Department of Business Management

Only study guide for MNI3701

Global Business Environments

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Foreword

The lecturers in **Global Business Environments** welcome you to this semester module, as set out in this study guide, and trust you will find your learning experience over the next few months both stimulating and rewarding.

We start the discussion of this module with a brief explanation of the importance of understanding the global business environment and its various components.

Owing to the growth of international business and the increasing involvement of business enterprises in the global market place, it is clear that there is a need for specific education, focusing on the global business environment. This is necessary, apart from the existing areas of study in business management such as strategy, organisational behaviour, marketing, finance, operations management, supply chain management and human resources management. Indeed, international business has come of age. It constitutes a separate field of study. In particular, it addresses the globalisation process and its many ramifications.

The emphasis on the globalisation process resonates with a recent statement by an internationally acclaimed political leader and observer. The essence of this statement is worth noting. It can be encapsulated as follows:

> "Globalisation today is conducive to the enhancement of trade and financial integration across borders, changing the way we do things and the way we think about how things can be done.
>
> New technologies have opened up new vistas for human enterprise. In economics, it has enabled each country's competitive advantage to be articulated in new ways. Manufacturing, traditionally undertaken in a single location, is now frequently broken down into discrete parts and distributed across national borders for completion and final assembly.
>
> Multinational enterprises (MNE's) are establishing Research and Development centres offshore, to tap the expertise of engineering in places such as India. Call centres have become ubiquitous over the last two decades, giving new meaning to the discipline of customer services management ... Globalisation is a process, a tool."

Indeed, while globalisation continues inexorably, it is, nevertheless, recognised that global business management presupposes that global business environments and practices, differ from country to country. These disparities are acknowledged in this module.

MODULE OUTCOMES

The aim of this module is to provide insight into the methodology of global business management and strategies, in the context of the global business environment. The

key objective is to provide managers and other functionaries, who are involved in global business management practices, with the necessary insights and applications. They represent the people who are directly affected by the ongoing process of globalisation.

In pursuing this objective, provision is made for highlighting the relevance of global business for South African business enterprises, and to indicate how these enterprises can contribute to the national economy, in order to enhance the country's competitiveness.

These initiatives culminate in a discussion on recent and prospective future developments in Africa, with a view to illustrating how the business community may benefit from Africa's integration into the global economy.

THE AIM OF THIS MODULE

Once you have studied this module, you should be able to:

- Understand the process of globalisation, in the context of international business.
- Demonstrate your insight into global trade applications and foreign direct investment flows, within the context of economic integration.
- Demonstrate the implications of economic integration and the development of regional trade blocs.
- Illustrate the execution of global business operations, within the context of international cultural, politico-legal and economic environments.
- Plan and implement international business strategies, including the formulation of entry strategies and strategic alliances.
- Develop a global mindset based on international leadership principles.
- Demonstrate how global collaboration and strategic alliances could influence business operations in Africa.
- Show how South African enterprises could benefit from the increasing, economic integration of Africa, as an emerging market.
- Show how development initiatives, could enhance economic development in Africa.

OVERVIEW OF THE MODULE

This module consists of **FIVE** parts. The first part discusses the scope and dynamics of global business, with specific reference to international trade. Here the scope includes the global and political environment, impinging as it does on the economic, legal and technological environments. The second part provides an overview of global business environments with specific reference to global trade and investments. This includes: global monetary systems and foreign exchange markets, the political economy of global trade, foreign direct investment (FDI) and capital markets.

Part three focuses on international management and leadership principles that influence the development of a global mindset. The importance of the development of sustainable, international competitive strategies and foreign market entry strategies concludes part three.

Part four focuses on managing business operations and global financial management.

Discussions on the role of emerging markets, relative to Africa's potential, socio-economic development initiatives, so as to enhance future economic growth, constitutes part five of this module.

PRESCRIBED TEXTBOOK AND STUDY GUIDE

The following textbook is prescribed for this module.

Aregbeshola, Luiz, Ojah, *et.al.* (2011). Global business: environments and strategies. 4th edition. Oxford University Press.

The study guide is an important tool for studying this module. The chapters in the prescribed textbook support the syllabus and aims of this module in Global Business Environments. The study guide is divided into **FIVE** main parts and there are various topics under each part. Topics are sometimes summarised by means of a topic chart, which indicates which study units make up the topic. At the end of each topic, you will find assessment questions that have been designed to test your knowledge of the topic. We do not always provide answers to these questions.

The study guide will guide you through the prescribed textbook. At the end of some of the study units, there is an activity to help you understand the concepts discussed in the relevant study unit and the prescribed textbook. It is very important that you use the study guide and the prescribed textbook together.

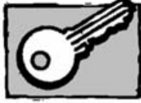
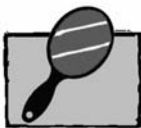
METHOD OF STUDY

As a Unisa student your success will be based on how well you are able to study independently. The primary purpose of the study guide is, therefore, to bring to your attention to what we consider to be the most important aspects of the syllabus. We believe you will succeed in your studies if you:

- Carefully study the study guide and the relevant sections of the prescribed textbook.
- Ensure that you study and follow the instructions contained in the tutorial material.
- Do additional reading.
- Discuss the study material with colleagues and experts.
- Contact us should you have difficulties with your studies.
- Do the assignments and activities to the best of your ability.
- Test your knowledge in practical situations.
- Regularly work conscientiously to improve your grasp of the material as you prepare yourself for the examination.

USE OF ICONS

To guide you effectively through this study guide, we use specific icons. These icons serve as a guideline of what you have to do in each study unit. The icons that will be used in this study guide are listed below, together with an explanation of what each means:

Icon	Description of icons
	**Key concepts** The key concepts icon draws your **attention** to certain keywords or concepts in the topic or study unit.
	Learning outcomes The learning outcomes icon indicates which aspects of the particular topic or study units you have to master. You will need to demonstrate that you have mastered these topics.
	Assessment When you see the assessment icon you will realise that you need to test your knowledge, understanding and application of the material you have just studied.
	Feedback The feedback icon indicates that you will receive feedback on your answers to the assessment activities.
	Activity The activity icon refers to the activities that you must complete in order to develop a deeper understanding of the study material.
	Study The study icon indicates which sections of the prescribed book or the study guide you need to study and internalise.
	**Reflection** The reflection icon requires you to reflect on the important issues or problems dealt with in the study unit.

TUTORIAL LETTER 101

The first tutorial letter is very important as it contains general information on academic and administrative matters, as well as the assignments and their due dates. In this tutorial letter we include a study plan as a guideline and timetable for you.

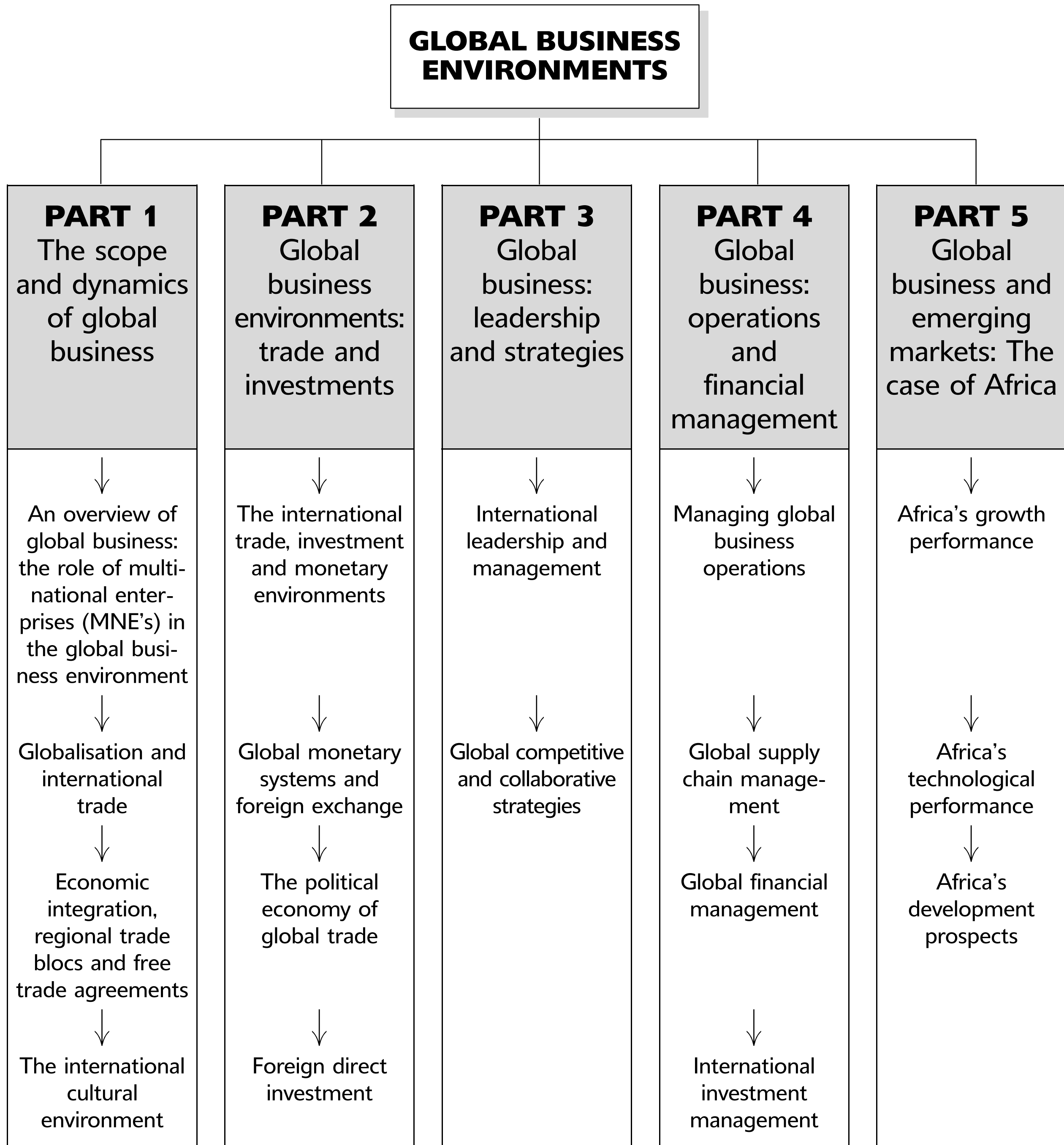
Other tutorial letters serve as the main source of information on events and issues that arise during the year. You should read these tutorial letters immediately and not file them away to look at later. The purpose of the tutorial letters is to supply feedback on assignments, give information on examinations and to discuss anything else of importance that may have come up during the academic year.

Your lecturers in Global Business Environments hope that you will enjoy this module and that it will encourage you to want to learn more about the best management practices in the global business environment. We believe the module will assist you when you apply what you have learned to real life business situations. We also trust that the module will stimulate your interest in further studies in the field of business management and, specifically, global business management in a competitive environment.

Best wishes and greetings

Lecturers in Global Business Environments

COURSE MAP

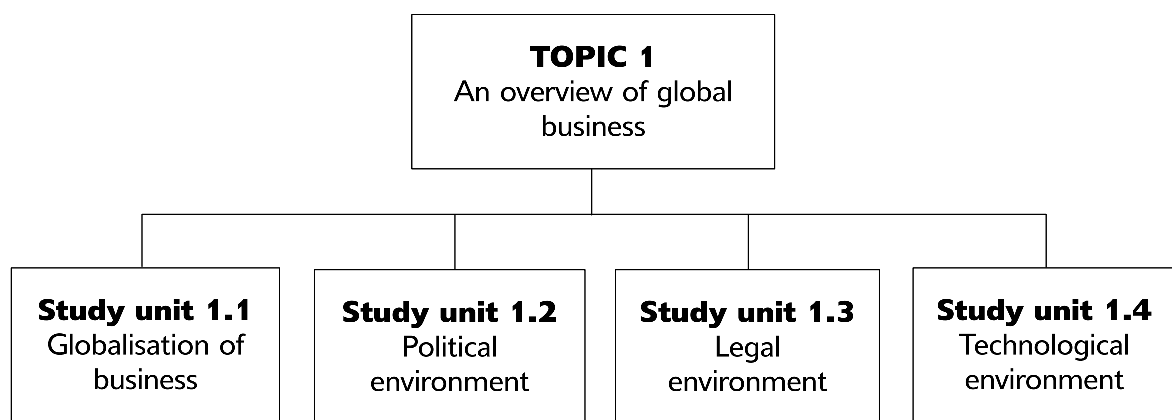


PART 1

THE SCOPE AND DYNAMICS OF GLOBAL BUSINESS: THE ROLE OF MULTINATIONAL ENTERPRISES

Topic 1

Overview of global business



AIM

The purpose, nature and scope of this topic is conducive to providing you with an overview of globalisation and the global business imperative. The objective is to create an understanding of the process and participants involved in globalisation as seen against the backdrop of appropriate international trade theories. To this end, the focus is on the process of globalisation (internationalisation) and, more specifically, the globalisation of business. This involves considering the evolution and development of multinational enterprises (MNEs).

Learning outcomes

After studying this topic you should be able to:

- Articulate the concepts of globalisation and the globalisation of business.
- Identify the appropriate trade theories that influence the globalisation of business.
- Describe the process of globalisation and how MNEs have developed within the context of the globalisation of business.

Study unit 1.1

Globalisation of business

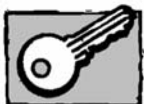
Contents

Study unit learning outcomes
Key concepts
Overview
1.1.1 The globalisation of business
1.1.2 Globalisation and the evolution and role of MNEs in the world economy
1.1.3 Review of international trade theories
Assessment
Summary

Study unit 1.1 Learning outcomes

Once you have finished this study unit, you will be able to:

- Define globalisation and describe the drivers of this process.
- Explain the concept "born global firms".
- Discuss the evolution and role of MNEs in the context of globalisation.
- Outline the globalisation process and the role of MNEs.
- Justify the motivations for firms expanding abroad.
- Provide an overview of international trade theories.



Key concepts

Globalisation
Drivers of globalisation
Multinational enterprises
Born global firms
Trade theories

OVERVIEW

In study unit 1.1 we focus on the process of the globalisation of business. Globalisation is defined. The corresponding global business drivers are described and discussed. In so doing we explore the concept of "born global firms" and the role of multinational enterprises (MNEs), both of which feature as vehicles in the globalisation process.

An understanding of these concepts allows us to crystallise the globalisation process and to discuss the role of MNEs as firms contemplate expanding abroad and getting involved in the globalisation process.

Pivotal to an understanding of the globalisation process is a firm grasp of the international trade theories which influence this process. These are discussed.

1.1.1 THE GLOBALISATION OF BUSINESS

In the context of globalisation in the 21st Century, it can be argued that while globalisation used to mean that business expanded from developed to emerging economies, today it could flow in both directions and, increasingly, from one developed economy to another.

Business, according to your textbook, is all about competing with everyone, from everywhere for everything. The opening sections of chapter 1 of the textbook confirm this. To this end, MNEs must create a sustainable, competitive advantage over a period of time.

Moreover, they must do so in the context of the ongoing process of globalisation. Globalisation continues inexorably, regardless of the degree of competition between enterprises or the size of the enterprise. But, it is MNEs (multinational enterprises) in particular, that frequently serve as the vehicle and conduit for the advancement of the globalisation of business. Indeed, it is the reality of competitive pressures and the prevalence of distinctive competencies on the part of enterprises, in search of sustainable profitability, that highlights the unique role of MNEs in the global business environment. This argument is unfolded on pages 4–7 of the textbook. It provides the environmental background to the advent of globalisation enabling us to crystallise the definition and meaning of globalisation. This is discussed, very specifically, on pages 5–7 of the textbook.

Globalisation denotes the level of interdependence between people, countries and nation states. We are, however, particularly interested in globalisation from an economic perspective. To this end the focus is on the globalisation of markets and production. You must be able to draw this distinction. Study pages 6–7 of the textbook very carefully.

If globalisation is such a ubiquitous phenomenon we are justified in asking the question: "what are the drivers of globalisation?" Generally speaking, the most common drivers include:

- Changes in the political environment, reflecting the impact of the creation global economic/trade regulatory bodies and the collapse of communism.
- Changes in the technological environment, being a reflection of the advent of the worldwide web, e-mail and video conferencing.
- Changes in transportation technology, innovations which facilitate long distance travel.

These developments are dealt with on pages 7–11 of the textbook.

1.1.2 THE ROLE OF MNEs IN GLOBALISATION

MNEs feature prominently in the globalisation process, particularly from an economic perspective. Because of the role they play it is important to trace the strategies they frequently use as participants in the globalisation process. These are discussed on pages 13–16 in the textbook. These initiatives include:

- International enquiries and networking with regard to expansions abroad.
- The appointment of an export manager.
- The establishment of an export department or direct overseas sales.
- The establishment of branches and/or subsidiaries.
- Overseas assembly of components and final products.
- Overseas manufacturing.
- Integration of overseas subsidiaries.

These initiatives represent different strategic entry modes.

1.1.3 BORN GLOBAL FIRMS

Contrary to MNEs which have globalised as a result of a definite decision to do so, is the prevalence of "born global firms". This reality is discussed on pages 16–17 of the textbook. It refers to firms that have begun their international activities, from their inception. They have not followed the strategic steps which most MNEs do when they globalise their operations.

These firms enter foreign markets from the outset of their formation and operations. This phenomenon is discussed on pages 16–17. Study the factors that give rise to "born global firms".

1.1.4 MOTIVATION FOR EXPANDING ABROAD

Given the unique attributes of MNEs and "born global firms", we would do well to consider some of the more general reasons why firms (enterprises) expand abroad. These are set out on pages 17–18 of the textbook. You must familiarise yourself with these forces influencing "expansions abroad".

1.1.5 INTERNATIONAL TRADE THEORIES

Traditionally, a knowledge of international trade theories has provided a useful background to understanding globalisation, from an economic perspective. These theories are discussed on pages 18–22 of the textbook. A study of these theories helps us contextualise the role of MNEs in the world economy, as discussed on pages 22–23.

The international trade theories are listed and discussed as:

- Mercantilism.
- Absolute advantage.
- Comparative advantage.
- Heckscher-Ohlin factor proportions theory of comparative advantage.
- The Leontief paradox.
- Product life cycle theory.

- New trade theory and;
- National competitive advantage.

These theories are debated as follows:

1.1.5.1 Mercantilism

This theory postulates the benefits of export promotion, but, at the expense of importation. It describes the use of the State's power and resources to promote exports in a nation state's economy. It emphasises the benefits of ensuring the State's security and prosperity through the pursuance of this strategy, as discussed on page 18 of the textbook.

1.1.5.2 Absolute advantage

This is premised on Adam Smith's publication: "The Wealth of Nations". Smith argued for the pursuance of absolute advantage, by countries, on the basis of the division of labour. By this he meant that each country should specialise in the production of one product, for which it is uniquely suited. The country would then specialise in trading in this product, the implications of which are spelled out on page 19 of the textbook.

1.1.5.3 Comparative advantage

This is premised on Ricardo's publication: "Principles of Political Economy". He advanced the argument that a country should specialise in the production of those goods that it produces most efficiently, but, import those goods it produces least efficiently.

The implication is that world production should be promoted in the context of unrestricted free trade. This would enable countries to export their surplus products freely while importing the products they need freely as well. This information can be gleaned from page 19 of the textbook.

1.1.5.4 Heckscher-Ohlin factor proportions theory

This is a corollary to the theory of comparative advantage. It introduces the concept of a country's factors of production and the availability thereof.

In short, this theory maintains that a country should export products that use its relatively abundant resources and import products that use its relatively scarce resources. The gist of this argument is discussed on page 19 of the textbook.

1.1.5.5 Leontief paradox

Paradoxically, this theory maintains that a country, like the USA, should be an exporter of capital-intensive goods- on account of its abundance of capital; as a factor of production. But, contrary to this argument, it was actually found that the USA's exports were eventually less capital-intensive than its imports. This contradiction, which is discussed on page 20 of the textbook, highlights this paradox.

1.1.5.6 Product life cycle theory

This theory is premised on the size and wealth of the USA market. It argues that as the demand for US products grows over time, so US multinationals will establish operations and facilities in those countries with the strongest demand for their products, to the point where price becomes the main competitor. This will enable foreign producers who are now clearly price competitive to export their products to the USA. This illustrates how developing countries eventually become cost and price competitive over time, but with US multinationals providing the catalyst.

The essence of this argument is traced on page 20 of the textbook.

1.1.5.7 New trade theory

This theory postulates that economies of scale in production may not always be attained within a country's borders, but that it could be attained "across borders". This theory calls into question the law of diminishing marginal returns to specialisation.

In essence, this theory emphasises that the competitive manufacture and sale of certain goods, for which economies of scale are not achievable, can only be realised if Government support-in the form of subsidies- is forthcoming. The thrust of this argument is spelled out on page 20 of the textbook.

1.1.5.8 National competitive advantage

This theory was developed and advanced by Michael Porter. He did so in the context of his well-known publication: "The Competitive Advantage of Nations". He maintains that there are four attributes of a nation that shape the competitiveness of the environment in which organisations do business. These are:

- Factor conditions;
- Demand conditions;
- Related and supporting industries;
- Firm strategies, structures and rivalry.

These attributes are expounded on page 21 of the textbook. Moreover, to these he added: "the role of government and chance", through the application of the instruments of trade policy so as to enhance or restrict trade. He expands on the reason for this inclusion on pages 21–22 of the textbook.

Porter maintains that the original FOUR attributes need to be positive and support each other to provide the ideal business climate for MNEs to operate in.

Assessment

You may want to check your understanding of the contents of this study unit by demonstrating that you can answer the following:

- *What type of business is most likely to qualify as a "born global firm"?*
- *What would be the most likely drivers of globalisation in the South African context? Would these same drivers apply to companies (MNEs) contemplating expansion into the rest of Africa?*

- *Why do MNEs play such a distinctive role in the globalisation process? Could other business models work as well?*
- *What are the dangers of the South African economy becoming entrenched in mercantilism? How could this impact on the country's absolute and comparative advantages insofar as its international trading potential is concerned?*

SUMMARY

This introductory study unit has exposed you to the globalisation process. The participants in this process have been identified in the person of MNEs and "born global firms". The catalytic role they play is considered. But, globalisation is circumscribed by the operation of a number of international trade theories. These are defined and illustrated, where appropriate.

Study the following pages in your prescribed textbook: Aregbeshola, Luiz, Ojah, *et.al.* (2011). Global Business: Environments and Strategies. 4th Edition. Oxford University Press. Pages: 4–8, 9–11, 13–17, 18–23.

Study unit 1.2

The political environment

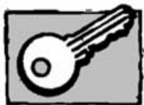
Contents

Study unit learning outcomes
Key concepts
Overview
1.2.1 The international political environment
1.2.2 Political risk
1.2.3 Political ideologies
1.2.4 The role of the State
Assessment
Summary

Study unit 1.2 Learning outcomes

Once you have finished this study unit, you will be able to:

- Understand and explain the institutional constraints having a bearing on global business environments.
- Illustrate the use of the PESTEL model as a means of analyzing environmental forces such as: political, economic, social and technological constraints.
- Describe and explain the concepts of:
  - Political risk.
  - Political ideologies.
  - Nation state.



Key concepts

Institutional constraints
PESTEL model
Political risk
Political ideologies

OVERVIEW

In study unit 1.2 you are made familiar with a number of elements that make up the global business environment. These include: the political, legal and technological

environments. You are introduced to these elements. In the process you are introduced to the PESTEL model. This is a tool that facilitates the analysis of these elements. The practical use of this tool is discussed. In so doing it alludes to a number of environmental factors that influence the globalisation process.

1.2.1 THE INTERNATIONAL POLITICAL ENVIRONMENT

The international business environment invariably reflects the dynamics of the international political environment. The two are closely interrelated.

Pivotal to the political environment is the reality of different political systems peculiar to different countries. Variations in political systems impact on the modus operandi of MNEs operating in different countries. Because of their involvement in foreign markets, MNEs must monitor the political climate of the countries in which it conducts its business. In particular, they are concerned about political constraints which can either encourage or discourage foreign investment and trade. Of primary concern to MNEs is the stability of the host country's political environment. This concern raises the spectre of political risk. This has implications for the stability of the host country's political environment, as discussed on pages 29–30 of the prescribed textbook.

1.2.2 POLITICAL RISK

For clarity sake, political risk denotes the impact of undesirable political changes on an MNEs foreign operations and decision-making process.

Political risk is fraught with different nuances for different MNEs. On page 30 of the textbook we are introduced to a checklist for assessing political risk. It is imperative that MNEs assess the political risk of a potential "host country" before investing in such a country. The use of the PESTEL model could prove invaluable in this regard, as set out on pages 28–29 in the textbook. However, the list appearing on page 30 of the textbook is not exhaustive. It will vary according to the MNEs core business and motivation for wanting to expand abroad. This is borne out by the arguments raised in Box 2.2 on page 31 of the textbook.

Activity 1.2.1

Draw up a checklist for a foreign mining company (MNE) contemplating doing business in South Africa. In so doing you must reflect on the observations expressed in Box 2.2 on page 31 of the prescribed textbook.

1.2.3 POLITICAL IDEOLOGIES

Though varied in type and corresponding importance for MNEs contemplating entry into foreign markets, political ideologies are frequently characterised by two extremes. The two extremes are: democracy and totalitarianism.

The impact of these two ideologies lies in the participation they afford citizens insofar as political decision-making is concerned. These extremes are discussed on pages 33–34 in the textbook. They can be dichotomised as follows:

- **Democracy**; which denotes the direct involvement of a nation's citizens in the political decision making process affecting the country.

  However, with the evolution of populous modern states, democracy is practised on a representative basis. This means that citizens are represented through elected members serving their interests in the democratic state. They do so through the formation and operation of a democratic government which must meet the conditions set out on page 33 of the textbook.
- **Totalitarianism**; which denotes the monopolisation of political power by one party, group or individual. This is supremely demonstrated through the manifestation of communist totalitarianism, which is contrasted with other forms of totalitarianism, as spelled out on pages 33–34 of the textbook.

You must be able to distinguish between these different political ideologies.

1.2.4 THE ROLE OF THE STATE

The State is a legal entity and an autonomous system of institutions that govern a specific geographical territory and population or nation.

A State's participation in the international political environment is frequently based on the principle that it has the authority to exercise sovereignty over its own citizenry and property.

The measure of State intervention in the economy has important implications for the production, distribution and consumption of goods and services.

The degree of State intervention is important to foreign investors as the State determines the nature of the economic system operative in a country. This also determines the State's involvement in economic development.

Frequently, the State's intervention is expressed through the conduit known as mercantilism. This is discussed on page 34 of the prescribed textbook.

Assessment

You may want to check your understanding of the contents of this study unit by demonstrating you can answer the following:

- *How could MNEs' distinctive role in the globalisation process be influenced by state interventionism?*
- *What are the dangers of the South African economy becoming entrenched in "mercantilism"? How could this impact on the country's international trading potential?*

SUMMARY

This study unit unpacks some of the political constituents peculiar to the global business environment. These are pivotal to our understanding of the political environment. The political environment is addressed in the context of political ideologies, political risk and the interventionist role of the State, in a country's political economy. These elements are discussed.

Study the following pages in your prescribed textbook: Aregbeshola, Luiz, Ojah, *et.al.* (2011). Global Business: Environments and Strategies. 4th Edition. Oxford University Press. Pages: 29–34.

Study unit 1.3

The international legal environment

Contents

Study unit learning outcomes
Key concepts
Overview
1.3.1 The legal environment
1.3.2 Different legal systems
1.3.3 Legal contracts and international law
1.3.4 The legal environment and investment status
Assessment
Summary

Study unit 1.3 Learning outcomes

Once you have finished this study unit, you will be able to:

- Differentiate between domestic and foreign legal systems, in the context of international law.
- Explain how these differences impact on the drafting and execution of legal contracts.
- Describe the implications of international law for international investment strategies.

Key concepts

Domestic and foreign legal systems
Common law
English law
Islamic law
International law
Legal contracts
International investment strategies

OVERVIEW

In study unit 1.3 consideration is given to the importance and dynamics of the

international legal environment. Distinctions are drawn between the different legal systems: domestic and foreign, English law and Islamic law, and indigenous legal systems and European legal systems. Throughout these comparative legal systems is the common denominator known as common law, which is accepted and applied in international law.

The impact of the international legal environment on the drafting and execution of legal contracts is discussed. This is done in the context of international law.

Pivotal to the global business environment is the impact of the international legal environment on the crafting of international investment strategies. This study unit focuses on the impact this has on international business decisions.

1.3.1 THE LEGAL ENVIRONMENT

MNEs generally operate in a regulatory environment, which is both politically and legally constrained. Therefore, it can be argued, that a country's legal system influences the global business environment.

The legal system of a country refers to the rules and laws that regulate behaviour, along with the process by which the laws are enforced and through which redress for grievances is obtained. The drafting and execution of legal contracts is influenced by these processes. The legal system of a country is of immense importance to international business. However, different countries have different legal systems. The international legal environment is characterised by domestic and foreign legal systems.

Domestic laws, for instance, govern commercial activities, in a specific country. MNEs need to be familiar with the domestic legal system, peculiar to the host country where it is doing business.

International law, in turn, defines the set of laws governing relationships between countries or internationally-based legal persons. This is frequently expressed through treaties and conventions. These agreements are spelled out on page 37 of the textbook. If binding, they require compliance, breaches of which warrant the imposition of sanctions. This, too, is discussed on page 37 of the textbook.

1.3.2 DIFFERENT LEGAL SYSTEMS

Because international business involves doing business across borders, differences in legal systems will always have a bearing on the way business is conducted.

Pivotal to the operation of these legal systems is the common law and civil law underpinnings peculiar to the respective legal systems. This distinction has a bearing on the different legal systems. The different legal systems are either premised on:

- English law.
- Islamic law or, the tenets of;
- European law, comprising French civil law, Portuguese or Spanish civil law or, German or Italian civil law; or
- Indigenous legal systems, which have their roots in Africa.

This mosaic of different legal systems regulates international business practice in one way or another. It determines how business transactions are executed and how contracts are formulated, relative to these respective legal systems.

The extent of these differences in legal systems, is a measure of how the legal environments of countries differ. Indeed, differences in legal systems can affect the attractiveness of a country as an investment destination or market. This is implied in pages 35–36 of the prescribed textbook.

1.3.3 LEGAL CONTRACTS AND INTERNATIONAL LAW

Business transactions are invariably formalised through legal contracts. This is the case both domestically and internationally.

The purpose of a contract is to stipulate the respective rights and obligations of the parties to the agreement.

Contracts are pivotal to international business, due to the risks and complexities inherent in the global business environment. Examples of these complexities and risks are spelled out on page 36 of the textbook. These examples touch on activities including: exporting, local supply chain configuration and management and freight forwarding agreements.

However, international contracts are periodically subject to disputes. Conflict resolution is often facilitated through the process of arbitration. This, too, is subject to the constraints of the international legal environment. If arbitration fails, litigation is the only option left for the parties involved. Here, too, the appropriate legal system comes into operation. This is clearly implied on pages 36–37 of the textbook.

In each instance, the burning question is: "which country's laws apply?" Invariably disputants appeal to the United Nations Convention on Contracts for the international sale of goods. This option is open to those disputants whose country has ratified this agreement.

1.3.4 THE LEGAL ENVIRONMENT AND INVESTMENT STRATEGIES

A decision to invest in activities in a given country must consider many economic, political, cultural and strategic variables. The legal environment impacts on this constellation of variables. It has the potential to influence the benefits, costs and risks of doing business in the country and thus its attractiveness as an investment destination.

The measure of this impact will be gauged by the level at which MNEs have to deal with these variables and the legal issues involved. Its choice of entry mode into foreign markets, and, therefore, the host country of choice, will determine the degree to which it will have to address the variables mentioned. But, there is no doubt that there are a variety of legal issues impacting on foreign direct investment. For example, foreign-based MNEs may be prohibited from acquiring property in the host country.

These issues are compounded by the prevalence of different contracting environments and/or the absence of a strong legal framework to protect investors. In all these instances, the risk for investors is compounded and needs to be managed accordingly,

given the prevailing legal system in the host country. Investment strategies need to be adjusted accordingly. This is the gist of the discussion on pages 38–39 of the prescribed textbook.

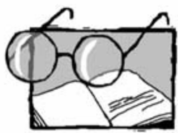
Assessment

You may want to check your understanding of the contents of this study unit by demonstrating you can answer the following:

- *What impact could nationalisation, specifically, have on the validity and execution of legal contracts, which have been entered into by MNEs, in a host country such as South Africa?*
- *How could different legal systems impact on international business transactions?*

SUMMARY

The legal environment is reviewed in this study unit. It is decomposed in terms of its constituent legal systems. The impact of these systems on the operation of international legal contracts and the implementation of investment strategies is considered. The focus of this discussion is against the backdrop of the relevant tenets of international law.



Study the following pages in your prescribed textbook: Aregbeshola, Luiz, Ojah, *et.al.* (2011). Global Business: Environments and Strategies. 4th Edition. Oxford University Press. Pages: 35–39.

Study unit 1.4

The technological environment

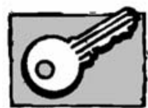
Contents

Study unit learning outcomes
Key concepts
Overview
1.4.1 Technology and the knowledge economy
1.4.2 Types of technology
1.4.3 Technological change
Assessment
Summary

Study unit 1.4 Learning outcomes

Once you have finished this study unit, you will be able to:

– Differentiate between the technological environment and the knowledge economy.
– Discuss the dynamics of the technological environment.
– Distinguish between the different types of technology.
– Defend the need for ongoing technological change in a country's technological environment.



Key concepts

Knowledge economy
Technological environment
High technology, hard technology and soft technology
Technological change

OVERVIEW

In study unit 1.4 we focus on the dynamics of the technological environment which is linked to the knowledge economy. The importance of technological innovation is emphasised. The technological source of global wealth is identified and discussed, relative to the different types of technology. Moreover, the impact of technological change on the technological environment is considered.

1.4.1 TECHNOLOGY AND THE KNOWLEDGE ECONOMY

Most political ideologies acknowledge that knowledge and technology have become increasingly important determinants of wealth and power. Moreover, this admission acknowledges that the pace of technological change has quickened. MNEs that cannot invest in research and innovation and adapt to rapid change will fall behind. Indeed, sources of profits in the global economy are shifting away from producers to those who control the knowledge of how to produce, market and distribute knowledge-intensive goods and services.

The technology environment and the knowledge economy are inextricably linked. This is because technology is a specific kind of knowledge about how to create and use material objects.

1.4.2 TYPES OF TECHNOLOGY

According to page 39 of the prescribed textbook, technology refers not only to knowledge but, also, to the skills and means of accomplishing a task. This perspective is significant when it comes to technological innovation. To this end, a distinction needs to be drawn between high technology, hard technology and soft technology. You must pursue this distinction as it is set out on page 39 of the textbook and be able to furnish examples of the different types of technology.

1.4.3 TECHNOLOGICAL CHANGE

These distinctive types of technology have a bearing on the dynamics of specific technological environments (for example, industry specific) and the changes taking place in those environments. Technological change impacts on the choice of technology application as highlighted in Box 2.4 on page 39 of the textbook.

But, not all of these technological changes are positive. For instance, the inappropriate application of technology can be deleterious to the global business environment. The increase in pollution and health-related problems in many business environments exemplifies this.

Nevertheless, technology is still pivotal to the prosperity of the global business environment. The reasons for this are spelled out on pages 39-40 of the textbook. Take note of the benefits to be derived from technology transfer as discussed on pages 40–41 of the textbook.

Regardless of the different perspectives on the development and control of knowledge and technology, it is clear that they play a central role in the global business environment. This is because knowledge and technology constitute an increasingly critical basis for wealth and power. Knowledge and technology confer a national competitive advantage. This is due to the fact that knowledge and technological prowess frequently drive economies of scale and the greater utilisation of capital equipment, with its corresponding productivity gains that benefit workers in the global business environment.

Activity 1.4.1

List and discuss the "disadvantages", that can justifiably be associated with a "technology and knowledge gap" in a country's technological environment.

Feedback on activity 1.4.1

This module, as you know, follows an outcomes-based approach in terms of Unisa's education policy. This module is based on outcomes-based learning.

