and are emphasized in the WTO. There are more than 200 Multilateral Environmental Agreements (MEAs) on various aspects of the environment. Twenty of these include provisions that can affect trade e.g., the Montreal Protocol for Protection of the Ozone Layer, the Basel Convention on Trade or Transportation of Hazardous Goods. The WTO is of the view that the most effective way of dealing with environmental issues is through international agreements.

Dilemma of Developing Countries-

Exports from developing countries continue to face significant market access impediments. Recent UN studies confirm that tariff peaks and tariff escalation still hamper developing country exports and their attempts to export new products such as beef, cigarettes, clothing, footwear and wooden articles.

To gain access to new markets in developing countries, the developed countries are acting in the interests of transnational corporations. They have rapidly imposed new agreements in telecommunications, information technology, and financial services. The Millennium Round talks paved the way for further economic liberalization in both the traditional and new sectors, which is contrary to the interests of developing countries. For example, Washington has interpreted WTO agreements to protect key industries. For example the U.S. has selectively opened its markets in the field of textiles and clothing, but this liberalisation has proved of little benefit to the developing nations. Similarly, the U.S. has misused the measures designed to safeguard domestic industries from a sudden increase in imports. It has also introduced its own Rules of Origins, rules used to identify where textiles or clothing products come from, changing the conditions of competition and adding to the restrictions against the low-cost textile exports from other countries.

New rules regarding information on plants will have both agricultural and medical implications. The Trade Related Intellectual Property Rights Agreement (TRIPS) fiercely protects the rights of corporations but easily allows the shared knowledge of indigenous communities to be patented by others. When fully implemented, developing countries will lose billions of dollars to the richer countries, as MNCs will continue to control virtually all the patents of developing countries.

The agreement between the U.S. and China, stipulated the terms on which China would join the WTO. This is the most significant deal between the two countries since diplomatic relations were established more than two decades ago. The Clinton administration hoped that this would pave the way for Congress to now vote permanent Normal Trade Relations (NTR) (also known as Most Favored nation), thereby giving China the same trading privileges now enjoyed without an annual review, by almost every other U.S. trading partner. The only other nations denied NTR status by the U.S. are: Afghanistan, Cambodia, Cuba, Laos, North Korea, and Yugoslavia, China has enjoyed NTR since 1980, but only by an annual vote of Congress. Only if the U.S. Congress approves permanent NTR for China can the November agreement be implemented. WTO membership for China and permanent NTR status will clear the way for Taiwan to join the WTO.

CONTRIBUTIONS OF THE WTO

It is a tribute to human civilization that sovereign nations have agreed to subordinate their freedom (to act) and have agreed to work within the framework of rules to promote global trade. The Uruguay Round of negotiations resulted in formation of a rule based system, which is expected to lead to smooth and orderly international trade.

- The WTO and its agreements have an impact on every economic activity, be it agriculture, trading, service or manufacturing.
- World markets are opening up due to lowering of tariffs and dismantling of other restrictions in developed and developing countries to benefit from their comparative advantages.

- Domestic markets will be increasingly threatened because of lowering of tariffs leading to freer entry of foreign goods and because of foreign companies' establishing local manufacturing bases.
- Whereas the developing countries will have greater opportunities in sectors in which they have cost bases comparative advantages e.g., textiles, agriculture etc., the developed countries benefit due to the opening of the service sector and tightening of Intellectual Property Regime.
- Export markets will become more difficult because of competition among developing countries with similar comparative advantages.
- Products from developing countries will face higher quality standards in developed markets particularly in the areas where they have comparative cost advantage.
- Every company, whether serving the domestic or international market, will have to undertake an internal exercise to identify factors affecting its international competitiveness in terms of cost as well as quality. It will need to study whether it can remain competitive once the product can be imported freely or tariffs are further lowered or both.
- The WTO regime will be of greater benefit to those countries that show ability and skill in the ongoing dialogue. The governments that are in constant touch with their industries and affected groups will be able to clearly determine how and what should be negotiated at multilateral negotiations to the best of their advantage.
- International trade is becoming increasingly trade, deregulation and privatization of internal economy have now been strengthened and legalized under the WTO. Countries have no option but to follow this direction. Countries that have understood this have moved swiftly in fine tuning their domestic and international trade policies, to create a winning environment for industry and business. Those who are still debating the issue or do not understand it clearly will be left behind.

REVIEW QUESTIONS

- ❖ What are difference between GATT and the WTO?
- ❖ Discuss about the organisation of WTO
- ❖ What are the contributions of the WTO in the growth of international business

FURTHER READINGS

1. International Business- Stuart Wall, Bronwen Rees
2. International Business- Aswathappa
3. International Business Environment- Les Dlabay, James Calvert Scott
4. International Business- Thomas L. Friedman
5. International Business- Leslie Hamilton, Philip Webster

UNIT- 9 INTELLECTUAL PROPERTY RIGHTS

CONTENTS

- ❖ Introductions
- ❖ The Procedure to Obtain IPR Protection
- ❖ Concept and Meaning of IPR
- ❖ Patent Cooperation Treaty
- ❖ Role of Patent and Trademark Attorneys
- ❖ Review Questions
- ❖ Further Readings

INTRODUCTIONS

What would have happened if Stevenson had not invented steam engine, Edison had not invented gramophone, Graham Bell had not invented telephone, Albert & Wilbert had not invented airplane and finally Einstein had not propounded three laws of gravitational force? Every product/s we use or enjoy is an outcome of known and unknown intellectuals. They continue to invent for the society and future. “It is intangible, sometimes perishable, infringeable and intrudable property of mind could be encashed by anyone if it is not legally protected”.

Intellectual property refers to ideas, discoveries and inventions that can be commercially exploited. At one time, intellectual property was manipulated by smart business. They could take ideas from innovations and inventors and make fortune. Currently, such inventions can be owned, protected and marketed by the inventor himself. Such legal protection is scheduled as a part of the WTO agreement. In some sectors like the pharmaceutical, chemical, engineering and manufacturing sectors ‘Intellectual Property Rights’ has become common parlance.

Human brain is a powerful creator, executor and controller of every function in the world, if optimum utilized. By converting its efforts one becomes world renowned, others remain common. Invent, Create and beyond, Commercialise.

The term Intellectual Property Rights (IPR) is often shortened further to Intellectual Property (IP). Intellectual property is a series of legal rights that afford, in most cases temporary protection for different types of inventions, designs, brand names or original creations. The legal rights given are the rights to prevent unauthorized use of the invention, design, brand name or creation for the period of protection. The right given can be an absolute monopoly right or simply a right to prevent reproduction. The legal rights in intellectual property can be transferred between parties, licensed to other parties and can even mortgage or used as security. IP only comes into existence after an application has been made and/or registration has been obtained. Alternatively, it may come into existence automatically upon creation of an original design or other work or upon the creation of a reputed brand name, with most forms of intellectual property, the temporary protection afford expires after a finite term. However, this is not true for all forms protection, some of which

can last forever. The various forms of intellectual property are given briefly below.

Components of IPR in current context

Patents: New and inventive technical innovations can enjoy an absolute monopoly for twenty years.

Supplementary Protection Certificate: This is an extension of up to five years on the absolute monopoly given by a patent, where the invention consists of a medicinal product for which approval by the relevant authority has yet to be given.

Trademarks: The owner of a trademark has an absolute monopoly for ten years. The legal protection of any brand name has the title of trademark and it is shown on any product as TM.

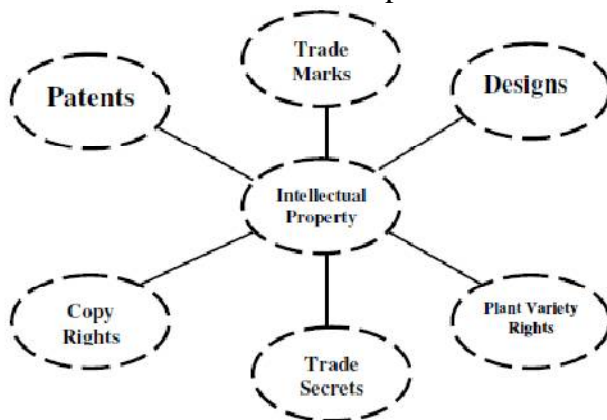
Designs: This is an absolute monopoly for twenty-five years, given for a new design of a manufactured article.

Unregistered Design Right: This prevents reproduction of an original design, which lasts for a maximum of fifteen years.

Copyright: Copyright prevents reproduction of an original literary, artistic, musical or dramatic work. It is valid for a period of seventy years after the death of the author.

Confidentiality and Trade Secrets: This prevents misuse of confidential or secret information.

Plant Variety Right: This relates to a new horticultural genus or species. It gives the monopoly rights of the new variety of plant to the scientist. Intellectual property rights legally prevent unauthorized use of ideas and designs. Thus if a patent exists for a product, other persons are prevented from making or selling that product. If a brand name is registered as a trademark then using the same or similar brand name amounts to infringement of that registration and is illegal. Thus intellectual property rights have obvious commercial benefits as they enable a company to maintain a monopoly in a particular area of business to the exclusion of competitors.



However, it may become necessary or advisable to join forces with other parties to exploit the protected area of business. This is permitted under intellectual property rights if the other parties, the licenses, pay a lump sum or royalties to the primary party. Thus if there is a big market, which a single party cannot, or does not wish to exploit alone, one or more licenses can be appointed who can also take advantage of the market and

the main party will receive royalties on their income. Alternatively, it may be desirable for the party to simply sell the intellectual property rights at an appropriate price. This is possible since the rights can be assigned (ownership transferred) to other parties. Suppose a party develops a product in an area in which it has no commercial interest, then the party may consider selling that invention to another party who operates in that area, as an alternative to licensing the party to exploit the invention.

Intellectual property rights can thus be used to avoid competition or to derive an income through licensing of selling the rights.

The existence of intellectual property rights also provides a useful tool for monitoring the activities of competitors. Published patent application, registered designs and applications for registration of a trademark can indicate the technical and commercial direction a competitor is taking, or thinking of taking. For example, published patent applications contain technical information relating to inventions and can indicate the area of technology that is currently of interest to the applicant or proprietor. An application for a new trademark may indicate a new line of business or change of corporate identity for a company.

All this material is available for public inspection and can be a valuable source of commercial information as it is unavailable elsewhere.

THE PROCEDURE TO OBTAIN IPR PROTECTION

Intellectual property rights can be obtained in one of two ways, by application or by automatic derivation. Where an application procedure is involved, it usually follows the steps set out in the following sequence:

1. File application
2. Search carried out to ascertain originality
3. Examination carried out
4. Objections raised/No objections raised
5. Dealing with objections
6. Grant/Registration

It is a simple six step procedure that anyone can follow. Where an application procedure is involved, the protection ultimately obtained is usually an absolute monopoly, patents registered designs and registered trademarks fall into this category. Intellectual property rights arise automatically if an original work, such

as a drawing, design document, or prototype is created. These rights are usually limited to preventing any form of reproduction of misinterpretation. Copyrights, unregistered design rights (including semiconductor topography rights) and unregistered trademarks fall into this category.

CONCEPT AND MEANING OF IPR

Patents

Patent protection can be obtained for many types of technical innovations. For example, a new piece of apparatus or machinery to carry out a particular operation, a method or process for performing an operation or making a product or the use of a piece of equipment or product for a particular purpose.

In order to determine if patent protection can be obtained, it is necessary to consider whether the technical innovation is both novel and

innovative. Both these terms have a legal definition. It is usually relatively straightforward to determine if a technical innovation is novel or not. The determination is based upon whether the innovation is different from that which existed previously. It is more difficult to assess if an innovation is inventive. This determination is based upon whether it will be obvious, given what existed previously, to arrive at the invention. Unfortunately this is a legal definition, which cannot be applied without knowledge of the concerned body of case law on the subject. Patent protection is not available for every type of innovation. It is excluded in the case of innovations that are artistic and not technical innovations, and innovations that are not applicable in industry. Once again these are strict legal definitions and a thorough knowledge of case law is needed to accurately assess whether an invention is an excluded invention. Patents are obtained via an application procedure that involves a search and an examination. Once any objections raised are dealt with, the application can proceed to grant the patent. Once the patent has been granted, it remains in force for 20 years, subject to payment of annual renewal fees to keep the patent in force, and a granted patent provides a patentee with an absolute legal monopoly which can be used to prevent unauthorized use of the patented invention.

Generally speaking, patents are territorial and it is necessary to obtain a patent in each country in which protection is required. A patent in a particular country does, however enable a patentee to prevent importation into that country of an infringing product from wherever that importation takes place. Therefore, it is common for patentees to protect their inventions in the countries which constitute either their major markets, or which contain their major competitors' manufacturing sites. Whilst patents are essentially territorial, there are a number of international conventions that make the process of applying for international patent protection more simple and cost effective than filing a national patent application in all the countries of interest. The most important these international conventions are the European patent Convention and the patent Cooperation Treaty.

Trademarks

Traditionally trademarks were any word or logo that serves to designate the origin of goods or services. In recent years the law has come to recognize that there are many other ways of designating the origin of goods or services, e.g. advertising jingles, smells and the shape of goods or packaging. Nowadays, therefore, these are also recognized as trademarks. For registration, a trademark must be capable of distinguishing the goods or services of one party from those of other parties. Furthermore, trademarks that consist of anything other than words or logos must be capable of being represented graphically. Any sign that does not satisfy these requirements cannot be registered as a trademark. Signs which are inherently non – distinctive or descriptive or which consist of words or symbols, things that traders in the same area of business may wish legitimately to use to identify the origin of their goods may be excluded from registration. For example surnames and geographical locations would not be allowed as trademarks.

