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International Business Management

The cultural differences between countries

Week 2

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Conscious breathing

Before you begin, do the following mental activity that will help you to improve your concentration.

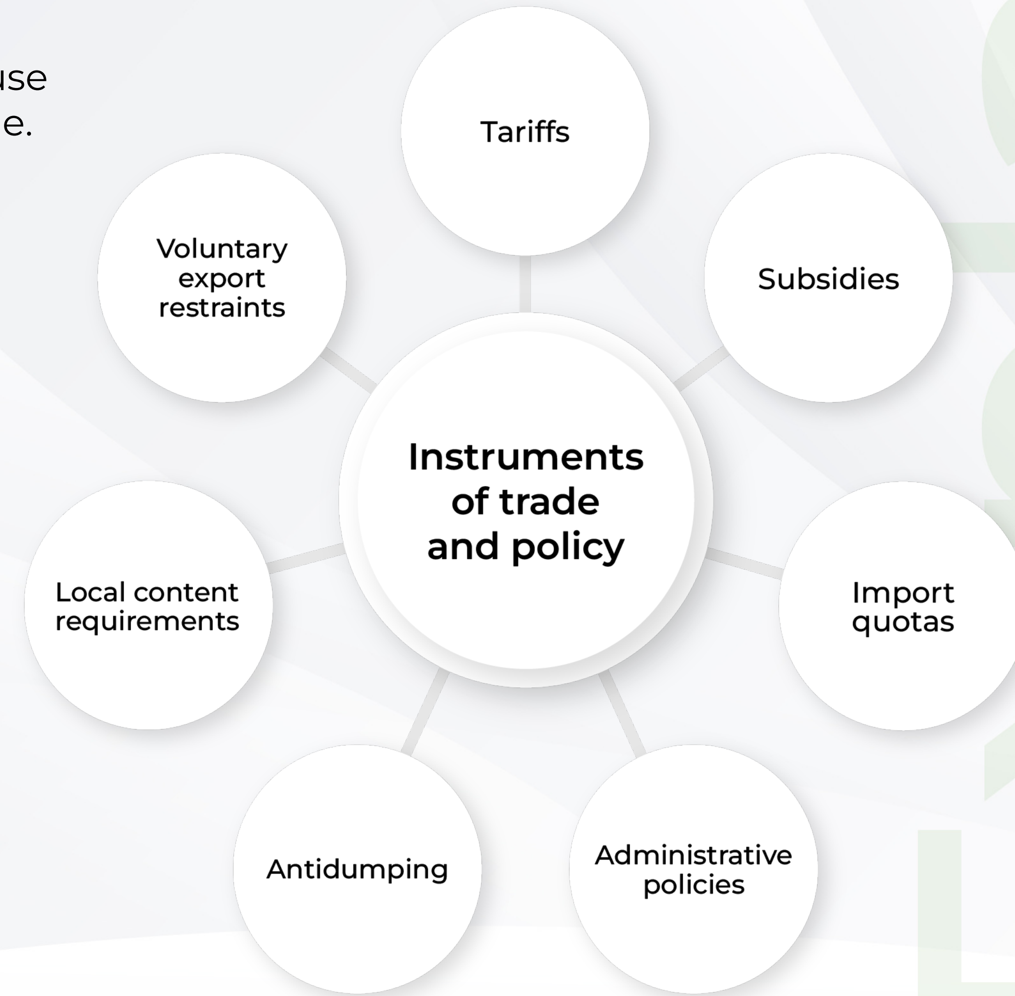
https://youtu.be/oq-klVxvm5g

Introduction

In this second week, we will explore how governments have many political and economic reasons for intervening in international trade. Not only that, but also you will learn about the different strategies and foreign direct investment and how this involves with the global financial environments.

Explanation

There is a wide range of policy instruments that governments use to intervene in international trade. The main seven instruments are tariffs, subsides, import quotas, voluntary export restraints, local content requirements, administrative policies, and antidumping duties, such as the following.



Explanation

A tariff is a tax levied on imports or exports. Tariffs fall into two categories and in most cases, tariffs are placed on imports to protect domestic producers from foreign competition by raising the price of imported goods.