Therefore, you are encouraged to compile notes, as you do the activities listed in this study guide. The notes for this activity could include:

- *The role of technology in the international business environment.*
- *The link between technology and the knowledge economy: a tenuous link means the presence of a knowledge gap.*
- *Technology as a driver of economic growth: a technology gap could inhibit economic growth.*
- *A technology gap means inhibitions as far as entrepreneurial initiatives are concerned.*
- *A technology/knowledge gap usually leads to a country's technological marginalization, thereby widening the gap between rich and poor countries. It is indicative of a lack of investment in technology. This does not augur well for the country's role in the global economy*

Assessment

You may want to check your understanding of the contents of this study unit by demonstrating you can answer the following:

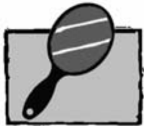
- *Why is the distinction between technology and the knowledge economy important?*
- *Furnish examples of a "knowledge gap" in the South African technological environment. You may want to refer to specific industries/sectors in the South African economy.*
- *List the types of technology that could be utilised in an infrastructure development project of your own choice. Describe the skills needed to drive this technology implementation.*
- *Can you cite an example of an MNE, industry or economic sector in South Africa that has possibly failed to keep up with technological change, and the impact this is having on the economy?*

SUMMARY

In this study unit we have reviewed the technological environment. The role of the knowledge economy, serving as a catalyst for technological change, is considered. The

fact that there are various types of technology is discussed and the extent to which this differentiation impacts on change initiatives and the need for sustainable development in this environment is noted.

Study the following pages in your prescribed textbook: Aregbeshola, Luiz, Ojah, *et.al.* (2011). Global Business: Environments and Strategies. 4th Edition. Oxford University Press. Pages: 39–41.



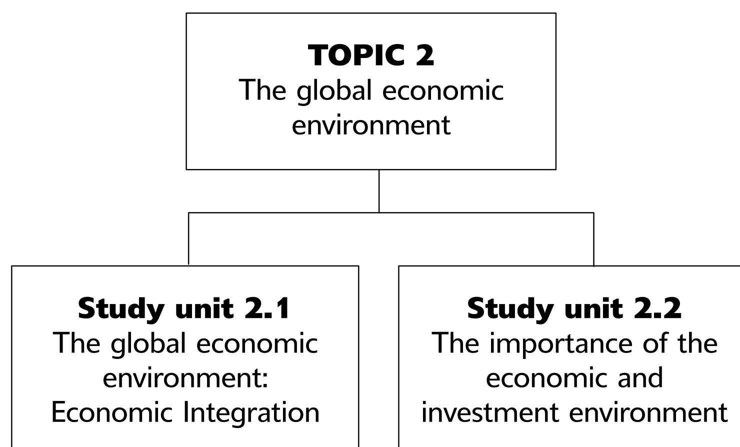
Reflections

Now that you have completed the FOUR study units that comprise Topic 1, it would be appropriate to reflect on what you have learned thus far. Here are some prompts which could assist you.

– *The globalisation phenomenon and its various aspects must become increasingly familiar to you. Are you sure you understand the globalisation of business?*
– *Various aspects of the globalisation process are frequently operationalised through the activities of MNEs. Do you understand the role of MNEs in this regard? Are you convinced that this is an appropriate model for this purpose?*
– *Globalisation, as you have noted, has a theoretical dimension to the processes involved. Are you comfortable with your exposure to the content and application of these trade theories?*
– *Globalisation, as we have argued, does not take place in isolation: it is circumscribed by a number of environmental influences: political, legal and technological. Can you unpack these and comment on their significance.*

Topic 2

The global economic environment



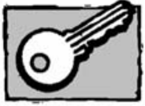
AIM

The purpose, nature and scope of this topic is to expose you to some of the dynamics of the global economic environment in the context of global and regional manifestations. The focus is on the manifestation of the global economy in terms of: systems and methodology. This includes the concept and constituents of economic integration.

Learning outcomes

After studying this topic you should be able to:

– Elucidate on the distinctives of the global economic environment.
– Explain the concept: economic integration.
– Describe the types of economic integration.
– Justify the benefits derived from economic integration.



Key concepts

Global economic environment
Economic integration
Types of economic integration

Study unit 2.1

The global economic environment

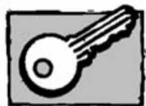
Contents

Study unit learning outcomes
Key concepts
Overview
2.1.1 The dynamics of the global economic environment
2.1.2 Economic integration
2.1.3 The major trade blocs
2.1.4 Free trade agreements
Assessment
Summary

Study unit 2.1 Learning outcomes

Once you have finished this study unit, you will be able to:

– Identify and describe the constituents of the global economic environment.
– Conceptualise the dynamics of economic integration.
– List and explain the types of economic integration.
– Elaborate on the implications of economic integration for South African businesses.



Key concepts

Global economic environment
Economic integration
Free trade areas
Born global firms
Free trade agreements

OVERVIEW

In study unit 2.1 we focus on the dynamics and elements of the global business environment and its corollary: **economic integration**. Economic integration can be decomposed in terms of the manifestation of major trade blocs and the formation of

free trade agreements, both of which are catalysts for the process of economic integration. The implications of economic integration for international business are discussed and illustrated with reference to South African businesses.

2.1.1 THE DYNAMICS OF THE GLOBAL ECONOMIC ENVIRONMENT

This study unit is premised on the concepts of economic integration: both globally and regionally.

Economic integration is usually expressed in the form of regional trade blocs. These trade blocs, which create and regulate trade creation and trade diversion, take the form of various economic co-operation groups and free trade areas (FTAs).

The dynamics of the global economic environment warrant the consideration of a number of definitions. These are spelled out on page 54 of the textbook. They include concepts such as: economic integration, trade blocs, and free trade areas. You must be thoroughly familiar with these concepts and definitions, before applying your mind to the concept and process of economic integration.

2.1.2 ECONOMIC INTEGRATION

Economic integration is to be understood in the context of the international trade theories discussed earlier on, notably the theory of international comparative advantage, which advocates free trade between countries.

Economic integration denotes the grouping of countries by agreement or treaty, usually on a regional basis, to secure a trade bloc that ensures benefits for mutual participants, through a significant downward revision of tariff and non-tariff barriers, on the cross-border movement of goods and services.

In practice, this means that when the member states of the WTO (World Trade Organisation)become participants in a new or existing regional trade agreement (RTA), they are obliged to notify the WTO. In consequence of this, several member states have multiple memberships, involving numerous such arrangements. The implications of this for international business are spelled out on pages 55–57 of the textbook.

Indeed, table 3.1, highlighted on page 56 of the textbook, demonstrates the significance of the incremental growth in merchandise trade, by region, as a percentage of GDP (gross domestic product) growth, in the major geographical areas, of the world. To this end, it vindicates the rationale for countries entering into regional trade agreements (RTAs). The statistics set out on pages 56–57 of the textbook confirm this assertion. Note the correlation between the growth in exports relative to the growth in global GDP. The converse applies as well. This is demonstrated on page 57 of the textbook. In so doing it highlights the types of economic integration.

In the light of these trends, you must be able to distinguish between the different types of economic integration, namely:

- Global economic integration; being facilitated by the rules and regulations of global institutions, such as the WTO and the IMF (International Monetary Fund);

- Regional economic integration; which exists among countries located in the same region;
- Bilateral trade relations; denoting a trade agreement between two countries. The aim is to facilitate preferential treatment between the two signatories to the agreement;
- Free trade area; which is a regional economic grouping of countries with which tariff and non-tariff barriers are generally abolished between nation-states.

Allied to these variations in economic integration is the role of the **customs union.** A customs union is a free trade area that eliminates tariffs between member nations and establishes a common tariff and other trade policies towards non-member countries. Customs unions such as the South African Customs Union (SACU) pool tariffs collected by member nations and share revenue according to an established formula. The details of this are described on page 57–58 of the textbook.

A further stage of economic integration is the **common market**. A common market is a customs union, established by members, to facilitate (liberalise) the movement of factors of production such as people and capital. The mechanics of this are spelled out on page 58 of the textbook.

The corollary to these various stages of economic integration lies in the formation of an economic union. This is a common market whose aim is to harmonise the fundamental economic policies among member nations. This includes fiscal and monetary policies.

However, the question frequently asked is: "how effective is the economic integration of trade?" The response to this is dealt with on pages 58–59 of the textbook. It is corroborated with reference to the benefits derived from economic integration as discussed on page 59 of the textbook.

2.1.3 THE MAJOR TRADE BLOCS

This section seeks to give practical expression to the concept and tenets of economic integration. In this section we examine the important, current, regional trade blocs. You are required to ensure that you understand the objectives of each trade bloc and why you consider them important.

The rationale for the existence of such trade blocs is discussed on pages 60–61 of the textbook. It is supported by the statistical presentation in Table 3.2 on page 61 of the textbook, which analyses global imports by region and selected economies between 1948–2007.

The major trade blocs are introduced as follows.

2.1.3.1 The European Union

The modus operandi of the European Union (EU) must be understood against the backdrop of the European Free Trade agreement. This agreement is pivotal to the EU functioning as a single market. This agreement provides for the elimination of trade barriers and controls that could impede trade between member countries. Tables 3.1 and 3.2 highlight the erstwhile successful operation of the EU, providing an analysis of trade data, relative to its membership and confirming its dominance in global trade and regional wealth.

The historical development, composition and trade characteristics, reflective of the current operation of the EU, are discussed on pages 62–65 of textbook. An understanding of these constraints will clarify the governance and policy-decision issues raised on page 64 of the textbook.

Of crucial significance was the establishment of the euro zone in 1999 and the euro as a single currency, thereafter. This was aimed at providing currency stability in the euro zone and at facilitating monetary transactions within and between euro zone countries. Given the present crisis in the euro zone, it is imperative that you understand the historical advent of the euro, its application to the euro zone countries and the operationalization of the euro as a legal currency for use in financial markets and MNE transactions. This vital information is dealt with on pages 64–66 of the textbook.

You are, therefore, required to make a careful study of the modus operandi of the euro zone and its monetary regime as discussed on pages 65–66 of the textbook. In so doing, you are encouraged to contextualise the operation of the EU and the euro, within the precincts of the European Free Trade Association (EFTA), as discussed on pages 66–67 of the textbook.

2.1.3.2 North American Free Trade Agreement (NAFTA)

This free trade agreement represents a joint arrangement between the USA, Canada and Mexico. It aims at removing most trade and investment barriers between member countries.

As you focus on this agreement, observe how it has:

- Increased trade.
- Delineated the trade characteristics associated with this trade bloc.
- Resulted in the elimination of trade barriers, giving rise to numerous benefits as discussed on pages 67–70 of the textbook.

2.1.3.3 MERCOSUR (Southern Common Market)

Similar trade agreements are expressed in what is known as the Southern Common Market. Brazil, Argentina, Uruguay and Paraguay are members of this trade bloc. Mercosur is the largest trade bloc in Latin America. It aims to achieve reductions in tariffs and quotas between member countries.

Originally, it was hoped to create a common market/customs union based on various forms of economic cooperation. This ideal eventually gave way to the introduction of reduced tariffs and quotas, between members. However, the ideal of implementing a common market, eventually took hold in 1995 and was operational until 2006. The upshot of this was the formation of associations with Bolivia and Columbia. These developments are discussed on pages 70–71 of the textbook.

2.1.3.4 Andean Common Market (ANCOM)

This bloc comprises countries such as: Bolivia, Chile, Colombia, Ecuador, Peru and Venezuela, and seeks to foster economic integration between them. This trading bloc focused on:

- Political and institutional support for this group.

- Promoting industrial development.
- Tariff reduction/eradication so as to obviate bilateral agreements.

These details are spelled out on page 71 of the textbook.

2.1.3.5 Central American Common Market and Latin American Integration Association (CACM and LAIA)

These trade blocs represent countries from Central and Latin America. The purpose is to promote trade between member countries. This is borne out by the substantial increase in imports and the establishment of a common tariff.

Such regional economic integration encourages free trade between participants in a bid to emulate the modus operandi of a common market, as spelled out on pages 71–72 of the textbook.

2.1.3.6 Caribbean Community Common Market (CARICOM)

This comprises numerous Caribbean countries including countries such as the Bahamas, the British Virgin Islands, the Turks and Caicos. Subsequently, it has been expanded to include other member states. The rationale for this economic integration and other developments are discussed on page 72 of the textbook.

2.1.3.7 South Asia Association for Regional Cooperation (SAARC)

The formation of regional trade blocs, as a means of economic integration, has spread to Asia as well. This is borne out by the membership of SAARC. The objective is to promote economic and social development in member states, through joint action in specified areas.

The goals of SAARC are spelled out on pages 72–73 of the textbook. Inter alia, they include trade and economic expansion in a much larger market, through the reduction and eradication of trade barriers. These and other initiatives are discussed on pages 72–73 of the textbook.

2.1.3.8 The Association of South Eastern Asian Nations (ASEAN)

Member states of this trade bloc aspired to establish and operate Free Trade Areas and Common Preferential Tariffs, within their economic jurisdiction. This they hoped would:

- Increase competitiveness.
- Allow members to exploit the trade characteristics of the region.
- Promote trade between members, regardless of their geographical location.

These goals are discussed on page 73 of the textbook.

2.1.3.9 Asia Pacific Economic Cooperation (APEC)

Of particular note is the diversity of the founding members of this trade bloc. Their sole aim has been to promote economic integration around the Pacific rim. The details of this trade bloc's operations are discussed on page 74 of the textbook.

2.1.3.10 Cairns group

This group comprises agriculture exporting countries with a commitment to reforming agricultural trade. The membership composition is discussed on page 74.

The advent of the Uruguay round of GATT (General Agreement on Trade & Tariffs) stems from the operation of the Cairns Group. You must take note of the extent of these initiatives as set out on page 75 of the textbook.

Indeed, the impact of these initiatives and reforms influenced the World Trade Organisation (WTO) agreement on agriculture. It sought to infuse trade liberalising rules in agriculture, globally. This is well documented on page 75 of the textbook.

2.1.3.11 Gulf Cooperation Council (GCC)

This trade bloc consists of six member states. These are Arab countries.

The group is an economic and political policy coordinating forum for its members. The nature of the cooperation is discussed on page 75 of the textbook.

2.1.3.12 Indian ocean RIM Association for Regional Cooperation

This comprises fourteen member states, it holds huge potential for emerging economies. This is borne out by the objectives and advantages of this association, as spelled out on page 76 of the textbook.

Pivotal to these potential benefits is the facilitation of trade and investment flows. This is particularly significant as far as forging closer ties with the Indian market is concerned.

2.1.3.13 Africa, Caribbean and Pacific group (ACP)

Closer to home (South Africa) lies Africa, with its potential for the formation and operation of regional trade blocs.

The ACP group comprises 79 member states spanning three continents. Though initially established to create a unified, negotiating body of members, who have "aid, trade and development" relationships with the EU, these relationships have not always been as strong as originally anticipated.

Today, the ACP is formally linked to the EU by convention agreements, facilitating tariff-free access to EU markets for the majority of the ACP members' exports. This agreement has reciprocal implications as well. ACP countries, for instance, qualify for concession loans should their profits fall.

The following conventions and agreements are noteworthy in this regard:

- Lome conventions, which facilitated special trade relationships with France's erstwhile overseas territories.
- Cotonou agreement, which replaced four successive Lome conventions, in June 2000, constituting a unique form of North-South cooperation. It aims at facilitating relations between EU and ACP countries on a thoroughly modernised basis.

The dynamics of this agreement are spelled out on pages 77–78 of the textbook.

2.1.3.14 Common Market of East and Southern Africa (COMESA)

Figure 3.3 on page 80 of the textbook highlights the importance of COMESA. It is one of two important regional trade blocs in Southern Africa. The reasons for the development of COMESA are spelled out on pages 80–81 of the textbook. They are dominated by political reasons.

Operationally, COMESA has evolved from a preferential trade area to a common market for East and Southern Africa. This transformation, culminating in the largest regional economic community in Africa, is discussed on page 81 of the textbook. However, one of the greatest challenges facing COMESA is the establishment of a free trade area. Hereto, the discussion on page 81 is helpful in trying to understand the problems facing COMESA.

2.1.3.15 Southern African Development Community (SADC)

SADC is extremely important, inter alia, to a country like South Africa, the practical focus of much of this module: Global Business Environments and Strategies.

The SADC was created to foster closer cooperation among the governments and people of Southern Africa. The reasons for and the mechanics of this cooperation are discussed on pages 81–84 of the textbook.

Of note are the objectives driving SADC to create a Southern African common market, as highlighted in Box 3.2 on page 83 of the textbook. This would reflect the ideals of free trade, free movement of people, a single currency, democracy and respect for human rights. These ideals have found their way into a legally binding treaty.

2.1.3.16 Southern African Customs Union (SACU)

This reflects the establishment of a customs union agreement between South Africa, Botswana, Lesotho, Namibia and Swaziland.

The objectives of SACU are spelled out on page 84 of the textbook. Fundamentally, it seeks to maintain the free inter-change of goods between member countries. To this end, it provides for a common, external tariff and common excise tariff for this customs area. The implications of this are spelled on page 84 of the textbook.

2.1.4 FREE TRADE AGREEMENTS

Free trade, in keeping with the laissez-faire notion that government intervention in the economy undermines efficiency and overall wealth, advocates and facilitates the

removal of protectionist measures (tariffs, quotas, etc.) that are designed to insulate domestic producers from international competition. Free trade is premised on the theory of international comparative advantage, as discussed earlier on in this study guide. Free trade arrangements are encapsulated in Free Trade agreements.

On pages 85–86 of the textbook, Free Trade agreements are discussed in the context of Free Trade Areas. The EU-Egypt and EU-Mexico Free Trade areas are cited as examples.

However, the focus of this discussion becomes more pointed in the case of EU-SA trade relationships. This is borne out by the implications of the Trade, Development and Cooperation Agreement (TDCA) as stipulated on page 86 of the textbook. Of particular note is the question of how South African companies should deal with the TDCA and with the status and operation of the euro as a single currency. This is discussed on pages 86–87 of the textbook.

The precursor to the TDCA was the EU-SA bilateral trade agreement, as discussed on page 88 of the textbook. Notwithstanding, the TDCA spanned new areas of political dialogue including: migration, health ICT, marine transport etc. To this end, the TDCA makes provision for the gradual relaxation of tariffs on both imports and exports which has implications for both SADC and SACU.

The upshot of the discussion on regional trade blocs is the delineation of criteria for successful trade blocs and trade agreements. These are discussed on page 89 of the textbook.

Despite the existence of these criteria, the operation of trade blocs can still be undermined by the ongoing conflict between world trade systems, as epitomised by the WTO and regional trade blocs, such as the EU and NAFTA. These are discussed on pages 89–90 of the textbook.

In the final instance, the formation of regional trade blocs has general implications for South Africa in particular. This is discussed on pages 90–91 of the textbook. The discussion is provided in the context of the advantages and disadvantages of Free Trade areas.

Assessment

You may want to check your understanding of the contents of this study unit by demonstrating you can answer the following:

- *Is the concept and practice of economic integration still valid, in the light of the Eurozone crisis?*
- *Many of the world's major trading blocs have been discussed. Their aspirations, achievements and successes have been highlighted in this study unit. But, not every trade bloc has been successful. This is particularly true of blocs such as: the Arab Maghreb Union (AMU) and the Economic Community of Central African States (ECCAS). What lessons can be learned from these failures?*
- *Ostensibly, the success of the "euro" as a single currency serving the Eurozone countries was appealing to African States seeking to introduce a*

single currency. But, more recent events in the Eurozone have put paid to these aspirations. Why do you think African economic communities are hesitant to introduce a single currency?

Feedback on assessment

Here are some indications as to how you could check your responses to the assessment questions.

- *The impact of the euro-zone crisis on economic integration depends on the level of economic integration involved. If it involves a common market or an economic union such as the European Union, then a crisis such as the euro-zone crisis could affect this type of economic integration.*
- *Political integration is pivotal to the success of trade blocs. This is particularly true in Africa where political turmoil in several African countries has impeded the progress and stability of trade blocs. ECCAS is a good example of this.*
- *The advent of the "euro" as a single currency has come at a cost. At times these costs exceed the benefits. Some of these costs are:*

  - *the loss of control over monetary policy;*
  - *the risks involved in exposing themselves to "political pressures" from regional economic authorities, for example, the European Central Bank;*
  - *the fact that the euro-zone has not proved to be an optimal currency area. There are insufficient similarities in the structure of economic activity of member countries to ensure an optimal currency area. If this is the case in Eurozone countries, how much more, in the case of Africa.*

Africa has taken note of these limitations.

SUMMARY

This study unit has focused on free trade areas and free trade agreements. It has done so in the context of regional economic integration. Regional economic integration has been discussed with reference to regional trade blocs. These trade blocs have been described and discussed. The rationale for their formation has been noted; while their achievements and limitations feature in this discussion as well. Certain trade blocs have not been as successful as others, for instance, the AMU and ECCAS and, more recently, MERCOSUR. Moreover, the advent of the Eurozone and the euro, as a single currency, warrant attention in the light of the Eurozone crisis.

Study the following pages in your prescribed textbook: Aregbeshola, Luiz, Ojah, *et.al.* (2011). Global Business: Environments and Strategies. 4th Edition. Oxford University Press. Pages: 54–58, 62–71, 72–73, 74–78, 80–84, 85–87, 89–91.

Study unit 2.2

The importance of the economic and investment environment

Contents

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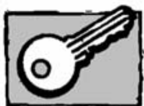
Overview
2.2.1 The importance of the economic and investment environment
2.2.2 Classification of economic systems: economic freedom
2.2.3 Economic development: metrics and indices
2.2.4 Innovation and entrepreneurship
Assessment
Summary

Study unit 2.2 Learning outcomes

Once you have finished this study unit, you will be able to:

- Articulate the importance of the economic environment.
- Discuss the various economic systems in the context of "economic freedom".
- Classify countries in terms of their "economic development".
- Explain the measures of economic activity, relative to "economic growth".



Key concepts

Economic environment
Economic systems
Economic freedom
Economic development
Economic growth

OVERVIEW

In study unit 2.2 we focus on the specific characteristics of the global economic and investment environment. In so doing, we look at the importance of this environment in terms of appropriate metrics and indices, which can assist in understanding and

predicting emerging trends. To this end, we evaluate the classification of global economic systems. This enables us to probe the concepts of "economic freedom" and "economic growth" and their corresponding metrics and indices.

2.2.1 THE IMPORTANCE OF THE ECONOMIC AND INVESTMENT ENVIRONMENT

Pivotal to understanding the importance of the economic environment is a grasp of the main types of economic systems. Implicit in the manifestation of different economic systems is the various levels of economic development, peculiar to different countries and the reality of economic freedom.

The barometer for gauging the dynamics of a country's economic environment are the economic and development indicators, which serve as predictors for the attractiveness of a country's economic and investment environment. While Foreign Direct Investment (FDI) will be dealt with in Part 2 of this study guide, the health of a country's domestic economic and investment environment can be measured, in terms of appropriate metrics and indices. Indicators such as economic growth, the inflation rate, the balance of payments (BOP), levels of external debt, employment levels and other demographic factors, serve as useful pointers to a country's prospective economic and investment potential.

Allied to these indicators are certain economic metrics which inform investment decisions. These include the following, as spelled out on page 95 of the textbook.

- Market size and efficiency.
- Current wealth in terms of purchasing power.
- Purchasing power parity.
- Gross domestic product (GDP), Gross National Income (GNI) and changes in the level of economic growth.
- Level of credit availability.
- Propensity to save.
- Exchange rates.
- Interest rate levels.
- Inflation.
- Foreign debt levels.
- Budget and trade deficits.
- Employment levels.
- Demographic trends.

All of these indices are of interest to investors. This is the essence of the discussion on pages 95–96 of the textbook.

Theoretically, economic freedom advocates the free movement of goods, services, capital and people. However, each of these initiatives is much harder to achieve in practice than to imagine in theory.

This does not, however, detract from the goals of economic freedom, but it does temper these goals with the realities of barriers such as non-tariff barriers, which inhibit the free production of goods and services, even in "market economies", as implied on pages 97–100 of the textbook.

2.2.2 THE CLASSIFICATION OF ECONOMIC SYSTEMS: ECONOMIC FREEDOM

Traditionally, a country's economic system has been defined and classified according to the structure and processes it uses to allocate its resources and conduct business. To this end, a country's economic system includes mechanisms and institutions that play a key role for this purpose. They represent the catalysts for implementing decisions relating to the ownership and allocation of resources, as discussed on page 96 of the textbook.

Broadly speaking, there are three types of economic systems that exist: (a) a market economy, (b) a command economy and, (c) a mixed economy.

2.2.2.1 Market economy

This is a system, in terms of which economic decisions and the pricing of goods, is determined by market forces, such as supply and demand. It is predicated on consumer sovereignty, and entrepreneurial spirit and competitiveness. Implicit in this system is the private ownership of factors of production. Moreover, market forces determine the "cost" of factors of production for the purpose of producing goods and services.

The tenets of a market economy are pivotal to the practise of economic freedom.

Clearly, a market economy implies a large degree of economic freedom, as spelled out on page 97 of the textbook. Consequently, we define economic freedom as the absence of government coercion or constraint on the production, distribution or consumption of goods and services, beyond the parameters of reasonable protection and liberty. The practical implication of this is well articulated on page 97 of the textbook.

The corollary to this is the use of the index of economic freedom as an aid to policy makers, international investors, international businesses, managers, etc.

According to page 97 of the textbook, the basic principles of economic freedom featuring in the index are: individual empowerment, equitable treatment and the promotion of competition. You are urged to familiarise yourself with the use and application of this index as set out on pages 97–99 of the textbook. You are, further, urged to consider the criteria used for "scoring" economic freedom and how this determines the categories of economic freedom and the measure of economic prosperity, as discussed on pages 98–100 of the textbook.

2.2.2.2 Command economy

Alternatively, described as a "centrally planned" economy, it represents a system in which government owns a nation's land, productive facilities and other economic resources. It also plans most of the country's economic activities.

This type of economic system means that the goods and services produced, the quantities in which they are produced and sold and the prices at which they are sold, are all determined by the government. This is consistent with "totalitarianism", a very distinctive political ideology. The import of this type of economic system is spelled out on page 101 of the textbook.

Historical developments in China- for instance- illustrate the effects of implementing a command economy. The example of China confirms that the objective of a command economy is to mobilise economic resources, for the public good, however, the opposite occurred. This is because in a command economy, every State-owned enterprise (SOE) has little incentive to cut costs and to be efficient. In the final analysis, it is the consumer who suffers. A glance at page 101 of the textbook bears this out.

2.2.2.3 Mixed economy

This system advocates and facilitates the more equitable distribution of economic resources between private and government participants in the economy. It implies government control of certain sectors of the economy that it considers important to the national interest, such as: health, energy and security.

Mixed economies are prevalent throughout the world. The antidote to mixed economies is deregulation and privatisation, as experienced by countries such as the UK and France. The "shift" from mixed economies to market economies is discussed on pages 101–102 of the textbook. As you study this transition, take note of the difference between "central planning" and "mixed economies" as discussed on page 102 of the textbook.

2.2.3 ECONOMIC DEVELOPMENT: METRICES AND INDICES

2.2.3.1 Economic development

Classifying countries in terms of their level of economic development provides valuable information for MNEs wanting to expand internationally.

This is because an MNEs competitive strategy compels it to consider the dual determinants of profitability and growth, as they contemplate foreign expansion into international markets, so as increase sales and profits.

Therefore, the level of economic development and the extent of economic activity, usually characterise foreign countries and markets sufficiently to warrant careful research, as MNEs search for suitable countries and markets as investment destinations. The corollary to this is the quest for promising economic activity, in a specific country, which is a function of the level of its level of economic development. To this end, the measures of economic activity warrant attention.

These measures or indices include:

- GNI- Gross National Income;
- GDP- Gross Domestic Product;
- GNP-Gross National Product;
- PPP- Purchasing Power Parity.

GNI, GDP and GNP are considered to be broad-based measures of a country's overall economic output and activity, during a given period.

GNI, per head of population (GNI per capita), is regarded as a yardstick for the economic activity of a country; it measures total annual income received by residents of a nation.

GDP is the sum of the gross value added by all resident producers in the economy and any product taxes (less subsidies) not included in the valuation of output. GDP is the market value of production that occurs within the national borders of a country, regardless of whether the factors of production are domestic or foreign.

GNP is the market value of all the goods and services produced in an economy, including the value of the goods and services imported, less goods and services exported in a particular year.

To account for differences in the cost of living, per country, GNI per capita can be adjusted by the purchasing power, per country. This is known as the purchasing power parity adjustment. It allows for a more direct comparison of living standards in different countries. The basis for the adjustment is the cost of living in the USA.

These measures of economic activity are defined and discussed on pages 103–106 of the prescribed textbook.

Economic metrics, of the type just mentioned, are pivotal to classifying the development status of countries. Invariably, countries are classified according to discernible phases of economic development and criteria adopted by the World Bank. This classification includes:

- Developed countries, with a high income, per capita.
- Less developed countries, falling in the low income categories.
- Developing countries, evolving from less developed to developing countries.

Of particular significance are the criteria adopted for these respective classifications. These are set out on pages 108–109 in the prescribed textbook. You must make a careful study of these.

2.2.3.2 Economic growth

Other metrics warrant attention as well. They include "economic growth" and changes in the level of economic growth, which plays a vital role in determining a country's economic development status.

The concept of economic growth is discussed on page 110 of the textbook. It is a function of a country's economic capacity to produce goods and services over a period of time. This is discussed with reference to changes in GDP, from one year to the next. Such measurement relates to real GDP, at constant prices, so as to eliminate the effect of inflation. You must contrast this with GDP at current prices as explained on page 111 of the textbook.

Economic growth has implications for international business. This is discussed on pages 112–114 of the textbook.

For instance, global trends in economic growth are important indicators of economic development world-wide. This is discussed on pages 113–114 of the textbook. It focuses on the rationale for identifying countries with potential for international business expansion.

Consequently, economic growth is a key macro-economic issue and information about a country's economic growth is crucial for informing decisions in international business.

2.2.3.3 Inflation

Inflation is a key macro-economic index. It is most frequently measured in terms of the consumer price index (CPI), and, as such, is an important economic metric.

Inflation is a monetary phenomenon. It denotes the general increase in the prices of goods and services over a period of time: thereby affecting the general political and economic confidence in a country. It impacts on CPI, interest rates and exchange rates. A country's rate of inflation is of importance to investors contemplating investing in a country. Monitoring and predicting a country's inflation rate is essential for the purpose of international investment decisions.

Contrary to inflation, is the phenomenon of deflation, referring to falling prices over a period of time. This phenomenon is discussed on page 114 of the textbook.

The demand-pull and cost-push factors driving inflation in a country are also discussed on page 114 of the textbook. The implications of these two forces in the inflation equation are discussed on page 114 as well. In particular, the impact of these forces on production costs and labour costs are noteworthy. Both of these forces drive up prices, which are then passed on to consumers, affecting consumer demand for goods and services.

Inflation is measured by the inflation rate which is the percentage change in prices from one year to the next. The importance of measuring the inflation rate on an annualised basis, is spelled out on page 115 of the textbook.

As alluded to, CPI (the consumer price index) is the most widely used measure to gauge the general level of price increases in a country's economy. CPI depicts price movements, relating to goods and services, purchased by the average household, over a period of time, usually one year. These price changes, over a year, indicate the annual inflation rate.

You are, therefore, strongly urged to familiarise yourself with:

- The processes involved in calculating the CPI.
- The meaning of the CPI headline inflation rate.
- The core inflation rate.
- The consumer price index, excluding interest rates on mortgage bonds (CPIX).
- CPI food price changes.

You must understand these indices and how they inform our understanding of inflation and its impact on a specific economy.

Apart from CPI, we need to take note of PPI (production price index). This indicates percentage changes over time in the average level of prices of all goods and services produced. The price used for calculating PPI is the price at which the product/service is sold for the first time. Both CPI and PPI can be based on monthly/quarterly figures. PPI refers to point of entry prices.

Both CPI and PPI indices have a direct bearing on the decision-making process in international business. The full implications of inflation for international business are discussed on pages 116–117.

Moreover, note the influence of inflation rates on interest rates, from an international

investor's point of view. For, higher interest rates impact the real rate of return on investments, but they tend to reduce domestic demand, thereby affecting economic growth. This is well documented on pages 116–117.

Activity 2.1

The CPI, as we have noted, is the yardstick used to measure the general level of price increases in the economy. The calculation of the CPI comprises numerous metrics. But, these metrics change over time. This is what is happening in South Africa at the moment. South Africa's CPI is being given a "new look", so that it better reflects the burden on households, reflecting some of the key drivers of inflation in the country.

In the light of these developments:

— Try and find out what the main drivers of inflation are in South Africa. Where would you start looking?
— List the reasons why you think the South African CPI calculation must be reviewed from time to time.
— What could happen to the international business decision-making process if these indices are not reviewed on a regular basis?

2.2.3.4 Balance of payments (BOP)

This represents a national accounting system, capturing all payments to entities in other countries and all receipts coming into the nation.

As a corollary to the discussion on inflation, the BOP reflects the strength of demand, both at home and abroad. To this end, it informs both policy makers and international managers, regarding the economic performance of a country, in the context of the global market place.

The characteristics and composition of the BOP are dealt with on pages 118–120 of the textbook. Note the purpose of the current account and the financial account in this respect. These aspects of the BOP must be understood in the light of the caveats mentioned on page 118 of the textbook. The caveats point to the limited purpose served by the BOP accounting system.

2.2.3.5 External debt

A further indicator of a country's economic health can be gauged by the size of its external debt. This macro-economic indicator assumed international prominence in the wake of the Eurozone crisis. Economies such as those of Greece, Spain, Italy and other Eurozone countries have been destabilised by the enormity of their external debt.

In the context of the international economic environment, the external debt of a country is the amount of money obtained from the foreign banking sector. External debt is expressed as:

- The total amount of monetary debt.
- External debt as a percentage of GDP.

These measures and their importance are discussed on pages 120–121 of the textbook.

Operationally, it forms part of assessing the potential benefits, costs and risks of doing business with specific countries over a given period of time.

2.2.3.6 Privatisation

The political ideologies discussed in this study guide, thus far, can be tempered by policy initiatives such as privatisation.

Privatisation has, as its stimulus, the process of deregulation. Privatisation denotes the transfer of ownership of state property into the hands of private individuals, usually by the sale of these state assets.

Privatisation usually takes place in the context of economic transformation. It is aimed at improving economic efficiency by giving new private owners a powerful incentive in their quest for increased profits and productivity.

The experience of the UK in the 1980's, when many state-owned assets were sold off, provides an informative example of the process of privatisation.

Privatisation invariably takes place against the backdrop of distinctive political ideologies such as socialism. But, it can also be the result of economic pressure that confronts MNEs in the international market place. These could be pressures for local responsiveness and cost reduction that confront businesses, as a result of globalisation that makes it difficult for governments to continue sustaining the competiveness of state-owned enterprises. This is discussed on page 121 of the textbook.

Notwithstanding, privatisation holds many advantages for countries. These advantages are spelled out on pages 121–122 of the textbook. Note the broad-brush benefits, such as the attraction of foreign direct investments (FDI) and the more specific benefits, such as improving enterprise efficiency.

2.2.4 INNOVATION AND ENTREPRENEURSHIP

International consensus confirms that both innovation and entrepreneurship are drivers of economic growth.

Innovation concerns new developments in products, services, processes, etc.

Entrepreneurship orientation, in turn, is frequently a function of a country's distinctive culture. This is true of the USA, where individualism has had an osmotic effect on the country's entrepreneurship orientation. This is discussed on page 122 of the textbook. This pattern varies from one country to the next.

Clearly a market economy, based on market principles and representative democracy, with the protection of property rights, provides the ideal climate in which innovation and entrepreneurship can flourish, as discussed on page 123 of the textbook.

The international economic environment is complex. These complexities embrace aspects such as: economic systems, economic growth, the stages of economic

development and the importance of macro-economic indicators such as GNI, GDP and GNP growth. They form part of the macro-economic mosaic which has been considered in this discussion.

Assessment

You may want to check your understanding of the contents of this study unit by demonstrating if you can answer the following.