In some countries, for example the United Kingdom, rights can be obtained on a trademark simply by using a symbol or sign extensively enough, so that it is identified with the product. In these circumstances, the person or company using the trademark has legal resources through an action for 'Passing Off or Unfair Competition', against other parties who are attempting to misrepresent themselves by using a similar trademark. Most countries however provide a statutory registration procedure for registration of trademarks and it is always advisable to register a trademark, where possible, since infringement of a registered trademark is a strict liability offence and is not dependent upon proving a reputation or any misrepresentation. Furthermore, in certain circumstances, infringement of a registered trademark can be a criminal offence and is punished accordingly. A registered trademark is obtained by filling an application with the Trade Marks Registry, which is then searched and examined. Once any objections raised are overcome, the mark is advertised in order to allow any interested party to object to the registration should they have grounds to do so. Subject to no objection being raised, the mark is then entered into the Register of trademarks. Once registered, a trademark can usually be kept in force for as long as is required. Subject only to the payment of renewal fees.

Copyright

Copyright, as its name suggests, is a right to prevent copying of an original artistic, musical, literary or dramatic work. Because copyright is only a right to prevent copying of the original work, there is no absolute legal monopoly and copyright cannot therefore be used to prevent the independent production of an identical or similar work without any reference to the original work.

From 1st January 1997, the copyright lasts for a period of 70 Years from the death of the original author of the work. Copyright is given on a national basis in the country in which the original work created but may be enforceable internationally by virtue of the Berne Convention or universal copyright convention.

In some countries, copyright can be used to prevent unauthorized application of the original work to a manufactured article and thus similar protection to that given by Unregistered Design right in the United Kingdom is afforded. However, a notable exception to this is the United States of America.

Confidentiality and Trade Secrets

There are laws that protect confidentiality of information. Companies or individuals may wish to keep commercial or technical information confidential. If this information is made public in breach of that confidence then it is possible to bring an action or breach of confidence against the offending party. For example, an employee has an obligation to keep all information, which is given to him or her by the employer, confidential. If confidential information is disclosed to a third party out of choice then the obligation of confidentiality also passes to the third party. It should be ensured that the third party is aware of the fact that they are expected to treat the information as confidential and they agree to do so. In practice terms this agreement should be given in writing in case there is ever any dispute as to what was agreed.

There is an exception to the protection of confidential information in circumstances where the dissemination of the information is deemed to be in the public interest. This is allowed, notwithstanding any obligation of confidence.

The current decade has witnessed innumerable inventions in India in the field of biotechnology, agro chemicals, telecommunications, pharmaceuticals, electronics, agriculture, food processing and natural herbal medicines. Biocon, Bharat Serum, Ranbaxy, Gharda Chemicals, Cadila, United Phosphorous and Glen Mark afford to employ separate invention team and protect another team with legal expertise.

PATENT COOPERATION TREATY

The original Patent cooperation Treaty was signed in Washington in 1970 but it has been modified many times since. The convention only came into force on 1st June 1978. This convention provides a mechanism whereby protection can be ultimately obtained in all or selected countries that have signed the treaty. This is carried out through a procedure which involves the filing of a single application that is subjected to a single international search and an international preliminary examination. At the end of the international preliminary examination an examination report is produced which sets out an opinion on the patentability of the invention described in the application. After completion of the examination report, the applicant has the option of proceeding with the application, or allowing the application to lapse, if the examination report is dismissive of possibilities for protection. If the applicant wishes to proceed further, the application is split into separate national applications in the countries of interest and may be subjected to a further national search and examination. The national offices function independently and may place as much weight as they wish on the opinion of the international authority, which was set out in the international preliminary examination report. Attitudes vary widely from country to country as to the weight attached to the contents of the international preliminary examination report. For Example, an applicant in the United Kingdom, should know that the Japanese and United States patent offices will often ignore the contents on the report and will carry out a full search and examination, just as if the application had not previously been searched or examined by the international authorities.

ROLE OF PATENT AND TRADEMARK ATTORNEYS

Patent and trademark attorneys are generally speaking, professional advisors who are qualified by an examination in the Law of Intellectual Property. However, it is important to note that the term, 'Patent and Trademark Attorney' may also be used by a solicitor, who may not have experience, or relevant qualifications, in intellectual property rights. Knowledgeable patent and trademark attorneys are qualified to give advice on infringement or exploitation of intellectual property rights and can also carry out searches to ascertain the patent, design and trade mark activities of competitors or any other person or company. They are fully experienced in the procedures for obtaining forms of intellectual property rights and can offer advice on the forms available for any particular

innovation or idea, and the procedures necessary to obtain the best protection.

Innovators and inventors in any field are required to consult a knowledgeable attorney prior to filing their applications. Following strict procedures and also keeping documentary evidence at all stages will enable the applicant to protect his intellectual property. Internationally renowned research organizations like Genentech, BioRad, Hoffkins, E-Merck and Pfizer are retaining attorneys permanently as a part of management team in the organization for this purpose.

REVIEW QUESTIONS

1. What are the components of IPR in current context?
2. Describe the procedure to obtain IPR protection.
3. Describe the concept and meaning of IPR.
4. Discuss about patent cooperation treaty.
5. What is the role of patent and trademark attorneys?

FURTHER READINGS

1. International Business- Stuart Wall, Bronwen Rees
2. International Business- Aswathappa
3. International Business Environment- Les Dlabay, James Calvert Scott
4. International Business- Thomas L. Friedman
5. International Business- Leslie Hamilton, Philip Webster

UNIT-10 TRADE BARRIERS

TRADE BARRIERS

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- ❖ Introductions
- ❖ Objectives of Trade Barriers
- ❖ Types of Trade Barriers
- ❖ Review Questions
- ❖ Further Readings

INTRODUCTIONS

A trade barrier is defined as “any hurdle, impediment or road block that hampers the smooth flow of goods, services and payments from one destination to another”. They arise from the rules and regulations governing trade either from home country or host country or intermediary. Trade barriers are man-made obstacles to the free movement of goods between different countries, and impose artificial restrictions on trading activities between countries. Despite the fact that all international organisations such as GATT, WTO and UNCTAD advocate reduction or elimination of barriers, they still continue in different forms.

Free and fair international trade is an ideal situation as it is beneficial to all countries. However, different countries impose various types of barriers. The contribution of GATT in removing such trade barriers has not been satisfactory as even now, both developed and developing countries, present such trade barriers. Such barriers are usually imposed by the country that imports the goods, but they adversely affect the volumes of both imports and exports. The volume of exports is reduced due to such trade restrictions and the tariff results in an escalation in prices.

OBJECTIVES OF TRADE BARRIERS

1. To protect domestic industries from foreign goods.
2. To promote new industries and research and development activities by providing a home market for domestic industries.
3. To maintain favourable balance of payment, by restricting imports from foreign countries.
4. To conserve foreign exchange reserves of the country by restricting imports from foreign countries.
5. To protect the national economy from dumping by other countries with surplus production.
6. To mobilize additional revenue by imposing heavy duties on imports. This also restricts conspicuous consumption within the country.
7. To counteract trade barriers imposed by other countries.
8. To encourage domestic production in the domestic market and thereby make the country strong and self-sufficient.

Since trade barriers are harmful for the growth of free trade, efforts were made to reduce such trade barriers, and international organisations initiated collective efforts of all countries involved in trade. WTO ministerial conferences held in Geneva or Doha Qatar or Hong Kong are focused on breaking barriers of trading in different forms.

TYPES OF TRADE BARRIERS

Broadly, Trade barriers are classified as tariff barriers and non-tariff barriers. They are now an inseparable part of global business and the location of a business operation and pricing decisions are determined by tariffs. A country may use both tariff and non-tariff barriers order to restrict the entry of foreign goods.

Tariff Barriers

A tariff barrier is a levy collected on goods when they enter a domestic tariff area (DTA) through customs. Tariff refers to the duties imposed on internationally traded commodities when they cross national boundaries and may be in the form of heavy taxes or custom duties (operated through a price mechanism) on imports, so as to discourage their entry into the home country for marketing purposes.

Tariffs enhance the price of the imported goods, thereby restricting their sales as well as their import. Governments impose tariffs only on imports and not on exports as they are interested in export promotion. Only a few exported items of any country are taxed.

The aim of a tariff is thus to raise the prices of imported goods in domestic markets, reduce their demand and thereby discourage their imports. Tariff barriers are major determinant factor to build or get away from the business. In India, over the past ten years the prime import duty has been reduced to 15% from 100% on many consumer durables and electrical items.

Classification of Tariffs

A) On the basis of origin and destination of the goods crossing national boundaries

1. Export duty: An export duty is a tax levied by the country of origin, on a commodity designated for use in other countries. The majority of finished goods do not attract export duty. Such duties are normally imposed on the primary products in order to conserve them for domestic industries. In India, export duty is levied on oilseeds, coffee and onions.

2. Import duty: An import duty is a tax imposed on a commodity originating in another country by the country for which the product is designated. The purpose of heavy import duties is to earn revenue, to make imports costly and to provide protection to domestic industries. Countries impose heavy import duties to restrict imports and thereby remove the deficit in the balance of trade and balance of payment.

3. Transit duty: A transit duty is a tax imposed on a commodity when it crosses the national frontier between the originating country and the country which it is cosigned to. African and Latin American nations impose such transit duties at any point of time. Sri Lanka is another country enjoying such benefits from Indian companies.

B) On the basis of quantification of tariffs

1. Specific duty: A specific duty is a flat sum collected on physical unit of the commodity imported. Here, the rate of the duty is fixed and is collected on each unit imported. For example, Rs. 800 on each TV set or washing machine or Rs. 3000 per metric ton on cold rolled steel coils.

2. Ad-valorem duty: This duty is imposed at a fixed percentage on the value of a commodity imported. Here the value of the commodity on the invoice is taken as the base for calculation of the duty, e.g., 3%

advalorem duty on the C&F value of the goods imported. In the ad-valorem duty, the percentage of the duty is decided but the actual amount of the duty changes as per the FOB value of a product.

3. Compound duty: A tariff is referred to as compound duty when the commodity is subject to both specific and ad-valorem duty.

C) On the basis of the purpose they serve

1. Revenue tariff: It aims at collecting substantial revenue for the government, but does not really obstruct the flow of imported goods. Here, the duty is imposed on items of mass consumption, but the rate of duty is low.

2. Protective tariff: Protective tariff aims at giving protection to home industries by restricting or eliminating competition. Protective tariffs are usually high so as to reduce imports. However, if the protective duties are too high, it may hurt consumers, as imports will stop, leading to shortages in the consumer market.

3. Anti-dumping duty: Dumping is the commercial practice of selling goods in foreign markets at a price below their normal cost or even below their marginal cost so as to capture foreign markets. Many countries follow dumping practices. It is international practice which has a “do or die” instinct associated with the company’s policy. It is harmful to less developed countries where the cost of production is high.

4. Countervailing duty: Such duties are similar to anti-dumping duties but are not so severe. Countervailing duties are imposed to nullify the benefits offered, through cash assistance or subsidies, by the foreign country to its manufacturers. The rate of such duty will be proportional to the extent of cash assistance or subsidy granted.

D) On the basis of trade relations

1. Single column tariff: Under this system tariff rates are fixed for various commodities and the same rates are made applicable to imports from all other countries.

2. Double column tariff: Under this system two rates of duty are fixed on all or some commodities. The lower rate is made applicable to a friendly country or to a country with which the importing country has a bilateral trade agreement. The higher rate is applicable to all other countries.

3. Triple column tariff: Here, three different rates of duties are fixed. They are general tariff, international tariff and preferential tariff. The first two categories have minimum variance but the preferential tariff is substantially lower than the general tariff and is applicable to friendly countries where there is a bilateral relationship.

Mutual understanding of products and tariffs is concluded through a cartel. It is also called preferential tariff.

Benefits of tariff to the home country

1. Imports from abroad are discourage or even eliminated to a considerable extent.

2. Protection is given to the home industries and manufacturing sector. This facilitates an increase in domestic production.

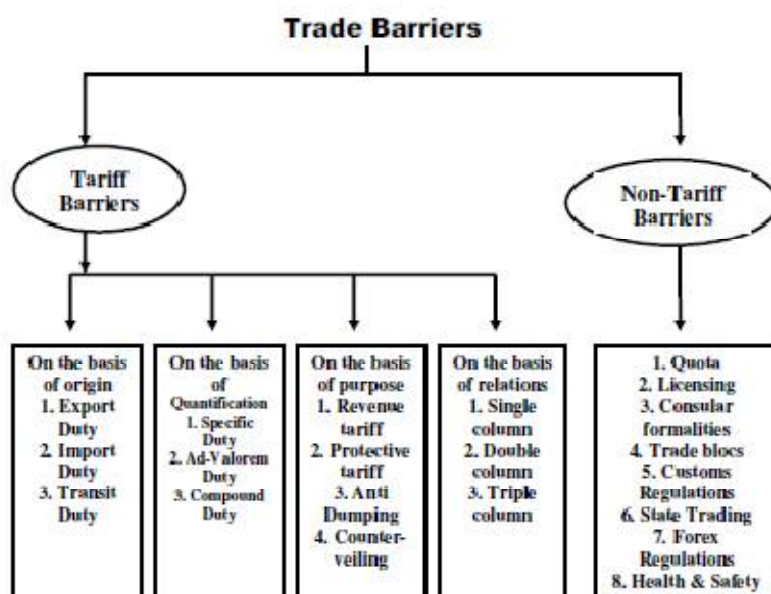
3. Consumption of foreign goods is reduced to a minimum and the attraction for imported goods is brought down.

4. Tariff brings in substantial revenue to the government. In addition it also creates employment opportunities within the country, by promoting domestic industries.

5. Tariffs aim to reduce the deficit in the balance of trade and balance of payment of a country.

Non -tariff Barriers

Along with tariff barriers, non-tariff barriers are imposed by countries in order to restrict free trade at a global level. Non-tariff barriers are quantitative restrictions as they directly restrict the entry of foreign goods over and above a specific limit fixed by the government. Other forms of non-tariff barriers are licenses, exchange control, complicated documentations, technical certifications etc. Non-tariff barriers are useful for reducing the total quantity of goods that are imported from abroad, but they do not affect the price of imported goods. However, the net effects of tariffs and non-tariff barriers are more or less the same. The impact of non-tariff barriers is more direct and faster.



