

International Business Management

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Abbreviations

MNE	-	Multinational Enterprise
MNC	-	Multinational Company
UNCTAD	-	United Nations Conference on Trade and Development
UNIDO	-	United Nations Industrial Development Organisation
ICI	-	Imperial Chemical Industries
NEC	-	Nippon Electric Company
R& D	-	Research and Development
GM	-	General Motor
MA	-	Multiple Sources of External Authorities
NAFTA	-	North American Free Trade Agreement
GATT	-	General Agreement on Tariff and Trade
MV	-	Multiple Denominations of Value
FDI	-	Foreign Direct Investment
GNP	-	Gross National Profit
UN	-	United Nations
WTO	-	World Trade Organisation
IMF	-	International Monetary Fund
ILO	-	International labour Organisation
SWOT	-	Strengths, Weaknesses, Opportunities Threats
ATC	-	Agreement on Textiles and Clothing
GSP	-	Generalised System of Preferences
EU	-	European Union
NAFTA	-	North American Free Trade Association
ASEAN	-	Association of South East Asian Nations
FDI	-	Foreign Direct Investment
MRS	-	Marginal Rate of Substitution
MRT	-	Marginal Rate of Transformation
PPC	-	Production Possibility Curve
EEC	-	European Economic Community
LDC	-	Least Developed Country
CAP	-	Computer Aided Production
CAD	-	Computer Aided Design
FEMA	-	Foreign Exchange Management Act
FERA	-	Foreign Exchange Regulations Act
EPCG	-	Export Promotion Capital Goods
DGFT	-	Director General of Foreign Trade
EXIM	-	Export and Import
IEC	-	Importer-Exporter Code
RBI	-	Reserve Bank of India
DD	-	Demand Draft
NRI	-	Non-resident Indian
RCMC	-	Registration-cum-Membership Certificate
FIEO	-	Federation of Indian Export Organisation
MPEDA	-	Marine Products Export Development Authority
APEDA	-	Agricultural and Processed Food products Export Development Authority
EHTP	-	Electronic Hardware Technology Park
STP	-	Software Technology Parks
DGFT	-	Director General of Foreign Trade
ITC(HS)	-	Indian Trade Classification Harmonised System
ACU	-	Asian Clearing Union
FOB	-	Freight on Board
UN	-	United Nations
EPCG	-	Export Promotion Capital Goods

CIF	-	Cost Insurance and Freight
DFRC	-	Duty Free Replenishment Certificate
DEPB	-	Duty Entitlement Pass Book
EPZ	-	Export Processing Zones
EOU	-	Export Oriented Units
SEZ	-	Special Economic Zones
GSP	-	Generalised System of Preferences
c.i.f	-	Common Intermediate Format
PPR	-	Post Parcel Receipt
AWB	-	Airway Bill
BIE	-	Bill of Exchange
DP	-	Documents Against Payment
B/L	-	Bill of Lading
CTD	-	Combined Transport Document
FEDAI	-	Foreign Exchange Dealers Association of India
L/C	-	Letter of Credit
SOFTEX	-	Software Export Declaration
PP	-	Personal Particular
GR	-	Exchange Control Declaration
SSI	-	Small Scale Industry
IHRM	-	International Human Resource Management
HR	-	Human Resource
IBF	-	International Banking Facilities
CKD	-	Complete Knock Down
CSC	-	Cold Storage Company
NIC	-	Newly Industrialising Country
MRTP	-	Monopolies and Restrictive Trade Practice
STC	-	State Trading Corporation
MMTC	-	Minerals and Metals Trading Corporation
GFS	-	Government Finance Statistics
CEO	-	Chief Executive Officer
M&A	-	Mergers and Acquisitions
GE	-	General Electric
PLC	-	Product Life Cycle Curve
UNCTAD	-	United Nations Conference on Trade and Development
WIR	-	World Investment Report
TNC	-	Transnational Corporations
WATS	-	Wide Area Telephone Service
SIHRM	-	Strategic International Human Resource Management
ESOP	-	Employee Stock Ownership Plan
ER	-	Employee Relation
NGO	-	Non-government Organisation
FII	-	Foreign Institutional Investor
FFI	-	Fast Forex Investment
ERM	-	Exchange Rate Mechanism
CDs	-	Certificates of Deposits
LIBOR	-	London Interbank Offered Rate
CP	-	Commercial Paper
GMAC	-	General Motors Acceptance Corporation
MTN	-	Medium Term Notes
FRN	-	Floating Rate Note
ADS	-	American Depositary Shares
SEC	-	Securities and Exchange Commission
GDR	-	Global Depositary Receipt
ADR	-	American Depositary Receipt

ECB	-	External Commercial Borrowing
LIBID	-	London Inter Bank Bid Rate
LIBOR	-	London Inter Bank Offer Rate
BIS	-	Bank for International Settlements
DTA	-	Double Taxation Avoidance
CHIPS	-	Clearing House Interbank Payments System
IBA	-	International Banking Act
BOP	-	Balance of Payments
CRA	-	Current Account Balance
CPA	-	Capital Account Balance
ORA	-	Official Reserve Account Balance

Chapter I

International Business Management

Aim

The aim of this chapter is to

- define international management
- explain the concept of globalisation
- introduce the role of international manager

Objective

The objectives of this chapter are to:

- elucidate the major forces of globalisation
- explicate the effects of globalisation
- explain the international service management

Learning outcome

At the end of this chapter, you will be able to:

- understand globalisation
- comprehend the recent changes in the IT sector
- describe characteristics of effective and efficient international managers

1.1 International Management

International management has never been as significant as it is today. Many of the world's largest firms are truly global, and even their smaller counterparts increasingly participate in cross-border activities by subcontracting—having customers and joint venture partners collaborate with them around the globe.

The arena of international management has never offered so many opportunities and challenges to individual managers, businesses, governments, and the academic community alike. The expansion of the global market has created a need for managers who are familiar with the problems of international trade and finance such as culture, political structure, foreign exchange, geographical terrain, time, food and technology. For instance, it has been estimated that the Asia-Pacific region could produce over half of the world's GDP by the next decade; new economic powers are an actual reality; technical countries spread production across countries; and the average GDP per capita is on the increase.

In this changing scenario, there is the growing risk of amplifying misunderstanding of what is occurring worldwide, especially if one is not able to advance a proper analysis concerning the nature of economic relationships. There is no country in the world today, including the United States, which is economically self-sufficient without some sort of interdependence with other countries.

The trend towards a single global economy is expanding markets and providing unlimited opportunities for international managers. To remain parallel and compatible to other technologies, countries need to work together as more of a global economy. In addition, to have the greatest amount of technological expertise they need to combine their shared knowledge, which could augment this reciprocal relationship.

The managerial talents within a nation are key ingredients in the economic welfare of such a nation. Being able to organise production is critically important for developing and maintaining high standards of living in any country. One can state that wise organisation and governance are equal in importance to a country's natural resources and its population.

1.1.1 Introduction to International Management

International management requires the understanding of crossing cultures, multinational corporations' interactions, global perspectives, and corporate issues. Understanding individual values of a high ethical standard would be another asset we want to emphasise throughout this book. Not only does international management rely on core business competencies, but also it requires the knowledge and skills necessary to operate and succeed in an international business arena. Today, multicultural managers are indispensable not only when they work with people from other countries but also with people from the same country, who speak the same language, have the same national heritage and yet, have different ways of looking at the world.

An economy per se is multicultural nowadays. In fact, international management involves planning, organising, leading, and controlling of employees and other resources to achieve organisational goals across unique multicultural and multinational boundaries.

An international manager is someone who must handle things, ideas, and people belonging to different cultural environments while ensuring that allocating and directing of human resources achieves the goals of the organisation, while respecting the beliefs, traditions, and values of the native or host country (Pierre, 1980). This is a non-current definition but it still gives a revealing discernment of this complex subject. Because the process of globalisation is becoming highly competitive and deepens interactions worldwide, the international environment has created enormous challenges for managers. These challenges include analysing the new environment, anticipating its effect on the home company, planning and managing to adapt to situational factors, while attempting to maintain an ethical climate. What is more important, international management demands a contingency approach to the ever changing environment. This means the choice of management system and style depends on the nature of the country, and the people involved.

1.1.2 International Manager

When a company faces the decision of whether to become an international enterprise, they will be encountering many issues they have never before dealt with. This can be a confusing and difficult process for everyone involved especially the managers. Some companies hire consulting firms to deal with the issues involved. However, for those companies that want to do it themselves, they first need to gather some information.

Companies encounter several major issues while going through the process of becoming international.

The major issues are mentioned below:

- Firstly, they have to decide who will run this new operation and what qualification (s) this individual must possess.
- Secondly, the company needs to examine the roles of this manager and how these roles may differ from the local manager.
- The location of the new operational facility,
- The relationships they need to have, to name only a few

International managers are responsible for developing strategies, deploying resources, and guiding their organisation to compete in this global environment. To understand the notion of international management better, it is logically necessary to first define management and international independently. There are many viewpoints as to the definition of management and for this book we will define management as the collective functions of planning, organising, leading, and controlling the resources of an organisation within its national borders to efficiently achieve its objectives. We refer to an individual who is responsible for the realisation of these objectives as a manager and his or her actions are termed managing.

International, on the other hand, is synonymous with multi-domestic firms, international firms, global firms, and transnational firms, but for the purpose of this book, the word international will be used. It is any activity of an organisation conducted beyond its national boundaries to exploit a potential expansion of emerging economies, earn greater return from their special competencies, and realise location economies and greater experience curve economies.

International management on the other hand is the collective functions of planning, organising, leading, and controlling organisational resources across its national borders.

The managerial approach that works in one country does not necessarily work in the same fashion or not at all in another one, this being explained by environmental differences (that is, cultural, political, legal, economic, and climatic) across countries. Because of these differences, a manager will need skills beyond those required to manage in his or her home country, and to be able to coordinate this type of manager at a level that goes beyond national boundaries is termed an international manager. An international manager is “someone who has to handle things, ideas, and people belonging to different cultural environments.” He or she can work either in a multinational corporation, an international organisation, an institution located in a foreign country or even in a local, regional, or national organisation in which people do not share the same patterns of thinking, feeling, and behaving.

In referring to this broad definition of an international manager, all managers within all organisations are actually multicultural. Some managers may be more involved with intercultural issues than others, but they all have to plan, organise, direct, and lead people with different cultural backgrounds characterised by various values, beliefs, and assumptions. Without realising it, most international managers have been multicultural in their jobs. So far, there was not a pressing need for them to be aware of the fact that they learn many of their management decisions by utilising their staff/personnel as resources.

Many managers now have to face the fact that a lone educational background will not be enough for them to be effective and efficient managers. They must also gain a deeper understanding of intercultural relations and various cultural practices and beliefs. This goes for local, regional, national, and, of course, international managers. This means that the old style of viewing management must adjust to meet the needs of the international managerial

functions. Management activities related to planning, organising, leading, and controlling must be approached from a cross-cultural perspective if public and private organisations want to keep up their productivity both inside and outside the countries and cultures to which they belong.

Today, one has placed so much emphasis on what is logical and rational, that one has become preoccupied with figuring out the right answers mentally, rather than seeing, hearing and feeling what is really going on inside and around us, and responding to it according to its demands and according to what we have to do to meet our needs. With that in mind, let us now examine what it takes to be an international manager.

A successful international manager should have the following skills or qualifications:

- The ability to communicate and cooperate across cultures, including being able to develop an understanding, trust, and teamwork with people of various cultural backgrounds.
- The ability to understand and appreciate numerous different cultures.
- The ability to use more than one language to communicate effectively. This may be important when travelling to different locations or simply dealing with someone who understands better in his or her native tongue.
- The ability to build and maintain relationships at work and in the family, by supporting, growing, and learning. However, to do this, one must first understand oneself, which includes being aware of one's own assumptions and preferences.
- The ability to learn and grow from the new information just discovered by carrying out the new ideas into one's behaviour, and simultaneously, the ability to maintain the health of the organisation and oneself.
- The ability to coach, guide, and educate others in the organisation to develop cross-cultural skills both at work and to incorporate them into their families as well.
- The ability to observe all cultures and accomplish management changes that will be most effective for the cultural mix present.

1.1.3 Role of International Manager

International managers face a tremendously complex environment. What worked in the role of a domestic manager does not always prove effective in the international market. Like the domestic managers, international managers must also stick to the four major roles of planning, organising, directing, and controlling. Planning for an international firm assures that the business organisation has some idea of its purpose, where it is heading, and how it will achieve its objectives.

International objectives may require plans that assign to each division goals that differ from what might seem appropriate from a domestic viewpoint. In preparing shorter long-range plans to achieve those goals, international managers must take into consideration not only local conditions but also overall international operations. These considerations should focus on nearby markets, servicing of regional sales divisions, transportation costs, value-added taxes, raw materials, and the purchases of the inputs from other producing divisions (Miller, 1987).

However, plans must be considered and should link operations in ways that achieve global rather than local goals. Therefore, international managers need to be aware of the extent to which local customers, employees, government officials, and suppliers are likely to accept or resist changes. These changes will affect an international manager's responsibility. The aspect of control in the responsibilities of an international manager includes ensuring that what is happening is what was intended to happen. Control applies to all levels of the organisation.