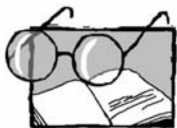
- *Is it justifiable to draw a distinction between the economic and investment environment?*
- *What macro-economic indicators would you use to confirm that a country's manufacturing output is declining? Where would you expect to find this information?*
- *Is the concept of "economic freedom" still valid, in the light of the Eurozone crisis? Do you think the Eurozone has any bearing on a command economy?*
- *How would you describe the South African economy, in terms of "systems orientation"? Are there any indications that the South African economy could move towards a "command economy"?*

SUMMARY

This study unit has explored both the economic and investment environments. It has done so systemically, by giving attention to the classification of economic systems in the context of economic freedom.

The corollary to this is the role and use of macro-economic indicators and their measurement in monitoring the economic development and investment potential of a country. These economic indicators are defined and discussed. Other metrics are considered as well. These are spelled out in the context of key economic indices and their influence on the process of decision-making in international business.

Moreover, the importance of innovation and entrepreneurship, as drivers of economic growth, is addressed as well.



Study the following pages in your prescribed textbook: Aregbeshola, Luiz, Ojah, *et.al.* (2011). Global Business: Environments and Strategies. 4th Edition. Oxford University Press. Pages: 95–96, 97–99, 101–102, 103–106, 108–109, 111–114, 115–117, 118–123.

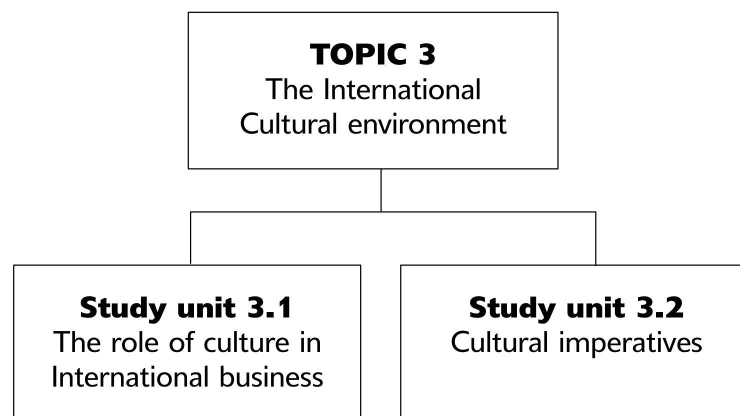
Reflections

Now that you have completed these TWO study units that comprise topic 2, it would be appropriate to reflect on what you have learned thus far. Here are some questions which can serve as prompts to see whether you are comfortable with this study material.

- *African countries have been experimenting with regional trade blocs for years. What lessons can Africa learn from international economic integration efforts?*
- *The temptation to introduce a common currency in Africa's trading blocs is very real. What about the caveats posed by the euro crisis?*
- *Given the information provided by South Africa's macro-economic indicators, what information should be garnered to try and find out why South Africa's potential economic growth is much lower than other countries?*
- *South Africa's CPI is, allegedly, much higher than reported on. How can a study of national accounting data clarify inflation trends in the country? Should we be concerned about these trends in both the host and parent countries?*

Topic 3

The international cultural environment



AIM

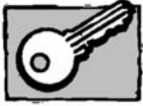
The purpose and scope of this topic is to familiarise you with the important role that culture plays in international business. Therefore, culture in this context, is defined. Its characteristics and elements are explored. Moreover, its importance, relative to society and the nation state is discussed. This has implications for international business, particularly with regard to "business culture" and "culture in the workplace".

Learning outcomes

After studying this topic you should be able to:

- Indicate the ways in which cultural differences influence the execution of business functions.
- Explain the role of culture in international business.
- Define and discuss the different characteristics and elements of international culture.
- Trace the impact of culture on society and nation states.

- Identify those cultural impediments that stand to inhibit success in international business.
- Outline and discuss the various levels of culture.



Key concepts

Culture and its constituents
Society and nation states
Culture and ethical systems
Cultural impediments
Levels of culture

Study unit 3.1

The role of culture in international business

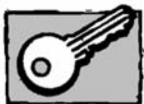
Contents

Study unit learning outcomes
Key concepts
Overview
3.1.1 Culture and international business
3.1.2 Defining culture
3.1.3 Culture, society and the nation state
3.1.4 Characteristics and elements of culture
Assessment
Summary

Study unit 3.1 Learning outcomes

Once you have finished this study unit, you will be able to:

- Define "culture" and its implications for international business.
- Delineate the characteristics and elements of culture.
- Discuss culture in the context of society and the nation state.



Key concepts

Cultural diversity
Cross-cultural literacy
Culture and the nation
Culture and society
Sub-culture

OVERVIEW

In study unit 3.1 you are introduced to the role of culture in international business. This introduction embraces the definition and meaning of culture, in the context of society and the nation state. Contextualising culture in this way allows us to highlight values, attitudes, beliefs and norms, relative to specific societies and nation states. Pursuant to

this discussion is the demarcation of the different characteristics and elements that make up the reality of culture. To this end, you are presented with the complex nature of international culture, which is a reflection of its varied and diverse constituents.

3.1.1 CULTURE AND INTERNATIONAL BUSINESS

International business is subject to cultural diversity, in terms of the international business functions and transactions involved. International business transactions differ from one country to the next. This calls for an awareness of differences in the global cultural environment.

Pivotal to understanding cultural differences is the notion of a "nation state", with its corresponding attributes of values, language, race and religion. Herein lies the national identity of ethnic and cultural groups, with their different patterns of cultural behaviour; the uniqueness of which allows for the designation "ethnocentric or home-country orientation" as opposed to polycentric orientation.

Cultural orientation must, therefore, reflect cultural knowledge and awareness of cultural differences between countries. This is clearly implied on pages 128–129 of the textbook. These considerations raise the question of culture in international business.

A country's unique culture is a reflection of its political, legal, economic and technological systems which impact on the international business environment. These aspects of the international business environment were treated in study unit 1.2 of this guide.

The dynamics of the international business environment have spawned the need for cross-cultural literacy. Cross-cultural literacy is a critical requirement for MNEs in foreign countries. It is essential in their quest to assimilate different cultural values, norms, beliefs and traditions peculiar to MNE employees. The impact of these cultural differences is discussed on page 129 of the textbook. The implications it holds for international managers is also spelled out. These implications help clarify the meaning of culture: they help define "culture".

3.1.2 DEFINITION OF "CULTURE"

On page 130 of the textbook a comprehensive definition of "culture" is provided. Its systemic characteristics includes the role of values, attitudes, beliefs, norms, symbols and traditions, thereby providing an all-encompassing definition of "culture" as set out on page 130 of the textbook.

All of these determinants of culture are a reflection on the unique nature of a particular society, as spelled out on page 131 of the textbook.

3.1.3 CULTURE, SOCIETY AND THE NATION STATE

Given the difficulties of crystallising an ideal definition of "society", your textbook spells out a workable definition. This definition is unpacked on page 130 of the textbook and expounded, thereby impinging on elements such as: sub-cultures, ethnicity, race, and a society's unique demographic characteristics.

These aspects are dealt with on page 132 of the textbook. While contributing to an understanding of concepts such as: "society" and "nation state", nevertheless, provision of precise definitions remains elusive. This is acknowledged on page 132 of the textbook therefore, attempts to crystallise these concepts must be understood in the context of: multi-ethnicity, religion, language and the realities of distinctive sub-cultures.

3.1.4 CHARACTERISTICS AND ELEMENTS OF CULTURE

Culture is characterised as being:

- Acquired through learning.
- Shared.
- Relative.
- Interrelated.
- Adaptive.
- Symbolic and;
- Pervasive.

These attributes are discussed on pages 132–133 of the textbook.

On the other hand, Figure 5.1 on page 133 of the textbook, illustrates the elements of culture. These elements influence the value systems in a society. Such value systems include: emergent values, beliefs and norms. These impinge on the social structure, religious and educational constituents of a society, all of which are circumscribed by the political and economic philosophy, unique to a particular society.

As stipulated on pages 133–135 of the textbook, the political philosophy of a society influences its values, norms and beliefs. Such influences impinge on a country's political ideology and systems. This is illustrated with reference to various political ideologies, as spelled out on pages 134–135 of the textbook. The burden of such political ideologies impact on international business decisions. This is explained on page 135 of the textbook.

The economic philosophy of a country is particularised through a select, economic system. We noted this in topic 2 of this study guide, where the different economic systems were discussed and contrasted. You may recall that these include:

- A market economy.
- A command economy.
- A mixed economy; each of which contains costs, benefits and risks.

Each one of these respective, economic systems, gives rise to different cultural nuances in different countries. This phenomenon is discussed on pages 135–136 of the textbook.

Notwithstanding, our review of the import of Figure 5.1 on page 133 of the textbook, would be incomplete if we failed to recognise the importance of the "social structure", as one of the elements of culture.

The social structure of a society denotes the overall framework that determines the roles of individuals and groups in a society, the stratification of such a society, its class

systems and the corresponding status of individuals in such a "class system", such as the British class system. The composition and dynamic of a country's social structure is treated on pages 136–138 of the textbook.

In particular, note the import of "social stratification", in terms of targeting investments and meeting consumer needs in particular social categories. This is spelled out on pages 137–138 of the textbook.

"Social stratification" impinges on social phenomena such as: class systems, social mobility, individualism and collectivism and inter-class conflict.

All of these "social realities" reflect on the uniqueness of specific cultures. This is discussed on pages 137–138 of the textbook. Take particular note of the implications this has for international business operations.

Activity 3.1

McDonald's Corporation is a highly publicised MNE. It is becoming a seasoned player in the global business expansion game but, McDonald's faced unique challenges when planning to enter India. India's Hindu culture posed the greatest threat. Moreover, Indian Muslim culture, posed an equally, unique challenge.

Given the unique nature of McDonald's business, make a list of the cultural impediments facing McDonald's in India. Prepare a basic plan as to how they could overcome this.

Assessment

Now that you have completed study unit 3.1 we would like to present you with some questions which you can respond to, in a bid to test your understanding of this study unit.

- *How does an understanding of "culture" facilitate cross-cultural literacy?*
- *What do you think the cultural differences are between a "nation state" and a society?*
- *List and illustrate the determinants of culture. How can a host country's political and economic philosophy influence the international business operations of MNEs, doing business in such a country?*
- *Why do you think that the culture of a country might influence the cost of doing business in that country? Try and illustrate your answer with examples.*

SUMMARY

This study unit has sought to highlight the complexity of culture in terms of its characteristics and elements. To this end we acknowledge the importance of values,

norms and beliefs as central components of culture, recognising that they are influenced by political and economic philosophy, social stratification, language and education.

These components assume different dimensions in different cultural settings; reflecting the cultural nuances of different nation states and societies and the reality of social stratification and educational differences.

Study the following pages in your prescribed textbook: Aregbeshola, Luiz, Ojah, *et.al.* (2011). Global Business: Environments and Strategies. 4th Edition. Oxford University Press. Pages: 128–129, 130–132, 133–135, 136–138.

Study unit 3.2

Cultural imperatives

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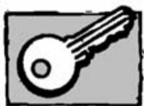
3.2.2 Cultural impediments
3.2.3 Levels of culture
3.2.4 Culture in the workplace
3.2.5 Implications of culture for international business
Assessment
Summary

Study unit 3.2 Learning outcomes

Once you have finished this study unit, you will be able to:

- Explain how religion and ethical systems influence the shaping of culture and cultural "values".
- Identify the impediments to culture and how these barriers can be overcome.
- Delineate and describe the various levels of culture.
- Discuss why culture in the "workplace" is important for international business.
- List the implications of culture for international business.



Key concepts

Religious/ethical systems
Cultural impediments
Levels of culture
"Workplace" and cultural values

OVERVIEW

In study unit 3.2 the diversities inherent in international culture are discussed. These range from: the influence of religion and ethical systems on the manifestation of culture in different societies and nation states, to the manifestation of culture at different levels

in societies, organisations and the individual "workplace", with its implications for international business. This discussion is accompanied by references to a variety of theories regarding our understanding of the international cultural phenomenon. An understanding of international cultural diversity, provides insights into the prevalence of various cultural barriers which impact, particularly, on the management of culture in the workplace. Such diversity is highlighted throughout this study unit.

3.2.1 CULTURE AND ETHICAL SYSTEMS

Cultural patterns of behaviour are usually deeply rooted in religious and ethical systems. This reality is addressed on pages 138–139 of the textbook. The reason for this is that religion and ethics invariably influence social and business environments. The ways in which this happens is discussed on page 139 of the textbook. As you explore this phenomenon take note of the close links between religion and ethical systems.

Given this close association between religion and ethical systems and their impact on culture, it is important to consider the major religions and philosophies of the world and their potential impact on the international culture mosaic.

3.2.1.1 Christianity

Institutionally, the origins of Christianity stem from Judaism and Roman Catholicism. The historical roots of Christianity can be found in these two citadels of religion. The evolution of Christianity is discussed on page 139. Its modern manifestations and practises lie, in particular, in the outcome of the Protestant reformation and modern Catholicism. This has implications for international business, due, inter alia, to the work of Max Weber, who spawned the concept of the "Protestant work ethic" and the impetus it gave to free market capitalism. This line of reasoning is set out on page 140 of the textbook.

3.2.1.2 Islam

Islam's vindication lies in its monotheism. Its religious principles are enshrined in the Qur'an. Their attitude towards materialism and temporal power is noteworthy. This is evident in their disposition towards their fellow men, expressed through their humility, charity and justice; which impacts directly on their dealings with others.

Such an attitude towards materialism, profits and "women" in society, has important implications for international business. This is considered and discussed on page 140 of the textbook.

It is imperative that you grasp these implications as they impact on decisions and transactions peculiar to international business.

3.2.1.3 Hinduism

Hinduism's origins are antiquated; going back more than 4000 years. Its beliefs and practises are not codified. There is no rigid text setting out their beliefs.

Contrary to other religious systems, Hinduism emphasises spiritual accomplishments rather than economic success. Their spiritual progress is marked by a belief in

"dharma" and "Karma". Both of these imperatives influence the way they live. This has implications for international business as spelled out page 142 of the textbook. Note how it influences their value system.

3.2.1.4 Buddhism

Buddhism's religious convictions are rooted in the virtues of suffering which can be compensated for by following the "Noble Eightfold path". Note that this emphasises virtues such as:

- Right seeing, thinking, speech, action, living etc.
- Mindfulness and meditation, all of which is discussed on page 142 of the textbook.

Such a distinctive life-style has economic and business implications, as discussed on page 143 of the textbook. These imperatives are spelled out on page 143 of the textbook.

3.2.1.5 Confucianism

Fundamentally, this is an ethical system rooted in the philosophical convictions of Confucius. Unlike other religious systems, Confucianism believes that attaining personal salvation is through correct actions.

Confucianism is based on a comprehensive, ethical code, providing guidelines for relationships with others. It espouses high standards of moral and ethical conduct. This has implications for international business, as summarised on page 143 of the textbook. Note the imperative of "trust" and how this influences contractual performance and "mutual trust" between companies.

3.2.2 CULTURAL IMPEDIMENTS

The overwhelming impediment, which is exemplified in the form of "ONE" of the cultural barriers, relates to language and communication.

Cross-cultural contact is forged through the means of language and communication. Language involves both spoken and unspoken communication.

The role of language in international business is discussed on pages 144–146 of the textbook. The formal means of cross-cultural communication are highlighted, with reference to numerous language groups. In essence, you must sensitise yourself to the communication challenges facing international managers and their staff. These arise due to numerous cross-cultural situations which require unique communication skills. These challenges are presented on page 145 of the textbook. In particular, note the relationship between education, culture and business.

The language barriers are compounded by other "cultural barriers". Examples of both types of impediments are provided in Box 5.3 and Box 5.4 as illustrated on pages 146–147 in the textbook. Notice the difference between verbal and written communication, as illustrated on page 146 of the textbook.

Pivotal to language impediments are the barriers posed by the paucity of education and poor education standards in many countries. Table 5.1 illustrates the very poor

literacy rates in certain countries. This has serious implications for MNEs following either a "polycentric" or "geocentric" approach to staffing and training in host countries, as discussed elsewhere in this study guide.

Impediments of this nature are of critical importance to MNEs seeking to enhance their national, competitive advantage. The arguments advanced by Porter in this regard, warrant attention, as set out on page 149 of the textbook. Notice the correlation between a country's level of education and its GDP, as discussed on page 149 of the textbook.

3.2.3 LEVELS OF CULTURE

A distinction is drawn between national, business and organisational culture. This distinction is discussed on pages 150–151 of the textbook. Figure 5.2 illustrates the link between these various levels of culture and multinational management.

National culture is to be understood in the context of the "nation state". Significantly, the dominant culture of the nation state usually has the strongest influence on international business. This in turn impacts on educational systems and religious beliefs. These cultural nuances are dealt with on page 150 of the textbook.

Business culture denotes values, norms, attitudes, beliefs and etiquette, affecting all areas of doing business in a specific culture. The pervasive influence of business culture and its impact on the work place is set out on pages 150–151 of the textbook. It focuses on all aspects of work and organisational involvement.

Indeed, the need to be culturally knowledgeable is imperative, if MNEs and their managers are to succeed in international business.

Organisational or professional culture, must be understood against the backdrop of national and business culture. Organisational culture denotes the norms, values and beliefs concerning the organisation and shared by its members. The outworking of these tenets of culture is of extreme importance to MNEs and their managers. The reasons for this are discussed on page 151 of the textbook.

"Organisational culture" provides us with an understanding of occupational or professional cultures. Though apparent at the same level as organisational culture, occupational cultures reflect the distinctive cultural groups such as: engineers, accountants, physicians etc. The implication this has for international managers is explained on page 151 of the textbook. Managers need to understand the values, norms and beliefs that these cultural groups espouse.

3.2.4 CULTURE IN THE WORKPLACE

Of considerable importance for MNEs, with operations in different countries, is how a society's culture affects the values found in the workplace. Indeed, management processes and practises may need to vary according to culturally determined work-related values. Inter-country, cultural differences, could well impact on management processes and practises in each country, respectively.

Therefore, to clarify these differences in management processes and practises, a framework of reference is provided as a catalyst to explore different cultural

approaches to managing people working in different cultural settings. These approaches are spelled out on pages 152–156 in the textbook. They include the following.

3.2.4.1 Low-context high-context approach

This approach differentiates between high-context and low-context cultures. In high-context cultures the context in which a conversation takes place is important: confirming that the words actually spoken are just as important as non-verbal communication.

In low-context cultures the speaker's words clearly communicate the message to the listener. The words spoken precisely convey the speaker's intentions.

You must make a careful study of the characteristics of high and low-context cultures as spelled out on page 152 of the textbook. Note the examples cited, relative to the countries mentioned.

3.2.4.2 Ronen and Shenkar's cultural cluster

These researchers framed a number of questions and documented the corresponding responses from respondents in different countries. The questions related to: work goals, job satisfaction, management style, work roles and inter-personal relations.

The outcome of the analysis of these responses confirm that international managers should expect few cultural differences, when moving between countries within one of these clusters of culture, than when moving between clusters of cultures. This is discussed on page 153, with reference to Figure 5.3.

3.2.4.3 Hofstede's cultural dimensions

Probably the most famous study of how culture relates to values in the workplace was undertaken by Geert Hofstede, during his employment at IBM.

He highlighted "FOUR" dimensions that he claimed, summarised different cultures. These include: power distance, uncertainty avoidance, individualism versus collectivism and masculinity versus femininity. These are listed and discussed on pages 153–156 of the textbook. They may be enunciated as follows:

- Power distance; focuses on how a society deals with the fact that people are unequal in terms of physical and intellectual abilities. Note the examples of inequalities in power and wealth.
- Uncertainty avoidance; this measures the extent to which different cultures tolerate uncertainty in different ways. Members of high uncertainty avoidance cultures: value job security, career patterns and retirement benefits. Low uncertainty avoidance cultures are characterised by a willingness to take risks and are less emotionally-resistant to change.
- Individualism versus collectivism; this focuses on relationships between the individual and his or her fellows. Individualism denotes loose ties between individuals, while individual achievement and success are highly valued.

- Collectivism, in turn, denotes the opposite: close or tight ties between individuals where the individual looks after the interest of others. Think of "Ubuntu" in African culture.
- Masculinity versus femininity: this focuses on gender relationships and roles in the workplace. In masculine culture, sex roles and masculine values such as achievement, determine cultural roles. In feminine cultures, sex roles are less differentiated in the same job.

Hofstede added another dimension: "time orientation", reflecting the extent to which members of a cultural group adopt a long-term rather than a short-term outlook on work, life and social aspects. This is discussed on page 154 of the textbook.

These dimensions are illustrated in Table 5.2, relative to the different countries listed in this matrix.

The implications of these dimensions for international managers are discussed on pages 154–156. Note how Hofstede applies this to various aspects of organisational performance, notably, performance appraisal, reward systems and long term planning.

3.2.4.4 Trompenaar's cultural parameters

These cultural parameters are summarised in Box 5.5 on page 156 of the textbook. They denote cultural differences between some 28 countries.

Of importance are the implications of these parameters as explained on page 157 of the textbook. Note the contrasting cultures: universal versus particularism, individualism versus collectivism, neutral versus emotional, work-life versus private-life relationships, as being totally separate, achievement versus ascription-orientated, sequential versus synchronic cultures.

These contrasts are spelled out on page 156 of the prescribed textbook. They are pivotal to understanding cultural differences.

3.2.5 IMPLICATIONS OF CULTURE FOR INTERNATIONAL BUSINESS

Pivotal to an understanding of the relevant implications is a grasp of the following:

- The link between culture and comparative advantage.
- The relationship between culture and business ethics.
- The need for cross-cultural literacy.
- The connection between culture and entrepreneurial-orientation.

These aspects are carefully discussed on pages 157–159 of the textbook. You must be sure you understand the relevance of each of these inferences that are being drawn from the cultural mosaic presented in this study unit.

You must study these imperatives and the impact they can have on the sustainability of international business operations, both in domestic and foreign markets, bearing in mind that cultural differences in various countries, could become an important catalyst for international business success stories.

Assessment

Ascertain your understanding of this study unit by testing your responses to the following questions against the content of this study unit.

- *Choose two countries that appear to be culturally diverse. Compare the cultures of those countries and indicate how cultural differences influence:*
  - *The cost of doing business in each country.*
  - *The likely future economic development of the respective countries.*
  - *Prospective business practises in each country.*

- *List and discuss what values of Islam, are hostile to western MNEs doing business in an Islamic country.*
- *Outline the cultural factors that drive differences in business etiquette to be observed by international managers travelling abroad.*

SUMMARY

Religious and ethical systems, have been defined and described in this study unit. Religious and ethical principles have been differentiated in terms of moral principles and values that are used to guide and shape behaviour. The world's major religious and philosophical systems have been considered.

Language and education have been explained as determinants of cultural resilience and national competitiveness.

Culture in the "workplace" features in our discussion. A number of dominant cultural dimensions in the workplace are presented and discussed. Their relevance to international business operations is highlighted.

Study the following pages in your prescribed textbook: Aregbeshola, Luiz, Ojah, *et.al.* (2011). Global Business: Environments and Strategies. 4th Edition. Oxford University Press. Pages: 138–139, 140–142, 143–147, 150–151, 152–156, 157–159.

Reflections

Your completion of topic 3 provides an appropriate opportunity to reflect on all you have learned thus far. Here are some prompts which could assist you.

- *Many argue that "culture" is a vague and nebulous concept: it cannot be measured, and, therefore, a knowledge of culture is of little use to international managers. Now that you have made a careful study of this topic, how would you defend the importance of "culture" in international business?*
- *The "class system" is very real in many societies, for example, India. Some of*

the impediments posed by such rigid class systems constitute serious deterrents to MNEs, planning to expand into foreign countries beset with aspects of the class system. In the light of this, try and come up with examples of such diverse "class systems", explaining how they represent entry barriers to MNEs planning to operate in such countries.

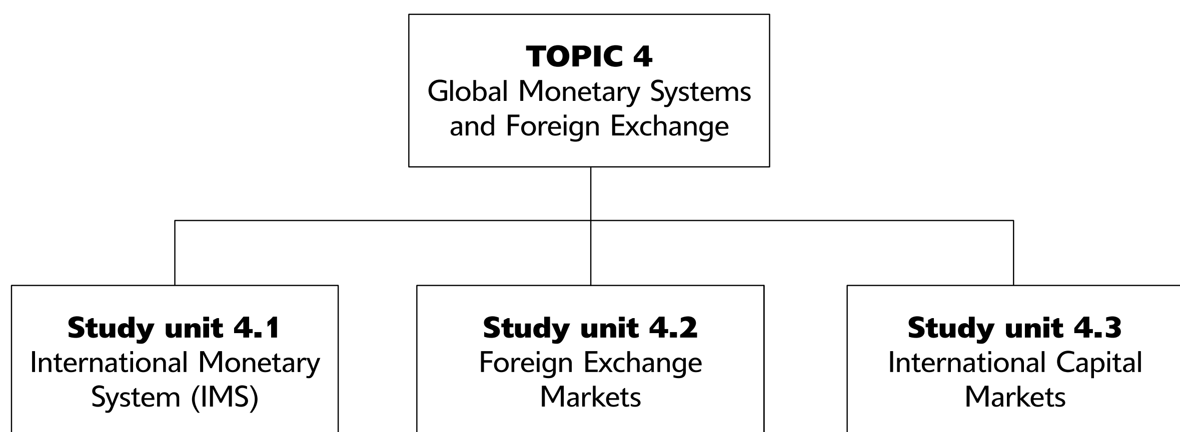
- *"If the cultures of the host and parent countries differ, regarding work-related values, an MNE, with operations in both countries, should vary its management processes and practises to account for these differences". Given such cultural differences do you think the application of Hofstede's "cultural dimensions" could assist in developing dual management processes and practices? Substantiate your answer.*

PART 2

GLOBAL BUSINESS ENVIRONMENTS: TRADE AND INVESTMENTS

Topic 4

Global monetary systems and foreign exchange



AIM

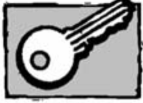
The purpose, nature and scope of this topic is to provide you with an overview of global monetary systems and foreign exchange markets. The global monetary system has spawned the advent and operation of foreign exchange markets. This system, and its derivatives, were formalised in terms of the Bretton Woods agreement. This agreement established the International Monetary Fund and the World Bank.

The objective is to expose you to the institutional framework within which the international monetary system (IMS and foreign exchange markets can be contextualised. This will clarify foreign exchange methodologies and the problem of exchange rate forecasting. It will also clarify the function of international money and capital markets: illustrating how these markets foster globalised production and development.

Learning outcomes

After studying this topic you should be able to:

- Articulate the modus operandi of the IMS and its institutional underpinnings.
- Distinguish between fixed exchange rates and floating exchange rate systems.
- Provide evidence of your understanding of the function of the foreign exchange market.
- Articulate and exemplify the purpose and function of international capital markets.



Key concepts

Bretton Woods Agreement
International Monetary Systems (IMS)
International Monetary Fund (IMF)
World Bank
Exchange rate systems
International capital markets

Study unit 4.1

The International Monetary System (IMS)

Contents

Study unit learning outcomes
Key concepts
Overview
4.1.1. The International Monetary System (IMS): evolution and constituents
4.1.2. The notion of a single currency
Assessment
Summary

Study unit 4.1 Learning outcomes

Once you have finished this study unit, you will be able to:

- Explain the rationale for the IMS.
- Identify and discuss the constituents of the IMS.
- Discuss the evolution of the foreign exchange rate system and the advent of a single currency.

Key concepts

International monetary systems (IMS)
Gold standard
Bretton Woods Agreement
Exchange rate system

OVERVIEW

In study unit 4.1 we introduce you to the IMS. This introduction focuses on the institutional elements of the IMS, namely, the International Monetary Fund (IMF), the World Bank, the European Monetary System (EMS), the Economic and Monetary Union (EMU) and the Bank of International Settlements (BIS).

The historical role of the gold standard and the Bretton Woods Agreement are considered in the light of the evolution of the floating exchange rate system. Allied to this is the recognition of other contemporary currency arrangements, all of which point to the introduction of a single currency, exemplified in the euro.

The evolution of foreign exchange markets warrants considerable attention, in the context of an evolving international monetary system. Hence the particular focus on the IMS.

4.1.1 THE INTERNATIONAL MONETARY SYSTEM: EVOLUTION AND CONSTITUENTS

The function of the IMS is to provide a set of rules and regulations aimed at facilitating international trade; but, not at the expense of national economies or even the global economy. The upshot of this arrangement is the provision of an institutional framework within which the foreign exchange market functions.

In order to understand the present functioning of the IMS and its constituents, namely the EMS (European Monetary System), the EMU (European Monetary Union) and the Bank of International Settlements (BIS), it is useful to consider its historical development.

Pivotal to the historical development of the IMS, is the importance of the following developments:

- The establishment and operation of the gold standard.
- The establishment of the Bretton Woods Agreement.
- The advent of the floating exchange rate system.
- The development of the EMS and the EMU.
- The establishment of the BIS.

These developments are dealt with on pages 164–169 of the textbook. As you study these pages, note the following:

- The gold standard and the modus operandi of the IMS.
- The mechanics of the gold standard.
- Reasons for the failure of the gold standard.
- The rationale for the Bretton Woods Agreement.
- The establishment of the International Monetary Fund (IMF) and the World Bank.
- The establishment of a fixed rate exchange system.
- The collapse of the Bretton Woods Agreement.
- The advent of a floating exchange rate system.
- Variations in the floating exchange rate system, giving rise to diverse currency arrangements: as documented on page 166 of the textbook.
- The development of the EMS and the EMU which would eventually pave the way for the formation of a single currency: namely, the euro. This development is discussed on pages 166–168 of the textbook.
- The establishment of the BIS, representing an attempt to rationalise the volume of international payment transactions. More recently, the BIS has assumed the role of an international financial agency, a role which has become more prominent, since the 2008/2009 global financial crisis. This is discussed on page 169 of the textbook. Take note of the important role the BIS is playing in the post 2008/2009 international financial crisis period.

4.1.2 THE CONCEPT OF A SINGLE CURRENCY

The formation of the EMU served as a catalyst for the introduction of a single currency: the euro. Complementary to this was the establishment of the European Central Bank (ECB), as a result of the impetus provided by the EMU.

The events marking the evolution of a single currency are delineated on pages 167–168 of the textbook. A study of these milestones will help you understand the history of the euro and its impact on prevailing economic communities. This is well documented on page 168 of the textbook. The benefits of a single currency are highlighted as demonstrated through: transparent prices, lower transaction costs, greater certainty for investors and increased competition.

Notwithstanding, the advent of the euro did not resolve all the issues facing members of the Eurozone. The uncertainties they continue to face in the areas of monetary and fiscal policy issues are discussed on page 168 of the textbook. They represent constraints on the Eurozone. Indeed, the gist of the argument is that the introduction of the euro has come at a cost, which is clearly implied on page 168 of the textbook.

Assessment

Now that you have completed this study unit, you should be able to assess your understanding of the contents. The following questions could assist you in this regard:

- *List and describe the financial institutions that support the IMS.*
- *Distinguish between fixed and floating exchange rate systems, was the "floating" exchange rate system a vast improvement?*
- *What was the original appeal of the "euro"?*

Feedback

Your response to the Assessment questions can be shaped by the following guidelines:

- *The IMS is supported by the following institutions:*
  - *The European Monetary System (EMS); which provided for the creation of a zone of monetary stability, by reducing exchange rate volatility, through convergence of member states' interest rates. It paved the way for the introduction of the euro. It also facilitated the management of member states' inflation rates through monetary policy, while coordinating exchange rate policies.*
  - *The European Monetary Union; is a monetary union which paved the way for a single monetary policy in a single currency.*
  - *The European Central Bank (ECB) plays a vital role in implementing the responsibilities of the EMU and the ECB. Indeed, they defined and aided the implementation of a single monetary policy.*
  - *The Bank of International Settlements (BIS); was established, inter alia, to rationalise the large volume of gross international payment transactions. It serves as a significant international agency, overseeing cross-border financial transactions.*

- *Fixed exchange rates; allowed numerous other currencies to be pegged to the US dollar. This is because the US dollar became international money to which other*

currencies could be converted. Floating exchange rates are conducive to exchange rate unpredictability. The dramatic volatility of exchange rates, relative to the US dollar, eventually led to the introduction of a dirty (managed) floating system of exchange rates. The magnitude of such volatility has caused some to question the wisdom of introducing floating exchange rates.

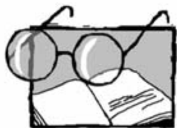
- *The appeal of the euro has been summarised as: transparent prices, low transaction costs, greater certainty for investors and increased competition. These advantages have, however, been tempered by numerous disadvantages which have not augured well for the Eurozone.*

SUMMARY

In this study unit we have looked at the international monetary system (IMS), bearing in mind its role in the determination of exchange rates. The IMS has been defined and its role described. It has been decomposed into its constituents. Institutional arrangements, peculiar to the IMS have been discussed, with reference to facilitating foreign exchange markets.

The foreign exchange market has been characterised by fixed and floating exchange systems. These systems have been pivotal to the functioning of the forex market.

This study unit concludes by acknowledging the merits of adopting a single currency, such as the euro. However, the demerits of a single currency, such as the euro, are discussed as well. This represents a caveat to those countries, who want to adopt a single currency.



Study the following pages in your prescribed textbook: Aregbeshola, Luiz, Ojah, *et.al*, (2011). Global Business: Environments and Strategies. 4th Edition. Oxford University Press. Pages: 164–169.

Study unit 4.2

The Foreign Exchange (Forex) market

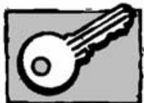
Contents

Study unit learning outcomes
Key concepts
Overview
4.2.1 Structure and functioning of the Forex market
4.2.2 Forex rates/transactions
4.2.3 Exchange rate determination
4.2.4 Exchange rate forecasting
Assessment
Summary

Study unit 4.2 Learning outcomes

Once you have finished this study unit, you will be able to:

- Explain how the forex market works.
- Identify the forces that determine exchange rates.
- Map the implications for international business of exchange rate movements.



Key concepts

Foreign exchange market
Foreign exchange rate
Foreign exchange transactions
Exchange rate determination

OVERVIEW

In study unit 4.2 we focus on the foreign exchange (forex) market. This is a market for converting the currency of one country into that of another. The structure of this market underpins its functioning. The dualism of the market is represented by: the interbank market and the retail/client market.

The functioning of this market is facilitated through forex transactions linked to forex rates. The determination of these rates deserves special attention.

Descriptions of and discussions on the various forex rates and transactions are provided. The methodologies involved in the determination of forex rates are illustrated for clarity purposes. It includes the challenges posed by forex rate forecasting.

4.2.1 STRUCTURE AND FUNCTIONING OF THE FOREX MARKET

The forex market is made up of many different players. It provides the physical and institutional structure of forex transactions.In essence, it is made up of a network of participants across the globe that facilitates forex transactions.

In practice, it is usually categorised according to:

- Reporting dealers.
- Other financial institutions.
- Non-financial institutions.

These categories encompass the participants in the forex market.

Inclusive in these categories are some of the largest banks in the world, because of this, they are often referred to as "money centre" banks, because of the volume of transactions they handle. To this end, they are influential in setting prices: they are market-makers.

Allied to these players are: commercial banks, hedge funds, pension funds, money market funds, currency funds, mutual funds and forex trading companies. This is clearly implied on pages 169–171 of the textbook.

Of significance are the key functions of the forex market. In essence, the forex market serves two main functions:

- To facilitate the conversion of the currency from one country into the currency of another;
- To provide some insurance against forex risk, which refers to the adverse consequences of unpredictable changes in exchange rates.

The detail relating to these functions is spelled out on pages 170–171 of the textbook. Further, detailed discussion on these functions will be provided in part 4 of this study guide.

As a precursor to the modus operandi of forex transactions, it is important to note that the forex market comprises: the spot exchange market and the forward exchange market: both of which impact on exchange rate determination. But, more about this in section 4.2.2 of this study guide.

4.2.2 FOREX RATES AND TRANSACTIONS

Foreign exchange is money denominated in the currency of another nation or group of nations. The market in which these transactions take place is the forex market. A forex transaction is an agreement between a buyer and a seller that a fixed amount of one currency be delivered for some other currency at a specified rate and time.