Non-Tariff Barriers Tariff Barriers

Types of non-tariff barriers

1. Quota system: The quota system is an important non-tariff barrier. Under this system, the quantity of a commodity permitted to be imported from various countries during a given period is fixed in advance. Such quotas are usually administered by requiring importers to have licenses to import a particular commodity. Imports are not allowed over and above a specific limit. This suggests that tariffs restrict imports indirectly while quotas restrict imports directly. Developing countries may use quotas in place of tariffs. The quota system acts as a barrier to international trade as it restricts the flow of goods in an artificial manner. There are different types of quota and a country can introduce any type of quota as per the need of the situation.

The types of quotas are:

Tariff quota: A tariff quota combines the features of the tariff as well as the quantity. Here, the imports of a commodity up to a specified volume

are allowed duty free or at a special low rate of duty. Imports in excess of this limit are subject to a higher rate of duty.

Unilateral quota: In a unilateral quota system, a country fixes its own ceiling on the import of a particular item.

Bilateral quota: In a bilateral quota, the quantity to be imported is decided in advance, but it is the result of negotiations between the country importing the goods and the country exporting them.

Mixing quota: Under a mixing quota, the producers are obliged to utilise a certain percentage of domestic raw material in manufacturing the finished products.

2. **Import Licensing:** Import licensing is an alternative to the quota system. It is useful for restricting the total quantity to be imported. In this system, imports are allowed under license. Importers have to approach the licensing authorities for permission to import certain commodities. Foreign exchange for imports is provided against the license. Such import licenses are the practice in many countries. This method is used to control the quantity of imports. Import licensing may be used separately or along with the quota system.

3. **Consular formalities:** Some importing countries impose strict rules regarding the consular documents necessary to import goods. Such documents include import certificate, certificates of origin and certified consular invoices. Penalties are imposed for non-compliance of such documentation formalities. The purpose of consular formalities to restrict imports to some extent and prevent free imports of commodities that are not necessary.

4. **Preferential treatment through trading blocs:** Some countries form regional groups and offer special concessions and preference to member countries. As a result trade is developed among the member countries and allows advantages to all member countries. On the other hand, it can cause a considerable loss to non member countries, as a trading bloc acts as a trade barrier. Even trade agreements and joint commissions are used as trade barriers as they restrict free movement of goods at the international level.

5. **Customs regulations:** Customs regulations and administrative regulations are very complicated in many countries. There are a number of 'Commodities Act,' pertaining to the movement of drugs, medicines, minerals, bullion etc. Restrictions under such acts are useful to curtail imports. Tax administration also acts as barrier to free marketing amongst countries.

6. **State trading:** State trading refers to import-export activities conducted by the government or a government agency. State trading is useful to restrict imports, as the final decision is taken by the government. Such state trading acts as a barrier, restricting the freedom of private parties.

7. **Foreign exchange regulations:** Countries impose various restrictions on the use of the foreign exchange earned through exports. Such restrictions have the following objectives.

- a) To restrict the demand for foreign exchange and to use the foreign exchange reserves in the best possible manner.
- b) To check the flow of capital.

c) To maintain the value of exchange rates. Under such regulations the foreign exchange earned should be surrendered to the government. The government provides foreign exchange to the businessmen as per priorities that are fixed periodically.

8. Health and safety measures: Many countries have specific rules regarding health and safety regulations, which are mainly applicable to raw materials and food items. Imports are not allowed if the regulations are not followed properly.

9. Miscellaneous non-tariff barriers: Such barriers include prior import duties such as deposits, embargoes and import restrictions due to environmental regulations, provision of subsidies to domestic industry, canalization of imports of some commodities and technical and administrative regulations. All such measures act as non-tariff barriers as they restrict the free flow of goods and services between countries.

REVIEW QUESTIONS

1. What are the objectives of trade barriers?
2. Describe the types of trade barriers.
3. What are the classification of tariffs?
4. What are the benefits of tariff to the home country

FURTHER READINGS

1. International Business- Stuart Wall, Bronwen Rees
2. International Business- Aswathappa
3. International Business Environment- Les Dlabay, James Calvert Scott
4. International Business- Thomas L. Friedman
5. International Business- Leslie Hamilton, Philip Webster

UNIT-11 INTERNATIONAL INSTITUTIONS AND ROLE IN INTERNATIONAL BUSINESS

INTERNATIONAL
INSTITUTIONS AND ROLE IN
INTERNATIONAL BUSINESS

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- ❖ Introductions
- ❖ IDA
- ❖ International Monetary Fund
- ❖ IMF Lending
- ❖ Technical Assistance:
- ❖ Asian Development Bank
- ❖ International Maritime Organisation
- ❖ Measures Of IMO
- ❖ International Labour Organisation
- ❖ International Telecommunication Union
- ❖ Review Questions
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INTRODUCTIONS

An international organisation must be established by a treaty (constituent instrument) providing it with legal recognition. International organizations so established are subjects of international law, capable of entering into agreements among themselves or with states.

Purpose of International organizations

International Organizations exist to increase international relations, promote education, health care, economic development, environmental protection, human rights, and conflict resolution throughout a region.

World Bank

The World Bank (the Bank), a part of the World Bank Group (WBG), was formally established on the 27 December 1945 following the ratification of the Bretton Woods agreement. The concept was originally conceived in July 1944 at the United Nations Monetary and Financial Conference in July 1944. The **World Bank Group** (WBG) is a family of five international organizations responsible for providing finance and advice to countries for the purposes of economic development and eliminating poverty. The Bank came into formal existence on 27 December 1945 following international ratification of the Bretton Woods agreements, which emerged from the United Nations Monetary and Financial Conference (1 July – 22 July 1944). The World Bank Group consists of

- the International Bank for Reconstruction and Development (IBRD), established in 1945, which provides debt financing on the basis of sovereign guarantees;
- the International Finance Corporation (IFC), established in 1956, which provides various forms of financing without sovereign guarantees, primarily to the private sector;

- the International Development Association (IDA), established in 1960, which provides concessional financing (interest-free loans or grants), usually with sovereign guarantees;
- the Multilateral Investment Guarantee Agency (MIGA), established in 1988, which provides insurance against certain types of risk, including political risk, primarily to the private sector; and,
- the International Centre for Settlement of Investment Disputes (ICSID), established in 1966, which works with governments to reduce investment risk.

The Bank's mission is to aid developing countries and their inhabitants achieve the MDGs (Millennium Development Goals), through the alleviation of poverty, by developing an environment for investment, jobs and sustainable growth, thus promoting economical growth and through investment in and empowerment of the poor to enable them to participate in development. The World Bank sees the four key factors necessary for economic growth and the creation of a business environment as:

1. Capacity Building – Strengthening governments and educating government officials
2. Infrastructure creation – implementation of legal and judicial systems for the encouragement of business, the protection of individual and property rights and the honoring of contracts
3. Development of Financial Systems – the establishment of strong systems capable of supporting endeavors from micro credit to the financing of larger corporate ventures
4. Combating corruption – Eradicating corruption to ensure optimal effect of actions

Areas of operation

- Agriculture & Rural Development
- Conflict & Development
- Development Operations & Activities
- Economic Policy
- Education
- Energy
- Environment
- Financial Sector
- Gender
- Governance
- Health, Nutrition & Population
- Industry
- Information & Communication Technologies
- Information, Computing & Telecommunications
- International Economics & Trade
- Labor & Social Protections
- Law & Justice
- Macroeconomic & Economic Growth
- Mining
- Poverty Reduction
- Poverty
- Private Sector

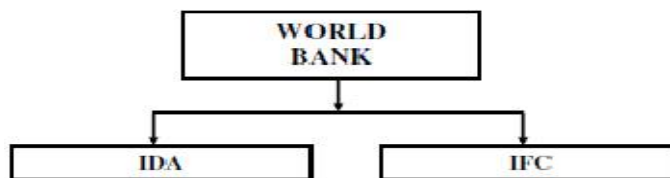
- Public Sector Governance
- Rural Development
- Social Development
- Social Protection
- Trade
- Transport
- Urban Development
- Water Resources
- Water Supply & Sanitation

IFC

Purpose of IFC is to:

- Promote open and competitive markets in developing countries
- Support companies and other private sector partners
- Generate productive jobs and deliver basic services
- Create opportunity for people to escape poverty and improve their lives

IFC promotes sustainable private sector development in developing countries. Our particular focus is to promote economic development by encouraging the growth of productive enterprise and efficient capital markets in our **member countries**.



IFC invests in enterprises majority-owned by the private sector throughout most developing countries in the world. **Developing regions** include:

- Sub-Saharan Africa
- East Asia & the Pacific
- South Asia
- Europe & Central Asia
- Latin America & the Caribbean
- Middle East & North Africa

The International Finance Corporation has 179 member countries. To join IFC, a country must:

- Be a member of the World Bank (IBRD);
- Have signed IFC's **Articles of Agreement**; and
- Have deposited with the World Bank Group's Corporate Secretariat an Instrument of Acceptance of IFC's Articles of Agreement.

Products and Services of IFC

IFC is a dynamic organization, constantly adjusting to the evolving needs of our clients in emerging markets. We are no longer defined predominantly by our role in providing project finance to companies in developing countries. We have also:

- Developed innovative **financial products**;
- Broadened our capacity to provide **advisory services**; and
- Deepened our **corporate governance, environmental and social** expertise.

Financial Products

- **Loans for IFC's Account**
- **Syndicated Loans**
- **Equity Finance**
- **Quasi-Equity Finance**
- **Equity & Debt Funds**
- **Structured Finance**
- **Intermediary Services**
- **Local Currency Financing**
- **Municipal Finance**
- **Trade Finance**

IDA

The International Development Association (IDA) is the part of the World Bank that helps the world's poorest countries. Established in 1960, IDA aims to reduce poverty by providing interest-free loans and grants for programs that boost economic growth, reduce inequalities and improve people's living conditions. IDA complements the World Bank's other lending arm—the International Bank for Reconstruction and Development (IBRD)—which serves middle income countries with capital investment and advisory services. IBRD and IDA share the same staff and headquarters and evaluate projects with the same rigorous standards.

IDA is one of the largest sources of assistance for the world's 80 poorest countries, 39 of which are in Africa. It is the single largest source of donor funds for basic social services in the poorest countries. IDA lends money (known as credits) on concessional terms. This means that IDA credits have no interest charge and repayments are stretched over 35 to 40 years, including a 10-year grace period.

Eligibility for IDA support depends first and foremost on a country's relative poverty, defined as GNI per capita below an established threshold and updated annually (in fiscal year 2007: US\$1,025). Some countries, such as India, Indonesia and Pakistan, are IDA-eligible based on per capita income levels, but are also creditworthy for some IBRD borrowing. They are referred to as "blend" countries. Eighty-two countries are currently eligible to borrow from IDA. Together, these countries are home to 2.5 billion people, half of the total population of the developing world. An estimated 1.5 billion people there survive on incomes of US\$2 or less a day.

INTERNATIONAL MONETARY FUND

The IMF is an international organization of 185 member countries. It was established to promote international monetary cooperation, exchange stability, and orderly exchange arrangements; to foster economic growth and high levels of employment; and to provide temporary financial assistance to countries to help ease balance of payments adjustment.

The purposes of the International Monetary Fund are:

- To promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems?

- To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
- To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.
- To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade
- To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.
- In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members

IMF LENDING

A core responsibility of the IMF is to provide loans to countries experiencing balance of payments problems. This financial assistance enables countries to rebuild their international reserves; stabilize their currencies; continue paying for imports; and restore conditions for strong economic growth. Unlike development banks, the IMF does not lend for specific projects.

A member country may request IMF financial assistance if it has a balance of payments need—that is, if it cannot find sufficient financing on affordable terms to meet its net international payments. An IMF loan eases the adjustment policies and reforms that a country must make to correct its balance of payments problem and restore conditions for strong economic growth.

An IMF loan is usually provided under an "arrangement," which stipulates the specific policies and measures a country has agreed to implement to resolve its balance of payments problem. The economic program underlying an arrangement is formulated by the country in consultation with the IMF, and is presented to the Fund's Executive Board in a "Letter of Intent." Once an arrangement is approved by the Board, the loan is released in phased installments as the program is carried out.

TECHNICAL ASSISTANCE:

IMF technical assistance supports the development of the productive resources of member countries by helping them to effectively manage their economic policy and financial affairs. The IMF helps these countries to strengthen their capacity in both human and institutional resources, and to design appropriate macroeconomic, financial, and structural policies.

ASIAN DEVELOPMENT BANK

The work of the Asian Development Bank (ADB) is aimed at improving the welfare of the people in Asia and the Pacific, particularly the 1.9 billion who live on less than \$2 a day. Despite many success stories, Asia and the Pacific remains home to two thirds of the world's poor.

ADB is a multilateral development financial institution owned by 67 members, 48 from the region and 19 from other parts of the globe. ADB's vision is a region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their citizens.

ADB's main instruments for providing help to its developing member countries are

- Policy dialogue • loans
- Technical assistance
- Grants
- Guarantees
- Equity investments.

ADB's annual lending volume is typically about \$6 billion, with technical assistance usually totalling about \$180 million a year.

INTERNATIONAL MARITIME ORGANISATION

The Convention establishing the International Maritime Organization (IMO) was adopted in Geneva in 1948 and IMO first met in 1959. IMO's main task has been to develop and maintain a comprehensive regulatory framework for shipping and its remit today includes safety, environmental concerns, legal matters, technical co-operation, maritime security and the efficiency of shipping. Specialized agency of the United Nations with 167 Member States and three Associate Members, IMO is based in the United Kingdom with around 300 international staff.

MEASURES OF IMO

IMO's specialized committees and sub-committees are the focus for the technical work to update existing legislation or develop and adopt new regulations, with meetings attended by maritime experts from Member Governments, together with those from interested intergovernmental and non-governmental organizations. Firstly, measures aimed at the prevention of accidents, including standards for ship design, construction, equipment, operation and manning – key treaties include SOLAS, the MARPOL convention for the prevention of pollution by ships and the STCW convention on standards of training for seafarers. Secondly measures which recognize that accidents do happen, including rules concerning distress and safety communications, the International Convention on Search and Rescue and the International Convention on Oil Pollution Preparedness, Response and Co-operation. Thirdly, there are conventions which establish compensation and liability regimes - including the International Convention on Civil Liability for Oil Pollution Damage, the convention establishing the International Fund for Compensation for Oil Pollution Damage and the Athens Convention covering liability and compensation for passengers at sea.