The organisation uses control in different ways depending on the level and scope of its application. For an international manager, "control should provide managers with the information necessary to monitor the operations of the firm to help achieve its global strategy" (Miller, 1987).

Leadership style

International direction and leadership style is “the way in which a manager chooses to fulfil leadership, delegation, communication, and supervision responsibilities. These choices reflect both personal and cultural differences” (Miller, 1987). In some cultures, employees tend to need explicit directions and supervision from their superior rather than from someone who is considered an equal. In other cultures, the employee’s leadership needs to come from relationships and communication built between co-workers. In addition, a leader should demonstrate a mix of competence in technical, interpersonal, and conceptual skills.

- A leader understands that people do the work and must interact effectively if they are to work well. Secondly, Hal Mason states (1987), "a leader gets organisational work done by motivating people, getting commitment, by energising behaviour, and by creating personal interests and excitement in the organisation’s goals."
- "A leader is keenly aware of what decisions and events mean to the others of the organisation." Mason (1987) continues to say that an effective leader is able to direct others without dominating all decisions and can achieve goals by overcoming all obstacles while utilising resources efficiently.
- A leader develops subordinates by sharing the power and responsibility with them. By delegating the power, the leader is creating opportunities to challenge people to go beyond the limits they have set for themselves and give them a chance to be creative.
- A leader also represents the values, goals, and visions of the organisation. However, in order to do this correctly, the leader must be active.

1.1.4 Characteristics of Effective and Efficient International Managers

As one could observe in the above information, effective and efficient international managers possess all of the characteristics that effective and efficient domestic managers possess. International managers, however, have to be willing to adapt to a new culture and the new ideas that come with it.

- An international manager must be willing to research the new lifestyles and cultural norms before entering the new operational facility. For example, an international manager should discover how to motivate his or her new employees. Just as often happens domestically, not the same things have motivated everyone. For instance, in Western culture, “choice” is highly motivating. There are many utilised theories that demonstrate that choice enhances employee job satisfaction, motivation, and how an employee performs. We know that the United States often encourages and promotes employee autonomy.
- The option of having work-related choices is a driver for employee satisfaction and his or her efficiency and output. Having the freedom to choose their hours worked, to participate in decisions made, and to contribute to their future career planning, enhances employee satisfaction and performance of both American and Hispanic employees. By contrast, Asians enjoy how much responsibility they have. This predicts their job satisfaction and performance. For example, while Americans perform better at and are more satisfied with work activities that they choose to do, some Eastern countries and employees perform better at tasks that trusted others have chosen for them; for instance, their manager. On the other hand, Asians are motivated by the tasks collectively decided upon by their entire group of colleagues— unlike the independent and autonomous Americans.
- Job satisfaction, success, new challenges, and self-respect motivate United Kingdom employees. Indian employees are motivated by their individual contributions and movement “up the ladder,” recognition, job security, and the image of the company for which they work. No two cultures are alike. Each has its own beliefs and value systems. As a result, different things motivate different people. Not only this, but different things motivate different people at different points of time. It is just another challenge that the international manager must be prepared to handle.
- Giving adequate thought and being able to delegate effectively are other key characteristics that effective and efficient international managers must have. However, international managers need to understand when and where to use this as well. For example, Mexicans do not like it when an authority figure gives up his or her power. Yet in other cultures such as in the United States, employees do not like to be highly supervised and they prefer not to be given explicit directions for every task. They rather enjoy the freedom to tackle a task the way they see fit.

1.2 Globalisation

The term globalisation became popular in the 20th century. Then onwards, it has become a typical issue affecting the whole socio-economic and political life of states throughout the world. Besides, the discourse on globalisation is complex with far-reaching effects on national and international laws and policies pertaining to the social, economic and political matters.

- Issues related to globalisation are open for debate as various people have varying perceptions about it. At one extreme, there are people who see globalisation as an irresistible and benign force for delivering economic prosperity in economically underdeveloped areas. On other hand, there are people who blame it as a source of all contemporary ills.
- Those people taking the latter line of argument emphasis on the negative impacts of globalisation from various dimensions. Specially, they make frequent reference to the difficulties faced by small enterprises in underdeveloped areas in taking advantage of the benefits of globalisation. As a result, the rural and informal economies remain on the margin, which in turn leads to persistent poverty. Besides, the industrial restructuring in force of competitive markets is highly probable to insecure jobs and dramatically affects the working conditions and rights of workers in some countries.
- In most developing countries, globalisation has undermined traditional livelihoods, changed the traditional social security systems and increased rural-urban and intra-regional inequalities. Moreover, some multi-national investment have been exacerbating environmental degradation and generated pressures for cheaper and more flexible labour in order to retain competitiveness, which in effect could erode the values of democracy and social justice.
- In relation to this, the accountability of these institutions engaged in business is debatable. In reality, some people feel that transnational bodies are unaccountable, which usually disregard the local perspectives of cultural, linguistic and other diversities.
- The other extreme argument is on the positive impact of globalisation. To this effect, it is widely accepted that the key characteristics of globalisation have been the liberalisation of international trade, the expansion of FDI, and the emergence of massive cross-border financial flows. This resulted in increased competition in global markets.
- It is also widely acknowledged that this has become about through the combined effect of different understanding factors, mainly, policy decisions, to reduce national barriers to international economic transactions and the impact of new technology. Due to the effect of the latter, the natural barriers of time and space have been vastly reduced. At present, the cost of moving information, people, goods and capitals across the globe has fallen dramatically, which in turn vastly expanded the feasibility of economic transactions across the world. People believe that markets can be global in scope and encompass an expanding range of goods and services.
- With the intention to benefit international communities on equal footing, various institutions were created. Among others, UN, ILO, WTO, GATT and IMF are the most influential ones. These institutions have set certain preconditions, which are necessary to get membership. Beyond that, a number of laws are issued to liberalise international business transactions. By this, it is sought that regional cooperation in trade and finance could increase stability.
- Globalisation can have both direct and indirect impact on states. It would also inevitably affect the laws of international business transactions either negatively or positively. The challenges against globalisation may dictate the revision of these laws in a manner, which may equally benefit the poor and the rich.
- If nations are to be benefited from the globalisation, most argue that there must be fair laws which consider the local realities in developing countries.
- Hence, some argue that the present laws to this end do not take the realities at ground in to account specially in third world countries. The fact that the market is highly competitive, the poor would be pushed out of game and this would even increased income disparities with in the industrial countries. The multi-national institutions which have small capital in industrial countries, may transfer to the countries with lower cost. These institutions would easily make profits in the expense of the poor. Then power would be shifted from local institutions to trans-national ones.

- Many agree that globalisation by itself is not a problem. But, laws which are designed to regulate the global transactions shall consider the existing realities the failure of which may raise various impediments against globalisation. Institutions like IMF, The World Bank, The WTO, The ILO, and other specialised agencies as well as business, trade unions and other NGOs are in a lead to guide the process to this effect.

Measures taken to reap benefits of globalisation

- To be beneficiaries of these institutions, nations have to revise their domestic laws in conformity with the guiding principles and regulations of the above institutions. In the due course, they are expected to enhance social infrastructures and respect human rights.
- The other face of this achievement would enable poor countries to get assistance and donations from these powerful donor institutions. As a result, limitations on free trade would be minimised and this in turn may lead to the flow of foreign direct investment which directly or indirectly add to efforts of poverty eradication and promote sustainable development. These measures would make nations to think of common laws regulating business transactions. By this, there would be free trade with no or little barriers across the borders.
- But does not mean that multinational corporations are free to exploit resources for the sole purpose of profit maximisation. Rather, they have to have social responsibility as well. In fact, it is debatable as to what responsibilities these institutions assumed to have. The debate in this regard largely revolve around the conduct of multi-national corporations and other large private companies which ,due to their sizes, have the ability to significantly influence domestic and international policy and the communities in which they operate.
- Central to the debate is the perceived deficiency of national and international law remedies regarding corporate accountability, particularly the ability of available regulations to successfully regulate a corporate conduct in jurisdictions outside their home state. Moreover, most people agree that the efficient functioning of the global markets depend on socially responsible business conduct. To this end, organisations, such as UN, the International Labour Organisation (ILO) have developed compacts, declarations, guidelines, principles and other instruments that outline norms for acceptable corporate conducts.
- To sum up, though there are the divided idea as to how all nations benefit from globalisation, at present, most agree that issues in relation to human rights, environmental matters etc are the common concerns of international communities, which have to be respected and promoted by the joint efforts in every corner of the world. Moreover, since international business transactions directly or indirectly related to these common concerns, it is believed to be a common concern as well.
- Therefore, laws of international business transactions have to be in a position to respect and promote principles and guide lines provided to regulate other global concerns. From this, it is easy to understand, how much the laws of international business directly or indirectly are under the influence of globalisation.

1.2.1 Historical Background

Globalisation is not a twentieth century phenomenon. Globalisation of economic activity has been closely linked with the development and establishment of empires worldwide through international trade since the sixteenth century. Looking back over the last three centuries, it would be nearly impossible to separate the political and economic—in particular, international trade—histories of Western nations.

- Empire building in the last three centuries was closely connected with the development of, and attempts to monopolise, international trade. The Spaniards and the Portuguese won trade routes from the Mediterranean powers in the fourteenth to the sixteenth centuries; subsequently, these routes were won over and monopolised by the British, the Dutch and the French.
- Major areas of the world that started out as “economic” colonies (and monopolies carved out among the three trading powers) subsequently became political colonies (including North America). Numerous wars were fought in Europe and elsewhere over international trading rights, trade routes, and maintenance of trading monopolies. Driving these activities and the prevalent philosophy of prevalent economy of those days was “mercantilism”—that is, the philosophy that, from the standpoint of a nation’s welfare, it is better to export than to import.
- By the late eighteenth century, propelled by the Industrial Revolution, Britain had become the undisputed world economic power.

- Economic historians have attributed a combination of factors, such as the technical progress and innovation in textiles, coal, iron, and steel, the harnessing of steam, the displacement of agricultural workforce to meet the needs of a fast-expanding industrial base, the Protestant ethic, riches plundered from colonies, and so forth, as among the reasons why Britain became the world's first industrial country. (For instance, by the mid-nineteenth century, Britain accounted for about 40% of the world export of manufactures.)
- Globalisation via the development and spread of the MNE through direct foreign investment is a more recent phenomenon. The earliest MNEs were mainly European firms, setting up manufacturing facilities in the colonies to extract primary resources for conversion to finished goods back home. However, by the mid-nineteenth century, many US firms began to globalise.
- The expansion of US firms was furthered after World War II when both European and Japanese industrial infrastructure was largely destroyed by the war. Resource transfers for rebuilding the economy through programs such as the "Marshall Plan" gave US firms the ability to consolidate their position even more firmly. Japanese firms were relatively late entrants into the world of MNEs. Although they were major exporters prior to World War II, most did not begin to set up subsidiaries abroad until well into the second half of this century.
- Alongside the development of the MNE through direct investment abroad, the numerous international agreements and institutions that were set up after World War II acted as further catalysts to the process of globalisation. Such institutions included the international fixed-exchange rate monetary arrangement under the Bretton Woods agreement, the International Monetary Fund (IMF), the World Bank, the General Agreement of Tariffs and Trade (GATT), and the World Court.
- Although these institutions represented the outcome of voluntary acceptance of worldwide agreements among member countries, they seemingly provided the basis for a more stable worldwide environment in which MNEs could conduct their business.
- Many of these agreements have subsequently broken down (for example, Bretton Woods), or are considered ineffective (the World Court), or have stayed from the original agenda that led to their creation (the IMF). Yet, by the 1970s, the process of globalisation propelled by the MNE as an organisational form had broken free; it had a life of its own and become irreversible.
- In terms of its ability to move knowledge, people, capital, goods and services, and technology across borders, the process of globalisation, led by MNEs, had gone far beyond the reach of any national sovereign government or international agreement. To borrow a phrase from a famous scholar of international business, Raymond Vernon, the MNE had reached a level of maturity and influence worldwide whereby it could keep "sovereignty at bay."

1.2.2 Meaning of Globalisation

Globalisation is the process by which an activity or undertaking becomes worldwide in scope. It refers to the absence of borders and barriers to trade between nations. Globalisation is defined as, "increased permeability of traditional boundaries of almost every kind, including physical borders, such as, time and space, nation states and economies, industries and organisations and less tangible borders, such as, cultural norms". As a consequence of increased global operation, the global economy is becoming more integrated than ever before. This gradual integration leads to the emergence of global village. UNCTAD defines globalisation at the macro level as follows: "The concept of globalisation refers to both an increasing flow of goods and services and resources across national borders and to the emergence of complementary set of organisational structure to manage expanding network of international economic activity and transaction". Strictly speaking, a global economy is one where firm and financial institutions operate in transnational manner, i.e., beyond the confines of national boundaries.

In such a world, goods, factors of production and financial assets would be almost perfectly substitutes everywhere and it would no longer be possible to consider nation states as distinct economic identities with autonomous decision making power in the pursuit of national objectives. The public goods that are needed to maintain an open market system, such as, secure property rights and stable monetary system would become a global responsibility.

However, the world economy has not reached this level. Although, the nation state is having less control as the forces regulating trade, finance and technology, it has still not given way to a new set of institutions with global responsibility. Hence, some term the current situation as ‘global interdependence’.