Specific tariffs are levied as a fixed charge for each unit of good imported (e.g., xid-4597_1 per barrel of oil).

Ad valorem tariffs are levied as a proportion of the value of the imported good.

Explanation

In general, two conclusions can be derived from an economic analysis of the effect of import tariffs.

First, tariffs are generally pro-producer and anticonsumer. While they protect producers from foreign competitors, this restriction of supply also raises domestic prices. Almost all studies find that import tariffs impose significant costs on domestic consumers in the form of higher prices.

Second, import tariffs reduce the overall efficiency of the world economy. They reduce efficiency because a protective tariff encourages domestic firms to produce products at home that, in theory, could be produced more efficiently abroad. The consequence is an inefficient utilization of resources.

Explanation

Moreover, these are the general explanation for the rest of the instruments of trade policy.

A **subsidy** is a government payment to a domestic producer. Subsidies take many forms, including cash grants, low-interest loans, tax breaks, and government equity participation in domestic firms.

An **import quota** is a direct restriction on the quantity of some goods that may be imported into a country. The restriction is usually enforced by issuing import licenses to a group of individuals or firms. A common hybrid of a quota and a tariff is known as a tariff rate quota (where a lower tariff rate is applied to imports within the quota than those over the quota.)

In the context of international trade, **dumping** is variously defined as selling goods in a foreign market at below their costs of production or as selling goods in a foreign market at below their "fair" market value. There is a difference between these two definitions: the fair market value of a good is normally judged to be greater than the costs of producing that good because the former includes a "fair" profit margin.

A **local content requirement** is a requirement that some specific fraction of a good be produced domestically.

In addition to the formal instruments of trade policy, governments of all types sometimes use informal or **administrative policies** to restrict imports and boost exports. Administrative trade policies are **bureaucratic rules** designed to make it difficult for imports to enter a country.

Activity

Reflect on what you have learned and answer the following activity:

- Imagine you are planning to expand a local preserves business. Research the main instruments of trade policy in at least three countries.

- What are the main challenges Mexican traders face when trying to export goods?

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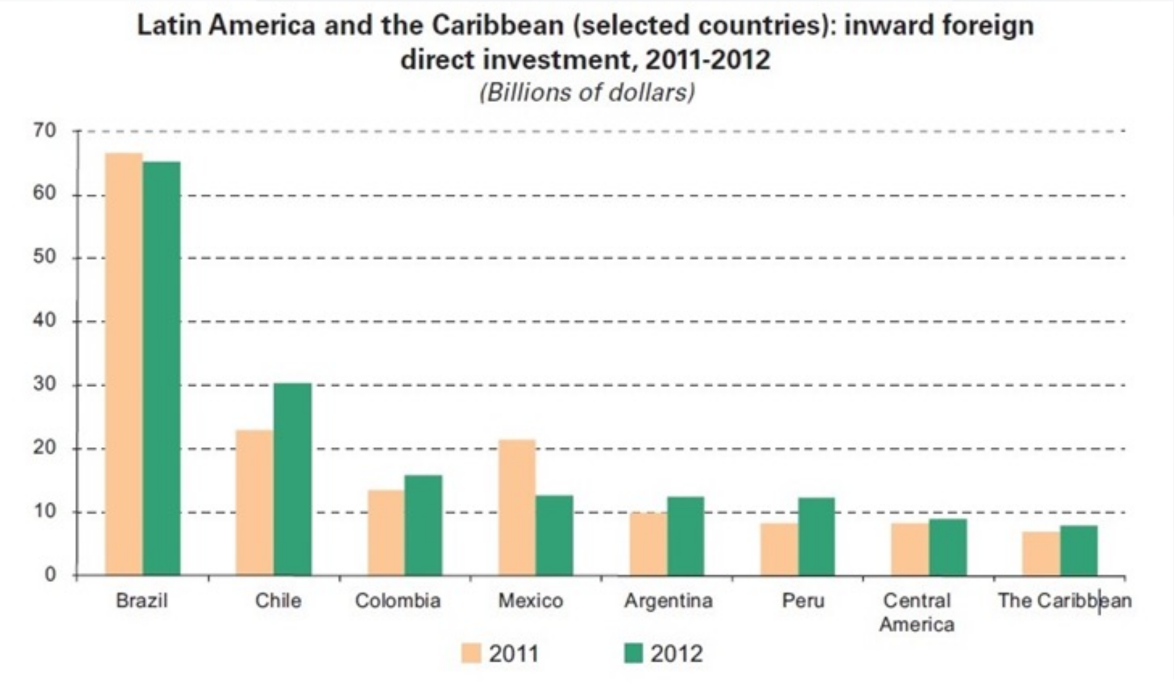
Introduction