INTERNATIONAL LABOUR ORGANISATION

The International Labour Organization (ILO) is devoted to advancing opportunities for women and men to obtain decent and productive work in conditions of freedom, equity, security and human dignity. Its main aims are to promote rights at work, encourage decent employment opportunities, enhance social protection and strengthen dialogue in handling work-related issues.

In promoting social justice and internationally recognized human and labour rights, the organization continues to pursue its founding mission that labour peace is essential to prosperity. Today, the ILO helps advance the creation of decent jobs and the kinds of economic and working conditions that give working people and business people a stake in lasting peace, prosperity and progress.

International Telecommunication Union

The ITU is a specialized agency of the United Nations and is the world's oldest international organization.²⁵ In general, the ITU seeks "to promote, at the international level, the adoption of a broader approach to telecommunications issues in the global information economy and society."²⁶ ITU decisions are made on a one nation, one vote basis;²⁷ therefore, each member-nation has equal authority in the ITU decision making process. In part due to this voting policy, developing countries view the ITU as an important organization to provide assistance and aid infrastructure development in these nations

REVIEW QUESTIONS

1. What are the purposes of international organizations?
2. What is the purpose of IFC?
3. What are the products and services of IFC?
4. What are the international development association?
5. What are the purposes of the international monetary fund?
6. What are the Asian development banks?
7. What are the international maritime organisations?
8. What are the measures of IMO?
9. What are the international labour organisations?
10. What are the international telecommunication union?

FURTHER READINGS

1. International Business- Stuart Wall, Bronwen Rees
2. International Business- Aswathappa
3. International Business Environment- Les Dlabay, James Calvert Scott
4. International Business- Thomas L. Friedman
5. International Business- Leslie Hamilton, Philip Webster

UNIT-12 INTERNATIONAL LOGISTICS

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- ❖ Introductions
- ❖ Importance of Logistics Management
- ❖ The Role of Depots and Warehouses
- ❖ Procurement
- ❖ Transport Mode and Characteristics
- ❖ Review Questions
- ❖ Further Readings

INTRODUCTIONS

Logistics is defined as a “system of handling the physical movement of goods and services from the place of origin to the destination as fast as possible at a low cost and with safety and security.” Logistics provides the means for the actual transfer of goods or services from the seller to the buyer. Once a product or service has been marketed and ordered, it is necessary to employ logistics to pack, deliver and manage the items for delivery. In order to be effective, logistics must address the following issues. Distribution has always been an important and inevitable function, but it is only relatively recently that it has been recognized as a major function in its own right. The main reason for this lapse was probably been the nature of distribution itself. It is a function made up of many sub-function and subsystems, each of which has been, and may still be, treated as a distinct management operation.

Both the academic and the business world now accept that there is a need to understand all the operations in a global perspective in order to see how they are interrelated.

Logistics primarily involves three broad areas of functions. Logistics = Supply + Materials Management + Distribution (L = S + M + D)

Logistics is an art and science of determining business success. Acquiring goods, distributing and finally maintaining them to win the goodwill of the customer is the major responsibility of logistic management.

Importance of Logistics Management

In advanced countries a large part of the final price of a product often goes towards logistics. In the case of bulk cargoes like sulphur, Bitumen, grains, iron ore and crude, the cost of logistics is the main factor in fixing the price. Major turnkey projects, can be completed provide the right materials are supplied in the right time. During an emergency, thousands of lives may be lost if medicines do not reach in time. Therefore, logistics is the management of cost and time. Hence, the UK Institute of Logistics and

Transport has defined logistics as “the positioning of resources at the right time, in the right place, at the right cost and in the right quality”. Logistics is an important activity making extensive use of human and material resources that affect the national economy.

A study indicated that about 30 % of the working population in the United Kingdom is associated with work that is related to logistics. Another such study undertaken by Michigan State University in the USA and reported in the Financial Times indicated that logistics alone represented between 10 % and 15 % of the gross domestic product of most important element at 46%, followed by storage/warehousing at 22 %, inventory carrying at 20 %, and administration at 12 %.

Logistics and Interrelationship with other functions

Value addition

Attitude towards distribution and logistics has changed over the past two decades. For a long time the view prevailed that various elements within logistics created additional cost for companies. Although there is a cost associated with the movement and storage of goods, it is now recognised that distribution and logistics contribute to the value of a product. This is due to the fact that logistic operations provide the means by which the product reaches the consumer or end user in an appropriate condition at the required location.

Dell supplies a laptop within sixty minutes in the US, from the moment order is placed. Honda Motors delivers car in Europe and North America in ten hours. Many mail order companies use logistics as a major weapon to win the market today. It is therefore, possible for companies to compete on the basis of providing a product either at the lowest possible cost so that the customer will buy it, because it is the least expensive or at the highest possible value to the customer. Few companies may try to achieve both these objective such as Hyundai Motors, LG in rural India and Electrolux in Europe. This is particularly important today as there are many products that are not sold on the basis of their brand name alone, but also on the basis of availability or price. This applies to many food products as well as technical products such as mobile phones and personal computers. Sony, Hitachi and Samsung are very strong in adding value through low cost of distribution.

The role of depots and warehouses

Companies like Sony, Johnson & Johnson, Asian Paints, HP and Sansui have succeeded through establishing depots and warehouses wherever they operate. There are many reasons why depots and warehouses are required; the main reasons are given below:

- To keep down production costs by allowing long production runs, thus minimising the time spent on machine set-ups.
- To match demand and requirements with production capabilities, to smoothen the flow and assist in operational efficiency.
- To enable large seasonal demands to be catered for more economically.
- To provide good customer service.
- To allow trade off with the transport systems
- To facilitate order assembly.

In addition, it should be noted that there are a number of different types of depots each of which might be considered in the planning of the physical distribution structure. These might include:

- Finished goods depots/ warehouses – these hold the stock from the factories.

- Distribution centers which might be central, regional or national or local depots – all of these will hold stock to a greater or lesser extent.
- Transshipment depots or stockless, transit or cross decking depots – by and large, these do hold stock but act as intermediate points in the distribution operations and selected orders to customers.
- Seasonal stock holding depots.
- Overflow depots.

Asian Paints emerged as a market leader in India by setting up warehouses all over the country, which led to effective distribution. Other well-known companies like ICI, Berger, Shalimar, Nerolac etc. compete with Asian Paints.

Cost relationships

The major cost relationships are discussed, starting with storage and warehousing. The major cost breakdown is outlined below, with the percentage values indicating the approximate relative importance of the different factors based on conventional warehouses.

Percentage

- I. Building costs including rent, furnishing and depreciation
- II. Building services, such as heating and lighting
- III. Equipment related
- IV. Labour overheads
- V. Management, supervision and security

Procurement

Procurement is one of the key links in the supply chain. It can have a significant influence on the overall success of the organisation. Ensuring that there is a sufficient supply of raw materials of the required quality, at the right price, in the right place at a right time is obviously crucial to any manufacturing plant. Over the years many organizations have developed large departments to deal with the sheer weight of supplier transactions. Recently, many companies have reduced the number of suppliers in order to reduce the cost of transactions. Single entity takes the responsibility and committed to supply many product lines required by customers. In addition to supplier reduction programmes many companies have moved away from the traditional adverse relationship with suppliers. Companies practice cooperation and coexistence concept wherein the buyer is also part of supplier. This style of relationship recognizes that both the parties need to make a profit to survive.

Procurement is not just about raw materials. The following goods and services also need to be acquired:

1. Utilities like gas, water, electricity and telephones
2. Fuel including diesel and petrol
3. Capital assets such as machinery, vehicles and buildings
4. Stationery
5. Consultancy services
6. Outsourced services such as distribution contracts, IT services etc.
7. IT equipment, e.g., hardware, software and support systems.

Very large sums of money are involved in the above areas. Depending on the nature of business of the organization concerned, emphasis will be placed on different elements. For a transport company, fuel may represent as much as 35% of the total operating budget, but for a

manufacturing plant the major costs may be running costs of the plant. These costs need to be carefully managed.

TRANSPORT MODE AND CHARACTERISTICS

Sea Freight

There are two main container loads in sea freight namely (i) the conventional load (ii) unit load. Both are applicable in the present practice. The main features in conventional sea freight are:

(i) Conventional Load Cost

For some products, the most economic means of carriage remains that of conventional sea freight. This particularly applies to bulk goods like rock phosphates, boilers and transmission equipments that are being transported to large distances. Where speed of service is unimportant, the lower cost of sea-freight makes it very competitive.

Flexibility: There are many liners and tramp ships available in many ports in the world. In addition to this, sailings are quite frequent making sea transport quite flexible in terms of the alternatives that are quite open. **Availability:** Liner services are widely advertised and extensively categorised and most types of cargo are categorised. **Speed:** Sea freight tends to be slow for several reasons, which include the turnaround time in the port and inefficient handling methods. This is specially true when compare to the more conventional “through transport” systems with which sea freight must compete. The problem is particularly apparent on some of the short sea routes.

(ii) Unit Load (Container System)

Container is a metal box having the unit 1 x 20 feet. These boxes ensure safety, security, reliability and easy mobility during transit and at the time of handling both at the port of discharge and destination. Container systems can now be viewed as a specialised mode of freight transport although the container is now a fundamental feature of all major national and international transport modes, whether rail, sea, road or air. Containers facilitate what is known as the ‘intermodel’ system of freight transport enabling the smooth movement of goods in bulk, from one transport mode to another.

The main attributes of containers and containerization are as follows:

- They enable a number of small packages to be consolidated into large single unit loads.
- There is a reduction in the handling of goods as they are distributed from the point of origin to the point of destination.
- There is a reduction in individual packaging requirements, depending on the load within the container.
- There is a reduction in damage to products caused by other cargo.
- Insurance charges are lower due to the damage potential is reduced.
- Handling costs at the docks and other modal interfaces are reduced.
- Turnaround time is faster for all types of transport used. Port utilization also improves.
- The all round delivery time is faster and hence service levels are better.
- Documentation is much simpler – this applies to both company and custom documentation.
- The concept of ‘through transit’ become feasible and allows a truly integrated transport system to be developed.

- The systems that were developed in the early days of containerisation, have been integrated across the different modes. This has considerably improved transportation in recent years.
- There is a need for special facilities and handling equipment, which are expensive. Thus, only a limited number of transfer points are feasible.
- The initial cost of the containers is quite high.
- Trade is seldom evenly balanced. Very often return loads may not be available and so the cost increases.
- Containers may leak, thereby causing damage due to rain or sea water.
- Loads may be affected by the position in which they are stowed, e.g., above or below deck.

Storage System

Ways to classifying storage systems are given below:

- Bulk storage for solids such as silos, bunkers and stockpiles.
- Loose items storage, e.g. casting and fabrications held loose on the floor.
- Pallet storage systems
- Small item storage for individual items or small unit loads.
- Non-standard unit loads such as loads.

Stock Location

The location of stock within a store is an important aspect of stock management and can be considered at different levels. For example, the placement of stock within a warehouse will affect the effort required to move material in and out of the warehouse. It will also affect the efficiency of selecting orders, as this depends on the distance employees have to travel to get the required stock.

At another level, it is important to locate certain stocks so that they can be easily lifted and handled by the operator. For example, items that have to be lifted mechanically should be stored at ground level for lifting and using material handling equipments. Fast moving product lines that have to be accessed frequently located at a level for optimum operator arm movement, i.e. neither too high or too low.

REVIEW QUESTIONS

1. What is the importance of logistics management?
2. What is the role of depots and warehouses?
3. What are the characteristics of transport mode?
4. What is the role of depots and warehouses?
5. What are logistics and interrelationship with other functions?

FURTHER READINGS

1. International Business- Stuart Wall, Bronwen Rees
2. International Business- Aswathappa
3. International Business Environment- Les Dlabay, James Calvert Scott
4. International Business- Thomas L. Friedman
5. International Business- Leslie Hamilton, Philip Webster

UNIT-13 INTERNATIONAL TRADE THEORIES

INTERNATIONAL TRADE
THEORIES

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- ❖ Introductions
- ❖ The Theory of Absolute Advantage
- ❖ The Theory of Comparative Cost Advantage
- ❖ Modern Theory Of International Trade: The Heckscher-Ohlin Theory
- ❖ Purchasing Power Parity And Impact On Trade
- ❖ Purchasing Power Parity
- ❖ Theory of Product Life Cycle
- ❖ Review Questions
- ❖ Further Readings

INTRODUCTIONS

Many renowned economists have carried out considerable research on scale of economies, productivity of the work force and advantages of resources, which certain countries are endowed with. The theories formulated by them were accepted by the contemporary economies. European industrialization, the emergence of the United State as a major power and rapid colonisation were the three major international developments during the era of classical economic theories. Today, these factors have lost their relevance. The revolution taking place in communications, transportation and banking makes every country resourceful if they formulate proactive policies. The diminishing importance of borders between countries has enabled many entrepreneurs to shift their manufacturing base anywhere in the world, invest their money in safe destinations and explore the resources at any point of time. Therefore, the theories of absolute advantage, comparative advantage are not really applicable in current international business operations.

To build a large mansion and an action plan, a strong foundation is a prerequisite. To establish a large international business, conceptual base is important. Trade theories and their impact in every aspect of operation are idely viewed as major inputs by organizations around the world.

However, it is important to understand, interpret and modify these concepts and apply them to current practices in business, especially the functions of labour productivity, resource exploration and demand forecasting.

THE THEORY OF ABSOLUTE ADVANTAGE

The classical theories of international trade that were propounded by Adam Smith, David Ricardo, John Stuart Mill and others were based mainly on differences in the cost of labour between different nations. Among the classical theories, the most discussed theory was the theory of 'Absolute Advantages' put forward by Adam Smith, which was widely accepted and relevant during his contemporary era.