These concepts are dealt with on pages 171–172 of the textbook.

Forex markets presuppose the participation of forex dealers. Banks are the most important forex dealers. This is evident from the discussion page 172 which highlights the size of the forex market and the extent of banks' involvement in this market.

But, there is a further aspect that relates to forex transactions and this is the forex mechanism. This mechanism provides for a number of options relating to forex transactions. These include the following forex transaction options.

4.2.2.1 Direct and indirect quotes

This means that the exchange rate quotations can take the form of a direct or indirect quote.

A direct quote provides the exchange rate of the home currency to one unit of the foreign currency. For example: R8.12/US dollar.

An indirect quote gives the amount of foreign currency unit(s) needed to buy one currency unit at home. For example: $0.1419/Rand. This is illustrated on page 172 of the textbook.

4.2.2.2 Bid, ask and spread

In this case, the bid is the price at which the dealer is willing to buy foreign currency; the "ask" (offer) is the price at which the dealer is willing to sell foreign currency. However, in the spot market, the spread is the difference between bid and ask rates: it represents the dealer's profit margin.

This specific option is well illustrated on page 173 of the textbook. Notice the factors causing the "spread" to vary.

4.2.2.3 Spot and forward transactions

The spot exchange rate is the rate at which a forex dealer converts one currency into another currency, on a particular day. For example, the Rand/dollar rate announced on South Africa's daily news bulletins is the spot rate for a particular day.

By contrast, a forward exchange rate occurs when two parties agree to exchange "currency" and execute the deal at some specific date in the future. Exchange rates governing such future transactions are referred to as forward exchange rates. Forward exchange rates are usually quoted for 30, 60 or 90 days in advance.

You must ensure that you can distinguish between these two options. By way of clarification, you are encouraged to consider the example of South African spot-forward rates appearing in Table 6.2 on page 173.

A useful example of how forward transactions work in practice, is provided on pages 174–175 in the textbook. Note that forward quotations for exchange rates are either at a **premium** or **discount**. This means that the difference between spot and forward rates is either the forward discount or premium.

You must pay careful attention to how forward premium or discount transactions are calculated as illustrated on page 174 of the textbook.

Moreover, you must note the advantages of the forward market for purposes of financial decision-making, as explained by the example given on page 174, illustrating how the premium/discount rates are calculated. However, remember that "forward cover" is never free. In the example provided, it means that the South African Rand is selling at a premium in the forward market by 5.1662% over the spot market.

4.2.2.4 Currency swaps

A currency swap is the simultaneous purchase and sale of a given amount of forex for two different value dates. Swaps usually take place between international businesses and their banks, between banks and between governments. This usually happens when it is deemed desirable to move out of one currency into another for a period, but, without incurring forex risks. The rationale for currency swaps is discussed on page 175 of the textbook.

Of particular importance is the example of a currency swap provided on pages 175–176 of the textbook. This is a spot against a forward swap. This kind of currency exchange is illustrated with reference to a South African manufacturer of domestic heaters. The trading partner is a UK company. You are urged to study the calculations involved in the case of such a currency swap. The currencies involved are South African Rand and UK sterling.

Remember that the swap deal resembles a conventional deal. It enables the South African manufacturer to insure itself against forex risks.

4.2.2.5 Cross rates

This represents the exchange rate between two currencies, calculated on the basis of their common relationship with a third currency. Note how cross-rates work in practice and observe that:

- This usually applies to infrequently traded currencies.
- Cross-rates are often used when the exchange rates between the two currencies are not available.
- It is a useful trading tool, giving rise to the prospect of gain through "arbitrage". An example of 'cross-rate' determination is provided on page 176 of the textbook. It clarifies this type of exchange transaction.

4.2.2.6 Arbitrage

The use of cross-rates usually gives rise to arbitrage activities in forex markets.

Arbitrage invariably denotes a profit-seeking activity. It represents the purchase of foreign currency on one market for immediate re-sale in another market in a different country, so as to profit from price discrepancies.

An example of arbitrage is provided on pages 176–177 of the textbook.

You are encouraged to take note of the following, as spelled out on page 177 of the textbook.

- That arbitrage usually involves more than two currencies.
- The role of cross-rates in arbitrage.

- How the cross-rate is calculated for the purposes of arbitrage.
- How transactions costs decrease the profits accruing from arbitrage.
- How arbitrage reflects the convergence towards a new equilibrium for some of the currencies involved.

4.2.3 EXCHANGE RATE DETERMINATION

Exchange rates are determined in the context of forex and international financial markets

At the most basic level, exchange rates are determined by the demand and supply of one currency relative to the demand and supply of another. However, what these determinants do not tell us is what factors inherently affect the demand and supply of a currency and what conditions govern the demand and supply of a currency and what conditions govern the demand for and supply of a particular currency. For example, when the demand for a currency ($US) will, for instance, exceed its supply?

Various perspectives on the demand for and supply of a foreign currency (ies) are discussed on page 177–178 of the textbook. A study of the motivators governing the demand for and supply of foreign currency (ies), will provide a deeper understanding of how exchange rates are determined. It will also clarify the process of forecasting exchange rate movements. Moreover, because future exchange rate movements impact on export opportunities, the profitability of international trade and investment deals and the price competitiveness of foreign imports, any appropriate information, clarifying exchange rate determination, is valuable for a MNE.

Implicit in these observations is the recognition that there are various forces impacting the determination of exchange rates. These are listed and discussed on pages 177–180 of the textbook. They are considered under the following heading.

4.2.3.1 Exchange rates and price levels

Pivotal to understanding how prices are related to exchange rate movements is an understanding of the economic proposition known as the "the law of one price". This is discussed on page 178 of the textbook.

The law of one price underpins the theory of purchasing power parity (PPP), which links changes in the exchange rate between two country's currencies to changes in the country's price levels.

The law of one price states that in competitive markets, free of transport costs and trade and tariff barriers, identical products and services, sold in different countries, must sell for the same price when their price is expressed in the same currency.

With reference to PPP, which is discussed on page 178 of the textbook, the presupposition is that if the law of one price is true for all goods and services, the PPP exchange rate could be found from any international set of prices. By comparing the prices of identical products in different currencies, it would be possible to determine the "real" or PPP exchange rate that would exist, were markets completely efficient.

This perspective is clarified on page 178 of the textbook by way of an illustration which states that:

> "the price of a basket of goods should be the same in each country and predicts that exchange rates will change if relative prices change".

Therefore, differences in national inflation rates, relative to other countries, is a major cause of changes in exchange rates. In the final instance, the exchange rate adjusts to keep the PPP constant between currencies.

The corollary to the concept of PPP is the distinction between absolute and relative purchasing power parity.

Absolute PPP means that the costs of goods and services stay the same, regardless of where they are sold. Relative PPP serves as an indicator of the changes in rates over time due to comparative changes in price levels.

The calculus for this distinction is spelled out on pages 178–179 of the textbook. Relative PPP implies that a change in the bilateral exchange rate at some future date is determined by differences in the inflation rates between two countries. Observe how the bilateral spot rate is calculated.

In practical terms, relative PPP means that the exchange rate between South Africa and a foreign country will change if the South African inflation rate is higher or lower than that of the foreign country. This is well illustrated in the example provided on page 179 of the textbook. But, PPP theory explains long-term trends in exchange rate movements, not short-term changes. For an explanation of short-term changes we need to consider the impact of interest rates.

4.2.3.2 Relationships: Exchange rates, interest rates and inflation

Pivotal to this relationship is the operation of the "Fisher effect". This is discussed on page 179 of the textbook.

Because interest rates reflect expectations about likely future inflation rates, the "Fisher effect" states that a country's "nominal interest rate (i)": is the sum of the required real rate of interest (r) and the expected rate of inflation (h) over the period for which funds are lent.

Fisher formalised this equation as:

$$i = r + h$$

The practical implications of this formulation are discussed on page 179 of the textbook. In essence the Fisher effect implies that:

> "an increase in the expected inflation rate will tend to increase the nominal interest rate. Ultimately, this means that there is a link between interest rates and exchange rates. This argument, too, is developed on page 179 of the textbook."

Moreover, the "Fisher effect" has an international dimension, hence the designation "International Fisher effect". This states that for any two countries, the spot exchange rate should change in an equal amount, but in the opposite direction to the difference in nominal interest rates between the two countries.

The formulation for the "International Fisher effect" is expressed on page 179 of the textbook. Note the example of South African interest rates (7%), relative to Swiss

interest rates (2%), reflecting relatively higher, expected inflation rates for South Africa, compared to those for Switzerland. In practice this means that the value of the Rand should decrease by 5% (7 – 2%) against the Swiss franc. This illustration is developed on page 180 of the textbook.

Despite attempts to predict short-term changes in spot exchange rates, both the PPP theory and "the Fisher effect" theories have failed to provide the perspicacity that investors are looking for.

4.2.3.3 The role of behavioural finance in forex markets

This seeks to clarify the impact of investor psychology on short-term movements in exchange rates.

"Investor psychology" frequently explains investor's conduct that does not fit into the "efficient market hypothesis".

One example of the impact of investor psychology is the "bandwagon effect", which reflects the collective behaviour of investors, as a result of initiatives taken by a single investor. This is explained on page 180 of the textbook, with one caveat, namely:

> "bandwagon effects can be hard to predict for they can be influenced by: political factors and macro-economic events". An example of this, in South Africa, is borne out by the industrial action events which led to loss of life – at a South African platinum mine, in 2012. This triggered off significant changes in collective, investor attitudes/sentiments towards South Africa, leading to an almost immediate weakening of the South African Rand, relative to major overseas currencies. Inherent in this phenomenon is the unpredictability of just how long this trend would continue, due to unpredictable changes in investor sentiment, as a result of the "bandwagon effect."

4.2.4 FORECASTING EXCHANGE RATES

The advent of floating exchange rates has complicated the process of predicting exchange rate movements. Indeed, these uncertainties necessitate exchange rate forecasting.

Pivotal to exchange rate forecasting is a clear understanding of the concept of "the efficient market" as postulated by the efficient market school. This is discussed on page 180 of the prescribed textbook. This school argues that the foreign exchange market is efficient at setting forward rates. It believes that the best predictors of future spot rates are "forward rates".

Contrary to this assertion is the argument raised by the "inefficient market" school. This school asserts that the foreign exchange market is inefficient. This is because an inefficient market is one which does not reflect all available information. Thus, in an inefficient market, forward exchange rates will not be the best possible predictor of future, spot exchange rates.

The dichotomy between these two schools highlights different approaches to forecasting. In particular, the inefficient school advocates two approaches, namely:

- Fundamental analysis and;
- Technical analysis.

These two approaches are explained on page 181 of the textbook.

In essence, fundamental analysis draws on economic theory to construct sophisticated, econometric models for predicting exchange rate movements. The variables featuring in this model are listed on page 181 of the textbook. Take note that they include:

- Relative money supply growth rates.
- Inflation rates.
- Balance-of-payment positions.

You are urged to consider how these variables influence the supply of and demand for a particular country's currency.

Technical analysis uses price and volume data to determine past trends which are expected to continue in the future. This approach does not rely on a consideration of economic fundamentals, as explained on page 181 of the textbook.

Those who support this approach are quick to emphasise that its usefulness lies in predicting short-term exchange rate movements.

You must familiarise yourself with these TWO approaches.

Activity 4.1

You are planning your first trip abroad. Describe how your understanding of foreign exchange, the forex market and forex rate determination could assist you in your planning.

If you decide to visit any Eurozone countries, how could this decision affect your planning? List the specific issues you would have to take care of.

Assessment

You have now concluded your consideration of and assimilated the contents of this study unit. You have complemented this process by referring to the appropriate pages in the textbook. We believe you are now in a position to respond to the following questions, as a means of testing your understanding of this study unit. Here are the questions.

- *"Changing money from one currency to another and moving it around to different parts of the world is serious business, on both a personal and corporate level. To survive, MNEs must understand foreign exchange (forex) and foreign exchange rates." What exactly is it that MNEs must understand and why?*
- *"Significant strides have been made and will continue to be made in the development of foreign exchange markets. This has led to increased opportunities for foreign exchange trading and is driving the cost of trading down". Notwithstanding, some countries like South Africa, have, over the years, been subject to foreign exchange restrictions. How could such restrictions impact on a country, like South Africa?*
- *One of the ways of estimating the exchange rate between the US dollar and other currencies, is to resort to the index which converts into US dollars, the price of a big Mac hamburger, in another currency. This mechanism*

illustrates differences in currency valuation but, more importantly, it illustrates the application of the PPP theory to exchange rate determination. To what extent can the PPP theory be relied upon in the exchange rate determination process? What are its limitations and how could this affect the outcome of the process?

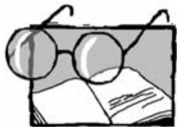
SUMMARY

Study unit 4.2 focuses on forex markets, forex rates/transactions and forex rate determination. It is predicated on the dynamics of floating exchange rates.

The various types of forex transactions are canvassed and discussed. The mechanisms governing these transactions are discussed, representing options open to forex dealers.

A number of factors were identified as influencing exchange rate determination, including, PPP, differences in real interest rates, inflation rates and the political and economic environment, all of which can impact on investor sentiment. These are listed and discussed.

The challenges of trying to predict the timing, magnitude and direction of exchange rate movements are considered in the context of exchange rate forecasting. Forecasting methods such as fundamental analysis and technical analysis warrant attention and are discussed



Study the following pages in your prescribed textbook: Aregbeshola, Luiz, Ojah, *et.al.* (2011). Global Business: Environments and Strategies. 4th Edition. Oxford University Press. Pages: 170–171, 171–172, 173–181.

Study unit 4.3

International capital markets

Contents

Study unit learning outcomes
Key concepts
Overview
4.3.1 Money and capital markets
4.3.2 Scope, structure and functions of capital markets
4.3.3 Classification of capital markets
4.3.3.1 The Eurocurrency market
4.3.3.2 The international bond market
4.3.3.3 The international equity market
Assessment
Summary

Study unit 4.3 Learning outcomes

Once you have finished this study unit, you will be able to:

– Differentiate between money and capital markets.
– Delineate the different types of capital markets.
– Discuss the global nature of capital markets.

Key concepts

Money markets
Capital markets
Eurocurrency
Bond Market
Equity Market

OVERVIEW

In study unit 4.3 we introduce you to the modus operandi of international capital markets. These markets have two subsidiaries: money markets and capital markets.

Their scope, structure and functions are considered. International capital markets can, further, be decomposed into Eurocurrency, bond and equity markets. The composition and operation of these markets is discussed.

4.3.1 MONEY AND CAPITAL MARKETS

Money and capital markets are distinguished. This distinction is discussed on page 181 of the textbook.

Note that money markets provide for the trading of short-term (one day to one year) financial assets. Capital markets provide for the trading of long-term financial assets: long-term denoting a maturity of more than one year. Examples of these different types of markets are provided on page 181 of the textbook. They will be canvassed in section 4.3.3 of this study unit.

These two types of markets constitute the international financial market. These capital markets usually assume the following structure and functions.

4.3.2 SCOPE, STRUCTURE AND FUNCTIONS OF CAPITAL MARKETS

The generic capital market: comprising the Eurocurrency market and, international bond and equity markets, aims at bringing together those who want to invest money and those who want to borrow money.

A Eurocurrency is any currency which is traded outside of its country of origin. Eurodollars account for the majority of all Eurocurrencies. They are dollars banked outside the USA. Other Eurocurrencies include: the euro-yen and the euro-pound.

Eurocurrencies reflect the European origin of the market. The Eurocurrency market is an important, relatively low cost, source of funds for international businesses.

The operation of the Eurocurrency market is discussed on pages 182–183 of the textbook.

4.3.3 THE INTERNATIONAL (GLOBAL) BOND MARKET

International bonds comprise two types:

- Foreign bonds.
- Eurobonds.

Foreign bonds are sold outside the borrower's country, but, they are denominated in the currency of issue.

MNEs usually issue bonds if they believe that it will lower their cost of capital. It is a cheaper way of incurring debt.

Eurobonds are usually underwritten by an international syndicate of banks and placed in countries other than the country in whose currency the bonds are

denominated. For example, a bond may be issued by a German MNE, but the bond is denominated in US dollars, and then sold to investors outside the USA, by an international syndicate of banks.

The import of the international bond market is discussed on pages 182–183 of the prescribed textbook.

4.3.4 THE INTERNATIONAL EQUITY MARKET

Global equity markets enable MNEs to attract capital from international investors by listing their shares on multiple, international stock exchanges, and to raise funds by issuing debt and equity in foreign countries, with a view to lowering the cost of capital.

Of significance is the discussion on page 183 of the textbook, which highlights the fact that:

> "Strictly speaking, there is no international equity market in the sense that there are international currency and bond markets. Rather, countries have their own domestic stock exchanges (equity markets), in which company shares are traded."

Although most domestic equity markets are dominated by domestic investors; the impact of globalisation is internationalising equity markets. Today, investors are investing heavily in foreign markets to diversify their portfolios.

Moreover, an interesting consequence of the trend toward international equity investment is the internationalisation of corporate ownership. This phenomenon is discussed on page 183 of the textbook. This eventuality facilitates the listing of shares on foreign stock exchanges.

Assessment

Your careful consideration of this study unit should enable you to respond to the following questions. Let's see how you do!

- *Why do you think the international capital market has grown so rapidly in recent years? Remember, as you respond to this question you may have to widen your search for additional information to respond more comprehensively.*
- *Many investors are still trying to recover from the 2008–2009 international financial crisis, which proved to be a sobering experience for many. Do you think you can link the operation of capital markets to such a crisis? If so, how?*
- *An MNE, based in South Africa, has found that its growth is restricted, by the limited liquidity of South African markets. List the MNEs options for raising money on the global capital market.*

SUMMARY

Study unit 4.3 focuses on international capital markets. This study unit introduces you to the dichotomy of international capital markets: namely, money markets and capital markets. The structure and function of these markets are discussed.

Allied to the operation of the international capital market is the role played by: the Eurocurrency, bond and equity markets. These markets are described and discussed, with appropriate illustrations. These illustrations confirm the impact of globalisation on financial markets.

Study the following pages in your prescribed textbook: Aregbeshola, Luiz, Ojah, *et.al.* (2011). Global Business: Environments and Strategies. 4th Edition. Oxford University Press. Pages: 181–183.

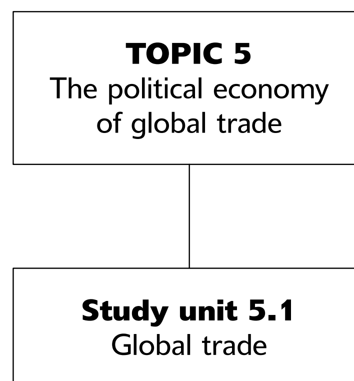
Reflections

Many students struggle with the study material relating to the Global Monetary System (IMS). Possibly you are feeling somewhat intimidated by this material. Perhaps you feel uneasy about the calculations relating to the determination of forex rates. If so, now is the time to reflect on the contents of topic 4 of this study guide. Here are some prompts to help you in your reflections.

- *"Foreign or currency exchange affects the value of everything a nation buys or sells on international markets. It also impinges on the cost of credit and debt and the value of currencies held in banks". Are you convinced of the veracity of this statement or is it an exaggeration? How can the dynamics of the forex market affect South African businesses?*
- *It has been argued that anyone involved in international business needs to understand how the exchange rates of countries, with which they do business are determined, because exchange rates affect marketing, production and financial decisions. Granted the logic of this argument, are you comfortable with the modus logic of this argument, are you comfortable with the modus operandi of forex rate determination and the various forces impacting this process? Are you sure you understand how exchange rates are really determined and how exchange rates are expressed in various types of forex transactions?*
- *Resistance to globalisation is growing, particularly in less developed countries. Do you think that the establishment and operation of global monetary institutions is responsible for this antagonism towards the globalisation process? What institutions would you single out as being responsible for this?*

Topic 5

The political economy of global trade



AIM

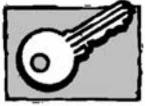
The purpose, nature and scope of this topic is to provide you with an overview of the impact of the political economy on global trade and, therefore, international business.

Inherent in the evolution of global trade is the advent of Government intervention in international trade and investments. This has been effected through various policy initiatives and institutional support. This topic will focus on these initiatives so as to clarify the nature of Government "interventionist measures"; involving various forms of subsidies and related concessions.

Learning outcomes

After studying this topic you should be able to:

- Debate the regulation of international trade.
- Discuss the reasons for trade barriers.
- Explain the instruments of trade policy.
- Highlight global trading arrangements.



Key concepts

Political economy
Global trade
Trade barriers
Trade policy instruments

Study unit 5.1

Global trade

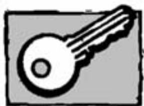
Contents

Study unit learning outcomes
Key concepts
Overview
5.1.1 Evolution of global trade
5.1.2 Trade barriers
5.1.3 Trade policy
5.1.4 Global trading arrangements
Assessment
Summary

Study unit 5.1 Learning outcomes

Once you have finished this study unit, you will be able to:

- Identify and trace the evolution of global trade.
- Articulate the reasons for trade barriers.
- Discuss the implications of trade barriers.
- Delineate the instruments of trade policy.
- Clarify the status of global trading arrangements.



Key concepts

International trade
Trade regulation/barriers
Trade policy
Trading arrangements

OVERVIEW

In study unit 5.1 we introduce you to the global trade environment. This presupposes a consideration of the evolution of global trade. However, international trade-related activities do not take place on a laissez-fare basis. International trade is regulated through trade barriers and policy instruments. These are discussed. The fabric of global trading arrangements is clarified as well.

5.1.1 EVOLUTION OF GLOBAL TRADE

International trade-related activities have their roots in the historical development of mankind.Pages 186–187 of the textbook bears this out, by highlighting the historical establishment of international borders, the flow of goods and services across such borders and the impact on international business. As you trace the history of international trade and investment – in the context of the international political economy – note the following:

- The historical practice of imposing costs on the cross-border flow of goods and services, often taking the form of duties, tariffs and taxes.
- The extent to which international business practices have been influenced by Governments' fiscal and monetary policies.
- The extent to which nation-states have regulated the flow of international trade, through policy instruments.
- How these historical imposts have influenced trade regulation.

5.1.2 TRADE BARRIERS

The history of globalisation and international trade in particular, has been marked by many of the world's nation-states erecting formidable barriers to international trade and foreign direct investment. The barriers take various forms and are invariably the subject of prospective liberalisation, through the efforts of global institutions such as the WTO (World Trade Organisation). It is their intention to reduce trade barriers.

We, however, are concerned with: (i) the reasons for trade barriers and, (ii) the implications of trade barriers.

Numerous reasons for trade barriers are provided on pages 187–189 of the prescribed textbook. These are outlined as follows:

- Protection of local jobs.
- Import substitution.
- Protection of infant industries.
- Reduction of reliance on foreign suppliers.
- Reduction in balance of trade positions or deficits.
- Promotion of exports.
- Anti-dumping remedies: which limits MNEs seeking entry into foreign markets, as far as pricing and competitive strategies are concerned.
- Political objectives: retaliation.
- Protection of national sovereignty.

Clearly, trade barriers have a restrictive effect on the dispersal of various production activities to those countries around the globe, where MNEs could execute their production responsibilities most efficiently. Trade barriers do, therefore, have international implications.These are dealt with on pages 189–190 of the textbook.

Some of the implications are listed on pages 189–190 of the textbook. They are discussed as follows.

- The fact that trade barriers frequently tend to be arbitrary and discriminatory; they tend to be applied subjectively, for this reason they tend to precipitate retaliatory measures: for as is often argued, "tariffs beget tariffs".

- The imposition of trade barriers presupposes special training support and administration. Employees involved in the administration of tariffs and other measures require specialised training.
- The impact of trade barriers usually fans out to other areas in a country's economy, leading to micro-economic problems.
- Trade barriers have consequences such as leading to the establishment of special interest groups and privileges. Tariff barriers often result in preferential treatment being granted to some trading partners at the expense of other trading partners.
- The imposition of trade barriers usually serves as a catalyst to Government intervention in a country's economy. Indeed, any form of protectionism in a country's economy implies government intervention in the economy.

Allied to the above are some further observations which are listed below.

- The fact that trade barriers raise the cost of exporting products.
- Trade barriers may limit an MNE's ability to serve a country from locations outside the country imposing such barriers.
- Enforceable compliance with local content regulations, to reduce reliance on foreign suppliers, which means that MNEs may have to locate more production facilities in the country demanding such compliance, than otherwise deemed viable. This could lead to the sub-optimal location of plants, pushing up costs.

The implications are clear: trade barriers are adopted to discourage the free flow of goods, materials and services across borders.

5.1.3 TRADE POLICY

Of importance here are the instruments of trade policy. Trade policy relies on two main barriers: tariffs and non-tariff (NTB) barriers. Tariffs are price-based, non-tariffs are administrative in nature.

Tariffs denote taxes levied on goods, materials and services imported into a country. On pages 190–191 of the textbook, a distinction is drawn between:

- Specific tariffs.
- Ad valorem tariffs.
- Export tariffs.
- Transit tariffs.

YOU MUST STUDY THESE DISTINCTIONS: BE SURE YOU CAN DESCRIBE AND ILLUSTRATE EACH ONE, BY WAY OF SUITABLE, PRACTICAL EXAMPLES.

Contrary to tariffs are subsidies. A subsidy is a government payment to a domestic producer. Subsidies can take many forms: usually, cash grants, low interest loans, tax-breaks and/or government share participation in domestic firms. Subsidies are aimed at:

- Discouraging foreign imports.
- Gaining export markets.

This dual objective is discussed on page 191 of the prescribed textbook.

However, trade barriers could also include non-tariff barriers (NTBs). Quotas are a good example of a NTB. Quotas often restrict the quantity of goods that may be imported into a country. This is discussed on pages 191–192 of the textbook. To this end, the following types of quota warrant attention.

- Import quotas.
- Voluntary export restraint quotas.
- Local content requirements.
- Buy national (proudly South African) restrictions.
- Technical barriers.

These variations are discussed on page 192 of the textbook. **NOTE** how they differ from tariffs and subsidies, as types of trade barriers.

The corollary to these measures is the role of dumping and countervailing duties, as instruments of trade policy.

Dumping is defined as selling goods in a foreign market at below their cost of production or as selling goods in a foreign market at below their "fair" market value. This is explained on pages 192–193 of the textbook.

Such measures are often countered through anti-dumping policies. Anti-dumping policies are designed to punish foreign firms that engage in dumping. If there is sufficient evidence, to confirm that dumping has taken place, then the aggrieved company (MNE) can request the responsible Government officials to impose countervailing duties (anti-dumping duties) on the offending foreign imports.This process is discussed on page 193 of the textbook. Take note of the "burden of establishing guilt" prior to the imposition of countervailing duties.

5.1.4 GLOBAL TRADING ARRANGEMENTS

The international trade landscape has more recently been dominated by the activities of the GATT (General Agreement on Trade and Tariffs) and the WTO (World Trade Organisation), which have emerged as global institutions. As already noted; the Bretton Woods agreement spawned institutions such as the IMF (International Monetary Fund) and the World Bank as well.

These institutions have helped to: manage, regulate and police the global market place and to promote the establishment of multi-national treaties to govern the global business system. These institutions were created by voluntary agreement between individual nation-states; their functions are enshrined in international treaties.

Of particular significance is the WTO which, like its predecessor, the GATT, is primarily responsible for policing the world trading system. This intervention has significantly impacted world trade and investment and the facilitation of free trade, in the context of reasonably open economies, as discussed on pages 193–194 of the textbook. Their objective is trade liberalisation and the integration of global markets.

Such liberalisation has served as a catalyst for furthering foreign investments and improving global trade relations.

The WTO has, however, superseded the GATT, whose deficiencies led to the

URUGUAY round of talks and the establishment of the WTO. This is discussed on page 194 of the textbook. **Observe** that, the advent of the WTO has promoted lowering barriers to cross-border trade and investment. The WTO has catalysed the globalisation of markets and production.

One of the consequences of this development is the increased flow of global FDI (Foreign Direct Investment), in keeping with the rapid increase in the volume of global trade.

Notwithstanding these developments, the WTO currently faces unprecedented challenges in the wake of the need to restructure existing agreements in agriculture, services and intellectual property. Negotiations to this effect were pursued in the Uruguay Round of Talks, which culminated in the Doha Development Agenda, which was initiated in 2001.

However, even the Doha negotiations and decisions did not yield the desired results. One of the reasons for this failure is the alleged skewness of earlier trade agreements that provide the developed economies with more of a competitive advantage than developing economies. This is discussed on pages 195–196 of the textbook.

Some of the vexing issues, which could not be resolved, relate to anti-dumping measures and protectionism in agriculture. This has precipitated the demise of the Doha accord, as implied on pages 195–196 of the prescribed textbook.

Activity 5.1

"South Africa needs to increase its trade with the rest of Africa, because African economies are growing faster than the global average". One of the options open to MNEs pursuing these opportunities is to promote exports into such markets. However, the prospect of encountering trade barriers and policy constraints remains an ever-present threat.

Given this scenario, you must:

- Identify the trade barriers that South African based MNEs could face upon trying to enter African markets. Indicate how you would try and find out as much as you can about these trade barriers and where you would hope to locate this information.
- Upon identifying these barriers, explain how they could be circumvented so as to promote exports into these African countries.

Assessment

You may want to check your understanding of the contents of this study unit by demonstrating that you can answer the following:

- *Why should international managers care about the political economy of free trade or about the relative merits of free trade and protectionism?*
- *Recall your study of international trade theory in Part 1, section 1.1.5 of this study guide. Given your understanding of the new trade theory and the instruments of trade policy, what kind of trade policy should MNEs be pressing their governments to implement, so as to preserve their interests as producers in their country of origin?*

- *How has the establishment of the WTO improved on the modus operandi of the GATT? Motivate your answer.*

SUMMARY

This study unit has sought to expose the realities of international trade and investments, relative to the ideals of trade theory and the policy of free trade. To this end, the realities of trade barriers are addressed, both in terms of the reasons for trade barriers and the implications of trade barriers.

Moreover, the instruments of trade policy are reviewed; highlighting the reality of government intervention in international trade. Indeed, such protectionist measures are monitored through the modus operandi of the WTO, who would prefer to open up protected markets and foreign direct investment. For this reason, the role and status of global institutions such as the WTO and its predecessor, the GATT, are considered as well.

Study the following pages in your prescribed textbook: Aregbeshola, Luiz, Ojah, *et.al.* (2011). Global Business: Environments and Strategies. 4th Edition. Oxford University Press. Pages: 186–189, 190–192, 193–194.

Reflections

Your completion of topic 5 provides an appropriate opportunity to reflect on all that you have learned thus far. Here are some prompts which could assist you.

- *How do you feel about the regulatory activities of the WTO, in the wake of growing resistance to globalisation?*
- *We have alluded to Africa's economic growth potential and lamented the fact that South African MNEs have not really capitalised on this. But, countries like China have; through opening up their economy and lifting restrictions on international trade. How do you explain China's penetration of African markets? Do you anticipate any resistance from African countries?*
- *In the context of international trade theory "owners of capital, highly skilled workers and many professionals are free to take their resources where they are most in demand". But, is this true in practice or, are there restrictions (constraints) on economic integration? Can you list and discuss some of these restrictions.*

FEEDBACK

Here are some guidelines as you reflect on these questions.

- *Although the WTO is an improvement on the GATT, it's policy/brokering measures, aimed at trade liberalisation, have been targeted by antagonists of globalisation. Anti-globalisation sentiments are, inter alia, aimed at:*

- *Agricultural protectionism, at the expense of poorer countries.*
- *Inadequate reduction of barriers for trade and investment.*
- *Inadequate "basic labour rights" for employees in the world trading system.*

The WTO is often seen as unwilling to counter these trends, which would not be in the interest of poorer, member countries. Clearly, these sentiments have fuelled anti-globalisation initiatives, such as disruptive demonstrations and vocal protests at WTO meetings.

- *The focus, in this case, is China, whose unprecedented economic growth and insatiable demand for Africa's products and resources have compelled it to enter the African continent to capitalise on Africa's resources.*
  - *China has resorted to this strategy in a bid to extricate many of its people from abject poverty and to sustain its unprecedented economic growth.*
  - *China's membership of the WTO has, further, legitimised its strategic initiatives. It has now been brought into the world trading system.*
  - *China's lifting of restrictions on international trade and travel has further, increased its capacity to penetrate African markets.*
  - *The attenuation of trade restrictions, has fuelled the growth in exports. This has enabled it to target the African market, as an export destination.*
  - *China's willingness to reduce tariff and non-tariff barriers and to curtail local content requirements, will open up sectors of its economy, previously inaccessible to foreigners. This augurs well for Africa.*

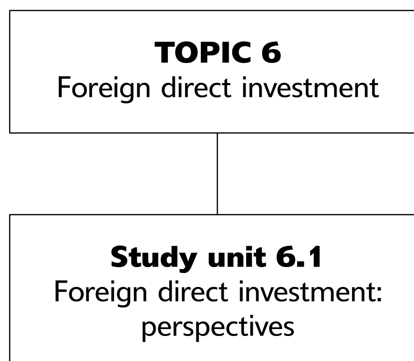
Notwithstanding, one can assume that, despite these relief measures, some African States will still resist China's encroachment on their economic jurisdiction. This is borne out for example, by Zimbabwe's resistance to China's inroads into its mining, wholesale and retail sectors.

Some of the constraints include:

- *Restrictions on economic integration often find expression through one or more of the following constraints:*
  - *The desire to protect local jobs and industries.*
  - *The maintenance of local content requirements.*
  - *Foreign policy objectives, which often compel countries to restrict foreign nationals accessing their professional skills employment market.*
- *Restrictions on the movement of capital across borders, due to the fear of "capital flight" out of the country of origin, which could weaken its foreign reserves.*

Topic 6

Foreign direct investment



AIM

The purpose, nature and scope of this topic is to provide you with an understanding of foreign direct investment (FDI), in the context of international capital markets. The reasons for articulating FDI, relative to capital-market transactions and international portfolio investment, are highlighted. Pursuant to this rationale for FDI is a description of the different forms of FDI, underpinned, as it is, by the theories of FDI.

The spin-offs of FDI are mentioned: the emphasis being on the economic growth aspects of FDI, through technology transfer and the potential absorption capacity of host countries.

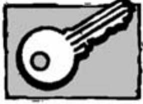
In conclusion, the reality of state-intervention in the FDI arena, as borne out by world trends in FDI, warrants attention.

Learning outcomes

After studying this topic you should be able to:

- Define Foreign Direct Investment (FDI).
- Distinguish between FDI and international portfolio investment.
- Delineate the advantages of FDI.
- Describe the different forms of FDI.

– Defend the theoretical underpinnings of FDI.
– Describe the link between technology transfer, absorptive capacity, economic growth and FDI.
– List and discuss the incentives for FDI.



Key concepts

Foreign direct investment
International portfolio investment
Acquisitions, mergers, greenfield investments
Technology transfer, absorptive capacity, economic growth

Study unit 6.1

Foreign direct investment: perspectives

Contents

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Key concepts
Overview
6.1.1 FDI and international capital markets
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6.1.3 Forms of FDI
6.1.4 Theories of FDI
6.1.5 Technology transfer, absorptive capacity and economic growth
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OVERVIEW

In study unit 6.1 you are exposed to the theory and practice of FDI. FDI is contrasted with international portfolio investment. FDI is described, as being a predominantly capital-market transaction, which permits a foreign economic agent to acquire a significant interest or controlling stake in the ownership of a locally domiciled firm. To this end, FDI can take various forms, each of which can be theoretically substantiated.

FDI implies economic growth, which can be linked to technology transfer and improved absorption capacity. Notwithstanding, most Governments usually incentivise the attraction of FDI. These incentives are explored in the context of international trends.

6.1.1 FDI AND INTERNATIONAL CAPITAL MARKETS

FDI, which refers to firm(s) investing directly in facilities to produce or market a product in a foreign country, needs to be considered in the setting of the operation of global capital markets. Indeed, some analysts argue that once a firm undertakes FDI, only then does it become a multinational enterprise (MNE).

The global capital market seeks to bring together those who want to invest money and those who want to borrow money. Between these two groups are the market-makers-financial service companies-that connect investors and borrowers, either directly or indirectly.