1.2.3 Global Development Challenge

The increasing world trade, as reported in the Directory of Trade Statistics (1993) of the international Monetary Fund, stood at \$3,687 billions of exports and \$3,846 billions of imports involving goods and services, can be used as a good indicator of globalisation of markets. The major trading units contributing to this world trade are the European Community (exports \$1,458 billion; imports \$1,524 billion), Asia, including Japan (exports \$916 billion; imports \$850 billion), and North America (exports \$623 billion; imports \$744 billion). In addition to international trade involving exporting and importing, international business activities include foreign direct investment, licensing, and joint ventures.

Trade activities helps one to understand MNE practices and strategies. They also help to understand the impact of international business on the economy. Research indicates that export and international business activities are critical to the success of a country’s economy by opening additional markets. If employment is growing at a faster rate than the export sector, then a country must either emphasise exports and create more jobs or find employment for people in faster-growing domestic industries (Mandel and Bernstein 1990). Imports on the other hand affect those seeking jobs in industries relating to this sector, who will find work scarcer and wages lower. Jobs lost by the importing sector of an economy need to be filled by the exporting sector.

A second international business activity as a result of globalisation is the growing foreign direct investment (FDI, or equity funds invested in other nations). These investments range from industrialised nations to less developed countries (LDCs) and newly industrialised countries (Hong Kong, Korea, and Singapore). Most of the world FDI is in the United States, EC, and Japan. The European Community (EC) or Common Market was founded in 1957. Its initial members were Belgium, Germany, Italy, France, Luxembourg, and the Netherlands. Since then Denmark, Ireland, the United Kingdom, Greece, Portugal, and Spain have joined. Foreign holdings in the United States by 1990 amounted to about \$1.5 trillion, while the U.S. holdings abroad totalled about \$1.2 trillion. In 1992 alone the FDI in the United States was \$420 billion and FDI by the United States was \$487 billion (U.S. Department of Commerce, Survey of Current Business, July 1993). As nations become more affluent they have pursued foreign direct investments in geographic areas that have economic growth potential.

The global development challenges

To become strong in markets conditioned by recent global developments, nations must excel in three areas. They must:

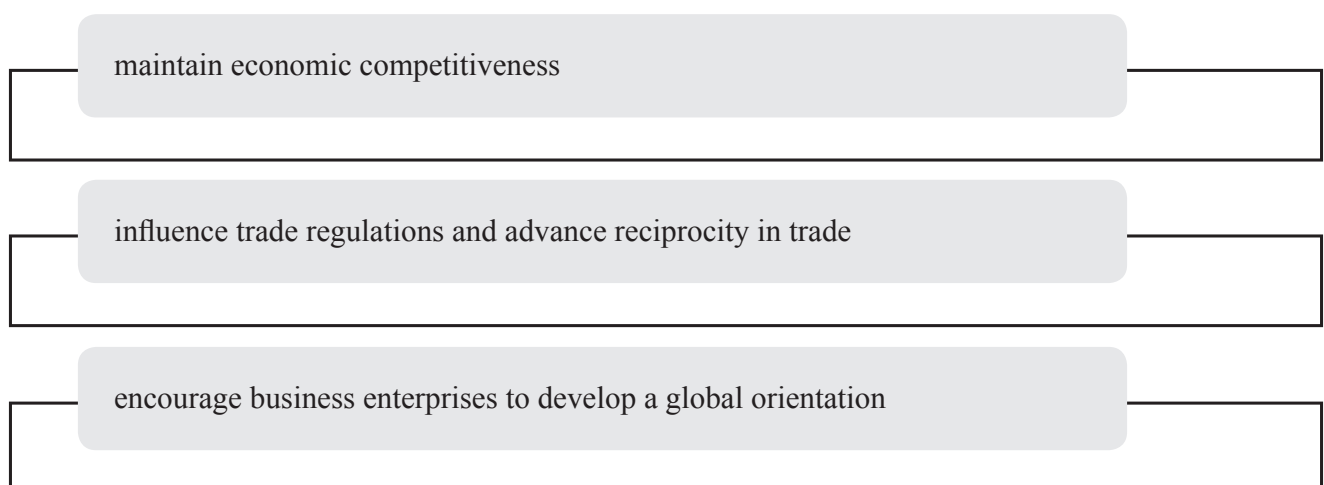


Fig. 1.1 Areas to become strong in market by recent global developments

- Economic competitiveness requires quality products and ability to develop unique capabilities in certain areas (such as Italy's leather goods and ceramic tiles, Germany's printing press industry, U.S. mainframe computers, and the like. In the service areas, specialty retailing in Britain, design services in Italy and fast-food services of the United States).
- Economic competitiveness is in a continual state of flux whose determinants are generally believed to be labour costs, interest rates, exchange rates, and economies of scale. However, this view fails to take into consideration the true sources of international competitive advantage (Porter 1990). The best way for companies to achieve competitive advantage is with innovation. To maintain this competitive advantage, firms have to make their past innovations obsolete by developing new products to replace old ones. Ability to innovate rests in four broad attributes:
 - factor conditions
 - demand conditions
 - related and supporting industries
 - and the environment in which firms compete

These attributes individually determine national competitive advantage (Porter 1990).

- The premise of international trade theory is that a nation will export those goods that make most use of the factor conditions with which it is relatively well endowed. The factor conditions are land, labour, and capital. Export of labour-intensive goods by a country with an uneducated workforce and sophisticated finished goods by a country that has a highly educated labour force are examples of the impact of distinctive factor conditions that other countries may find hard to match. Nations at times have developed factor conditions they need through innovative approaches (by Italy, technologically advanced minimills that use less energy and modest capital and locate close to sources of scrap and end-use customers, with efficiency at small scale).
- To be innovative a company needs to have access to people with necessary skills (factor conditions), domestic competition that creates pressure to innovate (rivalry), customers who want a better or less expensive product (demand conditions), and suppliers who can supply low-cost materials (supporting industry). Further, a firm needs to find ways to solve the problem through innovation rather than look for an easy way around a disadvantage (firm strategy).
- A strong local demand for its goods and services strengthens a nation's competitive advantage. Local demand helps the seller to understand buyer wants and also helps to monitor need for changes in the product, based on customers' signals of desires. Related and supporting industries that are internationally competitive act as low-cost suppliers and adjust to changing conditions that help producers maintain their competitive position and, thus, add to the national competitive advantage.
- The structure of the firms and a rivalry that is distinctive to an industry and is congruent with its nation's culture and characteristics provide yet another dimension of national advantage. Small and medium-sized firms managed like extended families (Italy's lighting, furniture, footwear industries), hierarchical organisations emphasising technical and engineering content and a disciplined management structure (Germany's optics, machinery industries), and organisations with unusual cooperation across functional lines (as in Japan) are all instances of national advantages based on firms' strategy, structure, and rivalry. Competitive global success, thus, comes from vigorous competition at home that pressures companies to improve and innovate and puts them in a position to compete globally.

1.2.4 Major Forces of Globalisation

Globalisation is not a new phenomenon either at the firm level or at the national/world economy level. Around 1880, the process of globalisation of the economy and the firm began. This was the recognition of comparative advantage. Many firms went global. They included Ford, Singer, Gillette, National Cash Register, Otis and Western Electronics. This was because of enjoyment of scale of economies due to the advancement of technology. In the interwar period, the thrust of globalisation declined. But the post war period witnessed once again tremendous growth of globalisation. Let us learn some of the important forces of globalisations.

International trade and globalisation

- International trade has grown substantially over the years. The growth experienced is in the range of 4-10 per cent per annum. In fact, international trade has grown faster than the world economy in recent years. For developing countries, trade is the primary vehicle for realising the benefits of globalisation. Growing trade has contributed to the ongoing shift of some manufacturing and service activities from industrial to developing countries, which further accelerates the process of globalisation.
- The creation of World Trade Organisation in 1995 is another step toward creating an environment conducive to the exchange of goods and services. Another significant and more important indicator of globalisation is the rate of Gross Domestic Product (GDP) of the world. The world merchandise trade and the world GDP have been steadily growing since 1990. The rate of growth in merchandise exports is faster than the rate of growth in the world GDP. Look at table below which shows that world merchandise exports and world GDP have been steadily growing till the year 1997. The world merchandise trade has been growing faster than the world merchandise production. Of course, world merchandise trade, world merchandise production and world GDP have decelerated sharply in the year 1998 due to oil crisis, fall in prices of international trade of goods and services and several other factors.
- Trade expansion does not confine to merchandise trade alone. Even international trade in services has grown tremendously. Trade in commercial services continued to be stronger than the merchandise trade throughout the entire 1990-1998 period.

The world merchandise exports, world merchandise production, world GDP and international trade in services have witnessed substantial growth as a result of the globalisation.

Annual Percentage change

Year	World Merchandise Trade	World Merchandise Production	World GDP
1990-98	6.5	2.0	2.0
1996	6.0	3.0	3.0
1997	10.5	4.5	3.0
1998	4.0	1.5	2.0

Source: WTO Annual Report, 1999.

Table 1.1 Growth in the volume of world merchandise exports, production and GDP

International capital flow

- Apart from expansion of international trade, the massive capital flows among countries has further strengthened globalisation of capital by a large number of countries. The catalyst for globalisation in the late eighties and nineties is not international trade, but cross border international finance flows. World inflow and outflow of FDI have been growing significantly.
- The inflow of FDI has increased from 359 billion dollar in the year 1996 to 644 billion dollars in the year 1998. Likewise the outflow has also increased from 380 billion dollar to 649 billion dollar. These levels were reached despite the unfavourable conditions in the world economy. FDI flows grew in 1998 by 39% in case of inflows and 37% in case of outflows. This is the highest growth rate attained in FDI since 1987.
- On an average, virtually all of the increase in FDI in the year 1998 was concentrated in developed countries, FDI inflows to and outflows from developed countries reached new heights of 460 billion dollar and 595 billion dollar. In case of developing countries, FDI inflows decreased slightly from 173 billion dollar in 1997 to 166 billion dollar in the year 1998. Most of the FDI is located in the developed world.

- Although the share of developing countries had been growing steadily until the year 1997, when it reached to 37%. It subsequently declined to 28% in the year 1998 due to the strong performance of the developed countries. The flows to the economies in transition of Central and Eastern Europe remained almost stable. The continuous growth in FDI will further accelerate the process of globalisation.

Billion Dollars

Year	Inflows	Outflows
1996	359	380
1997	464	475
1998	644	649

Source: World Investment Report, 1999.

Table 1.2 World FDI inflows and outflows

Globalisation and technology

Technological revolutions in transport and communications over the last three centuries, have integrated the world economy. The advances of technology in transport and communication have also brought peoples of the world nearer. The revolution of technology that has taken place in transport, communication and information is of qualitative difference during the last ten years from that of previous generation of technology. It is not only integrating but also bringing into existence a common culture, of national consumer. Consumer preference can be global and regional.

- Technological revolution has been rapidly transforming all productive systems and facilitating the process of globalisation. Technology has become one of the most important elements of the competitiveness. In modern production activities, competitiveness entails new, more rapid product innovation, flexible response, greater networking and closely integrated production systems across firms and regions. The leaders of technological change are evolving new strategies in response.
- Apart from investing heavily in innovation they are moving their technological assets around the world to match them to immobile factors, entering new alliances and reorganising production relations. This has further facilitated the process of globalisation.
- At the corporate level also technology is getting globalised. This is at two levels. First, technology is being sold in the world market. Although the market of technology is governed by slightly different rules such as relative importance of information, a few sellers and large number of buyers leading to oligopolistic market structure, the market for technology is vibrant.
- Consequently, many countries derive benefits from this. For instance, the US earns substantially from technology trade. The mechanisms of technology sale are outright purchases and technology collaboration agreements. There has been substantial increase in technology collaboration over the last two decades.
- Second, the globalisation of technology is also taking place in establishment of R & D centres. A large number of TNCs are establishing their R & D in various countries thus globalising their R & D operations.

1.2.5 Globalisation at Firm/Corporate Level

From the view of international business, globalisation of the firm is very important. There have been a number of approaches to globalisation of the firm. A few important approaches are discussed below:

- The term globalisation was first used by Professor Theodore Levitt of Harvard Business School. Globalisation according to him was referred to as an alleged consequence of markets in the world.
- Globalisation, in Levitt's view, is the emergence of global markets for standardised consumer products enabling a firm to benefit from enormous economies of scale in production, distribution, marketing and management. The impact of technology would be toward further standardisation.

- According to Levitt a successful globalised corporation does not abjure customerisation or differentiation and for the requirements of markets that differ in product preferences, spending patterns and shopping preferences. Global corporations accept these differences only reluctantly. For instance, Ford. US car maker has at several points in history tried to launch a world car.
- In the Japanese view as presented by Ohame Kenichi, Globalisation is understood as ‘business chain’. A business chain comprises a firm’s main activities such as Research and Development, engineering, manufacturing, marketing and sales and services. He distinguishes five steps in globalisation of a firm. Each of these steps involves the transfer of activities in the business chain to a foreign location. It is in reference to development in the 1980s.
- Since 1980s, globalisation has been dominated by unprecedented flows of foreign direct investment. Companies and customers horizons would stretch, ‘beyond national borders’, they would become global citizens.
- Export: The entire range of activities is performed at home. Exports are often handled by an exclusive local distributor.
- Direct Sales and Marketing: If the product is accepted in the overseas market, it will lead to establishment of an overseas sales campaign to provide better marketing, sales and service and functions to the customers.
- Direct Production: This step involves the establishment of local production activities
- Full Autonomy: All activities of the business chain as mentioned above are transformed to the key national markets.
- Global integration: In the ultimate stage of globalisation, according to Ohame, companies conduct their R & D and finance their cash requirements on a worldwide scale and recruit their personnel from all over the world.
- Globalisation is also presented in management centred concepts especially of Japanese firms
 - Management Centred around the head office
 - Management delegated to overseas operating units
 - Management centering overseas operating units with regional coordination
 - Management with a global perspective and conscious integration of total system and sub-system.
- The fourth globalisation strategy that of a global supplies, is one of export centred global expansion. All systems such as R & D, procurement, sales, marketing distribution and the organisational structure are designed so as to enhance export of products manufactured in the home country in such an operation.