Adam Smith was a champion of free trade and he claimed that free trade always leads to better division of labour and thereby encourages

specialization both in national and international markets. He advocated that every country is specialized in certain production function and ultimately will be able to enjoy the benefits. Countries can exchange the products they produce at a lower cost with each other. He remarked that, "it is the wise decision of every prudent master never to make goods at home, which will cost him more, but to buy them, which is cheaper". For example a cobbler does not attempt to make his own shoe, but he buys them from the shoemaker and vice versa. An individual select the occupation for which he thinks himself best fitted. Similarly, every country tries to specialise in the production of those commodities, in which it enjoys greater advantages e.g, Malta produces glass. China produces soft toys, South Korea produces synthetic fibres, and India produces metal ware and Myanmar produces good quality timber, The theory of absolute advantage can be explained with the help of an example, consider two countries A and B, each in which produces two different types of goods, namely X and Y. With one unit of labour, country A can produce either 20 units of commodity X or 10 units of commodity Y. On the other hand, with one unit of labour, country B can produce either 10 units of X or 20 units of Y. This clearly shows that country A has an absolute advantage in the production of goods of the type X and country B has an absolute advantage in the production of goods of the type Y. In this case, trade between countries A and B will be mutually beneficial, as with two units of labour, A can produce 40 units of X and B can produce 40 units of Y, i.e 80 units of X and Y between them. On the other hand without international trade, they can produce only 60 units of X and Y between them with the same amount of labour. Thus country A should specialize in the production of X by using all the available labour, which country B should devote its labour for the production of commodity Y. In China one unit of labour produce three soft toys per day, whereas, in India, one unit of labour can produce only 1.5 soft toys per day, At the same time one unit of labour in India cuts and polishes 10 carats of diamond a day whereas in China it is possible to achieve only 6 six carats a day with the same amount of labour.

In the above example the main factor is labour, In today's era of inventions and innovations, automation, outsourcing and cost reduction, and mass production, the theory of absolute advantages does not have much relevance.

The major drawback of the theory of absolute advantage is that it fails to explain the fact that even less developed countries, which have no real absolute advantage in any commodity are engaged in the export of goods. The limitations and shortcomings of this theory are given below:

1. It has not advocated quality, premium and brand aspects of a product.
2. It has restricted itself only to considering the maximum to labour force.
3. It has failed to take into account the fact that many cost reduction techniques are adopted in mass production.
4. There are many duties applicable when goods enter into other countries, which have not been accounted for.
5. The nature of the commodity may incur huge transportation costs, which may be even greater than the cost of the labour.

The theory of international trade, based on absolute cost difference is not fully applicable in the current century, although it was an acceptable concept during the period when industrialization was catching up in Europe during the time of Adam Smith. Another theory, the theory of comparative cost advantage was therefore evolved as the basis for international trade.

THE THEORY OF COMPARATIVE COST ADVANTAGE

It was David Ricardo, one of the prominent classical economists, who propounded the theory of comparative cost advantage or the theory of comparative advantage. He argued that it was the comparative difference in cost that led to trade between two nations. According to him, each country would specialize in the production of a commodity in which it has a comparative advantage in cost. The country should export these commodities and import those commodities that it produces at a higher comparative cost. The theory of comparative advantage is based on certain underlined assumptions given below:

- a) There should be two countries that produce the same two commodities.
- b) Labour is the only factor applied in production. It is assumed that the supply of labour is given and fixed. Also, the labour force is assumed to be homogeneous.
- c) Cost of labour, i.e, wages determine the price.
- d) Production is subject to the law of constant returns.
- e) There is no change in taste and preference of the people.
- f) No change in technology is expected.
- g) Factors of production are perfectly mobile within two countries but are not freely mobile between the countries.
- h) There is no transportation cost.
- i) There is full employment of factors in both the countries.
- j) There is homogeneity in consumption, buying behaviour and affordability.

Based on the above assumption, Ricardo showed that two countries could indulge in trade even when one of them has an absolute advantage in production of one of the two commodities vis-à-vis the other country.

Ricardo explained the theory of comparative advantage with the help of the example given below.

Suppose the two countries viz. England and Portugal produce two different types of goods say wine and cloth, whose labour costs in terms of man hours required for unit of production are as follows:

Country Wine Cloth

England 120 100

Portugal 80 90

It is very clear from the table that Portugal has to expend less labour as compared to England in the production of both the commodities. Thus Portugal has an absolute cost advantage in both the goods while England has an absolute cost disadvantage in both of them. But Portugal would benefit by producing wine and exporting it to England in return for cloth as it has a comparative advantage in the production of wine. This is due to the fact that the relative cost of producing a unit of wine (80/120), is

less than the relative cost of producing a unit of cloth (90/100). On the other hand, England has the least comparative disadvantage in the production of cloth, whose relative cost (100/90) is less than relative cost of wine (120/80). Thus Portugal should concentrate more on the production of wine whereas England should concentrate on cloth, thus benefiting both countries. Ricardo explained the principle of comparative cost in international trade, but did not explain the determination of the terms of trade i.e. the rate at which one commodity will be exchanged for the other. Since the ration of exchange, say wine for cloth would be the same for both the countries after they enter into trade, it must be somewhere between domestic exchange ratios of the two goods within each country. Since wine is costlier in England than cloth, as it takes more Labour to produce wine than cloth, the exchange ratio in England would be 1 unit of wine = $120/100 = 1.2$ units of cloth. On the other hand, cloth is costlier in Portugal as it takes more labour to produce cloth than wine. The exchange ratio would be 1 unit wine = $80/90 = 0.89$ units of cloth. So the international rate of exchange of wine for cloth would thus be settled somewhere between 1 unit of wine = 1.2 units and 0.89 units of cloth. Assuming that the rate is established at 1 unit of cloth = 1 unit of wine, England would gain because at home the ratio was 1.2 units of cloth for 1 unit of wine. Portugal would also gain because at home it could produce only 0.89 units of cloth for 1 unit of wine. Thus, with international trade both the countries will benefit. On the same lines Spain produces chicken and Chile produces wine at lower cost; Australia produces wool made ups and Singapore produces edible oil at relatively low cost; Malaysia produces rubber products at a low cost compared to knit wear, which Indonesia produces at a lower cost compared to rubber. In the latter case both countries are situated close to each other and hence it would be a distinct advantage for Malaysia to focus on rubber and supply it to Indonesia and for Indonesia to focus on knit wear and export it to Malaysia.

An important implication of theory of comparative cost is based on the principle of complete specialization. According to above example, England should specialize in the production of cloth and Portugal in the production of wine. Each country would produce only goods in which it has a comparative advantage and trade the surplus of production with other countries. The underlying basis of complete specialization is that the comparative advantage is permanent, irrespective of the scale of production in both countries- Ricardo assumes the production is subject to the law of constant returns i.e. the cost per unit of output would remain the same whatever be the scale of production. He also assumes that a permanent supply of raw material and other consumables associated with the product are available,

e.g., if wine is to be produced, grapes should be available all the times with no price fluctuations. Obviously, this cannot be the case and the availability of raw material (in this case grape) would affect the cost of the end product. This aspect of the theory has been criticised as the comparative advantage may only exist for a given range of production, sooner or later the law of increasing costs will come in to operation and the advantage may turn in to a disadvantage. Hence, countries do not

specialize completely and specialization also changes in many countries due to multifarious reasons. The major limitations of the theory are as follows:

1. Theory of comparative advantage is based on the value of the labour. It considers labour as the only factor of production and assumes that all labour is homogeneous. However, labour does not alone produce goods; there are other factors, such as availability of raw materials that have been ignored. Further, labour units are not homogeneous as there are different grades such as skilled, unskilled, semi skilled, efficient; less efficient etc. hence the whole theory is unrealistic.
2. The assumption that labour is used in same fixed proportions in production of both the goods in both the countries is too simplistic. In fact, labour is used in varying conditions in producing different goods, as some goods are more labour intensive than others, e.g., cotton becomes yarn, yarn becomes grey; grey becomes fabric and fabric is turned in to garments. It is difficult to verify the cost of labour at each stage.
3. The theory assumes constant labour costs even output of goods increases due to specialization under international trade. But in reality the cost may either increase or decrease as a greater quantity of goods are produced in the wake of trade. If costs decline with increased production, comparative advantage will be larger and vice versa. The theory does not take in to account these changes in costs.
4. Ricardian theory is based on the assumption that factors of production are mobile within the country but are immobile internationally. The theory advocates uniform wages in a particular country. Practically, however wages differ between one region and another in the same country and between one industry and another within the same country. Within the country, wages are very high in urban areas and lower in the interior areas. In USA, India and Australia, local transportation costs are than freight rates to neighbouring countries. These costs are not considered in the Ricardian theory.
5. The theory is one sided as it considers only the production costs, i.e., only the supply side. The demand factors that affect the price of goods and through them the prices of the factors of production are not taken in to account. This negligence of demand factors renders the theory incomplete and liable to providing wrong conclusions. However, in spite of these weaknesses, Ricardo's theory of comparative advantage is accepted as the basis of international trade. This is due to the fact that the theory provides a sound rationale for exchange of goods between two trading nations. Improvements have no doubt been made in the theory, but these mainly related to the factors that give rise to comparative advantage. The basic principle of trade viz, that a country should export goods in which it has comparative advantages and import those goods where its comparative advantage is the least, still holds good.

MODERN THEORY OF INTERNATIONAL TRADE: THE HECKSCHER-OHILIN THEORY

The classical theory of comparative advantage was based on a model where labour was the only factor considered in production and differences in labour productivity were regarded as the cause for differences in comparative cost and international trade. In 1993,

Heckscher and Ohlin took the Ricardian model and conceptualized further by thinking the source of a country's comparative advantage through the endowment of its factors of production. It was Eli-Heckscher who put forward the idea that international trade results from the fact that different countries have different factor endowments i.e., a few countries have more capital than labour while others have more labour than capital. These differences in factor endowments are the cause of comparative cost differences. Bertil Ohlin further refined this theory and formulated what are known as the 'general equilibrium theory', 'factor proportion theory', which is commonly known as the 'modern theory of international trade'. The theory states that the production patterns and trade among various countries are determined by the difference in factor endowments. The country that has abundant capital will produce and export capital intensive goods, and the countries with abundant supply of labour will produce and export labour intensive commodities. The main cause of differences in relative availability of factors of production or the difference in factor endowments.

Assumptions of Heckscher-Ohlin Theory

1. The theory is based on a $2 \times 2 \times 2$ model. It takes in to consideration that there are two countries, two commodities and two factors of production.
2. Transport costs or other impediments to trade are not taken in to account. This assumption applies that the prices of commodities under trade will be the same in both the countries.
3. The Theory assumes the existence of perfect competition in both the commodity and factor markets. This implies that both capital and labour are perfectly mobile in respective country, and would move from low paying industries in to high paying ones. Perfect competition in the commodity market implies that neither a monopolistic nor oligopolistic environment prevails.
4. All production factors are homogeneous in degree, specially it expects returns to scale in production of each commodity in each country. For example a 10 percent increase in factor inputs in each industry results in exactly 10 percent output in that industry.
5. The production functions are such that the two commodities show different factor intensities. This means that different combinations of factors or production techniques are used in different industries. The goods 'Y' may be capital intensive while the goods 'X' may be labour intensive. Goods that are labour intensive will always remain labour intensive irrespective of relative changes in the price of labour.
6. The production function differs between two commodities but nevertheless remain same in both the countries. Thus the production techniques and factors intensity used in producing goods 'Y' in country A is the same as that is used in producing goods 'X' in country B. the same is true about production function for goods 'X' in country A and B. This implies that the best available techniques are known to both the countries and are used in the price of labour.
7. The theory assumes that full employment resources exists in both the countries so that production takes place on the same point on the production possibility curve and not somewhere below it.

8. It also assumes that preferences and technology levels do not change. Practically, technology has become accessible to anyone both indigenous and internationally. Germany, Japan and USA have proved their high levels of technology in medical equipments, entertainment electronics and chemicals & drugs respectively. Today, productivity is directly proportionate to technology. Based upon these assumptions, the Heckscher-Ohilin theory demonstrates the proposition that capital rich countries export capital intensive goods and labour rich countries export labour intensive goods.

There are two alternative ways of defining whether a country is capital or labour intensive. The first way, known as capital abundance is based on factor prices and states that a country A is capital rich as compared to country B if capital is relatively cheaper in country A than in country B.

Thus the abundance or scarcity of a factor is identified on the basis of factor price. The second way compares the overall physical amount of labour and capital in two countries. For example, country A is said to be capital rich if ratio of capital to labour is larger the ratio in country B.

Logically, country B will be labour rich if its ratio of labour to capital is larger than in country A.

a. Capital abundance – based on factor price ratio orientation; According to the criterion of factor price, country A is abundant in capital compared to country B if,

$PAK < PBK$ where;

$PAK = PBL$

PAK – price of capital in country A

PAL – price of labour in country A

PBK – price of labour in country B

PBL – price of labour in country B

The above equation shows that capital is relatively cheap in country A and labour is relatively cheap in country B. Hence we can say that country A is a capital rich and country B is a labour rich one. According to the Heckscher-Ohilin theory, the capital rich country A would export capital intensive goods and labour rich country B would export labour intensive goods. This proposition can be explained by following diagram;

In the figure, we have two isoquants YY and XX showing the production of one unit each of goods 'Y' and goods 'X' in each one of the two countries. These isoquants are common to both countries showing that production functions are same in both countries. According to these isoquants, goods 'Y' are capital intensive and goods 'X' are labour intensive. Country A is rich in capital and hence capital here is cheaper relative to labour, which is shown by the relative factor price line AA. On the other hand, country B is labour rich and hence the relative price of labour is low, a fact shown by the relatively flatter factor price line BB.