RECALL YOUR STUDY OF THE GLOBAL MONETARY SYSTEM.

The role of global (international) capital markets – in FDI – is discussed on page 200 of the prescribed textbook.

You are urged to take particular note of the distinctions between FDI and international portfolio investment. This distinction implies that:

- The foreign investor's stake must be in the form of equity ownership to be deemed FDI.
- An equity stake must constitute at least 10% to qualify as FDI.
- FDI is a much longer-term interest in the recipient firm, than is the case with international portfolio investments.

6.1.2 ADVANTAGES (BENEFITS) OF FDI

The presupposition to discussing the advantages of FDI is the realisation that: "FDI reflects the objective of obtaining a lasting interest, by a resident entity, based in one economy (direct investor), in an entity resident in an economy other than that of the direct investor (entity). The lasting interest implies a long-term relationship between the direct investor and the recipient entity, involving a significant influence on the management of the recipient entity". This is highlighted on page 201 of the textbook.

Pursuant to this observation is a consideration of the benefits emanating from FDI flows into a host (recipient) country. These are listed on pages 201–202 of the textbook and include the following; they reflect the differences between FDI and international portfolio investment.

- FDI leverages capital markets in such a way so as not to destabilise the domestic capital market.
- FDI is more responsive to local needs in the recipient (host) country (ies).
- FDI complements other foreign entry modes, it often achieves this through acquiring a controlling interest in the domestic (recipient) firm.
- Foreign direct investors tend to operate like MNEs, with the advantages that holds.
- FDI catalyses the transference of product technology that is not available in the domestic market. Invariably, this leads to spillover effects. This holds potential advantages for local firms and governments. They can capitalise on these spillover effects, in order to build absorptive capacity and to stimulate local employment.
- FDIs frequently stimulate economic growth in host countries given the long-term relationship implicit in the controlling ownership.
- Inasmuch as FDIs have the potential to stimulate local, host-country, economic growth, this can also have a domino effect on the host country's economy. This coincides with economic theory which states that: 'the efficient functioning of markets depends on an adequate level of competition between producers. This is borne out by the rationale of economic growth theories, presented on page 211 of the prescribed textbook. The enhancement of competition is achieved when FDI takes the form of "greenfield investments". FDIs assuming this form, invariably spawn the establishment of new enterprises, which increase the number of competitors and, therefore, consumer choice.
- The upshot of such stimulatory growth in the host country is the corresponding effect it has on the country's balance-of-payments. FDI can, for instance, alleviate a current account deficit in the host-country's balance-of-payments. It can do so by:

- serving as a substitute for imports, thereby attenuating a country's cost of imports.
- Using foreign subsidiaries to export goods and services to other countries. This is often a major driver of export-led economic growth in host-countries-in both developed and developing nations.

While these benefits are not exhaustive, they confirm the traditional advantages of FDI. However, such advantages must be tempered by the realities of a number of costs, which accrue to recipient (host) countries. Observers argue that:

- Not all FDI-induced competition is beneficial for the host-country. It can also negatively impact local competition.
- Similarly, host-country balance-of-payments can be negatively affected, particularly through the outflow of earnings from foreign subsidiaries.
- The host country's national sovereignty could be undermined through FDIs and the loss of economic independence.

MORE RECENTLY, FDIs HAVE FAILED TO HOLD THE SAME ADVANTAGES, DUE TO THE GLOBAL FINANCIAL CRISIS, WHICH OCURRED IN 2008/2009. THIS CRISIS HAS ADVERSELY IMPACTED INTERNATIONAL CAPITAL FLOWS, DUE TO THE SHORTAGE OF FINANCIAL RESOURCES AND HAS DESTABILISED THE GLOBAL ECONOMY, INCLUDING EMERGING MARKETS. THE DROP IN DEMAND, WORLD-WIDE, HAS CAUSED MANY MNEs TO CURTAIL AND EVEN REVERSE THEIR FDI DECISIONS.

THIS CRISIS HAS CAUSED MANY CHANGES IN GOVERNMENT AND INTERNATIONAL BUSINESS RELATIONSHIPS, ON A GLOBAL SCALE.

6.1.3 FORM(S) OF FDI

FDI can take the form of:

- Greenfield investments.
- Acquisitions or mergers with an existing local firm.

These options are spelled out on pages 201–202 of the prescribed textbook. Notice how acquisitions/mergers (joint ventures) take place in practice. In the case of an acquisition; this implies that a foreign investor has acquired shares in a domestic enterprise, enabling it to have a controlling ownership in the local firm.

However, if a foreign firm teams up with a local or another foreign firm, to create a new enterprise that produces and sells its outputs, then this usually denotes a merger or joint venture (jv).

The preference for acquisitions and/or mergers is usually due to the fact that they are quicker to execute than greenfield investments. But, it could also be motivated by the desire to acquire strategic assets.

Moreover, acquisitions often increase the efficiency of the acquired unit by transferring capital, technology and/or management skills into the enterprise or subsidiary acquired.

On the contrary, as noted, greenfield investments involve constructing new facilities in the host-country. This often occurs in economic sectors where there is little competition, or where host-country governments oppose foreign acquisitions. Further arguments, in favour of greenfield investments, are developed on page 202 of the textbook.

6.1.4 FDI THEORIES

The presupposition to understanding FDI theories is an appreciation of the "theories of international capital flows". They provide clarity on understanding the contribution of FDI and FDI-embodied MNEs, to the economic growth of the host-country.

Pivotal to our understanding of FDI theories, is the need to consider the role of FDI-embodied MNEs, technology transfer, absorption capacity and economic growth. The linkage between these elements is spelled out on page 202 of the textbook. It provides the backdrop to a study of FDI theories. These theories are spelled out on pages 203–208 of the textbook. They are delineated as follows.

6.1.4.1 International trade and finance theories

These include: theories of trade in goods and services and theories of international capital movements.

6.1.4.1.1 Trade in goods and services

As you recall your study of international trade theories, remember the emphasis on: the theory of absolute advantage, comparative advantage and factor-endowments. These theories are useful in understanding why nations trade.

Recall Adam Smith's postulation of "absolute advantage", David Ricardo's principle of "comparative advantage" and Heckscher-Ohlin's focus on differences in factor-endowments. These theories are spelled out on page 203 of the textbook.

These theories explain why FDIs favour certain locations over other destinations for FDI. They try to clarify patterns of FDI flows.

6.1.4.1.2 International capital movements

Pivotal to understanding such capital movements is an awareness of the explanations provided by the "neoclassical arbitrage theory of portfolio investment", as discussed on page 204 of the textbook.

Various theoreticians feature, in our consideration of theoretical models. Here you are encouraged to consider the contributions of:

- Mundell's explanation of FDI in its portfolio form.

- Dunning's theoretical insights, which explain FDI flows in terms of finance contracts, but, at the expense of FDI's vindication of: technology transfer, access to markets and entrepreneurial and management styles, as positive spinoffs of FDI.

Notwithstanding, the capital arbitrage theory is deemed to be incompatible with many features of FDI and FDI-embodied MNEs. This deficiency is compensated for through the following theoretical explanations.

6.1.4.2 Industrial organisation theories

Here the focus is on the international operations of MNEs, as emphasised on pages 204–208 of the textbook. These theories can be delineated as follows.

6.1.4.2.1 Theoretical aspects of MNEs modus operandi

Page 204 of the textbook highlights Hymer's perspectives in this regard. He re-contextualised the theory of FDI, taking it out of the realm of international trade and finance and positioning it in the framework of industrial organisation theory. This enabled him to develop the "structured market imperfection" theory.

Hymer viewed MNEs as institutions of international production and not of international trade. This spawned a different notion of "ownership" and, therefore, foreign operations, which were aimed at leveraging the returns of technological applications for the benefit of MNEs. This resulted in FDI being construed as a unique phenomenon. This distinction is discussed on page 204 of the textbook.

6.1.4.2.2 Product-life cycle theory

Recall section 1.1.5.6, in Part 1, of this study guide, where your attention was drawn to the "Product-life cycle" theory, in the context of the discussion on international trade theories.

This theory applies to FDI as well. It relates to the timing of investments by MNEs, which can be decomposed into three stages. These stages are outlined on page 205 of the textbook. Note the culmination of the respective stages, which results in FDI replacing exports. This paves the way for the exportation of FDI-embodied MNEs products back to the home country.

6.1.4.2.3 Transaction cost economics

This is summarised in terms of the "natural market imperfection" theory, which is explained on page 205 of the textbook. It rationalises the existence of MNEs, arguing that they exist in order to organise interdependencies between subsidiaries in different countries.

You are urged to take note of the rationale for the market imperfection theory, which maintains that although firms might incur transaction costs, these can be eluded by using **internal** markets.

The corollary to this is the predilection of firms (MNEs) to internalise production, in a bid to prevent technological spillovers to other firms, so as to maintain their competitive advantage. This preference accounts for MNE's decisions on whether to

invest abroad or not, given the risk of host-country firms copying its technological know-how and applications, thereby precipitating the need to come up with counter-measures

This argument is embedded in the "internationalisation theory" (market imperfection theory), the tenets of which are discussed on page 205 of the textbook. It seeks to explain why firms often prefer FDI over licencing, as a strategy for entering foreign markets.

6.1.4.2.4 The electic paradigm

The British economist, John Dunning, is responsible for developing this integration framework. This framework is used to justify his argument that location-specific advantages are of considerable importance in explaining both the rationale for and the direction of FDI flows.

This paradigm combines:

- Ownership factors.
- Location factors, and,
- "Internationalisation theory", with its focus on market failure factors, thereby allowing for a more comprehensive understanding of FDI and MNEs' behaviour. Hence the designation: "eclectic paradigm".

The elements of this paradigm are spelled out on page 206 of the textbook. You must focus on: ownership advantages, location advantages and "internationalisation", which clarifies the question; "how should FDI be undertaken?"

Table 8.1, which appears on page 206 of the textbook, provides a matrix, illustrating the practical application of these elements. This is a useful illustration.

Like all theoretical models, the eclectic paradigm, too, has attracted criticism, which is discussed on page 206 of the textbook.

6.1.4.2.5 The investment development path theory

This is a corollary to the eclectic paradigm. It is premised on the prediction of a U-shaped relationship between a country's level of economic development and net outward flows of FDI. It is important to take note of the four stages of development driving this theory, as set out on page 207 of the textbook.

The U-shaped relationship, highlighted by Dunning, is borne out by empirical evidence in support of distinct international trends in FDI flows. These empirical trends are discussed on pages: 207, 211–213 and 218–221 of the textbook.

6.1.4.2.6 New trade theory

This theory seeks to rationalise why some countries choose foreign production rather than exports. It advocates the use of the proximity-concentration trade-off. This involves a cost-benefit analysis of FDI, which hinges on actual trade costs.

You must take note of how such a cost-benefit analysis has spawned the concepts of horizontal and vertical FDI. Horizontal and vertical FDIs represent an important distinction, clarifying the rationale for MNEs international operations.

6.1.5 TECHNOLOGY TRANSFER, ABSORPTIVE CAPACITY AND ECONOMIC GROWTH

Technology transfer-indicative of the core competencies of MNEs-frequently involves the transfer of skills and products derived from these core competencies, which are then transmitted to foreign markets, where MNEs conduct their international operations.

Technology transfer denotes the transmission of core competencies and technological know-how to host countries, where indigenous firms lack these skills. This is clearly implied on pages 208–210 of the textbook.

As you consider the rationale for technology transfers, note the role of oligopoly theory, in analysing the process of technology spillovers from MNEs to domestic firms in host-countries. This argument is developed on pages 208–209 of the textbook.

The benefits of technology spillovers are often augmented by the knowledge spillovers that frequently accompany technology transfers. You must familiarise yourself with the arguments relating to technology and knowledge diffusion for the benefit of the host-country. These benefits are highlighted on pages 208–209 of the textbook. They are frequently enhanced by the methods used to effect technology transfer. These are listed and discussed on pages 208–209 of the textbook. This discussion is strengthened by the illustration provided in Table 8.3, on page 208 of the textbook.

Notwithstanding, FDIs and technology transfers, begs the question as to whether the host country and indigenous firms have the capacity to absorb this diffusion of technology. This raises the question of "absorptive capacity". As you consider this phenomenon, you must distinguish between:

- Absorptive capacity at the firm level, and;
- Absorptive capacity at the country level.

This distinction is discussed on pages 210–211 of the textbook. This dualism highlights the significance of FDI spillovers.

Moreover, technology transfer, absorptive capacity and economic growth are linked. This link is highlighted on page 211 of the textbook. It highlights the link between growth and technological change.

But a study of this linkage presupposes an understanding of the determinants of technological change and knowledge. Hereto, you are urged to take note of the role of FDI in clarifying the link between technology, knowledge and economic growth. This is discussed on page 211 of the prescribed textbook.

The dynamic of the relationship between technology transfers, knowledge diffusion and economic growth, highlights the impact of FDI on economic growth, both at firm and country level. It points to the role of capital accumulation in economic growth.

Indeed, several researchers support this contention, as they seek to highlight the correlation between FDI and GDP growth and vice-versa. Proponents of this view are

identified and their arguments reviewed on page 211 of the textbook. Essentially, their argument is that technology and knowledge diffusion, through the conduit of FDI, enhance the economic welfare of domestic consumers, as a result of price-competition.

Conveniently, the theories relating to FDI are summarised. This useful summary appears on pages 207–208 of the prescribed textbook.

6.1.6 FDI INCENTIVES

Host countries often adopt policies designed both to restrict and to encourage inward FDI.

Encouraging inward FDIs is often facilitated through the use of incentives. These are offered to foreign firms to invest in their countries.

Such incentives take many forms, the most common being: tax concessions, low interest rates and grants and subsidies. However, as is argued on pages 213–218 of the textbook, incentive schemes have long played a subsidiary role, compared to other factors such as strong macro-fundamentals, availability of natural resources, market size, quality of human capital, infrastructure availability and political and economic stability. This discussion is to be juxtaposed with the summary of the pros and cons of incentive schemes, as presented in Table 8.5, on pages 214–215 of the prescribed textbook.

Notwithstanding, incentives can also be used to restrict inward FDI. Such incentives usually take the form of controls. These controls include:

- Ownership restraints, which exclude foreign investors from investing in certain economic sectors in a host country.
- Performance requirements, which ensure that there are controls over the behaviour of MNE subsidiaries in the host country. Examples include: local content requirements, export constraints, controls on technology transfers, ensuring the desired diffusion for the benefit of indigenous firms and local participation in the management of MNEs.

Incentives can, therefore, be used to speed up technology and knowledge diffusion, to the advantage of the host country and indigenous firms.

Activity 6.1

"South Africa's incidence of HIV/AIDS has reached epidemic proportions. This poses a threat, inter alia, to the numerous mining operations in the country. It clearly involves additional costs of doing business in South Africa. The spread of this disease is having a profound effect on the people of South Africa and its economy. It has significantly reduced life-expectancy on the part of migrant workers servicing South Africa's mines."

Given this scenario, you must draw up a memorandum to be considered by stakeholders who have an interest in inward FDI flows into South Africa's mining sector. You would be required to respond to the following:

— What the costs are associated with such a threat.

— How could the costs of doing business in South Africa's mining sector affect the form that FDI could take, if an FDI decision was taken to invest in the mining sector?
— Is it worthwhile considering incentives to attract inward FDI flows, in the face of such a threat? What form should these incentives take?

Assessment

Now that you have completed this study unit, you should be able to assess your understanding of the contents. The following questions could assist in this regard.

- *How do you account for differences in FDI inflows, between countries? Your response should reflect your understanding of FDI theories, notably, "internationalisation" theory and the "product-life cycle" theory.*
- *Why, in your opinion, do MNEs choose FDIs, in preference to international portfolio investment strategies, in order to enter foreign markets?*
- *"Hundreds of thousands of Chinese have comfortably set up shop in Africa, bringing with them economic growth and useful technical skills. Their government, eager to loosen constraints on resources and industrial expansion at home, supports them with abundant loans. Africa now supplies approximately 35% of China's oil, while two-way trade has grown impressively over the last few years. But, Africa is becoming resistant to this encroachment on their economic sovereignty, in the form of aggressive FDI initiatives, on the part of China". How, in your opinion, can African states counter this aggressive intrusion into their markets?"*

SUMMARY

This study unit exposes you to FDI and international portfolio investment, as means of investing in and penetrating foreign markets. It reviews theories that attempt to explain the pattern of FDI between countries, while reflecting on the potential influence of governments on MNEs decisions to invest in foreign countries.

In conclusion, cognisance is taken of how countries adopt policies (incentives) designed to both encourage and restrict FDI. They do so through offering incentives and imposing ownership restraints and performance requirements.

Study the following pages in your prescribed textbook: Aregbeshola, Luiz, Ojah, *et.al.* (2011). Global Business: Environments and Strategies. 4th Edition. Oxford University Press. Pages: 200–221.

Reflections

Now that you have concluded your study of this topic, it would be most appropriate for you to critically reflect on all the material that you have been presented with. Here are some prompts that could help you in your reflections.

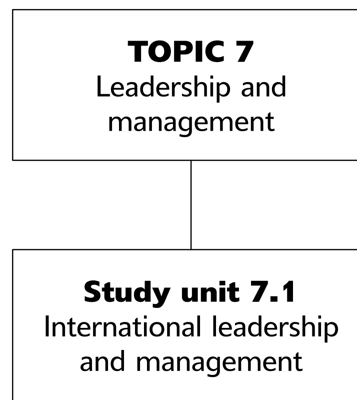
- *"The IMF, World Bank and WTO are common bedfellows. They are all key players in the international monetary system. Frequently, their contribution to globalisation is vindicated: these institutions are paraded as indispensable to the globalisation process".But, is this tribute justified, when the WTO, in particular, has a host of critics who object to its role in serving the desires of the richer countries, at the expense of the poor, less developed countries. What do you think of these allegations?*
- *"Lowering trade barriers is a concession you make to your trading partners, a sacrifice for which you require compensation, or "reciprocity". What theory (ies) of international trade could possibly advocate the lowering of trade barriers? How can authorities possibly lower trade barriers, once they have been established by consensus?*
- *FDIs are often punted as a "mixed blessing". Is there any justification for this statement, when the providers of FDI, themselves, bear most of the financial risk attached to the investment, while the host country enjoys the benefits of inward FDI flows?*

PART 3

GLOBAL BUSINESS ENVIRONMENTS: LEADERSHIP AND STRATEGIES

Topic 7

LEADERSHIP AND MANAGEMENT



AIM

This topic aims at exposing you to the role and dynamics of **international** leadership and management. It conceptualises the contrasts between leadership and management in the context of global business environments.

The importance of these contradistinctions in the modus operandi of MNEs is noted. The role of international leadership in the formulation of appropriate strategies is highlighted, by way of comparisons with the distinctives of international management. This includes an understanding of the magnitude of the risks involved in such initiatives.

The shaping of future directions for MNEs is traced through the impact of globally competitive forces, which impinge on the requisite role and responsibility of international managers. This profile of responsibilities highlights some of the requisite attributes for managers operating in a global business environment.

The dynamics of international leadership and management is, moreover, informed by the realities of cross-cultural leadership. The tenets of cross-cultural leadership are explored, culminating in a distinction between global and traditional managerial

mindsets. Such mindsets are informed by the reality and dynamics of emotional intelligence. The dualism of global and traditional mindsets also impacts on the challenges relating to emerging economies.

Learning outcomes

After studying this topic you should be able to:

- Distinguish between international management and leadership.
- Discuss the role of leadership and management relative to MNEs.
- Describe the environment of international management delineating the risks and challenges.
- Define and discuss cross-cultural leadership.
- Differentiate between global and traditional mindsets.
- Articulate the importance of emotional intelligence in international leadership and management.
- Defend and describe the importance of global leadership in emerging economies.

Key concepts

International management and leadership

Types of global enterprises

Global competitive intelligence

Cross-cultural leadership

Traditional and global mindsets

Emotional intelligence

Study unit 7.1

International leadership and management

Contents

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Overview
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Summary

Study unit 7.1 Learning outcomes

Once you have finished this study unit, you will be able to:

- Defend and describe the differences between leadership and management.
- Conceptualise the various types of enterprises, relative to the role of international leadership and management, in these enterprises.
- Articulate the international leadership environment.
- Delineate the risks and challenges inherent in this environment.
- Describe cross-cultural leadership.
- Distinguish between global and traditional mindsets.
- Discuss emotional intelligence in the context of international leadership.

Key concepts

Leadership and management traits
International, multidomestic, global, transnational and multinational enterprises
Competitive intelligence and risks
International environmental forces
Cross-cultural leadership
Global versus traditional mindsets
Emotional intelligence
Emerging economies

OVERVIEW

In study unit 7.1 the focus shifts to the people involved in the management and leadership of MNEs. They are globally-orientated managers and leaders. Their traits and skills have a direct bearing on the enterprises they oversee. The corollary to this process focuses on the leadership and management skills needed to oversee multidomestic, global, transnational and multinational enterprises. This process is subject to the influence of international environmental forces, necessitating the collection of competitive intelligence data and the assessment of the relevant risks in response to such pressures.

The skills, knowledge and mindset that leaders/managers need to function in a global business environment pre-empt the future direction that global leaders and managers will have to assume. This is discussed in the context of the prevalence of internationally competitive forces, having a bearing on the modus operandi of MNEs.

One of the dominant traits which characterises the skills, knowledge and mindset needed by such global leaders, relates to cross-cultural leadership. This is discussed against the backdrop of global and traditional mindsets. This dichotomy is articulated in this study unit. These dual "mindsets" reflect the reality and importance of emotional intelligence, which accentuates the two types of mindsets.

The leadership traits highlighted in this study unit apply to emerging economies as well. This is articulated in the ensuing discussion.

7.1.1 LEADERSHIP VERSUS MANAGEMENT

The distinction between these two concepts and practises is dealt with on pages 229–230 of the prescribed textbook. Leadership is aligned with an MNEs vision, identity, mission and strategies all with the future in mind.

In order to do this they need to respond to the global landscape and the array of competitive forces that confront MNEs. Frequently, reality dictates the necessity for change, innovation and the nurturing of diversity, in response to such a global environment. Distinctive responses to such internationally, competitive forces, highlights the differences in the "mindsets" of managers and leaders.

"Traditional" mindsets reflect those traits, which characterise managers involved in the routine operations of MNEs. This type of "mindset" is discussed on pages 228–230. The distinctive managerial traits inherent in the "traditional" mindset are accentuated by way of contrasts. These contrasts highlight the mindsets of managers and global leaders, whose "global" mindset is discussed on page 229 of the textbook. You are urged to note the characteristics of this mindset, reflective of global leadership traits, expressed in terms of:

- Its multi-cultural perspectives;
- A predisposition to forge international relationships with: suppliers, distributors, competitors and customers; forming partnerships, alliances and other, adaptable relationships in the process.

International management, in terms of its definition and modus operandi is different to the global leadership traits just mentioned.

While leaders visualise and conceptualise viable, global strategies, managers articulate

and implement the supportive processes, by which MNE's participation in the globalisation process can be managed. This is spelled out on page 230 of the textbook. It emphasises the extent to which managers are more involved with the implementation of global strategies, as gauged in terms of content, processes, culture and structure. To this end, Rhinesmith spells out the distinctive properties and responsibilities of international management, as articulated on pages 229–230 of the textbook.

This definition contrasts starkly with that offered by Adler, who articulates leadership in terms of: "the ability to inspire and influence the thinking, attitude and behaviour of people".

Globally effective leadership and management, is, therefore, a *sine qua non* for successful international, multidomestic, global, transnational and multinational enterprises. This is implied on pages 230–231 of the textbook.

7.1.2 LEADERSHIP: ENVIRONMENTAL DYNAMICS AND STRATEGIES

MNEs are subject to the influences of key, global issues and environmental forces, which determine the nature of their responses to the opportunities and threats with which they are confronted. Indeed, determinants of environmental opportunities and threats are documented on pages 231–233 of the textbook. They are fundamental to assessing the risks inherent in a particular business environment and to determining what an MNEs strategic response should be. Pivotal to such responses is the role of competitive intelligence in the development of appropriate strategies to address the opportunities and threats peculiar to the international business environment.

International business environments are, invariably, fraught with risks. These are articulated and discussed on pages 233–234 of the textbook. Such risks inform the analysis of competitive intelligence, with a view to enhancing the quality of the strategies developed by MNEs. You must make a careful study of the kinds of risks and the potential impact they could have on the global strategy formation process.

These risks present specific challenges for the managers and leaders of MNEs. They are carefully discussed on pages 234–239 of the textbook. Note the responses of researchers and authors to these challenges, which highlight the leadership traits needed to respond to such a constellation of environmental pressures and issues. This is emphasised on pages 234–239 of the textbook, with the aid of Figure 9.1 on page 236 of the textbook. Figure 9.1 articulates the group of competing factors which clarifies the ubiquitous nature of the international business environment. These competing factors are spelled out on pages 236–237 of the textbook.

The distinctive management and leadership traits required to manage the issues inherent in such a constellation of competing factors are carefully spelled out and discussed on pages 237–239 of the textbook. Many of the vexing issues relating to such a complex environment point to the importance of cross-cultural leadership.

7.1.3 CROSS-CULTURAL LEADERSHIP

Leaders and managers of MNEs invariably need to adapt to different cultural nuances as they seek to do business in different cultures. These cultural nuances include: cultural

diversity across markets and countries and an appreciation of different attitudes and perceptions, reflective of different values in different societies. This calls for leaders and managers to conform to the value systems and norms of different cultures. This has been alluded to in topic 3 of this study guide.

In topic 3 reference is made to the definition of culture. The implications of this definition for the development of a global mindset by the leaders of MNEs, is spelled out on pages 239–241 in the prescribed textbook.

Clearly, these cultural imperatives pose challenges to the leaders of MNEs. It raises the whole question of "cross-cultural leadership". However, the precise meaning of "cross-cultural" leadership is debatable. This is the gist of the argument advanced by Holden on pages 239–240 of the textbook. You are, therefore, urged to familiarise yourself with this argument. Note the role of knowledge and service workers in multi-cultural teams. These workers need to be managed in a particular way. This calls for special skills, conducive to managing cross-cultural differences.

Pivotal to an understanding of these differences is the reality of cultural diversity, which reflects a mosaic of cultural differences across people-groups, societies and nations. These differences are spelled out on pages 240–241 of the textbook.

Moreover, these differences highlight the distinctives of cross-cultural leadership styles. This is discussed on pages 241–242 of the textbook. Distinctive leadership styles are articulated in terms of:

- Charismatic leadership.
- Transformational leadership, and.,
- Transactional leadership.

This triad of leadership styles is carefully discussed on pages 241–242 of the textbook. You must make a careful study of each one of the leadership styles, taking careful note of the leadership traits they represent. You must be able to distinguish between these different leadership styles and explain the relevance of each one in our contemporary, global business environment.

Notwithstanding, these leadership styles cannot be rigidly delineated in practice. Leaders must be prepared to adapt their leadership styles to the culture of employees and clients. Frequently this calls for a global mindset, fraught with the virtues of emotional intelligence.

7.1.4 GLOBAL MINDSET AND EMOTIONAL INTELLIGENCE

Global and traditional mindsets are contrasted. This is highlighted on pages 242–246 of the prescribed textbook. These comparisons are summarised in table 9.1 on page 244 of the textbook. The distinctions between traditional and global mindsets reflect the challenges inherent in ever-changing global business environments.

While a traditional mindset is inclined towards a shorter-term perspective, being internally and operationally focused, coupled with a domestic-orientation; the distinctives of a global mindset are captured on page 243 of the textbook. To this end, Rhinesmith elaborates as follows, accentuating the uniqueness of a global mindset, *vis-vis* a traditional mindset.

Rhinesmith contends that; a global mindset is characterised by a: comprehension of the

bigger picture, a willingness to balance contradictions, putting trust before processes and structural considerations and capitalising on uncertainties and diversity, in a bid to effect improvement. He argues that a global mindset leads to three strategic leadership thrusts: visioning, crafting a strategy (ies) that resonates with this vision and harnessing resources to support these initiatives.

These initiatives confirm that a global mindset enables leaders and managers to understand the complexities of managing an interdependent and complex global network of relationships and stakeholders, thereby allowing them to participate in the globalisation process.

The characteristics of a global mindset extend to organisations as well. This is discussed on page 243 of the textbook. Note that an organisational global mindset represents an aggregation of skills and competencies within an organisation.

At the personal level of a leader or a manager, the characteristics of a global mindset are discussed on pages 244–246 of the textbook. They include an array of personal attributes and skills which stand to enhance an individual's global mindset.

Complementary to these skills and attributes is the reality of emotional intelligence, which potentially resides in leaders/managers, to one degree or another. Indeed, the subject of emotional intelligence, relative to leadership development, is reviewed on page 246 of the textbook.

Emotional intelligence in leaders explains how leaders handle themselves and their relationships. To do this they need to be emotionally aware of what is going on in other people's minds. This, in turn, highlights the attributes of emotional intelligence, itemised and discussed on page 246 of the textbook. These attributes are rooted in the following underpinnings of emotional intelligence.

- Self-awareness: being emotional self-aware, accurate self-assessment and self-confidence.
- Self-management; referring to self-control, transparency, adaptability, achievement, initiative and optimism.
- Social awareness; comprising empathy, organisational awareness and service.
- Relationship management; epitomising inspirational leadership, influence, developing others, being a change catalyst, having a predilection to resolve conflicts, building bonds, teamwork and collaboration.

These characteristics of emotional intelligence are alluded to on page 246 of the textbook. They are mentioned in terms of: self-awareness, self-regulation, motivation, empathy, trustworthiness, credibility, integrity, honesty, social responsibility, being emotionally aware of the world around them and cultural sensitivity.

You must take note of the strong correlation between the attributes of emotional intelligence and the characteristics of a transformational style of leadership. This correlation is further strengthened by the manifestation of social and political capital, which indicates a leader's reputation in a particular industry and his/her ability to influence the actions of others, ensuring that things get done.

An elaboration of these qualities is set out on pages 246–247 of the textbook. Notice how international leaders and managers can draw on this "political capital" to develop the skills needed to influence MNEs to get things done.

It is against the backdrop of unprecedented changes to the global business

environment that leaders/managers have to be socially and culturally well adapted. Indeed, as the tasks of international leaders become more complex and collaborative, the skills associated with emotional intelligence become increasingly pivotal. Leaders need to put their emotional intelligence to work if they are to be distinguished from the maze of leaders and managers working in an increasingly volatile global business environment.

7.1.5 LEADERSHIP IN EMERGING ECONOMIES

Emerging markets- the product of emerging economies – being those in transition from a less-developed country (LDC) status to a developing country status, are subject to constraints which present unique leadership challenges. As we noted in topic 2 of this study guide, LDCs are characterised by a number of features, many of which characterise emerging markets, to a lesser or greater degree. These include the following constraints as spelled out on pages 108–109 of the prescribed textbook.

- Social and political instability.
- Low levels of economic wealth.
- A shortage of investment capital.
- Inadequate education, health care and housing.
- High rates of illiteracy and low levels of employment skills.
- A strong emphasis on the agricultural and mining sectors.
- Low levels of infrastructure and technological development.
- Low life expectancy and a high dependency on foreign aid.
- An abundance of natural resources.
- Foreign trade tends to involve exports of agricultural products, raw materials and basic manufactured goods.

Emerging economies suffer from one or more of these constraints. In practice, this impact on the challenges facing MNEs with subsidiary operations in emerging economies, where, to due to inadequate: education, skills formation and capacity building; training and development needs are different and more exacting.

MNEs operating in emerging economies invariably do so through a variety of operations. These include the following, as set out on page 247 of the textbook.

- MNEs with limited relationships in host-countries, usually comprising export offices, joint ventures or distributorships.
- Foreign subsidiaries, staffed by expatriates and locals, who are the product of emerging economies.
- Regional businesses; which presupposes that local employees have been exposed to the necessary levels of training and development.
- Global businesses; which presupposes that locals need to be exposed to global development programmes, involving cross-functional-team building.

Indeed, the transition to emerging economy status, frequently highlights the need for significant training for host-country nationals. The reasons for this are discussed on pages 248–249 of the textbook. The measure of exposure required by host-country employees, in terms of skills training, management development and leadership training, warrants unique leadership qualities and inputs, on the part of MNEs and their executives.

This is particularly true of Africa, where it is widely acknowledged that leadership in business and politics will shape the future of Africa. Business leaders with drive, knowledge and perspective, who will be able to lead MNEs through the many challenges they face in Africa, are indispensable to the future prosperity of the continent.

Activity 7.1

"While Pick n Pay's woes continue: waning customer loyalty, lack of growth, poor implementation of systems, labour problems and insufficient re-investment in the company, it's board has appointed a new CEO. He is the previous CEO of TESCO- one of the UK's largest retailers. Clearly, he has a challenging task on hand. He needs to lead the turnaround of South Africa's second-largest retailer. This means he will have to engage with all stakeholders. He really needs to bring the retailer closer to how people really live their lives, for the more you do so the better you do as a retailer."

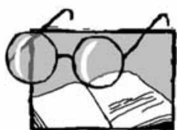
As the new CEO initiates the turnaround process, what should be:

- The most preferred leadership style to adopt? Defend your choice.
- His approach to the cross-cultural leadership challenges he is bound to face? What type of challenges is he likely to face?
- His response to the risks associated with an international CEO assuming the leadership of a South African retailer? You must try and list the risks he could possibly encounter.
- His emotional intelligence make-up, in order to successfully turn Pick n Pay around?

SUMMARY

This study unit focuses on the role of certain people mandated by MNEs and their counterparts, to engage in the globalisation process, on their behalf. They are designated international leaders and managers. Their task is to manage critical issues and environmental forces which characterise the environment of international management. This environment is fraught with risks. Risks of this nature are often associated with the competing factors comprising global competitiveness.

Globalisation, invariably highlights the realities of cross-cultural dynamics. This calls for a particular type of mindset and a special set of skills. These are discussed, culminating in a consideration of emotional intelligence, as a key competency in the armour of international leaders, even those involved in doing business in emerging economies.

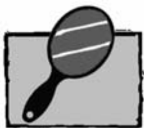


You are required to **study** the following pages in your prescribed textbook: Aregbeshola, Luiz, Ojah, *et.al.* (2011). Global Business: Environments and Strategies. 4th Edition. Oxford University Press. Pages: 228–249.

Assessment

You may want to check your understanding of this study unit by demonstrating you can answer the following:

- *Given China's persistent penetration of Africa's economies and markets, what type of leadership/management traits are needed to sustain their incursions into Africa?*
- *Emotional intelligence has been described as a highly abstract and subjective concept, which has little relevance to international leaders/managers competing at the cutting edge of international business. Why then, is it important to have a grasp of emotional intelligence and for leaders to understand themselves and how to handle their relationships with stakeholders?*



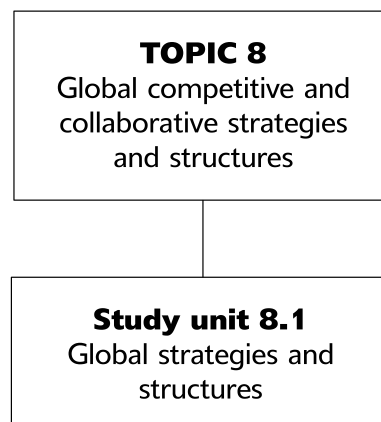
Reflections

Now that you have completed this study unit, it would be appropriate to reflect on what you have learned thus far. Here are some prompts which could assist you.

- *Significant emphasis is placed on the distinction between leadership and management and its application to various types of MNEs. Are you comfortable with this distinction or do you suspect that they are merely academic dichotomies? Try and provide convincing arguments in your response.*
- *Critics are often skeptical of international leaders/managers coming into South Africa and assuming to have the skills and experience to "fix up" ailing organisations, which are based in the country. Such criticism focuses attention, inter alia, on organisations such as Pick n Pay who have now, for the first time, appointed a CEO from outside the organisation. In the minds of some, this is risky. Given that Pick n Pay is in a period of transition, what, in your opinion, are the leadership traits and skills needed to successfully turn this iconic retailer around?*
- *"Doing business in Africa is fundamentally different. Even globalisation realities such as: economic integration and global competitiveness, which impact on all types of MNEs, take on different nuances when doing business in Africa. This raises the question as to the leadership skills needed to do business in Africa". What, in your estimation, are the factors that leaders and managers should take into account when expanding their business initiatives into the rest of Africa?*

Topic 8

Global competitive and collaborative strategies and structures



AIM

This topic aims at highlighting the concept of global competitiveness. In so doing, it seeks to delineate those factors which influence an MNE's global competitiveness. These factors are spelled out and discussed.