This process consists of four stages:

- creation of a global vision,
- integration of overseas organisation and establishment of multiple corporate headquarters; promotion of a global hybridisation process
- globalisation of personnel
- administration and the cultivation of entrepreneurial middle management

Porter’s view of globalisation

An industry can be defined as global if there is some competitive advantage to integrat activities on a worldwide basis. To diagnose the sources of competitive advantage in any context, domestic or global, it is necessary to adopt a disaggregated view of the firm which Porter calls ‘Value Chain’. “Every firm is a collection of discrete activities performed to do business in its industry”, which he calls ‘value activities’. The activities performed by a firm include such things as sales people selling the product, service technicians performing repairs, scientists in the laboratory designing products, processes or accountants keeping books. These functions are technical and physically distinct. The firm’s value chain resides in a larger stream of activities termed as value system.

- Suppliers have value chains that provide the purchased inputs to the firm’s chain, buyer’s have value chains in which the firm’s product or service is employed, channels have value chains through which the firms’s product or service passes. The connections among these activities become essential to competitive advantage. Value chain concept needs the notion of competitive scope.

- Competitive scope is the breadth of activities the firm performs in competing in an industry. There are four basic dimensions of competitive scope. They include: Segment scope, industry scope, vertical scope and geographic scope. Segment scope refers to the range of scope the firm serves, for example product varieties, customers types, etc. Industry scope refers to the range of related industries the firm competes in with a coordinated strategy. Vertical scope refers to the activities that are performed by the firm versus suppliers and channels.
- The geographic scope refers to the geographic regions in which the firm operates with coordinated strategy. Competitive scope is vital for competitive advantage. It shapes the configuration of the value chain how activities are performed and whether activities are shared among units. International strategy is an issue of geographic scope. A firm that competes internationally must decide how to spread the activities in the value chain among countries. The distinctive issues in international, as contrasted to domestic, strategy can be summarised in two key dimensions of how a firm competes internationally.
- Industries globalise when the benefits of configuration and/or coordination globally exceed the costs of doing so. The way in which an industry globalises reflects the specific benefits and costs of global configuration and/or coordination of each due activity. Further, in global competition, a country must be viewed as a platform and not as the place where all activities of a firm are performed.
 - Michael Taylor and Nigel Thrift considered that the emerging global corporation was the result of the complex process of interlocking between the relatively autonomous development sequences of subsidiaries, branches and affiliates. These firms grow into complex international economic network.
 - Globalisation: A Macro-Fordist view: This approach has been developed by Wisse Dekker, former president of Philips who calls it “transnationalisation of business.” Dekker defines globalisation as a relatively early stage in the internationalisation of the firm. According to him transnationalisation takes place in the following steps.
- The local enterprise produces and sells in one and the same country.
- The international enterprise still produces entirely or predominantly in the parent country but establishes sales in foreign markets. International firms are characterised by a strong central organisation.
- The global enterprise is transferring part of its production process abroad - often limited to assembling - to circumvent input barriers or because of transportation costs; Multinational enterprise has complete production facilities, sometimes even R & D in a host of countries. The MNC often has a federal structure, a network organisation in which synergy plays an important role. Production in many cases is no longer local for local.

1.2.6 Effect of Globalisation on World Economy

The impact of this level of globalisation has undoubtedly led to economic growth.

In specific terms, the effects of globalisation are as follows:

- The major effect of globalisation is that the global economy is becoming more integrated day by day.
- The volume of world trade has grown at a faster rate than the volume of world output.
- There has been a trend of lowering the barriers to the free flow of goods, services and capital among countries.
- Foreign direct investment has been playing an important role in the global economy.
- In order to become competitive, company have started investing in overseas operations.
- Global operations have led to the emergence of Multilateral Trading Systems.
- Imports are penetrating deeper into the world's largest economies as well.
- The growth of world trade, foreign direct investment and imports led to more foreign competition in the domestic markets.
- In order to compete with the foreign players, domestic firms are required to enhance the production and distribution capabilities.
- Companies have started looking the world as a market for their products.

- Companies have started dispersing their manufacturing, marketing and research facilities around the globe where cost and skill conditions are most favourable.
- Opportunities have been increasing for the firms.
- Innovations have started spreading faster.

1.2.7 Effects of Globalisation on Strategies for Small Scale and Medium Sized Business

The effects of globalisation on strategies for small scale and medium sized business are explained below.

- The 1990s are characterised by dramatic global developments that change the nature of international business as well as domestic business. These dramatic developments include the political and economic changes in Eastern Europe and Russia, which in turn have led to opening the doors of a wide variety of business activities. Multinational enterprises are moving into these areas to take advantage of new opportunities. Japan is becoming an economic power in the Asia Pacific region.
- Europe is moving toward economic integration, leading to a united European Community (EC). A recent major development is the extension of the free trade agreement from the United States and Canada to Mexico, resulting in what is known as NAFTA, the North American Free Trade Agreement.
- In the new century, regrouped major economic markets that would include North America, Europe, and Asia Pacific may emerge. Other markets outside these regions will also develop new alliances and emerge as major economic markets.
- Revolution in information technology and advances in transportation are leading to a globally integrated business system. In such a system, knowledge, skilled people, goods, and services become extremely mobile. Producers of goods and services often compete both domestically and internationally. Thus, small businesses and service sectors, which were considered traditionally by economists as “non-trade” sectors, have to become involved in international business and competition.
- The large multinational corporations (MNCs) rely on small businesses for goods and services and thus affect their success based on performance at the levels of international standards. While large multinational billion; imports \$850 billion), and North America (exports \$623 billion; imports \$744 billion). In addition to international trade involving exporting and importing, international business activities include foreign direct investment, licensing, and joint ventures.
- The structure of the firms and a rivalry that is distinctive to an industry and is congruent with its nation’s culture and characteristics provide yet another dimension of national advantage.
- Small and medium-sized firms managed like extended families (Italy’s lighting, furniture, footwear industries), hierarchical organisations emphasising technical and engineering content and a disciplined management structure (Germany’s optics, machinery industries), and organisations with unusual cooperation across functional lines (as in Japan) are all instances of national advantages based on firms’ strategy, structure, and rivalry.
- Competitive global success thus comes from vigorous competition at home that pressures companies to improve and innovate and puts them in a position to compete globally.
- Among other criteria the Small Business Administration of the United States of America (SBA) utilises the number of employees in a firm as a measure of the size of the firm. Accordingly, a firm with less than 500 employees is considered a small business. Other countries and some authors define a firm with 100 employees as a small business.
- Regions which are unable to adapt to open markets and face increasing competition close out when tariff barriers are eliminated. Regions with new resources (for example, Lombardia in Italy) may develop new trade flows and create new channels of transportation and attract new technologies. SMEs in such regions could expand their exports and work as subcontractors for medium sized and large firms to assist in their export expansion.

- An investigation to examine the impact of globalisation on SMEs in three small regions of Quebec has been recently reported by Julien, Joyal, and Deshaies (1994). They assess the behaviour of firms with respect to the 1988 FTA between the United States and Canada. How do small firms (in this study they utilised firms with less than 250 employees) face up to an increase in potential competition, and how do they take advantage of reduced customs duties? Their survey results initially showed that only a small number of firms knew about the FTA and had taken steps to take advantage of the reduced taxes or to counter potential competition. Further analysis revealed that actions were taken by SMEs within the wider framework of economic globalisation.
- Some firms had taken steps to reinforce their competitive position in terms of general international trade and not specifically in response to FTA. Thus, their focus was to adapt to world competition by designing strategies to develop a specific market.
- An interesting finding of the study is that when the capacity of SMEs to react to removal of international barriers consisting of trade between two countries is considered, the measure is found to be insufficient compared to a measure that widens the notion of competitiveness in terms of national and international markets. This is reflected in the number of firms reacting to opening of markets, 28.9 percent of the firms in the former case (trade between two countries) versus 78.1 percent in the latter case (international markets).
- The findings confirm that increasing numbers of SMEs realise the new challenges created by market globalisation. The FTA with the United States becomes just one element in the new international structure that includes Common Market countries, Japan, and the newly industrialised countries as well. SMEs develop different ways to face the challenge of market globalisation (Acs and Andretsch 1990):
 - Use of new production technologies (computerisation, CAD system, etc.).
 - Creating differentiation through innovation at the national and international market levels.
- Research tends to show that international competitiveness depends as much on product differentiation as on the use of new production technologies. SMEs refusing to adapt to new international environment while operating in open markets will find it hard to survive. Knowledge and some basic understanding of external environment in the context of the national as well as global developments and changes, together with an evaluation of the firm's resources, are necessary for the small firm's survival. Small businesses lack the resources to acquire such information and to conduct an analysis of its implication, to develop appropriate policies, and to undertake innovative programs to address this shortcoming.

1.2.8 Glocalisation

The alternative to the Globalisation strategy is dubbed as 'Glocalisation'. The objective of glocalisation is to establish a geographically concentrated inter-firm division of labour in the three major bonding blocks. Manufacturers strive to build their competitive advantage in a combination of vertical de-integration of production to local supplies and sub-contractors and structural control over local suppliers, dealers, workers, and governments. As glocalisation aims to establish production within the major markets international trade may decline. Glocalisation pertains to a company's attempt to become accepted as a local citizen in a different trade block.

Glocalisation also leads to the concept of global firms meaning that large firms cease to be national firms. Therefore, they can be treated as stateless Corporations. It is argued that time has not yet arrived to think of global firms. This is for a number of reasons.

- Even the large multinational corporations are still tied to a parent country
- There are very few non-nationals on the boards of parent company
- The legal nationality of the parent firm is still the nation state where it is registered
- In most cases technological activities are concentrated in the parent company.

1.3 International Technology Alliances: Recent Trends in IT Sector

The rapid growth of interfirm collaborations since the early 1980s has been the subject of a large and growing body of academic literature under the rubric of "strategic alliances." Although there is nothing new or novel about interfirm linkages, which are as old as the firm itself, recent trends in technology based alliances (domestic as well as international) present something of a new phenomenon, at least in terms of their rapid growth. More important,

they present an anomaly to some traditional and celebrated theories that attempt to explain vertical integration of corporate research and development activity and foreign direct investment (FDI). Prominent among them are the market failure argument and transaction cost and internalisation theories grounded in the industrial organisation literature.

1.3.1 Introduction

There are at least three major forces behind the rapid growth of technology based international strategic alliances in the information technology (IT) industry. Two of these forces, which are widely noted in the literature, are brought about by the external environment. The first of these is a general shift in almost all countries toward open markets with respect to trade and FDI (Graham 1996). The second is the emergence of a vastly more competitive market structure in the global IT industry (brought about, in part, by continuing radical changes in the structure of the U.S. telecommunications industry, beginning with the 1984 breakup of the Bell system), combined with a high degree of technological rivalry that seems to characterise both the software and hardware segments of the industry (OECD 1997). The third force—brought about by the second—which is the main focus of this chapter and one that does not seem to have received much attention in the literature on strategic alliances, has to do with fundamental changes in the way in which corporate R&D activity is organised in the IT industry.

1.3.2 Recent Evidence on Technology Alliances in the IT Industry

Recent studies by Duysters (1996), Duysters and Hagedoorn (1996), Hagedoorn and Narula (1996), Hagedoorn (1993), Hagedoorn and Schakenraad (1992), and Vonortas and Safioleas (1996) provide the most extensive documentation, analysis, and hypothesis testing on technology-based international strategic alliances in the IT industry. The first four studies use a common database developed by the Maastricht Economic Research Institute on Innovation and Technology (MERIT) on Cooperative Agreements and Technology Indicators (CATI)—often referred to as the MERIT-CATI database—and focus on strategic technology partnering issues in the IT as well as other high-technology industries.

The study by Vonortas and Safioleas (1996) also uses a rich database called Information Technology Strategic Alliances (ITSA), and its focus is on strategic alliances in the IT industry with developing country firms. Whereas the MERIT-CATI database was developed only from publicly announced interfirm cooperative agreements with technology content, the ITSA database was developed from all publicly announced interfirm alliances (although R&D and other alliances with technology content can be broken out) in the IT industry worldwide.