Consider country A whose factor price line AA is tangential to the isoquant YY at the point E. Since the isoquant YY represents one unit of goods 'Y', we find that in country A, one unit of goods 'Y' can be produced with OR of capital and OS of labour, the factor price ration line shows the rate at which one factor can be exchanged for the other. Thus

on the factor price line AA, with points A and E being on the same line, OS of labour is worth RA of capital and OR of capital is worth SA of labour. As we have seen, the cost of producing one unit of goods 'Y' is equal to OR of capital plus OS of labour. It is found that OS of labour, we find that the cost of producing one unit of goods 'Y' is equal to OR of labour SA of labour which has been substituted for OR of capital which is equal to OA of labour. By the same reasoning, the cost of producing one unit of goods 'X' in country A is OK of capital plus KA of capital (because OL of labour is worth KA of capital) and hence equal to OA of capital. In terms of labour alone, this cost is equal to OL of labour plus LA of labour (because OK of capital is worth LA of labour) and hence equals OA of labour.

Now, let us examine the cost of producing one unit of both types of goods in country B. Since country B is labour rich and therefore labour is relatively cheaper here, the factor price ratio line BB is flatter than AA. This price line BB is tangential to the isoquant YY at the point F. This shows that the cost of producing one unit of 'X' in country B in terms of capital alone. To find this we draw a price line CC parallel to and below the price line BB in such a way that it is tangential to the isoquant XX at point the H. The price line CC represents the same factor price ratio as the line BB as the two are parallel. At point H the cost of producing one unit of 'X' in country B is OM of capital plus ON of labour. Since on this price line CC, ON of labour corresponds to MC of capital, the price of one unit of 'X' is equal to OC of capital in country B. Thus, in country B the cost of producing one unit 'Y' is OB in terms of capital while for 'X' it is OC in capital alone. Hence in country B it is more expensive to produce 'Y' than to product 'X' in the same quantities as $OV > OC$.

The above analysis shows that country B has a cost advantage in production of 'X' and it is relatively cheaper to produce 'Y' in country A. This fact establishes the Heckscher-Ohlin theory, that a country abundant in capita will export capital intensive goods and a country abundant in labour will export the labour intensive goods.

One of the major drawbacks of this analysis is that it defines factor abundance in terms of factor prices. This is not free from flaws due to the fact that factor prices do not depend on abundance or scarcity of factor supplies alone, but they are also influenced by demand factors. It is therefore, not possible to say anything about factor prices on the basis of factor endowments alone. It would thus be more fruitful to study factor abundance in terms of physical amounts of the factors available in two countries.

b) Suppose country A has more capital than labour, and country B has more labour than capital. Taking into consideration the differences in factor endowments, we can draw a production possibility curve of these two countries (AA1 of country A and BB1 of country B) with respect to the goods 'X' and 'Y' of which 'X' is labour intensive and 'Y' is capital intensive. This is shown in the following diagram.

The resources endowment in county A is such that with the given total resources of labour and capital, it can produce more of capital intensive goods of 'Y' over 'X'. Similarly, country B can produce more of labour intensive goods 'X' than capital intensive goods 'Y' and thus has an

advantage in the production of 'X'. The production possibility curve AA1, of country A shows relative abundance of capital while the production possibility curve BB1 of country B shows relative abundance of labour. Thus country A will have a bias towards the production of capital intensive goods 'Y' while country B will be more inclined to produce labour intensive goods 'X'.

The nature of this bias is illustrated in the diagram. If both countries produce both the goods in the same proportion, it will be represented by the ray OR. The production of country A will be represented by the point S while that of country B will be represented by point S' on their respective production possibility curves. The slope of country A's production possibility curve at S' is steeper than the tangent P1P1 than the slope of the production possibility curve of country B at point S shown by the tangent P2P2. This implied that good Y is cheaper in country A than in country B and that good X is cheaper in country B than in country A.

As it is clear from the respective price lines P1P1 and P2P2, the operating cost of expanding production of goods Y is lower in country A than country B and vice-versa for good X.

This shows that the capital rich country A has a bias in favour of capital intensive goods Y and the labour abundant country B has a bias in favour of prevailing Labour intensive goods X.

PURCHASING POWER PARITY AND IMPACT ON TRADE

The estimates of per capita income in various countries are not strictly comparable because they are based on conversion of per capita income of a country as measured in its local standard money unit (the rupee in India) to a common currency denominator (US \$ in this case), the conversion being based on the official exchange rates. The official exchange rates do not reflect the purchasing power of different countries in their respective countries. Thus, India may have had a low per capita income e.g., US \$ 420 in 2002 can buy in the USA due to relatively lower prices in India. Hence, the comparison of national and per capita incomes do not reflect the true value or purchasing power or command over goods and services in their respective countries.

A change in exchange rate will also change the per capita income of a country as expressed in foreign currency. For example, when India devalued its currency against the US dollar, even when there was no change in the economy. This is illustrated by the following example:

The practice of devaluation and depreciation of local currency against the US \$ was very common in all developing countries and less developed nations, over the past two decades. Surprisingly, for the first time, Indian rupee is appreciating against dollar in 2007.

The competitive advantage of Nations

Competition is a challenge posed by any goods or service with equal or extra benefits, which cause the company or country to lose its share of business. Competition may come from the home country, host country or a third country. It may come from the same range of products or through outstanding technology or cost effective substitutes. Many companies devote considerable time and energy facing or managing competitors. As

far as nations are concerned, they consolidate their resources and move ahead, withstanding competitors and prospering in international trade. To prove such consolidating forces Michael Porter developed a model, which was applicable during the second half of twentieth century.

He conducted a comprehensive study of ten nations to learn about the factors that lead to success and the “five forces” influencing strategy. None of the five forces were new and were in fact known to people around the world. Porter advocated the conversion of these five forces in to a main competitive force that would enable a country to succeed in world trade. By ‘success’ he means that a country should be the centre of production for a particular item. This implies that for a given quality of goods, production costs must be the lowest.

However, he does not believe low production costs are solely due to comparative advantage. Sustaining comparative advantage depends on the ability to produce more with a given level of inputs. This in turn is based on innovation and upgrading of products, production processes and management.

Forces influencing Competitiveness

This model determines the competitive environment as being determined by the following forces:

1. The power of buyers, and how much leverage they have in determining the price.
2. The power of suppliers, and the competition among suppliers which determines the price of inputs to the firm.
3. The threat from potential new entrants in to the industry i.e. the degree of market contestability.
4. The threat from substitute products.
5. The degree of competition (rivalry) in the industry.

Porter’s Diamond – Four Determinants of National Competitive Advantage

1. Factor conditions: The basic factors are labour, land, natural resources, capital and infrastructure. Porter argues that advance factors including communications, infrastructure, sophisticated and skilled labour, research facilities and technological know how are created and most important for competitive advantage.

2. Demand conditions: The character of the home market demand shapes the way in which a company responds to the needs of the buyer. Nations can gain competitive advantage if sophisticated and demanding buyers provide a clear picture of buyer needs and demand innovations and product improvement.

3. Related and supporting industries: The existence or absence of internationally competitive suppliers. Their existence provides:

- a. Lower transportation costs
- b. Lower communication costs
- c. Firm strategy, structure and rivalry

4. Inferences: No single management system is universally appropriate. Domestic Competition spurs innovation.

The diamond as a system: The points on the demand constitute a system and are self re-in forcing.

1. Domestic rivalry stimulates the production of specialized intermediate goods. Suppliers of these goods can grow and realize economies of scale, and may become potential competitors of the firms they supply. They will enhance inter-firm rivalry.
2. Domestic rivalry also leads to specialized pools of labour, e.g., computer scientists in Silicon Valley.
3. Keen domestic competition leads to more sophisticated consumers who come to expect innovation and up gradation. It facilitates the development of supplier industries. The diamond promotes geographic clusters of competitive industries.
4. This leads to localized industries with numerous final goods producers, supporting firms and specialized labour. Positive feedback flows throughout.

How the Diamond Works: the Italian ceramic industry

Italian producers located near the small town of Sassuolo accounted for 30% of the total world production of ceramic tiles and 60% of their exports, constituting an industry of US \$ 10 billion.

Rebuilding and reconstruction activities after World War II led to a strong demand for tiles, especially in Italy as they were well suited to the climate and taste of the people. This led to the following steps:

1. A local pool of trained workers; engineers, designers, technician and maintenance workers etc, was formed.
2. Companies producing kilns and presses were started to replace imported items with local products. This was facilitated by the local need to modify imported equipments.
3. Retail outlets and specialized showrooms were established throughout Europe.
4. The Italian market was the most sophisticated due to familiarity with the product. This led to demand for better products by the customers.
5. Intense rivalry was fueled by geographic proximity.
6. Disadvantages in labour costs led to continuous process, production and automation.
7. Exports were facilitated by the existence of an industry association that promoted the product abroad. Advertising by the individual companies also promoted a positive image.

The same kind of competitiveness can be seen in the following countries with respect to specific products:

1. Cut flowers – Netherlands
2. IT – India
3. Soft Toys and ceramics – China
4. Rubber products – Malaysia
5. Glasses – Malta

Implications for business

1. Locations Implications: One direct implication is that firms should concentrate production in the country with the best diamond in the industry. This seems to rule out geographic separation of assembly and manufacture of parts, (the diamond works when these two ‘points’ are in same country). However, Porter acknowledges that a firm may want to source some materials and some components overseas.
2. First mover advantages: There are a number of advantages associated with early entry in to an industry. The firm that enters first are likely to

gain customers loyalty and access to distribution channels. Moreover, first mover may enjoy economies of scale. To the extent that diamond is mutually reinforcing, early advantages might snowball.

Implications for the government

1. An early lead in an industry is reinforced through the dynamics of the diamond.
2. The government should also focus on creating specialized factors such as education, apprenticeship, promotion, support for basic research, high quality infrastructure etc.
3. The government should limit direct cooperation among industry rivals. A recent trend is cooperative research ventures. While these may provide benefits for developing broad-based technology on a limited basis, they will blunt the motivational force of strong rivalry.
4. The government should enforce strong domestic anti-trust policies. While strategic alliances and mergers have become popular, they undermine vigorous competition. If we supply this model to the Indian automobile industry, IT industry, gem and jewellery industry, we will see the current advantages and the decisions necessary to be taken, for them to have a competitive edge over their competitors in the world.

PURCHASING POWER PARITY

The PPP was formulated by Gustan Cassel in the year 1920, when inflation was high. It represents a synthesis of the work done by economists like David Ricardo, Wheatley and Henry Thornton in the nineteenth century. The theory puts forward the idea that when currencies are exchanged among nations, their purchasing power is only transferred. This means that we should be able to buy the same amount of goods in either country, when expressed in either country's currency because people value currencies for what they pay. The theory suggests that the principle determinant of exchange rate is the difference in National Inflation Rates. This means, a country, where costs and prices are relatively less than other country will find its currency appreciating. The sole focus on inflation differentials among countries is the dominant factor that explains the movements in the exchange rates and also indicates why the spot rate is what it is at a given point of time. The law of one price is usually the basis to interpret the theory. According to this law, after making allowances for tariff and transport costs, the price of the goods in one country should not significantly differ from that in another country. Mathematically, this can be expressed as:

$$P = e.P^* \text{ ----- (1)}$$

Where, P is the price of a product in the domestic country. P* is the price of the same product in foreign country. E is the domestic currency price of the foreign currency. Thus if an item costs USD 1 in USA and its price in India is Rs. 45.50 then thus the exchange rate is 45.50 to USD 1.

Equation (1) can be written as $e = P/P^*$

Further if P and P* can be interpreted as the domestic and foreign index, representing the respective inflation figures; the exchange rate becomes a ratio of the (relative) price level (or inflation rates) in the two countries. An important application of the PPP theory is that the nominal exchange rate must be adjusted significantly and sufficiently so as to reflect/compensate the underlying inflation difference. Once this

happens, the international competitiveness of any country's product in the world market shall be maintained.

Thus the PPP theory tries to restore the real exchange rate, which is relevant for international business. Real Exchange Rate (R) = Nominal Exchange Rate \times The above equation is explained with following numerical example:

Suppose the nominal exchange rate is Rs. 40= USD 1, the foreign price index is 100 and the Indian domestic price index increase to 110 due to inflation. If the Indian authorities fail to adjust the nominal exchange rate what happens to the Real Exchange Rate (R)?

$$R = \frac{44 \times 100}{110} = \text{Rs. } 40$$

The real exchange rate thus appreciates to Rs. 40 although the nominal exchange rate is Rs. 44/USD. This will adversely affect the exporter's ability to compete globally due to the fact that is a U.S. buyer pays US\$ 1 for a product, the Indian exporter will get Rs.44 due to nominal exchange rate, which is worth only Rs.40 in real terms because of the effect of inflation in India. The supporters of PPP theory insist that the nominal exchange rate should be depreciated by 10% [the difference between Rs.44 and Rs.40] and the nominal exchange rate should be depreciated by 10% to Rs.48.40 per US\$ so as to restore the old exchange rate; in which case R will become:

$$R = 48.40 \times 100 = \text{Rs.} 44 \text{ which is the old nominal exchange rate } 110 \text{ prior to inflation}$$

Thus if nominal exchange rate is adjusted to inflation differentials then the exchange rate will be constant in terms of purchasing power. The essence of theory is that one must export to a country whose inflation rate is higher than the domestic rate. In the case of imports the strategy should be reversed as nominal exchange rates are not adjusted on a real time basis.

However the PPP theory does not take into account actual practice factors such as current account performance, portfolio decisions, interest rates, economic growth, and the central bank's intervention, which have an effect on the variations in exchange rates. Thus relative price level differences alone cannot explain exchange rate movements exhaustively. Further, the law of one price which is the basis of PPP theory has also been empirically challenged by absolute advantage theory and Factor Endowment theory. Studies have shown that there are significant and persistent differences among the relative prices of narrowly defined domestic and foreign manufactured products.

The floating exchange rate regime of 1970s and 1980s clearly showed that exchange rates over short periods depend significantly on asset market considerations rather than price movements.

The other issues associated with PPP theory are those of index numbers, inconsistency in the basket of products considered for inflation calculations and the weight age procedures adopted. However the theory holds well in long run. Empirically when prices gets affected by a large number of variables the exchange rate may overshoot the value postulated by the PPP theory.