The past 35 years have seen a marked increase in both the flow and stock of FDI in the world economy. The average yearly outflow of FDI increased from $25 billion in 1975 to $1.6 trillion in 2012. Over the past 30 years, **the flow of FDI has accelerated faster than the growth in world trade and world output**. As a result of the strong FDI flows, by 2011, the global stock of FDI was about $21 trillion. The value added by multinationals (revenues of fewer outside purchases of material and services) reached $7 trillion in 2011, roughly one-tenth of global GDP. Clearly, **by any measure, FDI is a very important phenomenon**.



O'Neil, S. (2013). *Foreign Direct Investment and Jobs in Latin America*.
Retrieved from https://www.cfr.org/blog/foreign-direct-investment-and-jobs-latin-america

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The form of FDI: acquisitions versus Greenfield investments

FDI flows into developed nations differ markedly from those into developing nations. In the case of developing nations, only about one-third or less of FDI is in the form of cross-border mergers and acquisitions, simply because there are fewer target firms to acquire in developing nations.

Mergers and acquisitions are quicker to execute than Greenfield investments. This is an important consideration in the modern business world, where markets evolve very rapidly (many firms apparently believe that if they do not acquire a desirable target firm, then their global rivals will).

Foreign firms are acquired because those firms have valuable strategic assets and production systems. It is easier and perhaps less risky for a firm to acquire those assets than to build them from the ground up through a Greenfield investment.

Firms make acquisitions because they believe they can increase the efficiency of the acquired unit by transferring capital, technology, or management skills.

Explanation

These theories approach FDI from three complementary perspectives.

One set of theories seeks to explain why a firm will favor direct investment as a means of entering a foreign market when two other alternatives, exporting and licensing, are open to it. An export strategy, for instance, can be constrained by transportation costs and trade barriers, and licensing may result in a firm's giving away valuable technological know-how to a potential foreign competitor (less control overseas.)

Another set of theories seeks to explain why firms in the same industry often undertake foreign direct investment at the same time and why they favor certain locations over others as targets for foreign direct investment.

A third theoretical perspective, known as the eclectic paradigm, attempts to combine the two other perspectives into a single holistic explanation of foreign direct investment. According to it, in addition to the various factors discussed earlier, it is important to consider the location-specific advantages (using resource endowments or assets that are tied to a particular location and that a firm finds valuable to combine with its own unique assets), and the externalities (knowledge spillovers that occur when companies in the same industry locate in the same area.)

Explanation

The main benefits of inward FDI for a host country arise from many factors, including the resource-transfer effects, employment effects, balance of payments effects, and effects on competition and economic growth. Let's see what they all are about.

Resource transfer effects

FDI can make a positive contribution to a host economy by supplying capital, technology, and management resources that would otherwise not be available, and thus boost that country's economic growth rate.

Employment effects

The effects of FDI on employment are both direct and indirect; direct effects arise when a foreign multinational company employs several host-country citizens, and indirect effects arise when jobs are created in local suppliers as a result of the investment and when jobs are created because of increased local spending by employees of that company. Take note: the indirect employment effects are often as large as, if not larger than, the direct effects.

Effects on competition and economic growth

When FDI takes the form of a greenfield investment, the result is to establish a new enterprise, increasing the number of players in a market (more choices for the consumer). This can increase the level of competition in a national market, thereby driving down prices and increasing the economic welfare of consumers. Increased competition tends to stimulate capital investments by firms in plant, equipment and R&D as they struggle to gain an edge over their rival.