In pursuit of an understanding of an MNE's global competitiveness and how this is achieved, this topic focuses on: the goals of MNEs, the sources of global competitive advantage, the relevance of international trade theories; all of which shape the formation of international, competitive strategies.

The corollary to this is the establishment of an MNE's strategic orientation. Typical of such orientations are: ethno-centric orientation, polycentric orientation, region-centric orientation and geocentric orientation. These orientations are carefully considered.

The reason for this is that an MNEs strategic orientation determines the strategic priorities of the MNE and the structuring of international operations and staffing. These

constraints influence the formation of globally, competitive strategies, which are subject to two types of competitive pressure, namely, pressures to be locally responsive and pressures for cost reductions. This topic explores these pressures.

International strategies are premised on responses to one or both of these pressures. These strategies may take the form of: (a) an international strategy, (b) a multi-domestic or local strategy, (c) a global strategy and, (d) a transnational strategy. These different strategies are discussed. The aim is to highlight the different characteristics associated with the different types of international strategies. This discussion culminates in the all important consideration of foreign market entry modes. The different types of entry modes are discussed.

Learning outcomes

After studying this topic you should be able to:

- Define global competitive advantage.
- Discuss the determinants of competitive advantage.
- Differentiate between the different types of strategic orientation.
- Describe the different types of conflicting, competitive pressures.
- Identify and discuss the different international strategies and foreign market entry modes.

Key concepts

Global competitiveness

Location economies

Economies of scale

Core competencies

International strategy, multi-domestic strategy, global strategy and transnational strategy

Modes of foreign entry

Study unit 8.1

Global strategies and structures

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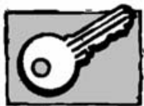
Study unit 8.1 Learning outcomes

Once you have finished this study unit, you will be able to:

- Articulate the concept of global competitiveness.
- Describe the sources of global competitive advantage.
- Discuss the strategic orientation of global firms.
- Delineate and discuss different international strategies.
- Identify and describe the modes of foreign market entry.



Key concepts

Global competitiveness and global firms
Determinants of competitive advantage
National competitive advantage
International competitive strategies
Strategic orientation
Foreign market entry

OVERVIEW

In study unit 8.1 the focus is on global competitiveness and its sources. The corollary to this involves the establishment of collaborative strategies and structures. These

strategies and structures are influenced by key factors in designated industries.Such factors are highlighted and discussed in this study unit. They can be decomposed to the level of national competitive advantage.

By concentrating on global competitiveness, cognisance is taken of an MNEs strategic orientation. The different types of orientation are listed and discussed. These strategic orientations influence an MNEs choice of international strategy. Various strategic options are identified and discussed.

These strategic choices are inter-related with the various modes of foreign market entry and how best they can be used by MNEs to drive an appropriate strategy for international expansion. The question of foreign market entry warrants particular attention and is emphasised accordingly.

8.1.1 GLOBAL COMPETITIVENESS

The success of MNEs in the area of international expansions lies in the leveraging of their core competencies to enhance their penetration of foreign markets – through the sale of goods and services – to foreign nations. Such core competencies drive select strategies designed to enter foreign markets.

These core competencies constitute the source of an MNE's competitive advantage, and, therefore, the global strategy(ies) of choice.

Pages 252–253 of the textbook, confirm the centrality of core competencies in assessing the competitive advantages of MNEs. A realistic assessment of core competencies enables MNEs to successfully match their internal strengths, capabilities and resources with key factors in select industries, in which they are involved.

The corollary to this focuses on determining MNE's competency(ies), from an international perspective. This is pivotal for MNEs engaged in international expansions, which usually means a shift in the basis of competitive advantage and, therefore, the analysis of competitive advantage which needs to focus on the MNE's international environment as well.

Consequently, capacity building, through leveraging an MNE's internal capabilities and resources is not enough. MNEs involved in international business need to consider other determinants of competitive advantage as well. These "factors" play a role in determining the competitive advantage(s) driving successful competition in international industries. They are indispensable to MNE's global competitiveness.

These "factors" include the following, as discussed on pages 253–254 of the textbook.

- **Location economies** – these are economies that arise from performing a value creation activity in the optimal location for that activity, wherever that international destination might be.
- **Economies of scale**, scope and experience- as illustrated by the experience curve effect. This refers to systematic reductions in production costs that have been observed to occur over the life of a product. Empirical evidence suggests that a product's production costs decline by a certain amount, each time cumulative output doubles. Cumulative output being output over time and not output in any one period, such as a year.

- **Capacity/ability** to leverage core competencies to increase financial returns. A core competence refers to skills within the MNE that competitors cannot easily match or imitate.
- **Leveraging subsidiary skills**. Local subsidiaries typically have skills which can be leveraged by MNEs, contemplating international expansion. These skills could augment efforts to enter foreign markets and to establish production/marketing facilities in foreign locales, thereby creating value.
- **Government incentives** – often influence the decision to globalise. Incentives may either be designed to attract foreign investment or to boost manufacturing/exporting to other countries. Such incentives can help lower an MNE's cost of operating, thereby enhancing their competitiveness. Government incentives could include: tax holidays, investment incentives and cheap loans, all of which can reduce an MNEs operating costs. This could also accelerate the establishment of production facilities in a more convenient way.

More specifically, global competitiveness can also be enhanced through a number of other determinants. These determinants feature at different levels: within the national environment, at industry level or organisational level. The different sources of competitive advantage, corresponding to these various levels, are discussed on pages 254–255 of the textbook. They constitute some of the determinants of global competitiveness.

These catalysts for global competitive advantage are complemented by the factors which augment a country's national competitive advantage.

Recall the discussion in Part 1, topic 1 of this study guide, where the focus is on "international trade theories" and, specifically, the "theory of national competitive advantage", as postulated by Porter. This theory rests on the following building blocks.

- Factor endowment.
- Demand conditions.
- Related and supporting industries.
- Firm, strategy and structure rivalry.
- Government chance events.

These are discussed on pages 255–256 of the textbook. They are powerful determinants of competitiveness.

8.1.2 STRATEGIC ORIENTATION OF MNEs

When managers design a strategy for a foreign environment, they consider numerous factors. These have been discussed in this study unit. However, international competitive strategies, are also influenced by various strategic orientations. An MNE's strategic orientation may reflect one of the following variations, as discussed on pages 256–257 of the textbook.

- **Ethnocentric orientation** – which denotes a policy according to which all key positions are filled by parent (home)-country nationals. The philosophy here is that what originates from an MNE's home country is best. The values and priorities of the parent MNE must guide strategic decisions.

- **Polycentric orientation** – which denotes host-country nationals being recruited to manage subsidiaries in the host country, while home country nationals occupy key positions in corporate headquarters in the home country.
- **Regiocentric orientation** – which presupposes that the parent MNE is largely blended with those of subsidiaries or operations in other regions.
- **Geocentric orientation** – which denotes the practice of assigning the best people for key jobs throughout the MNE's organisation structures.

When MNEs, wishing to compete in the global marketplace adopt a particular global strategy, the purpose is to leverage their core competencies by expanding into foreign markets. In so doing, they need to be sensitive to the pressures of: local responsiveness and cost-reduction.

These competitive pressures place conflicting demands on an MNE. They are tensions which shape an MNE's choice of global strategy. These pressures are singled out and discussed on pages 257–258 of the textbook.

8.1.3 GLOBAL STRATEGIES

Pressures for local responsiveness and cost-reduction could mean that MNEs cannot take full advantage of the factors driving global competitiveness. For example, they may have to customise their product-offering to local conditions, availing themselves of less than a low-cost location for this purpose.

These pressures impose constraints on the choice of a global strategy. This choice may be decomposed into the following options. They are discussed on pages 258–262 of the textbook. Take particular note of table 10.1 on pages 261–262 of the textbook. This table presents the characteristics of the different types of international strategies.

- **International strategy**

  The pursuance of an international strategy presupposes that MNEs are confronted with low-cost pressures and low pressures for local responsiveness.

  In practice, this means taking products, first produced for the domestic market, and selling them internationally, with only minimal local customisation. These MNEs are selling a product that serves universal needs, but they do not face significant competition; they are not faced with pressures to reduce their cost structure. This is borne out in the discussion on pages 258–259 of the textbook. You must take note of how this strategy enables MNEs to achieve competitive advantage and value creation.

- **Multi-domestic or multi-local strategy**

  This strategy focuses on increased profitability by customising the MNEs goods or services, so that they fulfil the tastes and preferences in different national markets. Pursuing a multi-domestic strategy is most appropriate when there are substantial differences across nations, with regard to consumer tastes and preferences and where cost pressures are not too intense. By customising the product-offering to meet local demand, the MNE increases the value of that product in the local market.

  The thrust of this strategy is dealt with on page 259 of the textbook. You must be familiar with the key characteristics of such a strategy.

- **Global strategy**
  A global, standardised strategy, focuses on increasing profitability and profit growth, by reaping the cost reductions that come from economies of scale, learning effects and location economies. The goal of MNEs pursuing this strategy is to pursue a low-cost strategy, on a global scale.

  In practice, this means that the production, marketing and R&D activities of MNEs, which have adopted a global strategy, are concentrated in a few favourable locations.

  MNEs pursuing a global strategy, try not to customise the product-offering and market strategy to local conditions, because customisation involves shorter production runs and the duplication of functions: thereby increasing costs. This is implied on page 260 of the textbook, which deals with the choice of a global strategy as one of the "international" strategies an MNE can adopt.

- **Transnational strategy**
  When MNEs simultaneously face both strong cost pressures and strong pressures for local responsiveness, they are inclined to opt for a transnational strategy. Adopting a transnational strategy is conducive to realising location economies and experience effects to leverage products internationally and to transfer core competencies and skills within the MNE, while simultaneously paying attention to pressures for local responsiveness. Significantly, such core competencies and skills do not only reside inside the "home country", but can be developed in any one of the MNEs international operations.

  Therefore, we can say that pursuing a transnational strategy is conducive to achieving low costs, through location economies, economies of scale and learning effects, while differentiating their product offerings, across markets, to account for local differences, thereby fostering a multi-directional flow of skills, between different subsidiaries in the MNE's global network of operations. The uniqueness of a transnational strategy is captured on pages 260–261 of the prescribed textbook.

These international strategies are very well summarised in table 10.1 on pages 261–262 of the textbook. You must make a careful study of this table.

8.1.4 FOREIGN MARKET ENTRY

The choice of mode for entering a foreign market is another challenge facing MNEs. The various modes of serving foreign markets are: exporting, turnkey projects, licensing, franchising, contract manufacturing, service sector outsourcing, strategic alliances, management contracts, joint ventures and wholly-owned subsidiaries. These are discussed on pages 262–269 of the prescribed textbook.

Each of these options has advantages and disadvantages. The magnitude of the advantages and disadvantages is determined by a number of factors. These factors are mentioned on pages 263–267 of the textbook. They are summarised in table 10.2, on pages 267–268 of the textbook.

More specifically, the choice of an appropriate mode of entry is determined by the nature of the particular foreign market that the MNE has targeted, and the prevalence of several factors, which were specifically considered in Part 1 of this study guide. They

would include: economic and political factors which have the potential to influence the attractiveness of a foreign market, together with factors such as the costs, benefits and risks associated with doing business in the country being targeted. Pivotal to these considerations is the timing of the entry.

The different types of entry modes are explained on pages 263–267 of the textbook. They include:

- **Exporting** – this is usually a first-move mode of entry. It has two advantages, namely: it avoids the substantial costs of establishing manufacturing operations in the host-country, and it helps an MNE achieve experience curve and location economies. But, it has certain drawbacks, notably, exporting from an MNE's home-base, may not be appropriate, if lower-cost locations for manufacturing can be found abroad. Moreover, exporting could incur high transport costs that make it uneconomical as well. Apart from this, tariff barriers could make exporting uneconomical. These draw-backs can be compounded when MNEs delegate their marketing, sales and service functions to other companies.
- **Turnkey projects** – in a turnkey project, a contractor agrees to handle every detail of the project for a foreign client, including the training of personnel. Upon completion, the foreign client is handed a key to a plant that is already in full operation. This entry strategy is particularly useful when host-government regulations limit foreign direct investment (FDI). One of the disadvantages is that the firm entering into a turnkey project with a foreign MNE, may become a competitor.
- **Licensing** – is an arrangement whereby a licensor grants the rights to intangible property to another entity (licensee), for a specified period and in return, receives a royalty fee from the licensee. The licensee bears all the costs and risks of opening and establishing foreign markets. Typically, this means that the licensee puts up most of the capital necessary to get the overseas operation going. However, the advantage is overshadowed by the fact that it does not give the investor, tight control over key functions, such as: manufacturing, marketing and strategy, which is indispensable for realising experience curve and location economies.
- **Franchising** – is a specialised form of licensing, in which the franchisor sells intangible property (a trade mark) to the franchisee, on the understanding that the franchisee abides by strict rules, as to how it does business. Typically, the franchisee assumes the costs and the risks.
- **Contract manufacturing** – allows MNEs to take advantage of location economies, by gaining access to cheap labour in foreign countries. The practical implications of this mode of entry are spelled out on page 264 of the textbook.
- **Service-sector outsourcing** – more recently, the availability of highly skilled knowledge workers, at comparatively low wages, has made outsourcing (e.g. software development) to developing countries, like India and China, a viable option.
- **Strategic alliances** – these are collaborative agreements. The terms strategic alliance and collaborative agreements, are sometimes used interchangeably. Practically, it refers to an agreement that is of critical importance to one or more partner(s), or to an agreement that does not involve joint ownership. Strategic alliances allow firms to benefit from a local partner's knowledge of country-conditions and allow partners – potential competitors – to share risks and costs, associated with doing business in a foreign market. Strategic alliances could

include: formal joint ventures and short-term contractual agreements. Box 10.1 on page 265 of the textbook, illustrates the versatility of strategic alliances in South African companies. It profiles the various types of international agreements.

- **Management contracts** – in terms of which a foreign company has the right to run a company from day to day but, is not allowed to take decisions regarding ownership, financing or strategic change.
- **Joint ventures.** This agreement entails establishing a firm that is jointly owned by two or more, otherwise, independent firms. It is a popular mode for entering a new market. This mode of entry is discussed on page 266 of the textbook. One of the advantages is that the MNE benefits from a local partner's knowledge of a host country's competitive conditions, culture, language and political systems. This is countered by a number of disadvantages, including the risks entailed in a joint venture, due to the transference of control of it's technology to it's partner(s). These and other advantages and disadvantages are discussed on page 266 of the textbook.
- **Wholly-owned subsidiaries**. In a wholly-owned subsidiary, the MNE owns 100 percent of the equity. Wholly-owned subsidiaries can be established in a foreign market by establishing a "greenfield" venture or acquiring an established firm in the host-country, and using this firm to promote its products. This mode of entry is discussed on pages 266–267 of the textbook. This discussion includes delineating both the advantages and disadvantages of wholly-owned subsidiaries, as spelled out on page 267 of the textbook.

You must take particular note that when an MNE's competitive advantage is based on technological competence, a wholly-owned subsidiary is usually the preferred mode of entry, because it reduces the risk of losing control over that competence. Notwithstanding, it is also the most costly mode of entry.

The burning question remains: how do MNEs select the best entry mode? Answers to this question are provided on page 269 in the textbook. Such answers relate to "guidelines" for entry modes, which are spelled out on page 269 of the textbook.

These guidelines reflect the trade-offs that are inevitable when selecting an entry mode

8.1.5 MANAGING THE GLOBAL FIRM

Your prescribed textbook focuses on the desirability of developing a framework for strategic management, as a means of highlighting the complexities of managing international firms.

The modus operandi of this development process is spelled out on pages 270–272 of the textbook. It is summarised in Figure 10.2 on page 271 of the textbook.

This framework typifies appropriate strategic thrusts for MNEs to penetrate foreign markets. It depicts an MNE's options for accessing the global market place. It also epitomises what is involved in engaging in cross-border trade and investment; emphasising that managing a global firm differs in many ways to that of managing a domestic business. Indeed, at the most fundamental level, differences arise from the fact that countries are different. This is the implication of Figure 10.2 on page 271 of the textbook.

Activity 8.1

Pick n Pay's new CEO will, understandably, be focusing on an appropriate turnaround strategy for the ailing retailer. His aim will be to return South Africa's leading retailer to it's pole position. This is because Pick n Pay has fallen from its place as a consumer's friend to a consumer's fiend.

However, this does not preclude the new CEO from considering international expansion plans as well. The CEO is, after all, not unfamiliar with other countries, because of his previous role at Tesco's, where he was involved in their international business operations, in locations as diverse as: Thailand, China and Poland.

Should Pick n Pay decide to proceed with international expansions, then, how would you respond to the following questions?

- At what time, in the turnaround process, should such international expansions be initiated?
- What would be the most appropriate international strategy to adopt, in order to drive such an expansion?
- What mode of foreign market entry would you recommend?

Feedback on activity 8.1

Here are some guidelines as you consider these questions.

- *You should note the following, with regard to differences between global and national competitive advantage. While the notion of national competitive advantage as postulated by Porter, stems from responses to the question, as to why a nation achieves success in a particular industry and country, thereby focusing attention on attributes such as:*

  - *factor endowments.*
  - *demand conditions.*
  - *relating and supporting industries, and;*
  - *firm strategy, structure and rivalry;*

  these factors are specific to particular countries and industry(ies). By contrast, global competitiveness is determined by the harnessing of these attributes across countries and their respective industries.
- ***Strategic orientation,** in the case of MNEs, shapes their choice of international business strategy. This is because one of the following strategic orientations will inform the choice of an international business strategy.*

  - ***Ethnocentric orientation**, implying that host-country nationals are recruited to manage MNE subsidiaries, while parent-country nationals fill key positions in an MNE.*
  - ***Polycentric orientation**, implying that host-country nationals are recruited to manage MNE subsidiaries, while parent-country nationals fill key positions at headquarters.*
  - ***Geocentric orientation**, in terms of which the best people are recruited for key jobs throughout the MNE organisation, regardless of nationality.*
  - ***Regiocentric orientation**, here the parent firm (MNE) is largely blended with those of subsidiaries or operations in other regions.*

- *With regard, to* ***foreign market entry****, the following is noteworthy. While MNE's strategic orientation shapes its choice of international business strategy, given such options as:*

  – *an international strategy;*
  – *a multidomestic strategy;*
  – *a global strategy;*
  – *a transnational strategy.*

  These strategic initiatives need to be implemented, in terms of target-country, market and product-offerings. It is for this purpose that specific mode(s) of entry must be decided upon by management. The various modes of foreign market entry have been discussed in this study unit. Your need to be familiar with these and be able to relate them to the various international business strategies, available to MNEs.

  Remember that each one of these entry modes is subject to advantages and disadvantages, with each mode being determined by a number of factors such as: transport costs, trade barriers, political risks, economic risks, business risks and costs, and the MNE's choice of strategy.

Assessment

Now that you have completed this study unit, you should be able to respond to the following questions.

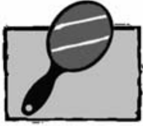
- *Just how comprehensive is the concept "global competitiveness"? Explain how global competitive advantage can be achieved.*
- *Is there really such a difference between global and national competitive advantage? Can you clarify this distinction?*
- *How does "strategic orientation" relate to the choice of international business strategies?*
- *Once an MNE has chosen its international strategy: why must it still consider the choice of an appropriate mode of foreign market entry?*

SUMMARY

This study unit highlights an MNE's global competitiveness. It explores the factors used to attain competitive advantage. These factors are described and discussed. Contrary to global competitive advantage, the study unit also ventilates the constituents of "national" competitive advantage.

These competitive profiles reflect the strategic orientation of an MNE, pointing to a possible choice of strategy for international business purposes. MNEs are faced with numerous international strategic choices which culminate in the choice of the most appropriate, foreign market entry mode. These are discussed in this study unit.

You are required to **study** the following pages in your prescribed textbook: Aregbeshola, Luiz, Ojah, *et.al*, (2011). Global Business: Environments and Strategies. 4th Edition. Oxford University Press. Pages: 252–253, 254, 255, 256, 257, 258–262, 263–268, 269–272.



Reflections

Now that you have completed this study unit, it would be appropriate to reflect on what you have learned thus far. Here are some prompts which could assist you.

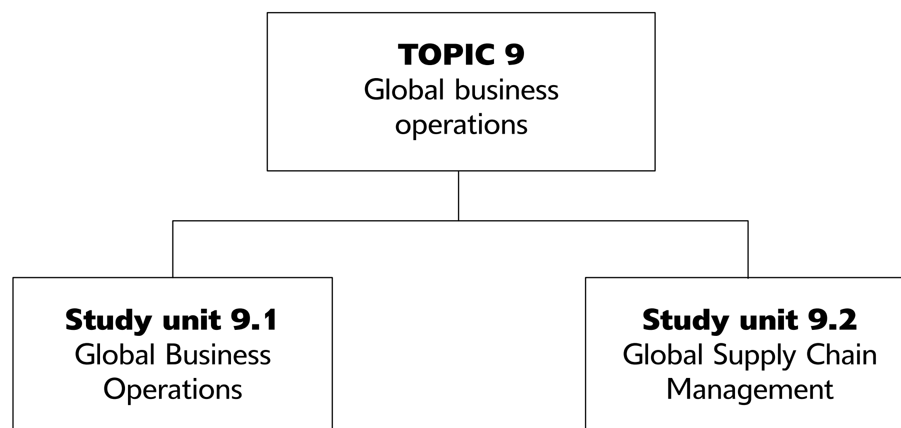
- *Porter's theory of "national competitive advantage" sparked considerable interest at the time of its publication. This theory is premised on the results of research which tried to establish why some nations succeed and others fail in international competition. Do you think this theory can really help us understand the dynamics of "global competitiveness"? Elaborate on your reasons.*
- *To what extent can we depend on our knowledge of "strategic management" to enhance our understanding of the complexities involved in choosing an international strategy?*
- *Much is made of the importance of "foreign market entry" initiatives. This is because of the substantial differences that exist between countries, markets and product-offerings. To what extent can country-specific factors and differences influence the choice of the most appropriate mode of "foreign market" entry? Do you think that the magnitude of such differences could even force MNEs to consider opting for a combination of entry modes, in a bid to overcome these differences and difficulties?*

PART 4

GLOBAL BUSINESS OPERATIONS AND FINANCIAL MANAGEMENT

Topic 9

Managing global business operations



AIM

This topic focuses on the "production operations" of MNEs. It exposes the MNE as a value chain, composed of a series of distinct, value creating activities, including: production, marketing, sales, materials management, R&D, human resources management, information technology systems and the firm's (MNEs) infrastructure. This value chain can be decomposed into primary and support activities, which drive the production of goods or services for customers.

Therefore, this topic highlights the modus operandi of the value chain, which is illustrated on page 279 of the textbook. It illustrates how value is added in the operations process, including: manufacturing, logistics, supplies and support services. These activities are pivotal to the value chain.

Moreover, the aim is to ventilate the application of the value chain to the global operations of MNEs. To this end, the value chain illustrates how inputs are transformed into outputs. This transformation is captured in the context of global operations, emphasising the importance of global operations and logistics, bearing in mind that the aim of MNEs is to produce value that meets the needs of customers.

The value chain also highlights the importance of supply chain management, based on an appropriate manufacturing strategy, reflecting optimum location decisions and international business strategies. The role of operations management and logistics is to enhance the value creating activities, set out in the value chain.

Learning outcomes

After studying this topic you should be able to:

- Illustrate the dynamics and composition of the value chain and its global application.
- Decompose the constituents of the global value chain, in terms of: strategy, logistics and supply chain elements.
- Explain the composition and constituents of a global manufacturing strategy.
- Highlight the importance of "location decisions" in the global manufacturing process.
- Discuss "inventory management" in the context of global operations.

Key concepts

Operations
Logistics
Value chain
Manufacturing strategy
Location decision
Inventory management
Foreign trade zones

Study unit 9.1

Global operations management

Contents

Study unit learning outcomes
Key concepts
Overview
9.1.1. Operations management: *modus operandi*
9.1.2. Operations management: strategies and structures
9.1.3. Global manufacturing and location decisions
Assessment
Summary

Study unit 9.1 Learning outcomes

Once you have finished this study unit, you will be able to:

- Articulate the definition and concept of operations management.
- Illustrate the global application of the value chain.
- Explain the characteristics of an MNE's potential international business strategy.
- Discuss the dynamics of global manufacturing.
- Motivate the importance of "location decisions".

Key concepts

Operations and logistics management
Value chain
Transformed resources
Transforming resources
Global manufacturing strategies
Location decisions/factors

OVERVIEW

In study unit 9.1 we focus on the role of operations management in achieving global, competitive advantage. The value chain serves to decompose the elements involved in the process of achieving global competitiveness. The importance of the value chain is highlighted.

Global operations management reflects the international business strategy(ies) being pursued by MNEs. The thrust of these strategies and their importance for operations management is discussed. This discussion culminates in a careful consideration of the importance of global manufacturing strategies and location decisions in the context of global operations management.

9.1.1 OPERATIONS MANAGEMENT: MODUS OPERANDI

Global operations management has to do with value creation and management across value chains, which serve as a conduit for the implementation of international business strategies. These strategies reflect an MNE's strategic positioning, relative to foreign market opportunities.

In positioning itself strategically, an MNE must, inter alia, configure its international operations such as manufacturing, marketing, logistics, information technology systems, human resources management etc, all of which must be supported by the right organisation structure so as to execute its strategy(ies). Indeed, the strategy, operations and organisation of the MNE must be consistent with each other, if it is to attain a competitive advantage and garner superior profitability. All of these constraints feed into the management of global operations, comprising the different value creation activities MNEs undertake.

Diagrammatically, this is borne out by Figure 11.1, on page 279 of the textbook. It illustrates the value chain and its application to operations management, including manufacturing and supportive service delivery.

Therefore, the illustrative value chain, in Figure 11.1, clarifies how value is added in the transformation process, in the context of operations management. A distinction is drawn between transformed resources and transforming resources. This is emphasised on pages 279–280 of the textbook.

9.1.2 OPERATIONS MANAGEMENT: STRATEGIES AND STRUCTURES

The strategic position an MNE adopts – as reflected in its international business strategy of choice- reveals how it intends adding value to the product(s) being offered to foreign markets, by reducing the costs incurred in the operations process.

The value chain decomposes the various value creating activities. Each of these elements has value-adding potential, providing the costs associated with these activities are reduced, as efficiencies are achieved across the value chain.

An MNE's strategic position confirms where management wants it to be positioned with regard to value and cost. This decision determines the configuration of an MNE's operations. It presupposes that the following constraints have been considered.

- Organisational goals.
- Product/service offerings.
- A feasible organisation structure.
- Business scope and level of diversity.
- Administrative systems used.
- The supply of resources.

- Location.
- Logistics.

These constraints are discussed on pages 280–282 of the textbook. They feature in the context of the determinants of effective and efficient production as distinctive, competitive advantages.

To this end, Figure 11.2, on page 282 of the textbook, illustrates how these constraints can influence value-adding, through increased product quality and lower costs. The discussion on pages 282–283 of the textbook, highlights how MNEs can achieve sustainable, competitive advantage by means of effective and efficient production. This can be attained by fulfilling certain, strategic objectives. These include:

- Minimising costs.
- Increasing production quality.

These objectives are discussed on page 282 of the textbook.

As these determinants of sustainable, competitive advantage, are extended to the implementation of international business strategies, they can be decomposed into the following requirements:

- the extent to which current and/or new resources will be used in the operations process.
- The development and application of core competencies to drive chosen international business strategies, through value creation.
- The identification of international business opportunities, the fulfilment of which will enhance an MNE's global competitiveness.
- The development of new international markets.

If MNE's global, operations potential, is to be exploited, then it is important to understand the link between strategy and operations management. This points to the importance of an effective, global manufacturing strategy, as discussed on pages 283–284 of the textbook.

An appropriate, manufacturing strategy, should address both production and logistics imperatives, with the emphasis on how these functions may be performed internationally, so as to lower the cost of value creation and in order to add value by better serving customers. In this regard, there are a number of key factors to be considered. They include:

- Manufacturing compatibility.
- Manufacturing configuration.

Moreover, a global manufacturing strategy implies that one or more of the following functions need to be globalised, as discussed on page 284 of the textbook.

- Manufacturing of components.
- Procurement of suppliers and materials.
- Maintenance and monitoring of foreign facilities.
- Logistics and distribution of components.
- Customer service and support.
- Knowledge-based processes;
- Product development and innovation.

9.1.3 GLOBAL MANUFACTURING AND LOCATION DECISIONS

Global manufacturing includes the internationalisation of production and logistics. If the performance of these functions is to be done in such a way so as to lower the costs of value creation while adding value by better serving customer needs, then it is imperative that the following factors be carefully considered by the management of MNEs.

- Product factors.
- Location (country-specific) factors.
- Technological factors.

Production involves activities aimed at creating a product. Production denotes both service and manufacturing activities. Products produced are usually subject to two dominant constraints, namely:

- Does the product serve a universal set of customer needs?
- What is the product's value-to-weight ratio?

These features are discussed on page 285 of the textbook. Complying with these product features, means ensuring that the product is manufactured in an optimum location. Prior to such a strategic, location decision, management needs to evaluate the prospective manufacturing of products, in terms of these two criteria. Once this has been done, management can decide whether the MNE's global strategy should be centralised in a country or region, or whether it has the potential to be decentralised all over the world.

These considerations emphasise the importance of the location decision in the global manufacturing process. In this regard, important country factors are discussed on pages 285–287 of the textbook. A consideration of these factors confirms their importance, as a prelude to the implementation of a global manufacturing strategy. This decision focuses on where to locate production activities, so as to minimise costs and improve product quality. The location decision emphasises the importance of "country factors" when deciding on where to locate a production facility. These factors are discussed on pages 285–287 of the textbook. They include:

- The political economy of specific countries being considered.
- Differences in culture between different countries.
- Differences in factor (resource) costs.
- The prevalence of trade barriers.
- Exchange rate instability.
- Location externalities, including external factors that influence free trade between countries.

Figure 11.3 on page 290 of the textbook summarises the important location factors for manufacturing site selection.

These "country-specific" factors means that, other things being equal, an MNE should locate its various manufacturing activities where the: economic, political and cultural conditions, including relative factor costs, are conducive to the performance of the

production and logistics activities that are value-adding in the MNE's value chain. To the extent that these preconditions are fulfilled, the MNE's global manufacturing strategy will result in the creation of a global web of value-creation activities.

Moreover, the type of technology an MNE uses to perform specific manufacturing activities, can be pivotal to the location decision. Therefore, the three dominant characteristics of a manufacturer's technology are of interest. They include: the level of fixed costs, the minimum efficient scale and the flexibility of the technology. These are discussed on pages 288–291 of the textbook.

Observe how these determinants of the optimum use of manufacturing technology and its impact on the choice of the most suitable manufacturing facilities, influence the choice of the type of factory that will be best suited to the manufacturing needs of the MNE.

The different global manufacturing facilities are classified on pages 289–291 of the textbook. They provide numerous global, manufacturing alternatives, which need to be evaluated in line with the MNE's international business strategy.

Assessment

At the close of this study unit, you should be able to respond to the following questions as you test your understanding of this material.

- *"An essential decision facing an MNE is where to locate its production activities to best minimise costs and improve product quality". What, in your opinion, are the most influential factors which could impact the "location decision", which MNEs must take, as a prelude to the implementation of a chosen manufacturing strategy?*
- *Describe and illustrate how the "classical value chain" can be applied to the management of an MNE's global business operations.*

SUMMARY

The value chain and its configuration, for purposes of facilitating the execution of a global manufacturing strategy, are pivotal to understanding the modus operandi of global business operations. Managing global business operations implies managing the value chain to this end. This is because operating internationally requires MNEs to determine how to link those activities. Dispersing value activities when and in how many places in the world is the issue of configuration. Configuration is a function of a global manufacturing strategy.

This study unit seeks to address these dynamics under the umbrella of "global operations management". It does so by highlighting the role of the value chain in global business operations. The value chain configures the processes involved in the transformation of resources into outputs, being goods and services.

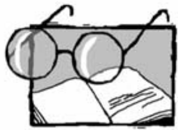
The modus operandi of this value chain is articulated in the context of operations management and logistics. These elements presuppose the execution of a viable, manufacturing strategy, which is facilitated with the aid of the global supply chain.

The configuration and coordination of global operations management is dependent on:

- The supply of resources.
- The location of production facilities.
- Logistics management.

These determinants are discussed. They represent catalysts directly linked to the formulation and execution of a global manufacturing strategy. The requirements for the implementation of a global manufacturing strategy are discussed in this study unit. Pivotal to this discussion is the importance of the global manufacturing "location decision". The various facets of this decision are considered, including the influence of "country factors".

In the final analysis, cognisance is taken of the various location factors impacting the implementation of an MNE's manufacturing strategy. The import of these factors is discussed.



Study the following pages in your prescribed textbook: Aregbeshola, Luiz, Ojah, *et.al.* (2011). Global Business: Environments and Strategies. 4th Edition. Oxford University Press. Pages: 279–280, 281–282, 283–284, 285–287, 288–291.

Study unit 9.2

Global supply chain management

Contents

Study unit learning outcomes
Key concepts
Overview
9.2.1 Globalising the supply chain
9.2.2 Supplier networks
9.2.3 Inventory management
Assessment
Summary

Study unit 9.1 Learning outcomes

Once you have finished this study unit, you will be able to:

- Explain the dynamics involved in managing a global supply chain.
- Discuss the role of supplier networks in global supply chain management.
- Highlight the implications of "make" or "buy" decisions.

Key concepts

Logistics
Supply chain structure
Supplier networks
Make-or-buy decisions
Just-in-time inventory
Foreign trade zones

OVERVIEW

Study unit 9.2 focuses attention on the logistics involved in managing a global supply chain. To this end, the supply chain is contextualised within the ambit of global manufacturing. The global manufacturing supply chain structure is illustrated. The key activities supporting this structure are discussed. This presupposes the particular design of a global supply chain, which takes into account a number of design issues. These are ventilated. In so doing the spotlight falls on the importance of supplier networks.

Supplier networks involve both local and foreign sourcing, as well as outsourcing. This complex network of relationships is illustrated in figure 11.4 of the textbook, which highlights the dynamics of global sourcing and appropriate manufacturing strategies.

Outsourcing, in particular, raises the implications of "make" or "buy" decisions. The advantages and disadvantages of this decision are listed and discussed. The steps involved in global sourcing warrant attention.

9.2.1 GLOBALISING THE SUPPLY CHAIN

Figure 11.1, on page 279 of the textbook, illustrates the typical value chain; it highlights the reality of the logistical processes in the value chain. This is because logistics encompasses those activities necessary to obtain materials from suppliers for delivery to a manufacturing facility, involving the manufacturing process and then out through the distribution system to the end user.

In the context of international business, the logistics function manages the global supply chain. Logistics has two objectives:

- To manage an MNE's global supply chain.
- To manage the supply chain in such a way so as to reduce costs and service customer needs in the fastest way, thereby lowering the cost of value creation, and enabling MNEs to establish a competitive advantage.

The reality of these objectives confirms the role of the supply chain in a global, manufacturing context, as borne out on pages 291–292 of the textbook. Figure 11.3 on page 292 of the textbook illustrates the typical, global manufacturing supply chain structure. It highlights the key activities that support a global supply chain. These activities include:

- Planning and developing an appropriate strategy.
- Sourcing goods and services through procurement from suppliers to meet demand.
- Manufacturing products to meet demand.
- Delivering and transporting manufactured products to customers.
- Handling returned goods that are excess, damaged or malfunctioning.

For this reason, the design and management of a global supply chain is pivotal to the efficient operation of such a supply chain. An effective supply chain, warrants the following design considerations.