Thus, there is more to exchange rates than what is stated in PPP theory. The deviations of exchange rates from those postulated by the theory are fairly persistent in countries with unstable monetary policies. The PPP theory plays a significant role in describing exchange rates in the long run or when inflationary forces are significant. Whether or not the PPP theory provides a tool to determine real exchange rate or prices in international markets is a moot point that continues to be debated. This is the reason why the PPP theory failed to explain volatility of exchange rates, which was a prominent feature of the floating rate experience during late 1990s. Current account performance and the monetary aspect of exchange rates are a simplified approach to study exchange rate variations. The view put forward by Keynesian Balance of Payment (BOP); dominate analysis during the 1950s because capital movements were minimal. The influence of asset markets and portfolio preferences of investors plays an important role in the present context of exchange rate determination and the PPP theory only supports the exchange rate variations in long run.

THEORY OF PRODUCT LIFE CYCLE

Theory of international product life cycle propounded by Raymond Vernon emphasizes that every product has to pass through different stages. Conceptually, the life cycle consists of four stages- introduction, growth, maturity and decline.

To understand the concept very clearly the international product life cycle starts from the location where the products originates. The introduction stage is marked by innovation. Innovation is an outcome of research and development. According to product life cycle theory, the production location for a specific product moves from one country to another at different stages. Generally, the life cycle movement starts from advanced countries where considerable amount is spent for research and development. Many occasions failures may occur. Still they pursue innovation. Out of ten innovations, two may be commercially viable for which they do not hesitate to spend money other eight innovations.

1. Introductory Stage

New products are generally developed after observation of demand, utility and benefits a group of a group of customers enjoy in a given market. It is a normal practice that Japanese company develops a new product for Japanese market first and US Company develops a product for US market first. The Research and Development group creates a new product and predominantly the company concentrates on the domestic market and gradually starts export to other countries. By way of getting constant market feedback the company modifies or alters or adds new features to match international markets.

Importance of innovation and decision of locations

Over the past 50 years all the new products have been developed either in US or in Europe or in Japan. The industrialized countries are having advantage of research, technological infrastructure, and manpower. Companies like Merck, Siemens, Sony, Honda motors, General motors, Matsushita allotted huge funds for such development. Those companies are capable of taking the risk on new product development in anticipation of long term gainful results. Innovations are taking place in

such companies on continuous basis. Few companies concentrate more on technological innovative products. Few companies are making improvements in the existing products. Few companies modify methods of manufacturing and process.

Even though the debate is going on that developing countries and less developed countries have lacunae in research capabilities currently innumerable innovations are taking place in developing and less developed countries also. In future, the industrialized countries will locate innovation centers or R&D intensive operations in developing countries.

Movement of labour and products

In the first stage of the product life cycle a minimum percentage of the total production may be exported. Labors intensive items are not standardized in the initial stage. Rapid change in the production process may not take place. Obviously, production with standardization will be a Herculean task. At the same time, since cost of production is not known to the customer, there is a possibility of adding comfortable margins. For example, entertainment electronic items innovated by Sony made a windfall gain right from the beginning. Dell is enjoying the same kind of benefits for its laptops. The major challenge in this stage is to educate and enhance the skill levels of labors force until the standardization is achieved. Once the labors force is trained and competitive, the organization can perform well.

2. Growth stage

Growth stage has few salient features:

1. It increases in export to many countries by which the company generates huge revenue.
2. More competitive forces crop up from a country by innovation, country of entry and any other third country.
3. The organization becomes high capital intensive.
4. The innovator resorts to foreign production units in order to bring down the cost and come closer to customer.

Since the customers are aware of the products and the demand is likely to grow substantially, setting up manufacturing units become inevitable. While Sony products have huge demand in South East Asia and Middle East, the company started manufacturing products in Malaysia. Hewlett Packard started setting up units in South East Asia due to rapid growth in sales in the whole region. The innovating company will increase its quantum of exports and is prepared to incur small loss in the export markets where the manufacturing subsidiary unit will commence its operations.

3. Maturity stage

This stage has following features:

1. There is a gradual fall in quantum of exports from innovating country.
2. Standardization and quality aspects are pre-requisites.
3. Sophisticated machineries are used, hence is huge.
4. Price war is inevitable due to many players.
5. Production facilities are available in many developing countries at a low labors cost.

Though the demand is growing in few countries, especially in the less developed ones it declines in all the developed and few developing countries. Cost cutting is the only strategy available for the innovator to sustain. Few of the companies shifted their focus to get products manufactured wherever per unit cost is low. It is a general trend that innovating countries no longer enjoy production advantage. Since many physical, fiscal and infrastructural incentives are offered by the developing countries, such innovators are lured and increase their production in developing countries. Today, we see such manufacturing units in Indonesia, Thailand, Malaysia and Brazil. India is also emerging as a strong production centre for automobiles, health care and consumer products.

4. Declining stage

1. The main feature of the declining stage is that maximum production takes place in less developed countries.
2. The innovating country starts importing from other countries.
3. The days of keeping high margins are over.
4. It is the stage of survival and no prosperity for the innovator.
5. The innovator may completely deviate from a specific product and go in for a completely new product.

The industrial countries disappoint the innovator because the affluent customer demands more and more. New products are flooded in the market with so many features. Since cost factor is the only weapon, production from less developed countries will win. The innovator of the product cannot depend on the first production unit which gave the first product for launching.

Limitations of Product Life Cycle

The theory is having application in few specific sectors such as entertainment, electronics and certain medicinal items. The movement of production centres from different stages may not be applicable in the following circumstances;

1. A vast majority of the products are having very short life cycle such as computers, tape recorder, musical discs and fashion items. Shifting production from one country to another country may not achieve cost reduction. The very nature of product itself is subject to obsolescence.
2. Cost involved in perfumes, cosmetics and other essential oils which fall under luxury category do not make any impact on the customer because brand is important to them.
3. Wherever costs of logistics are high the export is minimal at any stage. At the same time, few countries are producing certain essential bulk cargo. Irrespective of life cycle stages, they export all the time. Articles like bitumen from Iran, sulphur from Jordan and coal from China. They cannot shift production facilities to other countries.
4. Many MNCs are using aggressive marketing promotion such as advertising, personal selling and sales promotion. Any other competition will not be a great concern for such products.
5. Few products are very much associated with outstanding services and specialized knowledge. More than product life cycle stages, customers need assured technical support. Lifts and escalators will be accepted by customers provided service is given top priority. Same concept is

applicable to life saving medical equipments produced in Germany. Irrespective of the types of products the companies are all the time introducing new products simultaneously, both in the domestic and international markets. It is obvious that in the globalization era, companies develop different products to different segments and different prices. They cannot wait for an opportunity to start in the domestic market first and going to other markets later on. Multi domestic operations are very common among MNCs. Innovations are carried out to launch products in many countries at a time especially health care items and industrial consumables. Hence, product life cycle theory has very limited applications in the current globalised era.

REVIEW QUESTIONS

1. Describe the theory of absolute advantage.
2. Discuss about the theory of comparative cost advantage
3. Describe modern theory of international
4. Describe purchasing power parity and its impact on trade.
5. What is the competitive advantage of nations?
6. What are forces influencing competitiveness?
7. Describe porter's diamond – four determinants of national competitive advantage.
8. Describe theory of product life cycle. What are limitations of product life cycle?

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1. International Business- Stuart Wall, Bronwen Rees
2. International Business- Aswathappa
3. International Business Environment- Les Dlabay, James Calvert Scott
4. International Business- Thomas L. Friedman
5. International Business- Leslie Hamilton, Philip Webster

UNIT-14 CROSS CULTURAL COMMUNICATION

CONTENTS

- ❖ Introductions
- ❖ General Characteristics of Culture
- ❖ Culture and Business across the Globe
- ❖ Possible HR Areas for Core Competencies in Global Market
- ❖ Factors Affecting Global HR Planning
- ❖ Review Questions
- ❖ Further Readings

INTRODUCTIONS

A unique set of traits, behaviours, values, habits, norms and ethics innovated and practiced in the past and forwarded to the future generation for day to day practice is culture.

Culture is the essence of life. For many nations it is the basis of their identification and countries are often identified by their cultural inheritance. The culture of the country affects the way people behave, and often explain why they behave the way they do. In general, we often talk about oriental culture, western culture and material culture, but these terms are not explicit and can have a number of connotations. The pattern of behaviour in different cultures will reflect in business deals, working conditions, productivity levels and whether a company is accepted in different countries. The major challenges to do international business are not only managing people, money and resources. To trigger all those resources and succeed one has to understand two areas:

1. CULTURE

2. COMMUNICATIONS

When business firms operate in different nations, different cultures come together to do business. More than anything else they have to respect the cultural sentiments of each other. Often, businesses fail not because of logistical shortcomings, but due to the erroneous evaluation or total lack of understanding of the other party's cultural values. As stated above the culture determines an individual's actions or behaviour. The society that people grow up in shapes their basic beliefs, values and norms. They absorb, almost unconsciously, a world view that defines their relationship to themselves, to others, to nature and to the universe. A society's beliefs, values and norms are influenced by their family and by the social, educational, and religious systems of a country. What people buy, why they buy, when they buy and how much they buy, are all primarily determined by the typical culture of each country. Cultural attitudes vary considerably among countries, so it is difficult to find general patterns amongst them. For examples, despite the fact that their economic levels are similar, the French and Germans are culturally quite different. The French are somewhat hostile to frozen food, but the Germans welcome it. Thus, for a frozen food exporter, both these countries hold different importance.

GENERAL CHARACTERISTICS OF CULTURE

Culture is a distinctly human capacity for adapting to circumstances and transmitting these coping skills and knowledge to subsequent generations. Culture gives people a sense of belonging and shapes their behavioural pattern. Culture impacts behaviour morals and productivity at work and includes values and patterns that influence company operations and actions. Corporate culture affects the way in which an organization copes with competition and change, whether in technology, economies or people. The way people do business is different in different countries. In Japan employees are extremely loyal to their employers and will not easily leave their jobs. The Japanese have great respect for protocol and even the way a person presents his visiting card may determine his compatibility to initiate business discussions. The Indian business community strongly believes in the concept of a family business, with the line passing from father to son. In France it is usual to work five days a week, starting early in the morning. In Germany, serious business discussions do not call for humour. Delaying, often for weeks, to get a better bargaining strength, is an integral part of Chinese business. In Brazil, no major business decisions will be taken until the carnival.

Characteristics

Self-identity and appreciation of others can manifest as a humble bearing in one country and egoistic behaviour in another. Independence and creativity are countered in other cultures by group cooperation and conformity. Americans keep their distance in business negotiations, while this is not so in Latin America and Vietnam.

Communication and Language

In addition to the multitude of different languages, some countries have hundreds of dialects, spoken amongst their different communities and geographic units. Furthermore, even though body language is universal, the meanings given to gestures often differ in different cultures.

Dress and Appearance

This includes garments and adornments as well as body decorations that are distinctive of different cultures. For example the Japanese Kimono, the African head dress, the Englishman's hat and the Indian saree.

Food and Eating Habits

The manner in which food is selected, prepared, presented and eaten often differs in different cultures. Americans love beef, yet it is forbidden to Hindus. Both, Moslem and Jewish cultures forbid pork, which is consumed extensively by the Chinese. Many restaurants cater to diverse foods and offer national dishes to meet varying cultural tastes. Eating habits also differ from one country to another, from hands and chopsticks to a full set of cutlery. Even when cultures use cutlery such as a fork, one can distinguish a European from an American by the hand in which he holds a fork or spoon.

Relationships

Cultures fix human and organizational relationships by age, gender, status and degree of kindness, wealth, power and wisdom. The family unit is the most common expression of these characteristics. In a Hindu household a joint family lives under one roof. In some cultures, the

authoritarian figure in the family is the head male and this fixed relationship is then extended from home to community.

Values and Norms

Value systems vary in different cultures. Persons who are barely surviving, place importance on food and shelter. Richer persons need security while that with high security needs, value material things, money and position as well as law and order. The younger generation in many and position as well as law and order. The younger generation in many countries concentrates on quality of life, self-fulfillment and status. In some Pacific island cultures, the more one gives away or shares, the more he or she is recognized.

Beliefs and Attitudes

One of the most difficult tasks in carrying out international business understands the beliefs and attitudes of people in different countries and cultures. People in all cultures seem to have a concern for the supernatural that is evident in their religions and religious practices. Western culture is largely influenced by judeo-Christian traditions, while East Asian cultures are dominated by Buddhism. Confucianism, Taoism and Hinduism. The Japanese also believe in Shintoism, which is an offshoot of Buddhism, which originated in India. Religious beliefs can play an important role in political and legal aspects. This is especially true of Muslim countries like Saudi Arabia, Kuwait and Qatar, where business operations are strongly influenced by religious beliefs.

Mental Processes and Learning

The way people think and the process of learning vary from country to country. The British will enter into any business only after doing their home work thoroughly and follow strict documentation procedures; they also expect their counterpart to do the same. The Germans have a preconceived notion that they are technically superior and can produce perfect items, and lay great stress on logic, while the Japanese reject the western idea of logic. Learning is much respected in the whole of Europe. Europeans are never adverse to learning new things and they generally will not enter into discussions without a strong information base. The Americans spend a lot of time on documentation. Some cultures favour abstract thinking and conceptualization while others prefer strong base and continuous learning.

Work Habits and Practices

Another dimension for examining a group's culture is its attitude towards work. In some countries, the culture is oriented towards work, and holidays are minimum. An example is China, except for ten continuous days holiday during the Chinese New Year. A work ethic in which all members are expected to engage in a desirable and worthwhile activity in the same culture. For some cultures, the worthiness of the activity is narrowly measured in terms of income produce and the worth of he individual is assessed in terms of job status. In Japan, the culture lies in family which is transferred to the organization that employs the person and the quality of ones performance is expressed in work group participation, communication and consensus.

Global Culture – A Rationale

Today, there is an increasing need for an uniform culture across different countries, however it is not entirely possible. The main reason for this is the close bond with traditions and beliefs, which has been carried over generations. Time and space have largely divided the world into diverse forms and patterns, and cultural differences are evident even within a country. India itself is a land of varied cultures and beliefs. So is Canada, which is divided between English speaking and French speaking cultures. Even though cultures vary, our need to interact remains and it is essential to adapt to a new country and its culture. This is especially important in the exchange of commerce and persons doing business across the world have constantly felt a need for this. Many corporate fail because they did not take cultural differences into account. An American cannot sell port to a Muslim. This shows that there is a strong need to understand diverse cultures, for business to succeed.