Balance-of-payments effects

FDI's effects on a country's balance-of-payments account is an important policy issue for most host governments, since they are normally concerned when their country is running a deficit on the current account of their balance of payments.

Explanation

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There are a few costs of FDI that still concern most host countries, which generally arise from possible adverse effects on competition within the host nation, and the perceived loss of national sovereignty and autonomy.

Adverse effects on competition

Host governments sometimes worry that the subsidiaries of foreign multinational companies may have greater economic power than local competitors.

National sovereignty and autonomy

Some host governments worry that the FDI is accompanied by some loss of economic independence. The concern is that key decisions that can affect the host country's economy will be made by a foreign parent that has no real commitment to the host country, and over which the host country's government has no real control.

Adverse effects on the balance of payments

With the initial capital inflows that come with FDI, must be the subsequent outflow of capital, as the foreign subsidiary repatriates' earnings to its parent country.

Explanation

We now turn our attention to the various policy instruments that home countries and hosts countries can use to regulate the inflows and outflows of FDI.

Host-country policies

Host countries adopt policies designed both to restrict and to encourage inward FDI. To encourage inward FDI, governments offer incentives to foreign firms to invest in their countries, motivated by a desire to gain from the resource-transfer and employment effects of FDI, and to capture FDI away from other potential host countries. On the contrary, governments use ownership restraints and performance requirements in order to restrict inward FDI.

Home-country policies

Through their choice of policies, home countries can both encourage and restrict FDI by local firms. Most policies on this matter are designed to encourage outward FDI, such as foreign risk insurance, capital assistance, tax incentives, and political pressure. On the other hand, to restrict outward FDI, most countries limit capital outflows, manipulate tax rules, or outright prohibit FDI.

Activity

Reflect on what you have learned and answer the following activity:

- Imagine you are planning to expand a local preserves business. Research the main instruments of trade policy in at least three countries.
- What are the main challenges Mexican traders face when trying to export goods?

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Global financial environments

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The foreign exchange market (also known as **FOREX**) is **a market for converting the currency of one country into that of another country**. An **exchange rate** is simply the rate at which one currency is converted into another. For example, CEMEX uses the foreign exchange market to convert the dollars it earns (document in Spanish due to availability) from selling concrete in the United States into Mexican pesos.

Explanation

The foreign exchange market is **the primary institution for determining exchange rates**, and the impersonal market forces of demand and supply determined the relative value of any two currencies (i.e., their exchange rate). It serves two main functions; first, to **convert the currency** of one country into the currency of another; and second, to **provide some insurance against foreign exchange risk**.

Currency conversion

The payments a company receives for its exports, the income it receives from foreign investments, or the income it receives from licensing agreements with foreign firms may be in foreign currencies. To use those funds in its home country, the company must convert them into the local currency.

International businesses use foreign exchange markets when they must pay a foreign company for its products or services in its country's currency.

International businesses also use foreign exchange markets when they have spare cash that they wish to invest for short terms in money markets.

Currency speculation typically involves the short-term movement of funds from one currency to another in the hopes of profiting from shifts in exchange rates. This is different from carry trade, which involves borrowing in one currency where interest rates are low and then using the proceeds to invest in another currency where interest rates are high. Yes, you are not supposed to this.

Explanation

Insuring against foreign exchange risk: the second function of the foreign exchange market is to provide insurance against foreign exchange risk, which is the possibility that unpredicted changes in future exchange rates will have adverse consequences for the firm.

Explanation

The nature of the foreign exchange market: it is physically nowhere, but always open somewhere in the world; it actually never sleeps. The market, thus, is just **a global network of banks, brokers, and foreign exchange dealers connected by electronic communications systems**. When companies wish to convert currencies, they typically go through their own banks rather than entering the market directly.

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The international monetary system refers to **the institutional arrangements that govern exchange rates**. For instance, when the foreign exchange market determines the relative value of a currency, we say that the country is adhering to a **floating exchange rate** regime.