- A push system that considers market trends and sales estimates, before actual demand is considered. Manufacturing takes place according to these estimates.
- A pull system that reacts to actual customer demand, according to which goods are manufactured and then distributed through the supply chain.

These considerations are emphasised on page 292 of the prescribed textbook.

9.2.2 SUPPLIER NETWORKS

Supplier networks are frequently forged in terms of "strategic alliances". These alliances frequently emphasise the benefits of vertical integration.

Such supplier networks often crystallise into long term relationships with suppliers, which encourages suppliers to undertake specialised investments for the purpose of manufacturing specific components for its customers (MNEs). Strategic alliances build trust between suppliers and MNEs. These characteristics of strategic alliances are, you may recall, emphasised in your study of strategic management.

Supplier networks either support local sourcing or foreign sourcing, as discussed on pages 293–294 of the textbook. Figure 11.4 on page 293 of the textbook illustrates "global sourcing", relative to prospective, manufacturing strategies. This is highlighted on page 293 of the textbook. Indeed, this paves the way for the formalisation of relationships between the MNE and each essential supplier. Should the supplier fail to perform, this relationship can be terminated. Hence the importance of delineating the problems that could jeopardise such supplier networks. Typical of such problems that could impede this alliance are:

- Language differences.
- Exchange rate issues.
- Inordinate transport costs.
- Import tariffs and;
- Socio-political instability for example, strike action.

These impediments are compounded in the case of foreign sourcing. The attenuation of these impediments needs to be negotiated with the foreign supplier involved. They include:

- The need for foreign sourcing to yield significant cost reductions.
- The desired quality of input resources.
- Access to superior technology.
- The potential of foreign sourcing to enhance an MNE's competitive advantage.
- Improved compliance with customer specifications.

These are discussed on pages 293–294 of the textbook.

Allied to local and foreign sourcing is the reality of outsourcing. Sourcing and outsourcing focus attention on the make-or-buy decision. This implies a decision as to whether the MNE will be directly involved in the value-adding activities or whether an outside entity will be involved.

The advantages of an MNE making the product itself are:

- Lower costs.
- Ensuring that the benefits of specialised investments, will accrue to the MNE outsourcing the manufacture of a particular product.
- Improved scheduling.
- Protection of product technology.

These advantages need to be weighed up in the light of following considerations relating to buying components or a product from an outside entity.

- Flexibility, which allows an MNE to change suppliers as demand changes.
- Lower costs, implying that MNEs are not always able to achieve this by making the product internally.
- Leveraging the facilities and services of external manufacturers can lead to the development of new markets.

In the final analysis, outsourcing is a deliberate decision as to whether an MNE should perform the value-creating activity itself or outsource it to another entity. There are many facets relating to this decision. They are discussed on page 296 of the textbook.

Once the decision has been taken, a series of eight basic steps may be followed in the implementation of this decision. These steps are spelled out on page 296 of the textbook. They are pivotal to the management of supplier networks.

9.2.3 INVENTORY MANAGEMENT

Regardless of the origins of its source of materials, MNEs still need to manage the flow and storage of inventory.

The logistics involved in the distribution of materials has a significant effect on the manufacturing process and the required efficiencies for this process. The efficiency of this process is a determinant of an MNE's ability to deliver to its customers on time.

The ability to deliver on time has mutual benefits. For the manufacturer, the objective is to deliver to customers on time, while economising on inventory holding costs by having material arrive at its manufacturing plant just-in-time to enter the production process and not before. This confirms the importance of just-in-time (JIT) systems.

Just-in-time (JIT) inventory is discussed on pages 297–298 of the textbook. It has become a pivotal requirement for manufacturing operations as it has a direct impact on inventory and other related costs. In international business, the application of JIT has a significant impact on the logistics function and, therefore, the management of the global supply chain.

JIT has the potential to effect major cost-savings by speeding up inventory turnover. As observed, this reduces holding costs, such as warehousing and storage. Moreover, the use of a JIT inventory system presupposes that the manufacturer (MNE) obtains the required materials precisely at the time they are required in the manufacturing process.

Notwithstanding, as noted on pages 297–298 of the textbook, the application of JIT, in a global context, presents significant challenges, due to the lead and lag times involved in global supply chain operations. Often these disparities are due to inordinate transport distances and time constraints. These constraints make it difficult to apply JIT, on account of the necessity to ensure that "buffer" stockholdings are in place, so as to meet customer demand in foreign locales, at all times. The reality of disparate transport distances, which introduce lag times in the logistics process, focuses attention on the critical role of transport in global operations.

The importance of transportation is manifested in its many facets, all of which impact on the logistics function: being the critical link between the MNE and its suppliers and customers. The importance of this link is elaborated on in the discussion presented on page 298 of the textbook.

Indeed, when an MNE decides to manufacture its product(s) in a foreign location, the option of outsourcing the transportation of supplies as well as finished goods could be the only way of overcoming the inordinate transport costs that would be incurred by the manufacturer, if this was done internally. Moreover, such transport costs could be, further, compounded, by inordinate production costs and the prevalence of trade barriers. However, all of these constraints can be overcome by locating an MNE's manufacturing operations in a foreign location.

These constraints can be alleviated by the application of supply chain technology, as a means of enhancing the value-adding potential of the effectively managed global supply chain.

The application of information technology could find expression in the following aspects of an MNE's global manufacturing operations, as discussed on page 298 of the textbook.

- Decision support systems – to enhance the presentation of information to management.
- Network design applications assist in dealing with strategy issues relating to MNE's manufacturing facilities.
- Warehousing and transportation, where the planning and management involved, facilitates locating and controlling transactions, between different participants in the supply chain.

Allied to an MNE's global manufacturing operations, is the role of global services, which includes customer support.

Inasmuch as manufacturing demands support services, it is appropriate to focus on global service organisations. The importance of global service organisations is discussed on page 279 of the textbook. The unique characteristics of "global services" are spelled out in this discussion as well. They include:

- The intangibility of services.
- The fact that services are not storable.
- Services presuppose customer interaction.
- Services are usually linked to a product.

These characteristics should enable you to distinguish between manufacturing and the actual delivery of services, when sourcing for resources. The provision of such "services" is often included in an MNE's manufacturing configuration, highlighting its philosophy of global business operations.

Activity 9.1

The question is often raised as to whether an MNE should outsource its innovation processes, such as the Research and Development for entire lines of production required to complete products. As you respond to this question, you are required to advance the pros and cons for MNE's outsourcing their "innovation" processes.

Assessment

Now that you have made a careful study of the material presented in this study unit, you are urged to test your knowledge of this material, as you respond to the following questions.

- *Much is made of the make-or-buy decision, the outcome of which could motivate the outsourcing of component manufacturing to outside suppliers. Under what circumstances would it be inadvisable to pursue outsourcing as a sourcing strategy?*

- *A decision by an international producer of electronics to locate some of its factories in China, since 1985, has not produced the desired results. Mistaken estimates were made regarding the prospective demand for its products, by Chinese consumers. What originally attracted them to China, namely, the low-wage rate, with its obvious concomitant, low disposable income, soon began to work against their demand estimates, forcing them to hit on a new strategy, for their Chinese operations. In your opinion; what country factors should have featured in their decision to locate their production activities in China?*
- *Describe and illustrate how a typical "value chain" can be used to design an effective global supply chain, that will be conducive to delivering high quality products in a foreign location, given the constraints of transporting manufactured products to the warehouse, storing them and transporting them to retail outlets.*

SUMMARY

The typical value chain has the potential to be globalised. This configuration illustrates the global operations of MNEs. It focuses on operations management and logistics. This emphasis provides the backdrop to this study unit, which concentrates on the input, transformation and output processes peculiar to operations management. These processes are explored and discussed in the context of global supply chain management.

Implicit in this discussion are references to the role of strategy, logistics and supply chain management in the global operations process. These elements are pivotal to an understanding of the composition of a global manufacturing strategy which is determined by a number of key factors. These factors are discussed, including the importance of location decisions.

"Location factors" feature in the dynamics of the global, manufacturing location decision. These factors embrace a number of country factors which warrant analysis, when planning to locate a manufacturing facility, in a foreign location. There is a special emphasis on these factors which has been captured in this study unit.

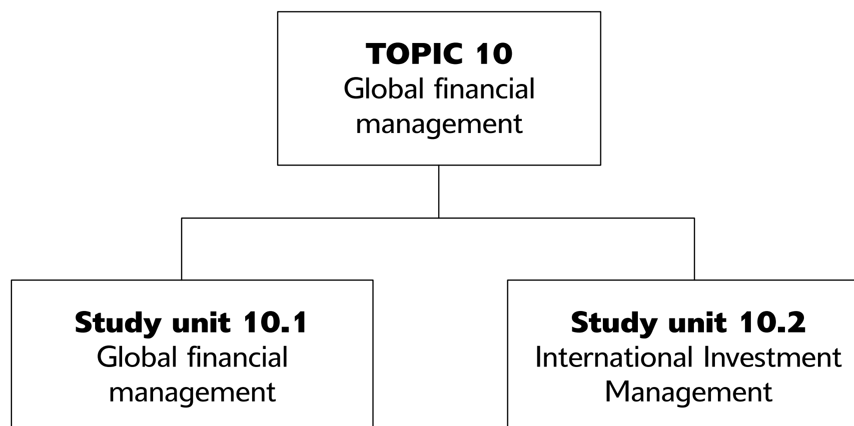
Global supply chain management is treated with reference to the support structure necessary for a global supply chain, supplier networks- including the question of outsourcing- and inventory management. These aspects are considered from the perspective of global supply chain management.

The catalytic role of free trade zones and information technology in global supply chain management is acknowledged as well.

Study the following pages in your prescribed textbook: Aregbeshola, Luiz, Ojah, *et.al.* (2011). Global Business: Environments and Strategies. 4th Edition. Oxford University Press. Pages: 291–292, 293–294, 295–296, 297–298.

Topic 10

Global financial management



AIM

The aim of this topic is to expose you to how MNEs leverage financial resources, with the aid of capital and money markets, so as to finance their international production operations.

This topic focuses on the management of global cash flows, foreign exchange risk management, international investment analysis, capital budgeting, international financing decisions and financial disclosure requirements. In so doing, it opens up the scope of international financial management, inclusive of the various types of decision-making, relative to financial management.

Decisions, for example, pertaining to international working capital requirements and global money management, pertain to the scope of international financial management, and, are acknowledged as such.

Therefore, the question of international working capital and global money management, is considered and discussed. While some of the decisions involved are short-term, in scope, such as decisions relating to the management of MNE's cash flows, others tend to be long-term; for example, those relating to foreign investment. Furthermore, some decisions relate to continuous processes, such as those pertaining to the management of international working capital.

Pivotal to the realities of working capital and global money management, is the need for foreign exchange risk management. This includes the management of: transaction exposure, translation exposure and economic exposure. The impact of foreign exchange rate volatility on these types of exposure is treated in this topic.

Such treatment focuses on the strategies and tactics of managing transaction and translation exposure, and how to reduce economic exposure.

Investment decisions, involving investment analysis, with the aid of capital budgeting, is illustrated, giving further impetus to the aim of this topic.

Pursuant to the outcome of a capital budgeting decision, is the question of the sourcing of funds to execute such a decision. This is discussed in the context of possible, financial structure(s) and the corresponding cost of capital.

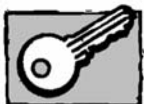
International financing decisions, also fall within the purview of the aim of this topic. Such decisions impact on the financing of international trade. The implications of this are highlighted and discussed.

In the final instance, the adoption and implementation of financing decisions raises questions as to appropriate, financial disclosure. The question of financial disclosure, with the aid of financial statements, is, therefore, discussed in this topic.

Learning outcomes

After studying this topic you should be able to:

- Articulate the scope of international finance.
- Explain the goals of international finance.
- Highlight the importance of foreign exchange risk management.
- Contrast international financial and investment management.
- Clarify the techniques used in international investment analysis.
- Rationalise the importance of an MNE's financial structure, relative to the corresponding cost of capital.
- Motivate the importance of appropriate financial disclosure.



Key concepts

Working capital

Global money management

Foreign exchange risk management

Capital budgeting

Financing decisions

Financial structure

Financial disclosure

Study unit 10.1

Global financial management

Contents

Study unit learning outcomes
Key concepts
Overview
10.1.1 The goals of global financial management
10.1.2 Working capital and global money management
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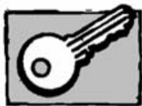
Assessment
Summary

Study unit 10.1 Learning outcomes

Once you have finished this study unit, you will be able to:

- Define financial management and its concomitant decisions.
- Articulate the goals of multinational financial management.
- Clarify the purpose of working capital and global money management.
- Motivate the importance and methodology of foreign exchange risk management.
- Highlight the strategies and tactics for managing foreign exchange rate risk management.



Key concepts

Capital budgeting
Capital structure
Working capital management
Global money management
Foreign exchange risk management

OVERVIEW

In study unit 10.1 we focus on the unique aspects of international (multinational) financial management. We do so against the backdrop of topic 4 in this study guide. The corollary to the discussion in topic 4 of this study guide relates to the three major

areas of decision-making, pertaining to international financial management. Therefore, decisions relating to: capital budgeting, capital structure and working capital management will be discussed. This discussion impacts on international working capital and global money management, which facilitate the realisation of the goals of multinational financial management. These goals are unpacked and discussed in the context of maximising an MNE's wealth.

Moreover, the maximisation of an MNE's wealth is, further, determined by the successful management of foreign exchange (forex) rate risk management. This is acknowledged and treated with reference to: translation exposure, transaction exposure and economic exposure and how best to manage this triad of "forex" exposure.

Deliberate strategies and tactics have to be adopted and implemented for this purpose. These are highlighted and discussed with reference to the need to adopt sound mechanisms and policies that will facilitate the implementation of these strategies and tactics, to minimise forex exposure.

10.1.1 THE GOALS OF GLOBAL FINANCIAL MANAGEMENT

This subject is discussed against the backdrop of topic 4 in this study guide, where reference is made to the workings of financial markets and their role in international production.

The globalisation of international business, which has resulted in the continued expansion of markets and operations and the corresponding financing of such operations, has given further impetus to the importance of financial management, which has become far more complex in a global economy.

These perspectives have infused international financial management with unique challenges. These challenges are presented on page 302 of the textbook. They clarify the unique requirements of international financial management, in the context of cross-border production activities. These challenges broaden the scope of financial management. They confirm the definition of international financial management, and the goals thereof as inferred on pages 304–305 of the textbook.

Granted that the goal of international financial management is the maximisation of an MNE's wealth, this study unit highlights the three major areas of decision-making that are pivotal to achieving this goal. These include:

- Capital budgeting.
- Capital structures and,
- Working capital management.

Their specific contribution to international financial management will be treated in subsequent discussions in the context of this topic. Suffice it to say that both the subject of capital budgeting and capital structures underlines the importance of the dividend policy decision, involving both investment and financing decisions.

Inherent in the dividend policy decision is the presupposition of continuous financial planning and control. This implies a measure of certainty. However, in the context of

international financial management, MNE's have to deal with a greater measure of uncertainty. This is often due to forex rate vacillation, as spelled out on page 303 of the textbook.

Notwithstanding, the effective management of these uncertainties could create a comparative advantage for an MNE. Indeed, a comparative cost advantage could, as spelled out on page 304 of the textbook, be achieved, if MNEs are successful in:

- Securing external financing for a project, by means of the lowest-cost source of capital available. This usually means accessing the global capital market.
- Leveraging multilateral netting facilities, which enable an MNE to reduce the transaction costs that arise when any transactions occur between its subsidiaries. These costs relate to forex transactions and represent commission paid to a dealer.
- Leveraging tax benefits, through transfer pricing, so as to capitalise on differences in tax and fiscal regimes across various production locations.

Indeed, it is the cross-border differential that distinguishes international financial management from uni-national financial management. This distinctive highlights:

- The importance of forex rate differentials.
- The benefits of a broader access to international finance.
- The opportunity to diversify operational and financial risks across different foreign subsidiaries.

These distinctions are highlighted on page 304 of the textbook.

Implicit in these benefits are the two fundamental goals of international financial management, namely:

- Shareholder wealth maximisation.
- Corporate wealth maximisation; as discussed on pages 304–305 of the prescribed textbook.

Shareholder wealth is derived from: the sum of capital gains and dividends for a given level of risk.

By contrast, corporate wealth maximisation implies the maximisation of wealth, not only for the benefit of shareholders, but for a much wider range of stakeholders as well. This could include: management, labour, community, suppliers, creditors and even the Government.

Indeed the above represents wealth maximisation – based on total risk – over a longer term, being driven by technological, market and human resources capacity as well.

These two aspects of wealth creation – though not without controversy – are, nevertheless, subsumed under the goals of international financial management. This is emphasised on pages 304–305 of the textbook, where the goal of international financial management is stated to be: "the maximisation of an MNE's wealth".

These goals focus on wealth optimisation, which can be gauged with the aid of capital budgeting decision tools, which can demonstrate how international production activities can add value to an MNE's current wealth.

10.1.2 WORKING CAPITAL AND GLOBAL MONEY MANAGEMENT

Short-term or current assets and liabilities are collectively known as working capital. Net working capital would be current assets minus current liabilities.

An important current asset is accounts receivable, another important asset is inventory. The most liquid current assets are cash and marketable securities.

These current assets need to be offset against current liabilities of which accounts payable (creditors) are the most important; these are outstanding payments to others firms (MNEs).

To finance its investment in current assets a firm (MNE) may resort to a variety of short-term loans. These could be secured or unsecured.

Administering an MNE's international working capital requirements is pivotal to the management of its global cash flows.

Allied to this is the management of its forex risks, its various investments, its capital structure and the leveraging of sufficient sources of finance, subject to prescribed financial disclosures. These activities are not only the responsibility of the parent company (MNE) but also that of overseas subsidiaries.

Some of the decisions pertaining to these activities are taken on a daily basis, for example, those relating to the management of an MNE's global cash flows. On the other hand, some decisions, such as those pertaining to long-term financing and foreign investments are taken periodically.

Indeed, money management decisions attempt to manage the MNE's global cash resources – including its working capital – most efficiently. This is a continuous process.

It is, furthermore, important to note that the components of working capital, namely, current assets, such as accounts receivable, cash and short-term marketable securities, as well as current liabilities, including accounts payable and short-term debt-funding, all affect the MNE's interim cash flow position. This is discussed on page 305 of the textbook.

Therefore, the management of an MNE's global cash resources involves two fundamental requirements, namely: minimisation of cash balances and reducing transaction costs. It involves the MNE's cash budget. These requirements are explained on pages 305–310 of the prescribed textbook. Ultimately, it involves managing the movement of money across borders.

You, therefore, need to consider the following aspects of global money management.

- Minimising cash balances; which means keeping cash balances as low as possible. This initiative must be linked to the management of liquidity. Three motives determine cash and liquidity requirements; namely,
  - The transaction motive.
  - The precaution motive.
  - The speculative motive.

These determinants of liquidity are discussed on page 306 of the textbook. Managing an MNE's liquidity requirements is often a fine balancing act, bearing in mind that the higher its cash and short-term investments are, the lower the overall rate of return.

- Centralised depositories; involving the centralised pooling of cash reserves so as to boost deposits and higher rates of return. This, too, is discussed on page 306 of the textbook.
- Reducing transaction costs. Transaction costs are the cost of exchange. Every time a firm changes cash from one currency into another currency, it must bear a transaction cost – the commission fee paid to forex dealers for performing the transaction. If banks are involved they charge a transfer fee for moving cash from one location to another. Because these costs associated with such transactions are substantial, MNE's frequently resort to using multilateral netting. This allows them to reduce transaction costs, as discussed on page 308 of the textbook.
- Optimising the use and positioning of funds. In order to utilise an MNE's cash resources most efficiently, it must ensure that it is able to transfer funds from one location to another around the globe in the most cost-effective way.
- The use of various techniques to optimise funds, including: dividend remittances, royalty payments, transfer pricing and fronting loans. These are explained on pages 307–310 of the textbook. Note that the number of inter-firm transfers of goods/services is determined by whether they are pursuing a global and transnational strategy. These strategies drive the distribution of value-creation activities to various optimum locations around the globe.
- Transfer-pricing which is, used to position funds within an MNE. The detail involved in this process is spelled out on pages 307–308 of the textbook.
- Tax havens, which are used to minimise an MNEs tax liability. A tax haven is a country with an exceptionally low, or even no, income tax. MNEs avoid or defer income taxes by establishing wholly-owned, non-operating subsidiaries in the tax haven. The details involved in setting up a tax haven are discussed on pages 308–310 of the textbook. In essence, this allows for the transfer of funds from forex-operating subsidiaries to the parent company (MNE), to be funnelled through the tax haven subsidiary.
- The use of fronting loans, which are parent to subsidiary loans, are channelled through a financial intermediary, usually a bank. Frequently this involves direct, cash loans to the foreign subsidiary, subject to repayment. MNEs use fronting loans for the following reasons.
  - To circumvent host-country restrictions on the remittance of funds from a foreign subsidiary to a parent company (MNE).
  - To provide tax advantages. The detailed outworking of these tax advantages is illustrated on page 310 of the textbook.

10.1.3 FOREX RISK MANAGEMENT

Forex risk management is discussed in the context of:

- Translation exposure.
- Transaction exposure.
- Economic exposure.

Translation exposure is the impact of currency exchange rate changes on the

reported, financial statements of an MNE. Translation exposure is concerned with the present measurement of past events. The resulting accounting gains or losses are said to be unrealised. They are "paper" gains and losses, but they are important.

Take note that since 1981, the current rate method is used for purposes of translating foreign, currency financial statements. This method has been adopted by a number of countries. The practical application of this method is discussed on pages 311–312 of the textbook.

Transaction exposure is the extent to which income from individual transactions is affected by fluctuations in forex values. Such exposure includes obligations for the purchase or sale of goods/services at previously agreed prices and the borrowing or lending of funds in foreign currencies. It is critical to manage uncertainties associated with fluctuations in forex values.

This kind of uncertainty affects the original cash flows agreed to when the transactions occurred. The impact of this uncertainty is illustrated on pages 312–313 of the textbook. The illustration in Box 12.1 is noteworthy.

Economic exposure is the extent to which changes in exchange rates affect MNE's future international earning power. It is concerned with the long-run effect of changes in exchange rates on future prices, sales and costs. This is contrary to transaction exposure which is concerned with the effect of exchange rate changes on short-term, individual transactions. But, because of its long-term implications economic exposure is the more important to try and manage. This is emphasised on page 314 of the textbook.

Because of forex rate volatility it is necessary for MNEs to adopt suitable strategies and tactics to manage such uncertainty. These are discussed in the context of "operational financial strategies".

Significantly, the fundamental aim of operational financial strategies is to minimise the effect of changing exchange rates on MNE's profitability. The various steps that can be taken to counter such uncertainty are discussed on pages 314–317 of the textbook.

In this regard, you must take note of the following options, as discussed in topic 4 of this study guide. They include:

- The value of adopting lead and lag strategies, as a means for MNEs to protect their cash flows.
- Currency forward contracts, which denote an agreement between two parties to exchange currency and execute the deal at some specific date in the future. The practical outworking of this is discussed on page 315 of the textbook.
- Currency swaps. This is the simultaneous purchase and sale of a given amount of forex for two different value dates. Swaps are transacted between MNEs and their banks, between banks and between governments, when it is desirable to move out of one currency into another for a limited period, without incurring forex risk. You must make a careful study of study unit 4.2.2, in topic 4, of this study guide.
- Currency options. A foreign currency option is a contract that entitles the buyer (holder) to buy or sell a given amount of forex at a fixed international price, at a future date or until the expiry of that date. The price is called the option premium. This currency conversion measure is discussed on page 316 of the textbook.

However, there are other tactics that can be used as measures to reduce transaction and translation exposure. These are discussed on page 316.

In the case of economic exposure, measures that can be adopted to reduce economic exposure are more complex. The reason for this and the measures that can be adopted to attenuate economic exposure are discussed on pages 316–317. It requires, inter alia, understanding and monitoring the underlying factors and trends that can influence exchange rates, giving rise to their fluctuation.

In the final analysis, reducing economic exposure requires strategic choices, choices that often go beyond the realm of financial management. Notwithstanding, the key to reducing economic exposure is to distribute an MNE's production assets to various locations so that its long-term financial well-being is not severely affected by adverse changes in exchange rates.

Assessment

Now that you have completed this study unit, you can test your understanding of this material by responding to the following questions.

- *How would you propose optimising the use of an MNE's internal funds?*
- *List the goals of international financial management. Do you think they adequately cover the activities and scope of international financial management?*
- *Why is it more difficult to manage the risks associated with economic exposure, relative to the risks associated with translation and transaction exposure? What strategies and tactics need to be adopted to manage "economic exposure"?*

SUMMARY

This study unit introduces you to the purpose and scope of international financial management. It defines the scope of international financial management, in terms of: capital budgeting, capital structure and working capital management. In so doing, it emphasises the fact that effective financial management can be a source of competitive advantage, if the cost of that competitive advantage is successfully managed.

Allied to the scope of financial management are the goals of international financial management. These are addressed in terms of: shareholder wealth maximisation and corporate wealth maximisation. Their management is pivotal to the maximisation of MNE's wealth.

In pursuit of these goals, MNEs are obliged to give attention to the management of their working capital and their global cash flows. This is done in the context of a global business environment fraught with risks and uncertainty.

The effective management of working capital and global cash flows is, therefore, addressed. The various ways of achieving this are discussed. They include initiatives such as: minimising cash balances, reducing transaction costs and optimising the use of an MNE's internal funds. These are discussed.

The overriding dynamic in this process is the reality of forex rate volatility and the need to manage the risks associated with this. Pivotal to managing these risks is the need to understand the various types of forex risks. This study unit addresses this in terms of: translation exposure, transaction exposure and economic exposure. Practically speaking, these risks are managed with the aid of numerous operational financial strategies, including lead and lag strategies. These are usually implemented with the view to minimising forex risks. They include strategies such as the use of:

- Currency forward contracts.
- Currency swaps and,
- Currency options.

These hedging strategies are discussed and explained.

Study the following pages in your prescribed textbook: Aregbeshola, Luiz, Ojah, *et.al*. (2011). Global Business: Environments and Strategies. 4th Edition. Oxford University Press. Pages: 302–305, 306–310, 312–317.

Study unit 10.2

International investment management

Contents

Study unit learning outcomes
Key concepts
Overview
10.2.1 Capital budgeting
10.2.2 International financing decisions
Assessment
Summary

Study unit 10.2 Learning outcomes

Once you have finished this study unit, you will be able to:

- Defend the connection between FDI's and capital budgeting.
- Define and illustrate the capital budgeting process.
- Distinguish between parent and project cash flows.
- Describe the risks associated with capital budgeting.
- Delineate the risk adjustments peculiar to the capital budgeting process.
- Discuss and describe the dynamics of international financing decisions.

Key concepts

Capital budgeting
Parent and project cash flows
Net present value
Internal rate of return
Cost of capital
Risk in capital budgeting
International financing decisions

OVERVIEW

In study unit 10.2 the focus is on MNE's international investment initiatives. These are frequently related to FDIs. FDIs were discussed in topic 6, study unit 6.1 of this study guide.

FDIs often feature in an MNE's long-term strategy to penetrate foreign markets. This often has benefits for the host country; the recipients of inward-FDI, particularly in terms of resource-transfer effects, employment effects, balance of payments effects and the impact it has on domestic competition and economic growth.

For the MNE, FDIs enable it to capitalise on foreign market opportunities or to respond to domestic problems, peculiar to the local market. FDIs are often preferred to other forms of foreign market entry. Indeed, such investment initiatives presuppose the consideration and analysis of a number of factors. These include: economic, political, legal and strategic factors, together with the corresponding cost-benefits and risks associated with such investments. These factors are spelled out in topic 1, study units 1.2 and 1.3, in this study guide.

These constraints compel MNEs to engage in careful investment analysis. An analysis of this nature seeks to quantify the prospective cash flows relating to such an investment, relative to the corresponding costs, benefits and risks. The use of capital budgeting techniques is pivotal to this process. The outcome of capital budgeting decisions is critical to the international financing decisions to be taken. This deals with the sourcing of and accounting for international finance to fund such international investment projects.

10.2.1 CAPITAL BUDGETING

Capital budgeting quantifies the cost, benefits and risks of an investment. This enables the management of MNEs to objectively compare different investment alternatives within and across countries, so they can make informed choices about where the MNE should invest its scarce financial resources.

Capital budgeting for a foreign project uses the same methodology that domestic capital budgeting uses. This means that the MNE must first estimate the cash flows associated with the project over time. These are after-tax cash flow estimates. They need to be discounted to their total present value to determine the impact of the investment on the MNEs wealth This methodology is discussed on pages 318–319 of the textbook. In this regard the following is noteworthy.

- Project cash flows and parent cash flows must be distinguished.
- The cash flow position of the parent company (MNE) often depends on regular sources of finance accruing from the project.
- The remittance of funds to the parent company must be delineated, explicitly, because of differential tax systems between countries and political and legal considerations.
- Differential inflation rates impact on the value of cash flows over time.
- Forex rate volatility impacts on the value of the project cash flows which needs to be accounted for in the capital budgeting analysis.
- Capital structure decisions and cost of capital calculations, where project financing depends on subsidised loans, can be complicated.
- Political instability can have a negative impact on expected cash flows from a project.
- Terminal value is more difficult to estimate, because purchases from the host, parent or third countries or from the private or public sector, may reflect different perspectives on the value of the project to the respective parties.

10.2.1.1 Parent and project cash flows

The fact that project cash flows are different to the cash flows accruing to the project, underline the distinction between parent and project cash flows.

Compelling arguments in favour of doing the investment analysis from a parent company's point of view, necessitates that the analysis reflects the parent company's involvement in the projection of cash flows. The reasons for this are the follows:

- Subsidiary projects may not be able to remit all their cash flows to the parent company, because of host country restraints or tax requirements.
- Cash flows to the parent company form the basis for dividend payments to the parent company's shareholders, for reinvestment at home or in other foreign countries, and for the repayment of company debt.

These constraints are discussed on pages 319–322 of the textbook. Significantly, the textbook emphasises that most international investment cash flows, accruing to the parent company, are financial rather than operating cash flows. This contradicts the basic rule of capital budgeting, namely, that operational and financial cash flows should not be confused.

The reason for this distinction has to do with potential restrictions imposed on cash flow remittances to parent companies, resulting in the non-availability of such cash flows to the parent company, thereby failing to contribute to the current value of the parent company. A further complication is that project cash flow remittances could be attenuated, as a result of cross-border tax differences.

Consequently, the relationship between parent and project cash flows are illustrated in Table 12.3 on page 320 of the textbook, while the process of remitting cash flows from a subsidiary to a parent company is illustrated in Figure 12.4 on page 320 of the textbook.

In practice, MNEs usually evaluate foreign-based, capital projects, both from the perspective of the parent company (MNE) and the project.

10.2.1.2 Risk and capital budgeting

As mentioned, when analysing a foreign investment opportunity an MNE must consider the political and economic risks that stem from the foreign location. These types of risks are discussed on pages 321–322 of the textbook. Once again, it is a reflection on the discussion in topic 1, study unit 1.2, and topic 2, study unit 2.2 in this study guide.

Insofar as **political risks** are concerned, these stem from: trade and investment barriers, exchange controls, requirements governing the remittance of earnings from subsidiaries to the parent company and the promulgation of new tax regimes. In extreme cases, such risks could stem from the prospect of nationalisation. These and other risks, though subject to forecasting, cannot always be quantified with accuracy.

In the case of **economic risk,** it denotes the prospect that economic mismanagement could occur in a foreign location. This eventuality could be deleterious for an MNEs goal-achievement and profitability. However, one of the most serious consequences of economic mismanagement could be uncontrolled inflation. This has

serious implications for foreign investments in the affected country. The impact of fluctuating macro-economic trends, on a host country's project cash flows, need to be carefully evaluated.

It is for this reason that adjustments have to be made to cash flow projections, to account for the risks associated with foreign investments. This is dealt with on pages 321–322 of the textbook. Note that two approaches are advocated, namely:

- Analysts must treat all foreign risks as a single issue by increasing the discount rate applicable to foreign investments, relative to the rate used for domestic projects. This will reflect the increased risks associated with foreign investments. The dominant risks are political and economic.
- Analysts must adjust all relevant, individual cash flow forecasts of the investment project, to reflect relevant foreign risks. This could mean revising future cash flows downwards.

All of these constraints add to the complexity of capital budgeting. These complexities are illustrated in Figure 12.5 on page 322 of the textbook. In essence, this represents a comprehensive, integrated, capital budgeting framework. The relationship between these elements is pivotal to capital budgeting decisions.

Against this backdrop, the following considerations are deemed to be crucial to capital budgeting analysis.

- The duration of the initial outlay of the foreign investment.
- The working capital requirements and the prospect of their recoverability, at the end of the project.
- The impact of: variable costs, fixed costs and inflation, on foreign investments.
- The salvage value on termination of the project.
- The tax implications pertaining to the foreign investment project.
- The cost of capital or IRR (internal rate of return) considerations.

10.2.1.3 Capital budgeting applications

On pages 322–326 of the prescribed textbook, a practical example is provided, illustrating the practical application of capital budgeting. Take note of the following aspects, which are relevant to the example of Delphi Enterprises Limited, to establish an operation in Austria, in their quest to expand their business in Europe.

- The initial investment.
- The project life.
- The demand for and product price.
- Costs associated with the project.
- Exchange rate estimates.
- Host-country taxes on income earned by foreign subsidiaries.
- The South African tax rate on income earned by the Austrian subsidiary.
- Estimated cash flows from the Austrian subsidiary, to be remitted to the South African parent company.
- Depreciation.
- Salvage value.
- Cost of capital or required rate of return.

Thereafter, take note of the method of analysis. This is spelled out on page 325 of the textbook. The steps involved are set out in Table 12.4 on page 324 of the textbook. Some of these steps include:

- Estimate total income expected from the project.
- Estimate total expenditure expected to be associated with the project.
- Calculate earnings before interest and tax.
- Ascertain host-government taxes.
- Calculate the after-tax cash flows accruing from the project.
- Determine the net amount to be remitted to parent company (MNE).
- Convert funds remitted to Rands at the prevailing exchange rate, for each of the four year periods.
- Determine tax deductions so as to arrive at the net amount to be remitted to the parent company.
- Calculate the Net Present Value (NPV) of cash flows accruing to the parent company.
- Calculate the cumulative NPV of cash flows accruing over the duration of the project.

The final outcome presupposes a positive NPV for the project. If not, the capital budgeting decision must be reconsidered.

While this is a simplified illustration, it does clarify the application of capital budgeting techniques.

10.2.2 INTERNATIONAL FINANCING DECISIONS

Here the focus is on the sourcing of funds for various foreign investment projects. Most MNEs have two options, namely:

- International sources of funds, comprising funds generated internationally, by foreign subsidiaries and funds originating from corporate sources. Figure 12.6 on page 326 of the textbook illustrates this source of capital.
- External sources of funds, from outside the corporate structures of the MNE.

These two options are subject to the following constraints.

- International funds can be sourced from the corporate family. Practically this means obtaining funds from the parent company or from a sister subsidiary. Funds could also be sourced from retained earnings and cash loans or via subsidiary borrowings with a parent company guarantee. These options are outlined in Figure 12.6 on page 326 of the textbook.
- External sources of funds to finance foreign investments can be obtained from one or more of the following.
  - Borrowing from the MNE's home-country sources, usually from banks.
  - Borrowing from outside home-country sources, which could include local currency loans or third country Eurocurrency loans.
  - Obtaining host-country equity from individual shareholders in the host-country or from joint venture partners, where the subsidiary is not wholly-owned.

10.2.2.1 Financial structures and cost of capital

International financing decisions, should be based on a financial structure that minimises the cost of capital. By financial structure we mean the mix of debt and equity used to finance a business.

Realistically, the financial structure of firms (MNEs) vary significantly across countries. One reason for this is that different tax regimes determine the relative attractiveness of debt and equity in a country. These differences in the financial structure of MNEs across countries impacts on the choice of an optimal financial structure. Here the following considerations are important.

- The need to minimise the cost of external funds after adjusting for the forex rate and political risk.
- The need to manage political risk and tax liability when selecting international financing sources.
- The importance of minimising the MNE's international consolidated cost of capital.
- The need to position funds in the parent company and its subsidiaries in an optimal way.