CULTURE AND BUSINESS ACROSS THE GLOBE

United States of America

The fourth largest nation in the world, the USA has been considered a melting pot of diverse cultures. An overview of the dominant culture of the USA reveals the following traits:

1. Highly achievement-oriented.
2. Highly organized and institutionalized.
3. Freedom loving and self-reliant.
4. Work-oriented and efficient
5. Friendly and informal
6. Competitive and aggressive

Doing business and negotiating with Americans

1. Basic concept of negotiation: Conflict and confrontation seen as an opportunity to exchange views.
2. Selection of negotiators: American negotiators are usually chosen based on their past record of success and their knowledge and expertise.
3. The role of individual aims: Americans encourage individual aims and achievements.
4. Complexity of language: Americans are low context communicators. Messages are not overridden by non-verbal communication.
5. Value of time: For most Americans time is money. They set schedules, appointments and tend to prioritize events.
6. Risk taking propensity: Americans are willing to take risks.
7. Form of satisfactory agreement: American culture is legalistic. Americans prefer and expect detailed contractual agreements to formalize negotiations.

Canada

Canada is a bilingual and multicultural country. Throughout Canada, the family is the center of the society and homes are often passed from one generation to another. Canada has one of the world's highest standards of living and the people are very industrious. Canadians are friendly but conservative and tend to observe formalities and rules of etiquette. They are patriotic and law abiding and confident of their future and welcome foreign business.

Doing business and negotiating with Canadians

1. Basic concept of negotiations: They focus on points of disagreement as they work through a problem by a linear process. This process involves identifying the problem/opportunities, the objectives, the alternatives, the decision and finally the plan of action.
2. Selection of negotiators: Canadian negotiators are usually chosen based on their past record of success and their knowledge and expertise.
3. Role of individual aims: Canadians are expected to put the objectives of the firm/country ahead of their personal aims.
4. Complexity of language: English speaking Canadians are low context communicators, whereas French speaking Canadians are high context communicators.
5. Value of time: Promptness in both beginning and ending a meeting is appreciated. They are rigidly bound by their schedules and deadlines.

People's Republic of China

The Chinese have always held themselves in high esteem. They see themselves and their country and culture as the center of civilisation.

Negotiating in China

China is a group-oriented society and any negotiations must cover the interests of many different parties. The Chinese will examine their counterpart's attitude and speech and apply it to solving the problem. The following points should be taken into account when doing business with China:

1. The Chinese are interested in long range benefits.
2. They stand by their word, and emphasis is placed on trust and mutual connection.
3. They prefer to negotiate through intermediates.
4. They will not compromise on their goals.

Japan

Language and communication

The Japanese prefer ambiguous terminology to direct and specific references. Sentences are frequently left incomplete. All business and negotiations are extremely polite and formal, but informality is seen during socialising. Often, negotiations are carried out during business entertainment.

Dress and appearance

Neat, orderly and conservative dress is recommended for executive staff, Blue collar workers and students generally wear a distinctive uniform and even a company pin which executives may also wear. Colours have considerable significance in the Japanese culture.

Food and eating habits

Eating is ritualistic, communal and time consuming, Businessmen avoid taking their wives to a business dinner even if invited.

Time and age consciousness

The Japanese are punctual, but they expect the other party to wait for group decisions that may take time. In negotiating a licensing agreement, the final decision may take up to three years but once the decision is taken, production may be started within a few weeks. Their planning is long term and implemented quickly. They give respect to seniority and the elderly.

Reward and recognition

There is a tendency to accept only group appreciation and not individual rewards,. Great emphasis is put on security as well as a social need for belonging. Money if given to Japanese should be in an envelope or else it is considered to be an insult.

Relationships

They are group oriented rather than individualistic. They are sensitive to what others think or expect and have a sharp sense of right and wrong.

Attitudes and beliefs

They are extremely adaptable. They do not resist change and are open to automation and new technology. The Japanese are hard working, both for the family and business. They are cooperative with the management.

Europe

The three large markets in the EU are Great Britain, Germany and France. In doing business with the EU the following points are to be considered.

1. Customer service is the key to success.
2. Price lists should be published in the local currency and not in any foreign denomination.
3. Sales personnel must know their products. Europeans are sophisticated buyers of foreign products.
4. Europeans gauge the commitment of the company by the way they treat their sales representatives.
5. Europeans value personal contact and mementos, so a token gift may create a favourable impression.

Australia

Australians are generally easy going and friendly. Australians speak directly and frankly; they dislike pretensions of any kind and will not shy away from disagreement. It is necessary for men to shake hands before and after meetings, but not necessary that women should do the same. The basic rules of etiquette in Australia are that:

1. Men should never wink at women, even if they are friends.
2. Yawning in public is rude.
3. Eye contact is important, especially in business meetings.

CONCLUSION

The international business community is constantly expanding its activities in different part of the world. The business executives and managers are required to interact with society, customers, and bureaucrats. Handling the work force is a major challenge even to multinationals. This has led to any transnational companies taking the advice of experts in a chosen field prior to entering a country.

1. Discuss the role culture that plays in determining the effective use of human resource management.
2. Identify critical HRM issues faced by multinational and global organizations.
3. Discuss human resources as core competent tools for Global organizations
4. Define Global HR planning and process.
5. Specify four important HR benchmarking measures.
6. Evaluate human resource information system (HRIS).

Human Resources as a Prime Mover

Strategic Human Resources Management deals with Organizational use of employees to gain or keep a competitive advantage against competitors. Core Competency is a unique capability in the organization that creates high value and that differentiates the organization from its competition. Human being is the only intangible asset which will bring an unimaginable quantum of tangible output provided the asset is identified, nurtured and groomed to shoulder global business responsibilities.

Possible HR Areas for Core Competencies in Global Market

HR-Based Competencies

1. Organizational Culture

a. The shared values and beliefs of the workforce

2. Productivity

a. A measure of the quantity and quality of work done, considering the cost of the resources used.

b. A ratio of the inputs and outputs that indicates the value added by an organization.

3. Quality Products and Services

a. High quality products and services are the results of HR enhancements to organizational performance.

Culture shock

The feelings of frustration and confusion that result from being constantly subjected to strange and unfamiliar cues about what to do and how to get it done when trying to live in a new culture. Many MNCs struggle hard at operational level due to their inability to overcome cultural shocks, especially in developing countries.

Ethnocentric HRM Perspective

A view of HRM whereby an organization thinks that the way of doing things in the parent country is the best way, no matter where business is done. Imposing ethnic or parent company's norms and operation styles will lead to detriments.

Expatriate manager

A manager who is on assignment in a country other than the parent country of the organization. This person is also called a parent country national (PCN). Such a manager has to be so quick in adopting the culture of his working domain if he wants to be an effective manager.

Foreign Corrupt Practices Act of 1977 (FCPA)

A law that makes it illegal for an American organization to pay bribes to foreign officials for the purpose of getting a competitive advantage in doing business.

Geocentric HRM Perspective

A view of HRM whereby nationality is ignored and managers are hired on the basis of qualifications. Merit and performance are the key criteria for HRM. They are highly respectable and capable of handling any turbulent situation.

Global Corporation (GC)

A corporation with a geocentric HRM perspective. National boundaries are ignored and HRM is viewed as a way of integrating operations all over the world.

Global Human Resource

The policies and practices related to managing people in **management** an internationally oriented business.

Host Country National (HCN)

An employee of an international organization who is from the local workforce rather than being from the parent country of the organization.

Parent Country National (PCN)

An employee from the corporation's home country is on assignment in another country. Generally the investing companies are prone to such a syndrome to bring key human resources from home country which may enkindle hatred amongst the people in the country of operation.

Sullivan Principles

Reverend Sullivan was the first African-American to serve on the Board of General Motors. The tenets of his principles were designed to eventually eliminate oppressive racism in South African business.

Third Country National (TCN)

An employee working for an international organization who is from a country other than the parent country of the organization or the host country in which the assignment is located.

Global organizational move Challenges

Driving force for globalization

1. Foreign direct investment (FDI) flows
2. Cross-border inter-firm agreements Organizations expand beyond domestic boundaries to achieve
 1. Satisfied employees
 2. Competitive products and services
 3. Searching for new or broader markets
 4. Acquiring new, more efficient manufacturing technology
 5. Large, inexpensive labor forces

Global human resource management (GHRM) includes the same functions as domestic HRM, plus several aspects unique to international management

1. "people challenge" the most difficult for firms becoming international
2. Most critical to success, acquiring a competent workforce (survey of top execs.)

The top HR challenges include

1. Finding suitable candidates
2. Intercultural understanding
3. Career management
4. Employee retention
5. Adjusting to environment
6. Partner dissatisfaction
7. Relocation reluctance

The cultural nature of global human resource management cultural differences

1. Individualism versus collectivism
2. Power distance
3. Uncertainty avoidance
4. Masculinity versus femininity

The concept of "fit" in global human resource management

1. Fit (congruence among HR policies, firm's plan & values of foreign culture)

2. Internal fit (HR policies that allow for smooth work flow: HQ & local)

3. External fit (HR to consider the local cultural/socioeconomic environment)

Multinational Corporation (MNC) – HRM Philosophy

1. Early stages of internationalization strategy

2. Ethnocentric orientation - PCN hires

3. Adapting products and services to local markets Global Corporation (GC) – HRM Philosophy

1. National boundaries disappear

2. Geocentric orientation – TCN hires

3. The world is the market for its products & services

The real challenge

1. Finding competent expatriate managers

2. To capitalize on the diversity of a global workforce without suppressing each nation's desire to maintain its cultural identity

Three sources of employees for international assignments include

1. Host Country Nationals (HCNs)

2. Parent Country Nationals (PCNs)

3. Third Country Nationals (TCNs)

Selecting the expatriate manager

1. Complex & sensitive task

2. Technical competence

3. Self image: self-confidence, self-esteem, stress coping

4. Interaction skills: interpersonal style, sensitivity to nonverbal communication perceptual orientation: open-mindedness, tolerate uncertainty accept cultural differences

Stages of reaction to foreign experience

1. Fascination

2. Culture shock

3. Adaptation

Effective measures to deal with culture shock

1. Select managers who desire/want foreign assignments (where possible)

2. Language fluency

3. Preparation for cultural differences

Training the expatriate manager

1. Provide intercultural training – improves chances for success

2. How much & type of training depends on level of contact with host culture

3. Degree of dissimilarity between home & host cultures

4. Training to differ/vary at different phases of expatriate's assignment (ex. pre-departure, overseas assignment, repatriation)

Compensating the expatriate manager

1. Expensive proposition

2. Pay expatriate premium, COLAs, allowances

3. Financial (education, home leave)

4. Social adjustment (language, cross cultural training, locate home)

5. Family support (child care, trailing spouse, schools) Host Country Nationals and the Global Corporation

1. Less expensive
2. Have distinct advantages in cultural sensitivity, understanding local employee needs/motivation strong reservations exist in using HCNs:
3. Concern that locals will not adopt PC culture & management system
4. Level of commitment to organization may not be high
5. Don't have the expertise or requisite skills that PCNs/expatriates possess
6. Communication between HQ and host offices will be less effective
7. Most problems can be eliminated by careful recruitment, selection, and training of HCNs

HCNs - Recruitment

When recruiting try to use the same recruitment methods as local businesses & other successful GCs The legal and ethical climate of global human resource management

1. Foreign Corrupt Practices Act – (1977) forbids in conducting to give the firm an unfair advantage
2. There exists varying degrees of employment discrimination in other countries which may cause problems/dilemmas for PCNs managers
3. Civil Rights Act of 1991 applies to US firms' operations overseas
4. Sullivan Principles

FACTORS AFFECTING GLOBAL HR PLANNING

Global HR Planning Process

Benefits of Global HR Planning

1. Better view of the HR dimensions of business decisions abroad
2. Lower HR costs through better HR management.
3. More timely recruitment for anticipate HR needs
4. More inclusion of protected groups through planned increases in workforce diversity.
5. Better development of managerial talent

Scanning the External Environment

1. Environmental Scanning
 - a. The process of studying the environment of the organization to pinpoint opportunities and threats.
2. Environment Changes Impacting HR
 - a. Governmental regulations
 - b. Economic conditions
 - c. Geographic and competitive concerns
 - d. Workforce composition

Internal Assessment of the Organizational Workforce

1. Auditing Jobs and Skills
 - a. What jobs exist now?
 - b. How many individuals are performing each job?
 - c. How essential is each job?
 - d. What jobs will be needed to implement future organizational strategies?
 - e. What are the characteristics of anticipated jobs?
2. Organizational Capabilities Inventory

- a. HRIS databases—sources of information about employees' knowledge, skills, and abilities (KSAs)
- b. Components of an organizational capabilities inventory
 - Workforce and individual demographics
 - Individual employee career progression
 - Individual job performance data

Assessing HR Effectiveness

1. Diagnostic Measures of HR Effectiveness

- a. HR expense per employee
- b. Compensation as a percent of expenses
- c. HR department expense as a percent of total expenses
- d. Cost of hires
- e. Turnover rates
- f. Absenteeism rates
- g. Worker's compensation per employee

1. HR Audit

- a. A formal research effort that evaluates the current state of HR management in an organization
- b. Audit areas:
 - i. Legal compliance (e.g., EEO, OSHA, ERISA, and FMLA)
 - ii. Current job specifications and descriptions
 - iii. Valid recruiting and selection process
 - iv. Formal wage and salary system • Benefits
 - v. Employee handbook
 - vi. Absenteeism and turnover control
 - vii. Grievance resolution process
 - viii. Orientation program
 - ix. Training and development
 - x. Performance management system

REVIEW QUESTIONS

1. What are the general characteristics of culture in international business?
2. Discuss About Culture And Business Across The Globe.
3. What are possible HR areas for core competencies in global market?
4. What are the challenges to global organizational ?
5. Describe the factors affecting global HR planning.

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Notes