- As with all databases that rely on counting and classifying information on publicly announced alliances reported in the press, MERIT-CATI and ITSA databases suffer from numerous biases. They include coverage bias (unannounced alliances are excluded), firm bias (exclusion of smaller and/or low-profile firms), and many more. More important, the two databases differ in their definitions of what constitutes a strategic alliance and what constitutes the IT industry.
- Briefly, in the MERIT-CATI database, only those interfirm agreements that contain some arrangements for transferring technology or joint research are included. Joint research pacts, second-sourcing, and licensing agreements are clear-cut candidates. Joint ventures in which new technology is received from at least one of the partners or joint ventures having some R&D program are also included.
- Production or marketing agreements are excluded, as are agreements with majority ownership. By contrast, the ITSA database contains a broader range of interfirm alliances that includes mergers and acquisitions, contractual agreements along with joint ventures, R&D agreements, and licensing and equity agreements.
- However, the ITS database allows categorisation of alliances into three types: alliances with technological content (for example, joint R&D agreements), alliances without R&D content (for instance, marketing and distribution), and mixed alliances. Note that neither of these definitions conforms to the one proposed by Yoshino and Rangan (1995)—who made a significant effort at clarifying the definitional issues—which excludes, among other types, all traditional contracts (for example, licensing and cross-licensing) on the grounds that they do not call for continuous transfer of technology, products, or skills between partners. Indeed, as Vonortas and Safioleas (1996) note, the lack of a generally accepted definition of what constitutes a strategic alliance is one reason for the lack of a consistent analytical framework.

The definition of the IT industry in the MERIT-CATI database includes computers, telecommunications, and microelectronics (software and industrial automation are sometimes included). By contrast, the ITSA database covers many more industry groupings such as consumer electronics, media, and even finance, banking, and insurance, which are heavy users of IT.

1.4 International Service Management

International service management has become a top priority in today's society as organisations realise the importance of customer service. With new technological advancements, organisations are learning how easy it is for services to cross international borders to deliver their products to other customers. Organisations are learning that if they do not take care of their customers, both internally and externally, their business will not succeed. There are important factors that organisations look at to determine if they are complying with the needs and wants of today's customer. Service standards, service quality, the service process, and technological advancements have helped to make service management a fundamental tool for organisations. Euro Disney is an example of an organisation that has incorporated the tool of service management and has succeeded because of it.

1.4.1 International Service Standards

As succinctly stated by Aldous Huxley (1932), "Experience is not what happens to a man; it is what a man does with what happens to him." With this in mind, service standards are hard to define, because they are based on the perception of the individual customer. Therefore, having one set definition is not possible, but having guidelines and benchmarks is possible, and they are necessary.

- Each type of organisation must meet and/or exceed their customer's needs, and in order to do so they must first be knowledgeable of their product and their customer. An example of this would be how British Airways turns negative situations into positive opportunities. British Airways had a three-hour delay, due to fog, that the crew on the plane made a memorable experience for all of the passengers. They not only made the time pass by telling jokes and making light of the whole situation, but they also gave out prizes for a game that the crew made up as a way to pass the time. The passengers on the flight could have been very upset, but the service of the crew saved what could have been a negative experience and turned it into a positive experience.
- An organisation must know their product and/or service and customers inside and out or they will fail. This is the first step to becoming successful as a manager. It sounds easy enough, but is it that easy? If so, why are so many organisations all over the world struggling with their services? Almost all organisations can define their product, but what is it about service that makes it so hard to define? According to James L. Walker (1995), service has two aspects. One is the technical aspect and the other is the functional aspect. If you were to ask ten people to define what service is to them, they would each give you a different answer. That is because they each have a different perception of what is happening around them, so they will internalise the information differently than the person next to them.
- How do managers meet and exceed the needs of several people who are their customers? First, they must know these customers expectations. Walker defines expectations as "predictions about what is likely to happen during the impending exchange, are used as a reference against which one can compare performance and assess disconfirmation" (Walker, 1995). Once the expectations of the customers are determined, managers must then perform to that level and above. To perform to their expectations, some simple questions need to be answered: what service are they receiving? How are they receiving it? Why are they receiving it? In addition, where and when are they receiving the service (Walker, 1995)? These questions are especially important when the customer only receives value from the service, due to no tangible object (Samiee, 1999). If we look at service to another country from the United States, we have to realise that that country does not have the same points of view and does not practice business the same way.
- Therefore, that country's standards of service will depend on the economy, government structure, and the beliefs or culture of the people in that country (Stauss and Mang, 1999). Once an organisation has its standards in place, it must keep working at them to make them better. When an organisation has found a standard that works for it, it needs to continue to improve on that standard. Once it has made the standard the most effective it can be, its competition will pale in comparison.

1.4.2 Service Quality

Service quality and customer satisfaction are qualities customers expect everywhere they go. It does not matter if the business is a restaurant, hotel, gas station, or a grocery store. In today's society, customers (internal and external) demand a high level of quality service. If they do not feel they have received the quality of service they have demanded, they will not return to that particular place of business. For that reason alone, it is important that organisations realise the need and importance of improving their service quality.

Quality service is a competitive advantage that an organisation can use to draw customers to use its services. Service quality has emerged as an irrepressible, globally pervasive strategic force, as well as a key strategic issue in the organisation's agenda, according to Rapert and Wren (1998).

Service quality can be defined as the relationship between the customer's expectations of a service and the perception of the service after it was received according to Edvardsson, Thomasson and Ovretveit (1994). Because service quality is based on expectations and perceptions, service quality changes with every customer. Along with expectations and perceptions, quality of the product or service is included in how a customer views service quality.

Organisations need to be able to adapt their services to each customer they deal with in order to survive in today's society. If they are able to do this, customers will realise that the organisation is focussed on treating customers with the service and respect they desire.

There are strategies that organisations can use to achieve a high level of service quality and customer satisfaction:

- The first strategy is to have an objective that is clearly defined. This objective should include the organisation's definition of service quality and what goals that organisation is trying to meet for its customers.
- The second strategy is to improve basic conditions within the organisation. It is important that all employees understand that they can be successful. Show employees that the organisation is committed to them and that they are what makes the organisation a success.
- The third strategy is to pay attention to what customers and employees are saying. The organisation needs to have open ears to listen to suggestions, compliments, and complaints that internal and external customers may have. It is important that the goals and objectives are clearly understood by both the customer and the employee, especially when it comes to international customers. By listening, the organisation will be able to see perceptions of the services that are provided.
- The fourth strategy to achieve service quality is to implement training and education for employees and for customers. By training the customer and the employee, the organisation will continue to be successful. The employee will learn new techniques to provide quality service to customers, and the customer will be able to see that the service is reliable because the organisation cares about the customer.
- The fifth and last strategy is to stress the need for continual improvement. Everyone must work together to achieve a high level of service quality. Service quality is a way of life for the organisation as well as for the customer (Stamatis, 1996)
- Two unique approaches of service quality need to be looked at carefully by organisations that strive for a high level of service quality. The first approach is the customer-perceived quality and the needs of the market. This approach looks at the external customers and is income-oriented. This approach is cantered on the expectations and experiences that are related to the customer. Because the quality in this approach is perceived, it is cantered on the customers' background characteristic features.
- The second approach is directed toward quality control within the organisation. This approach is directed toward the internal customers, the employees, and management staff. The internal customers need to understand and fulfil what is expected of them to attain a high level of service quality throughout the organisation (Edvardsson, Thomasson and Ovretveit, 1994). Employees need to understand the importance of doing it right the first time, every time. Rework just adds additional costs and frustrations for the organisation that are not necessary.

1.4.3 Service Process

Many international organisations have similar service processes. The international service managers, who run these organisations overseas, need to understand the different cultures that he or she will be living and working in.

- The most important thing for international service managers to do is keep their customers. Service process is one of the most fundamental areas of service management. It is described as the method and design of how service-operating systems work. Service process involves transforming input from the customer to output of the product or service. A service process is a list of steps an organisation follows to reach its main goal of “satisfying its customer.”
- Service processing can be categorised in four different areas such as people processing, possession processing, mental stimulus processing, and information processing. People processing involves tangible actions to the customer. These tangible service items are physically present while the service is going on. Such items include transportation, machines, or technologies. The customer has to be physically present to absorb these benefits throughout the service.
- If customers want the benefits of the people processing service, they must cooperate with the service operation. For instance, their involvement in travelling from one place to another requires them physically to take a car, bus, train, or airplane. The output of this is that the customer reached their destination and is satisfied with everything that happened along the way, from the beginning to the end. This is where the decisive moment sets in. It is very important for organisations to have an international service manager to think about these processes and outputs.
- The last thing an international service manager wants is to lose customers, just because the process was not beneficial to the customer. “Do not do unto others, as you would have them do unto you: their tastes may not be the same” (Albrecht, 1990). The next area of service process is possession processing; taking a product the customer already has and keeping it in operational condition. Examples of this are cleaning, improving, painting, restoring, or anything that would add value to the product.
- Customers are rarely involved in this stage. For example, when a customer travels, they drop off their luggage. They do not see where it goes or how it is delivered. If a customer has a product that is too heavy to move, the service provider will assist such a customer. Possession processing involves customers trusting the organisation providing the service. After the possession process, international service managers need to focus on the mental or psychology aspect of the service process. In some countries, services that interact with people’s minds have to be very careful in what they provide for the customers.
- The reason for this is that many countries have different religious backgrounds. Some countries have ethical standards to live and go by. This is a big problem for many US organisations looking into the international marketplace. Many US organisations see this as a reason for not going global. However, for some they find it necessary to go after foreign markets.
- Receiving a mental service takes time on the customer’s part. For instance, education and entertainment are examples of services dealing with a customer’s mind and behaviour. Television and seeing an event in person are components that translate information to the customer. This leads service managers to use the information processing service area. Mainly computers, the Internet, and many other technologies have developed the area of information processing service. Customer involvement in information processing is low, based on tradition or personal desire to use this service.
- The banking and insurance industries focus mainly on this. Customers can get all the information over the Internet about the service needed. Some customers prefer to use the telephone or e-mail to build strong relationships with their service provider. Another way for customers to receive good service is through ATM machines. Information processing is a way of getting the product or service to the customer quickly and efficiently.
- The most important thing about the service process is whether you can deliver the service. Many international organisations use the Internet as a way of dealing with customers. Other organisations use call centres as a way of getting information, which will better serve their customers. Call centres have become an interactive tool that organisations can use to communicate efficiently and effectively with their customers.

- Organisations are realising that customers need a place to call when they have questions or when they have compliments and/or complaints. Customers today do not want to speak to machines and voice mail; they prefer real people with real voices. The service process is a unique way of establishing good solid relationships with customers. Without the service process layout, an organisation could find itself left in the dark. Many organisations strive to have good service but do not have a process of achieving it.

Summary

- The arena of international management has never offered so many opportunities and challenges to individual managers, businesses, governments, and the academic community alike.
- International management requires the understanding of crossing cultures, multinational corporations' interactions, global perspectives, and corporate issues.
- When a company faces the decision of whether to become an international enterprise, they will be encountering many issues they have never before dealt with. This can be a confusing and difficult process for everyone involved especially the managers.
- An international manager must be willing to research the new lifestyles and cultural norms before entering the new operational facility.
- Globalisation of economic activity has been closely linked with the development and establishment of empires worldwide through international trade since the sixteenth century.
- Globalisation is the process by which an activity or undertaking becomes worldwide in scope. It refers to the absence of borders and barriers to trade between nations.
- The alternative to the Globalisation strategy is dubbed as 'Glocalisation'.
- Service quality and customer satisfaction are qualities customers expect everywhere they go. It does not matter if the business is a restaurant, hotel, gas station, or a grocery store.

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Self Assessment

1. _____ requires the understanding of crossing cultures, multinational corporations' interactions, global perspectives, and corporate issues.
 - a. International management
 - b. Economics
 - c. Planning
 - d. Research methodology
2. The objective of _____ is to establish a geographically concentrated inter-firm division of labour in the three major bonding blocks.
 - a. relocation
 - b. glocalisation
 - c. globalisation
 - d. naturalisation
3. In the Japanese view as presented by _____, Globalisation is understood as 'business chain'.
 - a. Ohame Kenichi
 - b. Abraham Maslow
 - c. Sterling Good
 - d. Abe Messer
4. A rich database called _____ focuses on strategic alliances in the IT industry with developing country firms.
 - a. Bi-lingual Interface system (BLIS)
 - b. Information Technology Strategic Alliances (ITSA)
 - c. Cooperative Agreements and Technology Indicators (CATI)
 - d. Manchester Phase Router system (MPRS)
5. A recent major development is the extension of the free trade agreement from the United States and Canada to Mexico, resulting in what is known as _____.
 - a. North American Free Trade Agreement (NAFTA)
 - b. South American Free Trade Agreement (SAFTA)
 - c. East American Free Trade Agreement (EAFTA)
 - d. West American Free Trade Agreement (WAFTA)
6. Which statement is false?
 - a. An international manager is someone who must handle things, ideas, and people belonging to different cultural environments.
 - b. When a company faces the decision of whether to become an international enterprise, they will be encountering many issues they have never before dealt with.
 - c. Marketing managers are responsible for developing strategies, deploying resources, and guiding their organisation to compete in this global environment.
 - d. To understand the notion of international management better, it is logically necessary to first define management and international independently.