In essence, it is most prudent that an MNE choose a financial structure that minimises its own consolidated cost of capital, rather than that of its foreign subsidiaries, regardless of whether this structure is consistent with local practice in the respective host countries. This is discussed on pages 327–328 of the textbook.

10.2.2.2 Financing international trade

The outcome of international financing decisions is often linked to the financing of international trade. To this end, it is important to distinguish between the following types of international trade relationships, involving exporters and importers.

- **Unaffiliated unknown** – where the importer is unknown to the exporter, meaning that the two parties will need to enter into a contract enabling the exporter to seek protection against non-payment.
- **Unaffiliated known** – where the importer is a known customer, enjoying a long- standing relationship with the exporter. The parties may enter into a contract to solicit third party protection against non-payment.
- **Affiliated** – where the importer is an affiliated, foreign subsidiary, of the exporter parent company. This is tantamount to inter-firm trade, where business is conducted without a contract or protection against non-performance.

In order to cope with the uncertainties arising from these different international trade relationships, a number of mechanisms and devices have evolved to reduce these uncertainties, associated with the lack of trust between parties. These are discussed on pages 328–330 of the textbook. They include:

- **The letter of credit (L/C),** which states that the bank will pay a specified sum of money to a beneficiary, usually the exporter, on presentation of the specified documents. Letters of credit are either revocable or irrevocable. This distinction is addressed on page 329 of the textbook. It has to do with whether the L/C can be cancelled or not. The advantage is that both the importer and the exporter are likely to use reputable banks they can trust. The drawback is that the importer must pay a fee for the L/C.

- **Bill of exchange.** This draft is an unconditional order by an exporter instructing an importer or his agent, to pay he face amount of the draft on sight or at a specified future date. This is discussed on page 329 of the textbook. Draft bills of exchange fall into two categories: sight drafts or time drafts. A sight draft is payable on presentation to the drawee (importer). A time draft allows for a delay in payment (usually 30–180 days). It is presented to the drawee who signifies acceptance of it by endorsement of the draft to this effect. Time drafts are negotiable instruments.
- **Bill of lading.** This is issued to the exporter by the carrier. The carrier transports the product, which act constitutes a receipt, or a contract or a document of title. The implications of these conditions are spelled out on page 329 of the textbook. The bill of lading can also serve as collateral against which funds may be advanced to the exporter by its bank, before or during shipment and before final payment by the importer.
- **A commercial invoice;** which is the exporter's description of the product being shipped to the importer. The features of this invoice are stipulated on page 329 of the textbook.

Practically, a typical international transaction is illustrated, for clarity purposes, in Figure 12.8, on page 330 of the textbook. In this diagram you are presented with:

- A South African importer.
- A German exporter.
- The securement of a l/c to pay the exporter on the importer's behalf;
- A commercial invoice, describing the item being shipped.
- A bill of lading providing title to the items.
- A draft, bill of exchange, requiring a South African bank to pay for items on behalf of the importer.
- A transaction in terms of which the importer pays the bank who has passed the title on to the importer. The bank represents the issuing bank in South Africa and the advisory bank in Germany.

As you can appreciate, this is a simplification of the process, but it does highlight some of the steps involved in an international trade transaction.

10.2.2.3 Financial disclosure

Disclosure implies the release of relevant information which enables users to take important decisions. Such information could be of a financial or non-financial nature

The conduit for the dissemination of such information is usually the annual report. This report contains both quantitative and qualitative information. Quantitative information is articulated through the financial statements. Sometimes there are consolidated financial statements which provide accounting information about a group of companies (subsidiaries) that recognise their interdependence.

Qualitative information is typified through notes that are added to the financial statements, supplementary schedules and management discussion analysis and the shareholder report(s).

Whatever form disclosure takes, it is invariably a sensitive matter. It is a challenge to know what to disclose and what not to disclose. Frequently, the information that is

disclosed is designed to highlight the positive aspects of an MNE's performance. By so doing, MNE's are able to minimise the negative impact of less positive information, which could have a deleterious effect on an MNE's share price or investor confidence, not to mention how it could affect creditors' perception of the MNE.

Regardless of how information is disclosed in annual reports, the purpose should always be to inform decisions that need to be taken. These are usually investment decisions, notably, foreign investment decisions.

Financial disclosure could either be mandatory or voluntary. Mandatory disclosure stems from regulatory requirements, prescribed by statute. They could be imposed by stock exchanges or accounting standards, particularly international accounting standards. Accounting standards consist of normative requirements relating to the compilation and presentation of the: income statement, balance sheet, cash flow statement and notes to the financial statements. Observe that in most cases MNEs use International Financial Reporting Standards or GAAP (Generally Accepted Accounting Principles) standards. These are discussed on page 331 of the textbook. The purpose of these normative requirements is to harmonise accounting standards across countries.

Voluntary disclosure is the release of information in excess of what is required in terms of accounting standards. The release of such information is to facilitate stakeholder decision-making.

Voluntary disclosure compensates for the lack of information in traditional financial reporting, thereby attenuating share price volatility and insider trading. This decreases the cost of equity capital. Voluntary disclosure is influence by a number of factors. These are discussed on page 331. These include the: ownership structure, dual listing, the number of independent directors and the existence and operation of audit committees.

10.2.2.4 The role of financial statements in disclosure

Financial statements serve as a direct means of disclosure. These statements allow MNEs to release information about their performance. This information enables stakeholders to take informed decisions.

Financial statements typically comprise: the income statement, balance sheet, statement of cash flows and statement of shareholder's equity. These statements are usually enhanced by footnotes and supplementary information designed to assist in the interpretation of this information. The information disclosed would have to comply with international accounting standards.

The income statement discloses information about the performance of an MNE, in terms of revenue, expenses and profit. Allied to this is the statement of comprehensive income, indicative of how shareholder's wealth has increased through trading and non-trading activities.

The balance sheet reveals the MNE's assets and liabilities. A description of the elements comprising the balance sheet is set out on page 333 of the textbook.

The statement of cash flows reports cash receipts and payments for a stipulated period. Note that these receipts and payments are classified in terms of operating, investment and financial activities.

Moreover, a statement of changes in equity reports the amounts and sources of changes in equity from capital transactions by the owners. These statements are discussed on page 333 of the textbook.

10.2.2.5 Harmonisation of accounting standards

Substantial efforts have been made in recent years to harmonise accounting standards across countries. The reason for this is the rise of global capital markets, which facilitate the provision of capital across borders. Providers are demanding consistency in the way in which financial results are reported, so they can make informed decisions.

Consequently, in the USA, accounting standards are harmonised with the aid of the Generally Accepted Accounting Principles (GAAP). But, international accounting standards are determined by the International Accounting Standards Board, which serves to harmonise accounting standards. It involves harmonising the accounting standards. It involves harmonising the accounting standards of different nations. These standards are called the International Financial Reporting Standards. Figures 12.9–12.12 illustrate the application of international accounting standards. This appears on pages 332 and 334–341 of the textbook.

The two main advantages of harmonisation are: comparability and consistency. This facilitates comparing two similar company's listed in different countries, because they use similar policies, principles and standards in presenting financial information. This is emphasised on page 342 of the textbook.

Allied to the harmonisation of accounting standards is the role of the independent auditor who must confirm the integrity of the financial statements, prepared according to international accounting standards. The auditor proffers an unqualified or qualified opinion, or a disclaimer opinion or an adverse opinion. This is done according to international accounting codes as spelled out on pages 342–343 of the textbook.

Independent auditing can be augmented through other governance initiatives, aimed at enhancing disclosure. This is particularly relevant today in the light of recent, international and local financial scandals.

In South Africa, governance issues are formalised through the King 1,11 and 111 reports. Of particular note are the recommendations of the King 111 report. The purpose of this report is to elaborate on the disclosure requirements of companies that claim to apply the King code of corporate governance. This is discussed on pages 343–344 of the textbook. It requires that a company's board of directors plays a significant role in ensuring that the company (MNE) discloses adequate information. This is borne out in the discussion on pages 343–344 of the textbook.

Assessment

Now that you have completed this study unit, you are in a position to test your knowledge of this material. You can do so by responding to the following questions.

- *Why should MNE's use capital budgeting techniques to evaluate FDI opportunities? Are these the only techniques they can use?*
- *How is it possible to confuse parent and project cash flows in capital budgeting analysis?*

- *How would the prevalence of political and economic risks influence the optimisation of an MNE's financial structure?*
- *How has the King 111 report catalysed the financial disclosure process?*

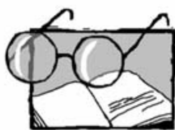
SUMMARY

In this study unit the spotlight falls on the international investment analysis process, with the aid of capital budgeting techniques. Investments are often construed as FDIs needing careful evaluation. Such evaluations need to consider a number of constraints. These include economic, political, legal and strategic factors.

The potential of capital budgeting as an investment analysis tool is explored. The capital budgeting process, with its corresponding features, is discussed, illustratively. Difficulties relating to parent and project cash flows are acknowledged in the context of prevailing risks which need to be adjusted for in the capital budgeting process.

The outcome of the capital budgeting decision presupposes the sourcing of funds for purposes of implementing the capital budgeting decision. The dual sourcing of funds is recognised. The impact it has on the financing of international trade is discussed. The various aspects of international trade financing is discussed and illustrated by way of typical international trade transactions.

In the final instance, global financial management requires adequate financial disclosure measures and controls. These are discussed in the context of the harmonisation of international accounting standards and the application of governance initiatives.



Study the following pages in your prescribed textbook: Aregbeshola, Luiz, Ojah, *et.al.* (2011). Global Business: Environments and Strategies. 4th Edition. Oxford University Press. Pages: 318–321, 322–326, 327–328, 329–344.

Reflections

Now that you have completed this topic, you may want to reflect on all you have learned. Here are some prompts to assist you.

- *What, in your opinion, increases the challenges, for firm's seeking to manage their cash resources, when the firm is an MNE, involved in international business across several countries?*
- *"Pursuing the objectives of utilising the MNE's cash resources most efficiently and minimising the MNE's global tax liability, means that MNEs must be able to transfer funds from one country to another?" Describe, in practice, how this can be done.*
- *Are you able to spell out the elements of an international trade transaction?*

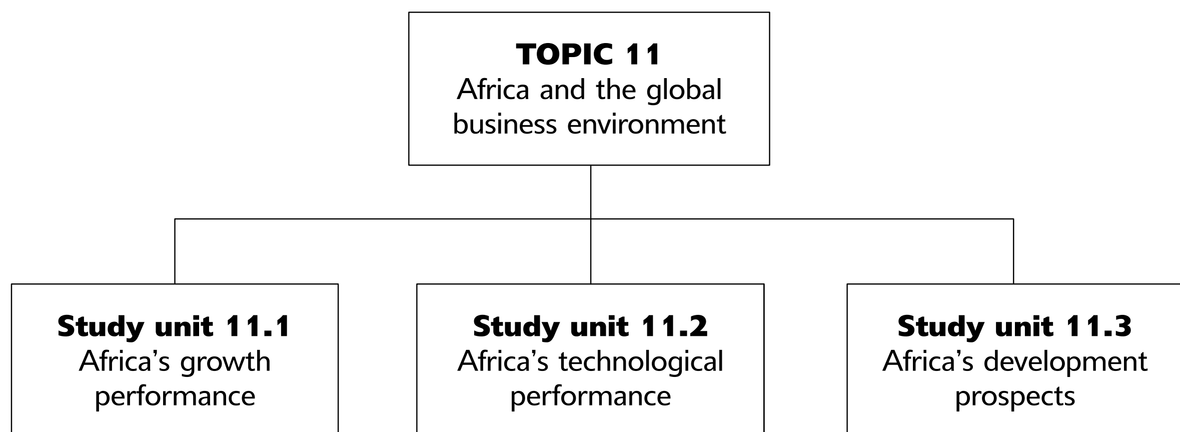
In practice, how do these elements fit together, so as to crystallise the steps involved in a typical international transaction. Try and order your thoughts by way of an illustrative diagram.

PART 5

GLOBAL BUSINESS AND EMERGING MARKETS: THE CASE OF AFRICA

Topic 11

Africa and the global business environment



AIM

The focus of this topic is to present you with a perspective of Africa's unique socio-economic, political and institutional profile, relative to its participation in the globalisation process.

To this end, it unpacks Africa's economic performance in the context of a theoretical framework that includes: the old growth theory, the new growth theory, the theory of FDI flows; culminating in the metrics for gauging Africa's socio-economic and institutional performance. Here the emphasis is on criteria such as: economic freedom, health, governance, corruption and democracy.

Against the backdrop of these somewhat disappointing indicators of Africa's socio-economic and political climate, it is useful to evaluate the impact of technology on Africa's growth prospects. This topic explores these prospects.

The culmination of this discussion is the focus on Africa's role in the global economy; its development prospects and its unique regulatory environment. All of this raises the question as to why MNEs should do business in Africa and how this should be conducted. This is discussed.

Learning outcomes

After studying this topic you should be able to:

- Describe Africa's unique socio-economic and political characteristics.
- Discuss Africa's participation in the global economy.
- Articulate Africa's institutional performance and constraints.
- Highlight the impact of technology on Africa's growth prospects.
- Delineate the challenges facing MNE's wishing to do business in Africa.

Key concepts

Growth performance
Growth theory
Growth rates
Human development indicators
Technological marginalisation
Disclosure index Operations

Study unit 11.1

Africa's growth performance

Contents

Study unit learning outcomes
Key concepts
Overview
11.1.1 Africa's growth performance
11.1.2 Africa's institutional performance
Assessment
Summary

Study unit 11.1 Learning outcomes

Once you have finished this study unit, you will be able to:

- Profile Africa's growth performance.
- Discuss Africa's participation in the global economy.
- Articulate Africa's international business profile.

Key concepts

Business risks
NEPAD (New Partnership for Africa's Development)
Growth and development
Institutional performance potential
Social metrics
Globalisation prospects
Transnational corporations (TNCs)

OVERVIEW

In study unit 11.1 we concentrate on Africa's growth performance. We consider its economic and institutional potential and the impact thereof on the business environment. But, this evaluation is tainted by Africa's risk profile, due to MNE's perception of a business environment fraught with risks, relative to returns. This presents challenges for doing business in Africa.

These challenges impact on Africa's economic growth prospects and its corresponding participation in the globalisation process.

Africa's economic growth prospects are evaluated in terms of growth theories, potential growth rates for exports and prospective FDI inflows. The potential role of TNCs in this growth scenario is considered.

11.1.1 AFRICA'S GROWTH PERFORMANCE

The fillip to Africa's economic growth is partly due to the inordinate FDI inflows into the continent. Countries such as: Egypt, Nigeria, Sudan, Tunisia, Morocco, Algeria, Chad and Ghana, have been substantial recipients.

These inflows have evolved in the wider context of NEPAD (New Partnership for Africa's Development) which has facilitated the process. These catalysts have served to open Africa to international business on an unprecedented scale. The stimulus to this enhanced globalisation, and corresponding economic development, is discussed on pages 348–349 of the textbook. These catalysts to growth have occurred, despite unfavourable risk profiles, relative to returns on investments.

These returns on investments are often, substantially higher than elsewhere. This is alluded to on page 348 of the textbook, thereby confirming the resilience of Africa's business environment.

Foundational to grasping the economic growth performance of Africa are the theoretical postulates presented on page 349 of the textbook. These include: the old growth theory, the new growth theory and prognostications on the impact of globalisation on African economic development.

These predictions are dealt with on pages 349–350 of the textbook. But, Africa's globalisation efforts have not always been inspiring. The continent has often lagged behind other developing countries. Indeed, Africa's performance is often below the world average, in terms of average, annual growth rates of exports, which is a decisive measure of economic growth. This is particularly true, relative to other developing countries. Trends like this are not, necessarily, due to the limitations of globalisation. Rather, such trends, when carefully interpreted, do confirm that Africa's share of world exports have, fluctuated. This is implied on page 349 of the prescribed textbook.

As alluded to earlier, Africa's globalisation achievements are inextricably linked to FDI flows. This is clearly outlined on page 349 of the textbook. Nevertheless, recent and more dramatic increases in global FDI flows to developing countries, must not, however, be allowed to eclipse the fact that Sub-Saharan Africa's share of these flows is still disparate, compared to other, developing countries. Statistics for this purpose are highlighted on pages 349–350 of the textbook. Africa does not compare favourably with, for instance, East Asia, as spelled out on page 350.

These disparities have a dual dimension: external and internal. Notwithstanding, the dominant reason for such disparities in inward FDI flows is often due to the inordinate risks associated with Africa's business environment, as alluded to on page 350 of the textbook. Such risks reflect what are perceived to be exceptionally high levels of political risk and instability. But, this perception has created a countervailing economic

scenario, namely, that, due to its neglect, Africa still has a wealth of untapped potential and opportunities, which, if correctly leveraged, could yield significant returns for investors.

Unfortunately, there is a further drawback to Africa serving as an attractive FDI destination. This is attributed to the absence of TNC (transnational corporation) activity on the continent. TNCs are engines of economic growth in the localities where they operate. Sadly, Africa has lost out on this economic largesse. For, as mentioned on page 350 of the textbook, not one of the world's foremost and largest TNCs came from a developing country. The minimal number of TNCs that came from Africa, came from South Africa. This is hardly an inspiring reflection on the rest of Africa. But now, even these few TNCs are beginning to exit South Africa for other international locations. This is drawn to your attention on page 350 of the textbook.

Clearly, it is the sustained flow of FDI into a developing nation, such as Africa, that is an important stimulus for economic growth in the countries of Africa. Unabated FDI flows into Africa can only bode well. Africa needs a business environment that is conducive to attracting FDIs. For, as has been argued in topic 6 of this study guide, FDI creates growth. This growth brings with it technical expertise, access to foreign markets and the creation of new employment possibilities. Moreover, foreign MNEs have access to sources of finance, especially important to developing countries where local financial institutions are weak.

All of this underlines the fact that FDI does play an important role in most successful development stories. Examples of this include countries such as: Singapore, Malaysia and China. This is what Africa should emulate.

11.1.2 AFRICA'S INSTITUTIONAL PERFORMANCE

Institutions comprise the formal structures and informal rules and norms that govern our behaviour and expectations in interactions with others.

Institutions can either help or hinder development, depending on how the decision-making process is structured. Where institutions reinforce the decision-making processes that are conducive to economic growth, they are considered "good".

Good institutions promote economic growth in three major ways. They create environments conducive to protecting property rights, constraining the action of elites and providing the population with investment opportunities and economic activities. On the contrary, "poor" institutions promote the vested interests of elites to the detriment of the majority.

In terms of Sub-Sahara Africa, developing good institutions is particularly difficult. This is due to several impediments, including:

- Continuously underdeveloped and ineffective institutions, which make Africa a high-risk and unattractive environment for foreign investors.
- Poor policy-driven institutions, which lead to economic mismanagement, through kleptocratic dictatorships and political instability.
- Weak social capital and social policies prevent inter-group cooperation required for the necessary economic development.
- A lack of state capacity to reform or invest in institutions that promote economic development.

Therefore, institution building in Africa is difficult due to prevailing, poor institutional arrangements and capacity. In reality, institution building should be an effective combination that addresses issues of: disease management, geographical isolation, poor infrastructure and poor human capital development, all of which contribute to the perpetuation of Africa's ubiquitous poverty traps.

These issues emphasise numerous aspects, pertaining to Africa's socio-political and institutional performance, as highlighted on pages 350–356 of the textbook. They include:

- Living standards, income levels and the pervasiveness of poverty.
- Human development indicators, highlighting the vexing question of "life expectancy".
- Health, including mortality rates and he impact of HIV/AIDS on Africa and the productivity of its people.
- Governance and transparency, with particular reference to "poor governance" as spelled out page 352 of the textbook. This is often due to the "weak link" of accountability between government and people. Frequently this is accompanied by poor regulatory frameworks, which, if improved could be seen as working against corrupt officials and politicians. In short, there is often a relative lack of democracy.
- Civil war and conflict. Table 13.3, on page 354, clarifies the real cost of conflict.
- Corruption; the cost of which is often borne by the poor.
- Democracy; given Africa's history and experiences, it is the pervasive lack of democracy that is most striking. This implies single party dominance, which minimises the pressure on political leaders to act democratically.

If these standards of socio-economic and political integrity are absent or have been significantly diluted, then the corresponding institutional performance of a country will be jeopardised as well.

Assessment

You are now in a position to consider answering the following questions.

- *Why is FDI inextricably linked to Africa's growth performance?*
- *Africa is often accused of having "poor" institutions, rather than "good" institutions. Why do you think this is the case?*

SUMMARY

In this study unit we debate Africa's growth prospects. The catalysts for this are, it is contended, FDI inflows and the initiatives of NEPAD. But, these catalysts could not be sustained, were it not for the prospects of higher returns for investors and the evolution of democratisation and economic liberalisation, which have been hallmarks of Africa's growth and development. This contention is discussed.

Africa's participation in the global economy hinges on the fulfilment of a number of preconditions to growth. These are listed and discussed. Once again, Africa's

globalisation prospects are linked to FDI inflows. This is noted. The fulfilment of these preconditions is circumscribed by a number of risks that are associated with Africa's business environment. These are noted. Their potential impact on Africa's growth prospects is taken cognisance of.

The antidote to these risks is often seen to lie in the evolution of TNCs, which serve as "engines of growth". However, Africa has not always availed itself of this potential stimulus to its future growth prospects.

Africa's history of poor institutional performance does not improve matters either. For this reason, evidence of the lack of "institutional capacity" is juxtaposed with the postulates of "growth" theories.

Study the following pages in your prescribed textbook: Aregbeshola, Luiz, Ojah, *et.al*. Global Business: Environments and Strategies. 4th Edition. 2011. Oxford University Press. Pages: 348–349 and 350–356.

Study unit 11.2

Africa's technological performance

Contents

Study unit learning outcomes
Key concepts
Overview
11.2.1 Africa's technological challenges
11.2.2 Africa's technological infrastructure
Assessment
Summary

Study unit 11.2 Learning outcomes

Once you have finished this study unit, you will be able to:

- Discuss technology as a driver of economic growth.
- Describe the advent of technological hubs.
- Debate Africa's technological marginalisation.

Key concepts

Technological drivers
Technological progress
Technological gap

OVERVIEW

The ability to create, acquire and adapt new technology is a critical requirement for competing successfully in the global market place. Various international forums and agreements on technology access and technology capacity building have recognised the importance of technology transfer, especially to developing countries. But, widespread consensus, based on well-researched evidence, suggests that Africa has not kept pace with technological advancement. Africa's technology gap could well be the source of increased economic deterioration, because other regions are constantly upgrading their technological capabilities, in response to the global market place becoming increasingly liberalised and competitive.

Consequently, this study unit explores these technological disparities. It does so with

reference to Africa's marginal technological status and its reluctance to create the necessary infrastructure to take advantage of technology transfer. This emphasis also focuses on how these shortcomings negatively impact on investment opportunities for Africa's technology economy.

11.2.1 AFRICA'S TECHNOLOGICAL CHALLENGES

Africa, and in particular, Sub-Sahara Africa, has emerged as lagging, not only in terms of the volume of technological applications, but also in terms of technology content in its economic activity. This has huge implications for the continent's economic and technological competitiveness. For, while it was possible to remain competitive in certain traditional activities, which required unskilled labour and the processing of natural resources, this is rapidly changing. Today, sustainable competitiveness presupposes technological applications and advancement. The new competition requires better technological capability, regardless of resource base and location.

Sadly, Africa's economies are showing very little sign of upgrading, to the required level of technology application. Technology efficiency is relatively low if not abysmal, with little sign of the prevalence of technological dynamism or innovation. African firms are frequently operating well below international "best practice" technology levels and below levels needed by other developing countries. This is implied on page 357 of the prescribed textbook.

These technological weaknesses have slowed down economic growth. Indeed, in a world of accelerating technological change, intensifying competition and globalised production, Africa is failing to improve its competitive position. It is quickly falling behind.

11.2.2 AFRICA'S TECHNOLOGICAL INFRASTRUCTURE

World-wide, the advantages associated with technology hubs is proving to be a useful indicator of technological strength and specialisation, for the benefit of specific economic sectors.

While they do not capture trends for non-trade activities, they do provide an overview of underlying technology activity. Such technology hubs represent technologically-intensive structures. They are usually established in locations that meet certain conditions. These are listed on page 357 of the textbook. But, as this discussion notes, none of the locations that have been deemed suitable for this purpose are located in Sub-Sahara Africa. Its business environment is unsuitable for purposes of creating technology-infrastructure initiatives. This is one of the reasons why Africa has been technologically marginalised.

Africa's technological marginalisation is directly linked to its poor investment in technology. This is borne out in Table 13.4, as illustrated on page 358 of the textbook.

Technological outcomes are the result of long-term investments made in the area of human capital creation and research and development. But, Africa's abysmal performance in this area means that it has failed to take advantage of the knowledge economy. This is borne out in the discussion presented on page 358 of the textbook.

Africa's leverage of the benefits of technology, can either catalyse its transcendence of current, development impediments or, lead to marginalisation through failure to do so. The discussion on pages 358–359 of the textbook highlights these choices.

Assessment

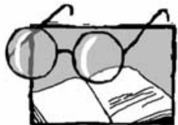
The following questions can serve as a test of your knowledge of the material we have just covered.

- *According to the internationally recognised indicators of technological competence, Africa has very low levels of technological capability. How can such technological deficiencies have a direct impact on FDI inflows into the continent? How can the establishment of technology hubs assist in overcoming these deficiencies?*
- *Why is the ability to create and adapt new technologies a critical requirement for competing successfully?*

SUMMARY

This study unit focuses on the need for technological capability as a sine qua non for successful global competitiveness. It does so against the backdrop of Africa's "technological gap", reflecting the fact that Africa has not kept pace with technological advances. These technological disparities are explored. They are portrayed as technological challenges facing Africa.

Much of Africa's technological failure is attributed to the deficiencies inherent in its technological infrastructure. These deficiencies are acknowledged and discussed.



Study the following pages in your prescribed textbook: Aregbeshola, Luiz, Ojah, *et.al.*, (2011). Global Business: Environments and Strategies. 4th Edition. Oxford University Press. Pages: 357–359.

Study unit 11.3

Africa's development prospects

Contents

Study unit learning outcomes
Key concepts
Overview
11.3.1 Africa in the global economy
11.3.2 Africa's development prospects
11.3.3 Africa's business environment
Assessment
Summary

Study unit 11.3 Learning outcomes

Once you have finished this study unit, you will be able to:

- Contextualise the prospects of Africa participating in the global economy.
- Provide some perspective on the Africa's future development prospects.
- Describe Africa's business environment.

Key concepts

Global economy
Global poverty reduction
Barriers to fair trade
Afro-pessimism
African exceptionalism
Africa's business environment
Disclosure index

OVERVIEW

In study unit 11.3 we focus on Africa's development prospects. To this end, we focus on Africa's prospective participation in the globalisation process. This draws our attention to the practice of rich countries imposing unfair trade barriers, calculated to

exclude developing countries from fully participating in their economies. The irony of this stems from the practice of developed countries exploiting the market openings of developing countries, that have accompanied economic liberalisation.

Africa's growth and development prospects remain dependent on its ability to fully participate in the globalisation process, but, this is being frustrated by developed countries, who continue to restrict access to their markets. This aspect of Africa's future development prospects is ventilated. These measures are exacerbated by the activities of TNCs.

Africa's development prospects raise questions about its business environment, particularly its regulatory environment, which continues to inhibit doing business in Africa. The uniqueness of this business environment is explored.

11.3.1 AFRICA IN THE GLOBAL ECONOMY

Africa's participation in the global economy depends on its amenability to the dispersal of economic activities across national boundaries. This feature of globalisation is conducive to the flow of trade and services, people, values, ideas and technology, all of which transcend national boundaries.

These constraints are, further, exacerbated by many developed countries, who, in their bid to reap the rewards of globalisation, are making it difficult for the developing nations of Africa to access their markets. This is the gist of the argument presented on pages 359–362 of the prescribed textbook. The products affected include industrial products and agricultural products in particular. African countries need to resist these initiatives, while rich, developed countries, need to commit themselves to the course of action advocated on page 361 of the textbook. These include:

- Opening up their markets to exports from developed countries. This would lead to the promotion of exports from Africa, in pursuit of an export-growth-led strategy.
- Promoting equitable patent rules, to ensure the affordability of new technology.
- Contributing to debt-relief for African countries, enabling them to participate in the global economy.

These measures will stimulate the trans-nationalisation of production and marketing, making African countries more competitive. Indeed, the incorporation of Africa into the global economy cannot occur, without the meaningful cooperation of rich countries. The implications of an expanded global economy – due to the contribution of African exports – are spelled out on pages 361–362 of the textbook.

Such expansion of the global economy would highlight the realities of international linkages and exchanges and transnational interactions, all of which confirm the integration of global production and markets. This integration could culminate in the convergence of values, consumption patterns, aspirations and life styles, in participating countries.

Pivotal to this process is the role of TNCs, who should spearhead initiatives to facilitate the opening up of global markets for African countries.

Indeed, some would argue that Africa's growth potential is increasingly dependent upon their ability to participate in this integrated production system and upon the nature and scope of their participation.

11.3.2 AFRICA'S DEVELOPMENT PROSPECTS

Africa's future development will depend on its ability to extricate itself from its economic marginalisation. Sub-Sahara Africa, in particular, will have to realign its policy frameworks, with those of TNC participants, whose participation in the global economy remains dominant. They need to do this, if they are to have any chance of participating in the global economic system, failing which, their economic marginalisation will persist, as discussed on ages 362–365 of the textbook. Such entrenchment will lead to persistently dubious policy decisions and, with a lack of institutional capacity, will result in an unattractive business environment.

To achieve this, African countries must concentrate on leveraging prevailing advances in technology, that are revolutionising production, transforming management techniques and shortening the product life cycle, all of which are, increasingly, forming the basis of competitive advantage in the global market place. For, it must be borne in mind that globalisation presupposes: economic liberalisation, elimination of trade and non-trade barriers and protectionist measures, together with the quest for regional cooperation and economic integration.

Indeed, these hallmarks of globalisation constitute the indispensable prerequisites for Africa's participation in the global economy; failure to accede to these preconditions could lead to it being de-linked from the global economic system. Africa will then revert to its status of economic marginalisation. This will add to the cost of doing business in Africa, as spelled out on page 363 of the textbook.

Indeed, not even the application of the principles on which NEPAD is based – and which are confirmed on page 364 of the textbook – will be able to resuscitate Africa's long-term development prospects, unless it rises above the overwhelming perception that Africa is:

- failing in its efforts at economic transformation and the attraction of investors, resulting in ongoing poverty;
- prone to suffer the perennial effects of famine;
- forever engaged in civil war and conflict;
- riddled with political corruption, economic mismanagement and the blatant violation of human rights.

The eradication of these impediments, and the application of the NEPAD principles, could improve the prospects of African markets. This would enable investors to access an enormous market, which could, further, stimulate Africa's business environment. This is the kind of environment which could prove to be an attractive destination for MNEs and TNCs contemplating doing business in Africa.

11.3.3 AFRICA'S BUSINESS ENVIRONMENT

We have already alluded to the difficulties besetting those who wish to engage with Africa's business environment. It is an environment characterised by:

- Inordinate regulatory measures, excessive administrative costs, burdensome, bureaucratic procedures and the inadequate protection of property rights.
- An informal economy which constitutes an inordinate proportion of the total economy.

- Tenuous economic growth, dependent on the removal of the constraints that have been mentioned in section 11.3.2 of this study guide.
- The impact of political and ethnic conflicts.
- External, market shocks, in terms of declining terms of trade, debt and falling aid inflows.
- Poor macro-economic management.
- Inadequate infrastructure.
- Inappropriate industrial policies.
- Limited managerial and technological capabilities.
- Rampant profiteering.
- Prospective nationalisation of key players in many a country's economy.
- Inadequate contract enforcement.

Added to these potential impediments are a number of employment constraints which are set out on page 365 of the textbook, together with inhibitions, which could potentially affect investor protection.

Due to the overwhelming constraints besetting the business environment of numerous African countries, the question of much needed regulatory reform is debated on page 367 of the textbook. Some would even argue that if regulatory reform is successful, then this could precipitate unprecedented opportunities for those affected countries.

Notwithstanding, if Africa's business environment is so beset by difficulties and limitations, then we must ask the question: "why do business in Africa?" The answer to this is:

- That analysts do believe that profound change is underway, as confirmed by increasing FDI inflows, that are pouring into countries like Nigeria and Kenya.
- That Africa's GDP will continue to grow much faster than elsewhere.
- That Africa's resilient population is growing more than in other countries, representing increased, disposable income to be tapped into.
- That rapid urbanisation is creating efficiency gains, luring investors to capital cities which, in order to thrive, have become a hub of small-scale industrialisation.
- That technology is gradually pervading Africa, particularly cell phone technology, which is revolutionising business.
- That despite Africa's poor governance reputation, there are signs of improvement.
- That Africa has the potential to become a middle-income group of nation-states, a status it could possibly reach by 2025.

These signs of progress are alluded to on page 368 of the prescribed textbook.

Therefore, when doing business in Africa, the following must be noted:

- The unique complexity of this business environment.
- The cost of doing business in this environment.
- The ongoing indigenisation of Africa's business environment, which means that participation in this environment must be infused with Africanisation programmes enhancing the indigenisation process, in the context of cultural diversity.
- That exception cannot be made when it comes to applying fundamental management principles to the running of such a business. This is emphasised on page 369 of the textbook.
- That the role that NEPAD can play must be acknowledged.

Assessment

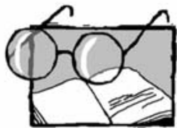
- *The failure of Africa to fully integrate into the global economy, is often blamed on "rich" countries and their reluctance to open up their markets to developing countries. Is this a fair allegation? Substantiate your answer.*
- *How can Africa's integration into the global economy enhance its competitiveness?*

SUMMARY

This study unit is devoted to Africa's globalisation prospects. Disparities between rich and poor countries are discussed. The allegations levelled against developed countries, who are accused of failing to remove barriers, denying Africa access to their markets, is considered. The potential role of TNCs in closing this gap is noted.

Africa's globalisation prospects, it is contended, are linked to its future development potential. The danger of failing in its globalisation efforts is emphasised, despite the initiatives of NEPAD and other institutions.

Often, failure to globalise is a reflection on Africa's business environment, which is fraught with difficulties. This contention is debated and the difficulties spelled out.



Study the following pages in your prescribed textbook: Aregbeshola, Luiz, Ojah, *et.al.* (2011), Global Business: Environments and Strategies. 4th Edition. Oxford University Press. Pages: 359–362, 363–365, 367–369.

Reflections

Now that you have completed the study units that compose topic 11, it would be appropriate to reflect on what you have learned thus far. Here are some prompts which could assist you.

- *Sceptics of Africa's long-term prospects, contend that Africa is still poor, despite accolades to the effect that Africa has now reached its golden age. How would you respond to these criticisms? What more can be done to accelerate its transition from poverty to "middle-income" status?*
- *"Technology imports are, by all indications, very low in Africa. Liberalisation does not seem to have increased the general propensity of firms to buy new technologies, although exceptions do exist"? How can such weak, local technological capabilities, influence an African-based MNE's choice of foreign market entry strategies?*
- *What more does Africa need to do, in order to enhance its prospects of fully integrating into the global economy? List some decisive initiatives that are indispensable, if Africa is to achieve this goal.*

Appendix A
Recommended reading

BOOKS

Balaam, DN & Dillman, B (2011). *Introduction to International Political Economy*. 5th Edition. Longman.

Daniels, JD, Radebaugh, LH & Sullivan, DP (2011). *International Business: Environments and Operations*. 13th Edition. Pearson.

Hill, CWL (2011). *International Business: Competing in the Global Marketplace*. 8th Edition. McGraw-Hill.

Mills, G (2012). *Why Africa is Poor and What Africans Can Do About It*. Penguin.

Stiglitz, J (2002). *Globalisation and its discontents*. Penguin.

ARTICLES

Luiz, JM (2009). International and Economic Performance: Implications for African Development. *Journal of International Development*. Vol 21(1); pp 58–75.