The Mexican peso and the world's major trading currencies (the US dollar, the European Union's euro, the Japanese yen, and the British pound) are all free to float against each other. Thus, you should always remember that their **exchange rates are determined by market forces and fluctuate against each other** day to day.

Americas

	USD	PEN	MXN	BRL	ARS	CLP	COP	EUR
USD	-	0.3074	0.0536	0.3062	0.0508	0.0017	0.0004	1.2269
PEN	3.2526	-	0.1743	0.9958	0.1653	0.0055	0.0011	3.9906
MXN	18.6625	5.7377	-	5.7137	0.9482	0.0314	0.0066	22.8970
BRL	3.2663	1.0042	0.1750	-	0.1660	0.0055	0.0012	4.0074
ARS	19.6814	6.0510	1.0546	6.0256	-	0.0331	0.0069	24.1471
CLP	594.9700	182.9214	31.8805	182.1541	30.2301	-	0.2096	729.9687
COP	2838.2400	872.6065	152.0825	868.9465	144.2093	4.7704	-	3482.2367
EUR	0.8151	0.2506	0.0437	0.2495	0.0414	0.0014	0.0003	-

Explanation

Many observers initially believed that the collapse of the Bretton Woods system in 1973 would diminish the role of the IMF within the international monetary system, but that did not happen. The IMF's activities have expanded because periodic financial crises have continued to hit many economies, **lending them money and requesting in return that the governments enact certain macroeconomic policies**.

Financial crises in the post Bretton Woods era

A **currency crisis** occurs when a speculative attack on the exchange value of a currency results in a sharp depreciation in the value of the currency or forces authorities to expend large volumes of international currency reserves and sharply increase interest rates to defend the prevailing exchange rate. This happened in Brazil in 2002, and the IMF stepped in to help stabilize the value of the Brazilian currency on foreign exchange markets by lending it foreign currency.

Evaluating the IMF's policy prescriptions

By 2012, the IMF was committing loans to some 52 countries that were struggling with economic and/or currency crises. All IMF loan packages come with conditions attached. Until very recently, the IMF has insisted on **a combination of tight macroeconomic policies, including cuts in public spending, higher interest rates, and tight monetary policy**. It has also often pushed for the **deregulation of sectors formerly protected from domestic and foreign competition, privatization of state-owned assets, and better financial reporting from the banking sector**.

Explanation

While foreign capital entering a country can bring needed investment, it can also cause an economy to overheat by generating speculative bubbles. Thus, efficient and well-run capital markets are vital for the orderly functioning of the global economy.

Benefits of the global capital market

The global capital market is growing at a rapid pace. By late 2012 the stock of cross-border bank loans stood at $33,913 billion, compared to $7,859 billion in 2000 and $3,600 billion in 1990. What factors allowed the international capital market to boom? There seem to be two answers: advances in information technology and deregulation by governments.

The euro currency market

A euro currency is any currency banked outside its country of origin (actually a misnomer because a euro currency can be created anywhere in the world). The euro currency market has been an important and relatively low-cost source of funds for international businesses. The main factor that makes the euro currency market attractive to both depositors and borrowers is its lack of government regulation. This allows banks to offer higher interest rates on euro currency deposits than on deposits made in the home currency, making euro currency deposits attractive to those who have cash to deposit.

The global bond market

Global bonds are an important means of financing for many companies, and the most common kind of bond is a fixed-rate bond; **foreign bonds**, sold outside the borrower's country and are denominated in the currency of the foreign country. **Euro bonds**, normally underwritten by an international syndicate of banks, and placed in countries other than the one in whose currency the bond is denominated.

Activity

Reflect on what you have learned and answer the following activity:

Stay updated. As a Mexican businessperson, it is recommended to always follow the latest financial headlines and rate hikes, and one well-reputed source to check constantly is the Forex section at “El Financiero” newspaper. So, go ahead and bookmark it!

Closing

In this second week, we have learned about the wide range of policy instruments that governments use to intervene in international trade. Also, there is a market where the countries exchange their currencies, it is called "forex". At the end, we learned about the benefits and costs of being a country into the global financial environment.