7. MNEs face _____ that is broader than non-MNEs because of their geographic dispersal, deeper than non-MNEs because of the variances among country environments.
 - a. Excess of Authority (EA)
 - b. Multiplicity of authority (MA)
 - c. Duplicity of Principle (DP)
 - d. Verbosity of Order (VO)
8. The term globalisation was first used by _____ of Harvard Business School.
 - a. Professor Theodore Levitt
 - b. Professor Walt Whitman
 - c. Professor James Harney
 - d. Professor Archibald Thomas
9. _____ activities related to planning, organising, leading, and controlling must be approached from a cross-cultural perspective.
 - a. Management
 - b. Economic
 - c. Planning
 - d. Communication
10. Which of the following is the main goal of an organisation?
 - a. satisfying its customer
 - b. achieving the targets
 - c. increase in per capita income
 - d. organisational behaviour

Chapter II

Introduction to International Business Environment

Aim

The aim of this chapter is to:

- define international business environment
- introduce the cross cultural communication process and negotiations
- delineate the strategies dealing with cultural differences

Objectives

The objectives of this chapter are to:

- elucidate the various environments that influence international business
- analyse the components of foreign environment
- explain the role of political ideology and the role of the government

Learning outcome

At the end of this chapter, you will be able to:

- describe the innovation and management of technology transfer
- understand the role of technology in the process of globalisation
- comprehend the cultural universals that are integral to the business environment

2.1 Introduction

A global company has to formulate strategies based on its missions, objectives and goals. Strategy formulation is a must for a global company to make decisions regarding the markets to enter, product/service range to introduce in the foreign countries and the like. Further, the severe and intensified competition in the global market makes the strategy formulation a challenging task. The fundamental basis for strategy formulation is the environmental analysis. Environment provides the opportunities to the business to produce and sell a particular product. For example, the present day business environment provides wide opportunity for Internet.

Similarly, environment in India provides opportunity for production and selling of fuel saving motor bicycles. European climatic condition provides an opportunity for woollen and leather garments. Environment, sometimes poses threats and challenges to business. Business should enhance its strengths in order to face the challenges posed by the environment.

For example, China dumped steel at cheap prices in the Indian market and posed a threat to the Indian steel industry, i.e., consequently, Indian steel industry improved its technology in order to meet the challenges and dumped its steel in US markets. Study of environment helps the business to formulate strategies and run the business efficiently in the competitive global market. We understand that environment has significant and crucial impact on the business. Thus, business depends on environmental dynamics.

2.1.1 Meaning of International Business Environment

Environment means the surrounding. International business environment means the factors/activities those surround/encircle the international business. In other words, business environment means the factors that affect or influence the MNCs and transactional companies. Factors that affect International Business include Social and Cultural factors (S), Technological factors (T), Economic factors (E), Political/Governmental factors (P), International factors (I) and Natural factors (N). (STEPIN) William F. Glueck defined the term environmental analysis as, “the process by which strategists monitor the economic, governmental/legal, market/competitive, supplier / technological, geographic and social settings to determine opportunities and threats to their firms.” “Environmental diagnosis consists of managerial decisions made by analysing the significance of data (opportunities and threats) of the environmental analysis.

International business environment factors

Business environmental factors are broadly divided into internal environmental factors and external environmental factors.

- Internal environmental factors influence/affect the business from within. They include: human resource management, trade unions, organisation structure, financial management, marketing management and production management, management leadership style etc. External environmental factors are further divided into micro external factors and macro external environmental factors.
- Micro external environmental factors include: competitors, customers, market intermediaries, suppliers of raw materials, bankers and other suppliers of finance, shareholders, and other stakeholders of the business firm. External macro environmental factors include: social and cultural factors, technological factors, economic factors, political and governmental factors, international factors and natural factors.
- Environmental protection received greater attention in order to protect the lives of the people, animals, plants and to maintain ecological balance. The analysis of internal environmental factors indicates the strengths and weaknesses of the business firm while the analysis of micro external and macro external environmental factors indicate the opportunities provided by the environment to the business. The strengths, weaknesses, opportunities and threats (SWOT) analysis helps to formulate strategies for the business firm.

2.2 Concept and Relevance of International Business Environment

In order to gain a better understanding, let us have a look at two important classifications of environment. One classification is the micro and macro environments.

2.2.1 Micro and Macro Environments

Micro environment can be defined as the actors in the firm's immediate environment, which directly influence the firm's decisions and operations. These include: suppliers: various market intermediaries and service organisations such as middlemen, transporters, warehouses, advertising and marketing research agencies, business consulting firms and financial institutions; competitors, customers and general public. While the customers constitute firm's market, suppliers and market intermediaries help providing the firm with inputs and assist in production and marketing processes. Competitors and general public also influence the way a firm conducts its business.

Macro environment, on the other hand, consists of broader forces which affect the firm as well as other actors in the firm's micro environment. These include factors such as geographic, economic, financial, socio-cultural, political, legal, technological and ecological forces. Firms need to continuously monitor changes in these environmental forces and devise strategies to cope with them.

2.2.2 Domestic, Foreign and Global Environment

Another way of understanding various factors constituting international business environment is to divide the various factors into three broad groups: domestic, foreign and global environments. This classification is based on the location at which environmental actors and forces exist and operate. Look at the following figure where a schematic presentation of these three levels of environment along with their components has been shown.

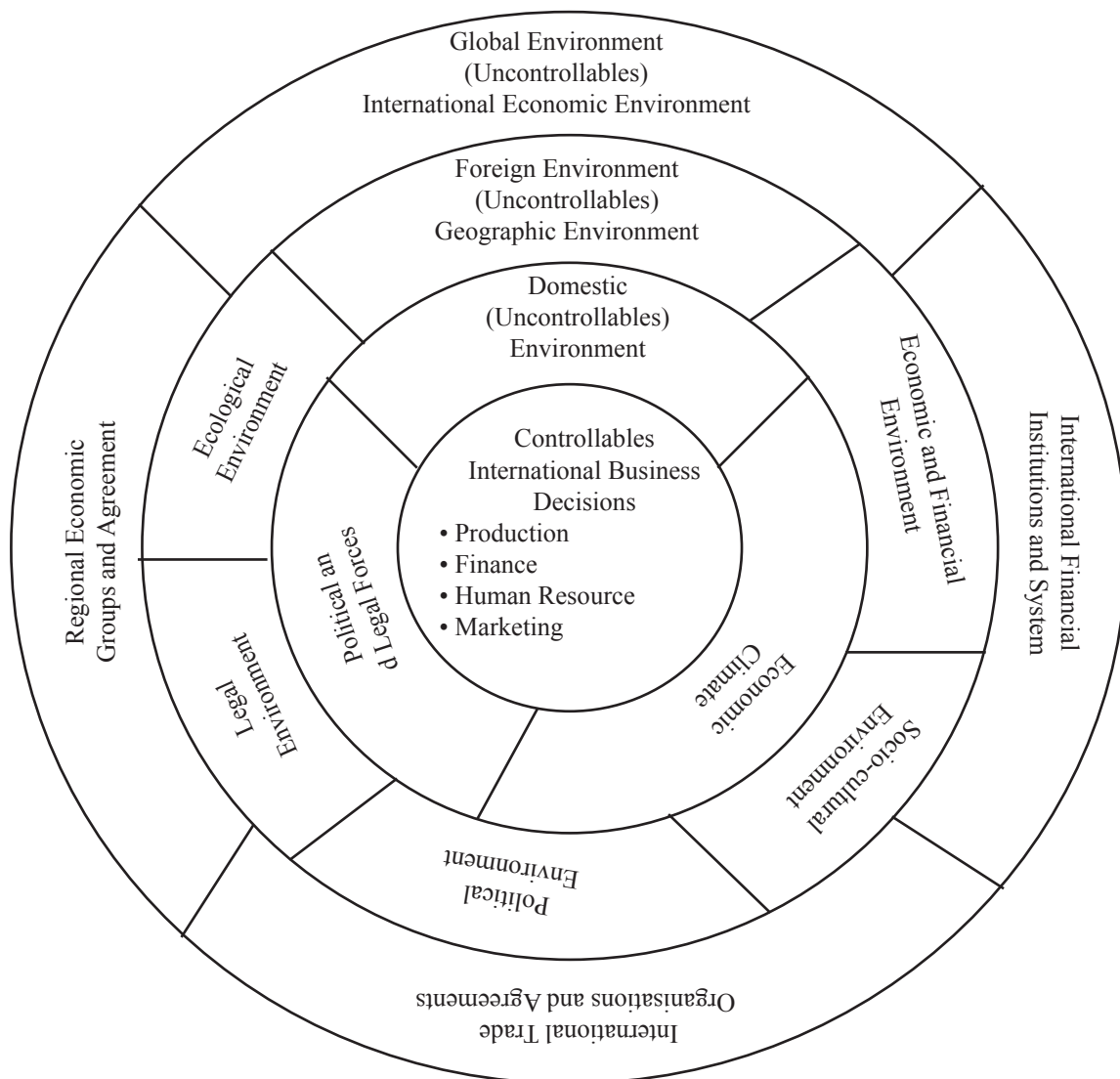


Fig. 2.1 Domestic, foreign and global environment

- In the figure, innermost circle represents firm's business strategy and decisions with regard to production, finance, marketing, human resources and research activities. Since these strategies and decisions are made by the firm, they are called controllables. Firm can change them but within the constraints of various environmental factors.
- The next circle represents domestic environment and it consists of factors such as competitive structure, economic climate, and political and legal forces, which are essentially uncontrollable by a firm. Besides profound effect on the firm's domestic business, these factors exert influence on the firm's foreign market operations. Lack of domestic demand or intense competition in the domestic market, for instance, have prompted many Indian firms to plunge into international business. Export promotion measures and incentives in country have been other motivating factors for the firms to internationalise their business operations. Since these factors operate at the national level, firms are generally familiar - with them and are able to readily react to them.
- The third circle represents foreign environment consisting of factors like geographic and economic conditions, socio-cultural traits, political and legal forces, and technological and ecological facets prevalent in a foreign country. Because of being operative in foreign market, firms are generally not cognisant of these factors and their influence on business activities. The firm can neglect them only at the cost of losing business in the foreign markets.
- The problem gets more complicated with increase in number of foreign markets in which a firm operates. Differences exist not only between domestic and foreign environments but also among the environments prevailing in different foreign markets. Because, of environmental differences, business strategies that are successful in one nation might fail miserably in other countries. Foreign market operations, therefore, require an increased sensitivity to the environmental differences and adaptation of business strategies to suit the differing market situations.
- The upper most circle, viz., circle four, represents the global environment. Global environment transcends national boundaries and is not confined in its impact to just one country. Global environment exerts influence over domestic as well as foreign countries and comprises of forces like
 - world economic conditions
 - international financial system
 - international agreements and treaties
 - regional economic groupings

2.2.3 Relevance to International Business Environment

As stated earlier, environment plays a vital role in the conduct of business operations. Especially in the context of international business, environment assumes critical importance as no two countries have similar environments and demand different business strategies to cope with differing business conditions. As the environment affects firms' strategic as well as tactical decisions, it becomes imperative for the firm to have in-depth knowledge of the domestic, foreign and global environments.

- When a firm decides to enter into international business, it faces two major decision problems: one, in which market(s) to select, and second how to enter into those markets. Both these decisions are strategic in nature and are greatly influenced by the environmental forces.
- Firms select those countries as their target markets which have sufficient market potential. Market potential, in turn, depends upon geographic, economic and cultural environments prevailing in the foreign countries. Demand for fans, for instance, will be more in countries which are geographically located in hot zones and where per capita income is high enough for the people to afford purchase of fans. Besides climate and sufficient income, electricity should be available to make the fans workable.
- Once the firm identifies countries with market potentials, it needs to decide as to what mode it should use for entering into those markets. A wide range of options such as exporting, licensing franchising, joint ventures or setting up wholly owned subsidiaries abroad are available to firms.

- Firm's actual choice of market entry mode is influenced by a variety of environmental factors. Exporting is desirable when it is economical to produce in the home country and there are no legal restrictions on import of given product in the foreign markets. In the case of import bans or excessive costs of transportation, a firm may choose to set up its manufacturing and marketing subsidiaries abroad. But this is feasible only when foreign governments are not averse to foreign direct investment, and necessary raw materials and labour are available locally at competitive prices in the foreign countries.
- In countries where first condition is not fulfilled, the firm can go in for either licensing or joint venture as these entry modes are politically less objectionable.
- Environmental forces play an equally important role in shaping a firm's functional and tactical decisions. What should be the scale of production? Should the firm employ labour or capital intensive techniques? How to finance a firm's foreign operations? How much to repatriate? What marketing mix should the firm use? Should it hire local persons or employ foreign nationals? What should be their compensation package? Answers to these and other questions require in-depth analysis of the prevailing environments in foreign countries. Since the environments differ, firm cannot be much successful by falling back upon its domestic decisions and practices.
- Firm needs to screen the foreign country environments and accordingly decide about the best course of action in each country.
- It may be pointed out here that environmental analysis is important not only for the firms entering into the foreign markets for the first time, but it is also important for the firms already in international business. Since environmental conditions change over time, firms need to continuously monitor changes in the environment and make suitable changes in their decisions.

2.3 Analysis of the Components of Foreign Environment

All the three types of environments, viz., domestic, foreign and global environments have their effects on international business operations. Because of the vastness of subject, it is not possible to discuss all the three types of environments and their impact on business in one unit. The present unit, therefore, confines itself to a discussion of various components of foreign environment. The other two types of environments and their business influences are examined in detail in other units.

Foreign environment was described, in the preceding section as consisting of geographical, economic, financial, socio-cultural, political, legal and ecological forces. A firm needs to examine these components of the environment for each one of the foreign countries in which it operates..

There is a lot of overlapping among the socio-cultural, legal and political forces. Geographic characteristics of a country have profound impact on the country's economic and socio-cultural environments. Moreover, it should be kept in mind that all the components and elements of the environment might not be relevant to a decision maker. Much depends on the nature of the firm and its decisions. For a small firm interested in exporting, analysis of the commercial policy and the economic environment would be sufficient. But for a multinational corporation interested in setting up a manufacturing plant in a foreign country, geographic as well as socio-cultural, legal and political environments would be as important as the economic environment.

2.4 Geographic Environment

Geography is an important component of the foreign environment and refers to a country's climate, topography, natural resources and people. Everyone engaged in international business must have some knowledge of geographic features of the foreign country as these influence the nature and characteristics of a society. It also affects demand pattern of the people living in the country. Geography is a major contributory factor to the development of business systems, trade centres and routes.

- Different climatic conditions (viz., rain, snowfall, wind, temperature, humidity etc.,) give rise to demand for different types of products. It is largely due to climatic differences that people differ in their housing, clothes, food, medical and recreational needs. Many a time needs are same, and the same products are demanded. But because of the climate and the topographic differences, products need adaptation or modifications to suit local conditions. Rolls Royce cars from England, for instance, required extensive body work and renovations in

Canada because the salted sand, spread over streets to keep them passable throughout four or five months of virtually continuous snow in Canada, caused rusting and corrosion in the fenders and door panels and oil system also developed leaks.

- Geographic conditions also affect a firm's plant location decision. A firm prefers to set up its manufacturing plant in a country which has favourable climatic conditions, possesses suitable topography (i.e., surface features such as hills, plains, river and sea) and where raw materials, energy and labour are cheaply and abundantly available. Foreign country's nearness to other markets and its strategic location on major trade routes are other equally important considerations.
- Firms' distribution and logistic strategies are directly influenced by geographic conditions in the foreign markets, Re-order points and safety level stocks are kept generally higher for those countries or places which are not easily accessible and can be cut off suddenly and heavily due to bad weather.
- Location of a country on the world map is an equally important consideration. It affects its trade prospects with other countries. Landlocked countries such as Bolivia, Zambia and Zimbabwe are not only costly to reach but are also difficult to penetrate as trading with these countries depend upon their relations with neighbouring countries through which goods have to cross.
- Consumer demand for man, a low priced and essential product is directly related to the number of people living in a country. It is primarily due to large populations that the countries like China and India have become the targets of the multinational corporations which are vying with one another to gain a foothold in these markets.
- To arrive at a correct estimate of the market size, however, one needs to take into account these factors also such as population growth, population density and population distribution by age, income, location and occupation, take together, these variables provide better estimates of the present and future market potentials and also help in providing information relevant for communication, distribution, product quality and pricing decisions.

2.5 Economic and Financial Environment

Among the entire uncontrollable, economic environment is perhaps the most important factor. An analysis of economic environment enables a firm to know how big is the market and what its nature is. Answers to these questions in turn determine whether a firm should enter a given foreign market, and if yes, what strategies it should use to successfully run its business operations, Closely related to the economic environment is the financial environment, which affects a firm's capital structure, investment decisions and accounting practices.

Various dimensions one needs to consider, while attempting an economic and financial analysis include : foreign country's level of economic development, income, expenditure pattern, infrastructure including financial institutions and system, inflation, foreign investment in the country, commercial policy, balance of payments account, accounting systems and practices, and integration of the foreign country's foreign exchange, money and capital markets with the rest of the world.

2.5.1 Economic Environment

Economic environment is the most important indicator of the global market analysis.

- **Economic Development:** Economic development is directly related to the development of marketing in a country. Countries characterised by high levels of economic development not only have high demand for a variety of products, but also have better infrastructure and more developed marketing systems. Competition is also high in these countries. In the less developed countries, on the other hand, not only demand is low, but infrastructure is also poor. It, therefore, becomes quite difficult and more expensive to do business in such nations.
- **Income:** Income is an important indicator of the country's level of development and also its market size.
 - Gross national product (GNP) and per capita income are among the major measures of income. While sales of most of the industrial goods and capital equipment generally correlate with GNP, demand for consumer products depends on per capita income. Besides income, one should acquire information about the sectoral distribution of the GNP as it is an important determinant of kinds of goods in demand in a foreign country.

- If the majority of a country's GNP comes from agriculture, it implies that the country is agriculture based and it shall have a good demand for agricultural inputs such as seeds, fertilisers, pesticides and agricultural machinery and tools. An industrial nation with relatively higher dependence on manufacturing, on the other hand, shall have a good market for raw materials, plant and machinery, and also for a variety of consumer durables and non-durables.
- Though per capita income is a useful measure, it is not a full-proof measure of the country's development and prosperity. What is more relevant is the distribution of income. While in the developed countries income distribution is relatively more even, it is highly skewed in the developing countries. Since only a small portion of the population accounts for 60 to 70 percent of the country's GNP and the rest are poor in the developing countries, market for high priced product and non-essential products is limited only to select rich people.
- Expenditure Pattern: Data on expenditure patterns are useful in judging as to how the money is spent on different item and which products receive more weightage.
- Infrastructure: Infrastructure is another vital dimension of the country's economic environment and is directly related to the country's economic development. Infrastructure refers to various social overheads such as transportation, telecommunications, commercial and financial services like advertising, marketing research, various media, warehousing, insurance, distribution, credit and banking facilities. Absence of adequate infrastructure not only hinders country's development but also affects firms' costs and capacity to reach various market segments. Companies find it difficult to co-ordinate and control their business in countries with poor communication systems.

2.5.2 Financial Environment

Sound financial position of the country coupled by the favourable investment policies reflect strong demand potential.

- Monetary and fiscal policies: Inflation, interest rate, various kinds of duties and exchange rates are the variables related to the country's monetary and fiscal policies and have a substantial impact on the costs and profitability of business operations. These variables also influence a firm's decision to move funds from one nation to another.
- Commercial and foreign investment policies: Each country has its own commercial and foreign investment policies which must be studied in detail to ascertain country's openness to trade and investment with other countries. A proper understanding of these policies can be quite helpful in ascertaining what tariff and non-tariff barriers the particular country uses to protect its domestic industry from foreign competition. The country may plan to minimise the incidence of these trade measures.
- Balance of payments account: A country's balance of payments account is another major source of information about the country's foreign trade and foreign currency reserves. The current account throws light on the country's exports and imports as well as its major sources of imports and destinations of exports. Capital account reveals stocks of foreign investments, borrowings, lending and foreign exchange reserves. An international firm must be duly aware of exchange controls prevalent in the foreign countries.
- Countries running deficits in their balance of payment accounts generally impose controls on movement of foreign exchange into and out of their economies. These controls prompt the multinational corporations to resort to transfer pricing mechanism, i.e., over invoicing of imports and under pricing of exports so as to move out more than permitted funds from such countries.

2.6 Socio- Cultural Environment

Business is as much a socio-cultural phenomena as it is an economic activity. Per capita income in two countries may be the same, yet the consumption patterns in these countries may differ. Socio cultural forces have considerable impact on products people consume; designs, colour and symbols they like; dresses they wear and emphasis they place on religion, work, entertainment, family and other social relations. Socio-cultural environment influences all aspects of human behaviour and is pervasive in all facets of business operations.

2.6.1 Introduction

Culture can be defined as a “sum total of man’s knowledge, beliefs, art, morals, laws, customs and any other capabilities and habits acquired by man as a member of society.” It is a distinctive way of life of a group of people, their complete design of living. Culture thus refers to a man’s entire social heritage - a distinctive life style of a society and its total value system which is intricately related to the consumption pattern of the people and management philosophies and practices.

Furthermore, within each culture there are many subcultures that can have business significance. For instance, in a country like United States, distinct subcultures prevail in the South North-Eastern or mid-western parts. Subcultures are found in all national cultures and failure to recognise them may create impressions of sameness which in reality may not exist. A single national and political boundary does not necessarily mean a single cultural entity.

Canada, for instance, is divided between its French and English heritages, although politically the country is one. Because of such distinctive cultural division, a successful marketing strategy among the French Canadians might not effectively work among the English Canadians or vice-versa. Similarly, a single personnel policy may not work with workers employed in two different plants if they belong to different sub-cultural groups and differ in their work habits and underlying motivations.

2.6.2 Elements of Culture

Some of the important elements to understand a country’s culture are: language, aesthetics, education, religions and superstitions, attitudes and values, material culture, social groups and organisations, and business customs and practices.

Language

- Language is an important element of culture and it is through language that most of the communication that takes place. An international marketer should have a thorough understanding of the language of the market - particularly the semantic differentials and idiomatic nuances which are essential characteristics of all languages of the world.
- Dictionary translation could be quite different from the idiomatic interpretation of a language. When literal translations are made of brand names or advertising messages from one language to another by people who know the language but not the culture, serious mistakes that may occur.
- When General Motors of the United States literally translated its marketing phrase ‘Body by Fisher’ into Flemish language, it meant ‘Corpse by Fisher’. Similarly, the phrase “Come alive with Pepsi” faced problems when it was translated into German advertisements as “Come out of grave” or in Chinese as “Pepsi brings your ancestors back from the grave”.
- When the American car called ‘Nova’ was introduced in Puerto Rico, sales were poor until the company realised that the word Nova was pronounced as ‘Nova’ - which literally meant in Spanish “does not go”. Sales were better when the name was changed to ‘Carbie’.

Aesthetics

- Aesthetics pertain to a culture’s sense of beauty and good taste, and is expressed in arts, drama, music, folklore, dance and the like, Aesthetics are of special interest to the international business executives for these govern the norms of beauty in a society and are helpful in correctly interpreting meanings of various methods of artistic expressions, colours, shapes, forms and symbols in a particular culture. Colours, for instance, mean different things to different people.
- The colour of mourning is black in the United States, but it is white in the Far East. Green is relaxing colour to Americans, but it is disliked by people in Malaysia where it connotes illness and death. Symbols also need to be interpreted correctly, Seven, for instance, signifies good luck in the United States but just opposite in Singapore, Ghana and Kenya. Use of number four should be avoided in Japan because it is pronounced as ‘shi’ which in Japanese means death. Sensitivity to the aesthetics of a society and their symbolic expressions can greatly help in avoiding socially embarrassing situations and correctly designing the products and messages.

Education

- Education is generally understood as formal schooling. But it is better to adopt a broader perspective and define education as any process, formal or informal, through which one learns skills, ideas and attitudes. Education is important as it affects not only the education levels but also the development of mental faculties and various skills. In general, educated people have been found to be more sophisticated, discriminating and receptive to new products and ideas.
- Availability of educated manpower like skilled labour, technicians and professional is also dependent on the country's education level. Media to be used by a company for promoting its products and services are also dependent on education level prevailing in the country. The conventional forms of printed communications, for instance, do not work in countries where literacy rates are low.

Religions and superstitions

- Religions are a major determinant of moral and ethical values and influence people's attitudes, habits and outlook on life which are reflected in their work habits and consumption patterns. Dr. Ernest Dichter observed: "In puritanical cultures, it is customary to think cleanliness as being next to godliness. But in Catholic and Latin American countries, to fool too much with one's body to overindulge in bathing or toiletries has the opposite meaning. It is that type of behaviour which is considered immoral and improper".
- There are numerous religions and faiths in the world, with prominent ones being : Animism, Buddhism, Christianity, Hinduism, Islam and Shinto. Each one has its own morals and codes of conduct. A working knowledge of the religions prevalent in the target markets helps in understanding people's work habits, underlying motivations and consumption behaviours.
- Equally important are the superstitions of the people in a society. People's beliefs in astrology, hand reading, ghosts, lucky days and places are integral part of certain cultures. In some countries, single storey houses are preferred because it is considered bad to have another's foot on one's head. Location of a building and its architecture in many Asian countries is governed by the principles of 'vastushastra' rather than purely geographical and economic considerations.

Attitudes and values

- Besides religions and superstitions, one must be cognisant of attitudes, values and beliefs prevalent in a society. These attitudes and values may relate to consumption level, material possessions, risk taking and change. 'What is important and desirable' differs from society to society and is largely governed by the attitudes and values existing in a society. Americans in general are more receptive to change and risk taking, but people in many societies are averse to change and risk taking. They prefer doing what is traditional and safe. New products are not accepted unless these have the approval of local chiefs or religious leaders.

Material culture

- According to Ball and McCulloch, material culture refers to all manmade objects and its study is concerned with how man makes things and who makes what and why. While the question 'how relates to technology, other questions 'who', 'what' and 'why' are part of economics.
- Technology includes the ways and means applied in making of material goods. It is technical know-how in possession of the people of a society. Choice of technology has its repercussions like the size of investment, scale of operations as well as type and the number of workers to be employed.
- Technology transfer has been a highly controversial issue in the past. Because of supply of obsolete or inappropriate technology, many developing countries have laid down stringent rules and regulations concerning technology import and payments. Since transfer of new technology is often riddled with workers' resistance to change and public criticisms, multinational corporations are advised to have suitable action plans to counter such opposition.

Business customs and practices

- A familiarity with business customs and practices prevalent in different countries is a must to avoid business blunders. An international business manager must have necessary knowledge about how business is conducted and what importance business people in a foreign country attach to work, time, formality, change and achievement. American managers, for instance, are by nature highly work oriented and attach utmost importance to speed and punctuality in business dealings. They are, moreover, highly achievement oriented and fond of new things. But people in other parts of the world do not share these values and beliefs. Japanese, for instance, are also workaholics but they are very slow in decision making. Latin Americans too do not believe in haste and spend considerable time in socialising and developing friendships before coming to business transactions.

A person dealing with people from different cultures should be well aware of differences in the number and nature of stages involved in business negotiations and formalities to be observed in concluding business contracts. While in countries like the United States, it is necessary to have final agreement in writing, this practice is not much appreciated in many West Asian countries where oral agreement alone is considered more than sufficient.

2.6.3 Cultural Attitude and International Business

Dressing habits, living styles, eating habits and other consumption patterns, priority of needs are dictated/influenced by culture. Some Chinese and most of the Indians do not consume beef. Thailand Chinese believe that consumption of beef is improper and Indians (particularly Hindus) believe that eating beef is a sin as they believe cow is sacred (Kamadhenu). The eating habits vary widely. Chinese eat fish stomach's, and bird's nest soup, Japanese eat uncooked sea food, Iraqis eat dried, salted locusts and snakes while drinking. The French eat snails, Americans and Europeans eat mostly non-vegetarian food. Indians eat mostly vegetarian food. It was surprising to the rest of the world to know that there were pure vegetarians in India. However, the foreign culture regarding food has been adapted. Masala dosa and Hyderabadi Biryani have become popular in Europe and the USA whereas pizzas have become popular in India.

Similarly, dressing habits also vary from country to country based on their culture. Different dress styles have been observed of the West, Middle East, India, Pacific, etc. Wearing 'saree' by Indian women is influenced by the culture. Similarly, wearing 'burka parda' by the women of the Middle East is another example for the cultural influence on the dressing habit. The international businessmen should eliminate the social, religion and cultural effect in order to understand the foreign cultures as they have to carry on business under the existing cultures.

Most of the businessmen of the USA react to the methods in ethnocentric terms and prefer to conduct business on Western lines though they know the cultures of Asia and Africa. The businessman should eliminate the influence of social, religion and cultural as it helps to prevent a transfer of personal culture to the overseas market. This awareness helps the manager to formulate customer-oriented strategies and avoid the possible failures. Guidelines for the businessman, when they launch business in foreign countries:

- resist the tendency to conduct business immediately on landing
- offer favours as a business tool to generate allies
- contact, cultivate and conduct field work among at least one sample clientele to serve as an initial testing centre for the firm's product
- introduce the product line into the sample group by local firms of cause-related marketing
- extend product acceptance beyond the sample clientele into related market segments.
- businessmen should follow these guidelines in order to prevent possible failures.

2.6.4 Cross Cultural Communication Process and Negotiations

In some countries like the USA, Canada, Germany and Switzerland the messages that the people convey are explicit and clear. They use the actual words to convey the information. These cultures are called 'low-context cultures'. In countries like India, Japan, Saudi Arabia, and other Middle-Eastern Arab countries, communication is mostly indirect and the expressive manner in which the message is delivered becomes critical. Much of the information is transmitted through non-verbal communication. These messages can be understood only with reference to the context. Such cultures are referred to as, "high-context cultures."

According to Hall, cultures also vary based on the manner of information processing. Cultures which handle information in a direct, linear fashion are called, "monochronic." Americans are more monochronic. Americans' fast tempo and demand for instant responses are viewed as pushy and impatient. The other type of culture is 'polychronic.' In this culture people work on several forms simultaneously instead of pursuing a single task. Japanese and Indians belong to polychronic culture. American businessmen consider the failure of the Japanese to make eye to eye contact as a sign of rudeness whereas, the Japanese do not want to look each other in the eye as eye to eye contact is an act of confrontation and aggression.

The possible confrontation would be a low context German may insult a high context French counterpart by giving too much information. In contrast, a German (low context) becomes upset when he feels that he does not get enough data and details from the Frenchman.

2.6.5 Cultural Universals

Irrespective of the religion, race, region, caste etc. all of us have more or less the same needs. These common needs are referred to as 'Cultural Universals.' Murdock has identified cultural Universals like athletic, sports, bodily adornment, cooking, dancing, singing, education, joking, kin groups, status differentiation and dream interpretation. The cultural universals enable the businessmen to market the products in many foreign countries with modification for example, TVs, cars, video games.

Culture is not a barrier to computer software. As such, computer software industry of the USA, Europe and Australia has been attracting most of the Indian computer software engineers. Other examples include diamonds, gold ornaments, flowers which have world wide demand. Many managers felt that Japanese would not eat "black food", when Yamazaki-Nabisco thought of introducing Oreo Cookies in Japan. But the Oreo Cookies became number one cookies in Japan. Cultural universals do not mean that two cultures are not very much close to each other.

Communication through languages

Language is the basic medium of communication. There are more than 5,000 spoken languages in the world. The same words in the same language may mean different things in the different regions of the country. Safe rules in international communication are: Over punctuate, when you are in doubt. Keep ideas separate, making only one point at a time. Confirm discussion in writing. Write down all figures using the style of the person you are talking to. Adjust your language to the level of your foreign counterpart. Use visual aids whenever, possible. Avoid technical, sports and business jargon. In other words, "speak to the rest of the world as if you were answering a slightly deaf, very sick old auntie, who just asked you how much to leave for you in her will."

Non-verbal communication

People also communicate through non-verbal communication, which have different meanings in different cultures. Some other non-verbal communication clues include: medium. "As stated earlier, prolonged eye to eye contact is polite in the USA and rude in Japan, Indian and Lino cultures. Indians offer food or beverages to the guests first. They start eating only after the guests start eating. Americans or Europeans generally do not offer food or beverages or even water. They eat in the presence of guests without offering them. Indians respect the guests. In fact, they treat the guest equal to God (Athithi Devo Bhava).

Similarly, they respect teachers also. They greet the guests, elders and teachers with the folded hands (i.e., giving the treatment equal to God).

“Indonesians are polite people. A business guest will often be served something to drink and should not reach for his drink until the host gestures to do so. It is polite to at least taste the drink or any food offered. Indonesians are not known for their punctuality, so one should not get offended, if functions do not start on time or if your guest arrives late. Indonesians avoid the use of the left hand when offering food and other objects as it is regarded as the unclean hand. It is also considered rude to point with a finger.”

Most of these are applicable in India, and other Asian countries. It is always appropriate to appreciate the cultural differences in language (both verbal and non-verbal).

Time and culture

Time has different meanings in different cultures. Asians do not need appointment to meet someone and vice versa. But Americans, Europeans and Africans need prior appointment to meet someone’ and vice versa. Friday in the Middle East is just like Sunday in the West. Time is money for Americans both for work and leisure and enjoyment. Time takes a more” leisurely walk” and there is no urgent work in most of the non-Western societies. In general, there is a lack of punctuality in Asian and African cultures. Swedish people are very prompt. Chinese are very much punctual for social occasions and appointments. In Asian countries, particularly in India, auspicious time is most important for business deal, admission in a college, travel, starting a new project/work etc.

Space and culture

Space between one person and another person plays significant role in communication. But culture determines the distance/space between one person and another person. Latin Americans are comfortable with a few inches of distance. Asians need substantial conversational distance and no physical contact. This is followed strictly in case of people of opposite sex. Americans need more distance from a third person for privacy. This is unimportant for Indians.

Culture and agreement

The United States of America is a very legalistic society and Americans are very specific and explicit in their terms of agreement. The opposite is true in case of Asian countries. Asians never pick up face to face confrontation. They keep quiet in case of disagreement. A South Korean or an Indian businessman considers a contract as loosely structured consensus statement that allows flexibility and adjustment. In Silicon Valley area of California, the culture is characterised by multiculturalism and diversity. There, American cultures are characterised by straightforward approach, while Asian cultures do not teach workers to argue point-blank with immediate superiors.

Culture to friendship

Americans develop friendship even in a short time. In fact, they don’t develop deep personal ties. Sometimes, people in the US complete the business and then develop friendship.

People in Japan and China first develop friendship through several means including eating together, presenting gifts and then transact business. General Motor Corporation has learnt this culture. In Turkey, “Let us make friends first and then see, if we can conduct business. “ Once a business meeting between an American and an Italian was conducted over dinner. The Italian client appeared next morning with the signed contract. The US company, although pleased, was surprised. Americans use the first name but the French people and most northern Europeans feel it offensive. In Germany, only relatives and close friends call by the first name. “In Australia and Venezuela, the proper waiting time could be five minutes, in Argentina, Germany and France one year, in Switzerland three years, and in Japan a decade.”

Culture and negotiation

Americans are straightforward. Chinese negotiations are generally tough minded and well prepared and use various tactics to secure the best deal.

Culture and superstition

Superstitious beliefs like fortune telling, palm reading, dream analysis, phases of the sun and the moon, birth date and time analysis, vastu are more prominent in Asian countries and also in some of the African countries. Americans knock on wood, cross their fingers and feel uneasy when a black cat crosses their path. Even Indians feel uneasy when a cat crosses their path.

Culture and gifts

Culture attitudes concerning the presentation of gifts vary widely across the world. In Japan and India gifts are given first, but in Europe only after a personal relationship is developed. The international businessman should study the customs of the society in offering gifts. Clocks are a poor choice of gifts in China and Taiwan, Knife is poor choice in France, Russia, Germany and Thailand and Handkerchiefs in Thailand, Italy, Brazil and Venezuela.

2.6.6 Social Environment

- Social environment consists of religious aspects, language, customs, traditions, beliefs, tastes and preferences, social institutes, living habits, eating habits, dressing habits etc. Social environment influences the level of consumption. For example, though the economic position of Germans and French people is more or less the same culturally they are different. Consumption level of French people is more than that of Germans. Hence, the study of social environment helps in deciding on the type of product, market, and the like. Now, we discuss various aspects of social environment. Religion: Religion is one of the important social institutions influencing business. A few religions have spread over large areas in the world. The Protestants' influence is dominant in the USA, Canada and Australia with regard the production and distribution. Roman Catholics dominate in Latin America, and Southern European Countries. Islam dominates northern Africa, Middle East, Malaysia, Brunei, Indonesia etc. These religions have enforced prohibition of liquor. Buddhism and Hinduism dominate in most part of Asia. It has an effect on high spiritual values, low value of material goods and more emphasis on ethics and moral values. Religions play significant role in normal and ethical standards in production and marketing of goods and services. Most of the religions indicate in providing truthful and honest information. But most of the marketing practices deviate from these standards.
- Family System: In addition to religion, family system has its impact on international business. In most of the Islamic countries, women play less significant role in the economy and also in the family with limited rights. In Latin American countries, though the role of women is better compared to that in Islamic countries, women's role is limited in economics and in families. But, women play a dominant role in European and North American countries. In addition, joint families are more prevalent in Islamic and Hindu religions. Joint family system reduces the demand for goods and service compared to nuclear families.

2.6.7 Strategies Dealing with Cultural Differences

Businesses should identify the cultural variations in foreign countries and evaluate their influence on human resource management, marketing, stakeholder relations etc.

Making adjustments, wherever necessary

Business firms, after evaluating the influence of cultural variations on business practices and processes should decide the nature and degree of adjustments necessary. Host country's cultures, in certain areas do not expect foreigners to adjust to them. For example, western female flight crew are permitted to wear jeans and T-shirts in public places when staying overnight in Jeddah, Saudi Arabia, even though local women are not allowed to do so.

However, human resource practices need to be adjusted based on the host country culture. For example, in Saudi Arabia, a male family member accompanies women employees to the office. Similarly, business should also modify the product and other marketing practices wherever necessary based on the host country's culture. For example, Whirlpool is successful in Indian market only after modifying its washing machine to suit Indian sarees.

Communication

Communication plays vital role while doing business in various foreign countries. Businesses should be cautious in spoken and written language, translation, and the silent language, otherwise they face serious problems in various transactions. For example, Microsoft purchased a thesaurus code for its Spanish version of word 6.0, but the meaning of Dany synonyms had changed and become insulting. This program was denounced by the reports of newspapers and radio. Later the company corrected the software, but by that time the company lost many customers.

Poor translations may also result in tragic consequences. The collision between aircraft from Air Kazakhstan and Saudi Air in New Delhi, India was due to inaccurate translations. Therefore, appropriate technical words should be chosen in advertisements, reports, agreements and in all other business transactions. Silent language includes using different colours to denote various meanings, keeping appropriate distance, time and status cues and use of body language. United Airlines promoted a new passenger service in Hong Kong by providing white carnations to its customers, which backfired as people in Hong Kong present white carnations only in sympathy for a family death.

Competitive Advantage

Culture of a country determines cost of doing business, productivity, entrepreneurship and innovations. Japan's culture emphasises teamwork, loyalty, reciprocal obligations and honesty. Education enhances employee commitment and increase productivity and, thereby, reduces cost of operations. These factors ultimately enhance competitive advantage of the business. American culture of risk taking and supportive of entrepreneurial activity helped the country in having competitive advantage in software and bio-technology industries.

2.7 Political Environment

It is rightly said that a foreign business firm operates only as a guest and at the convenience of the host country government. The government reserves the right of allowing a foreign firm to operate in the country as well as laying down the manner in which a foreign firm can conduct business. To gain an insight into a foreign country's political environment, one needs to analyse factors such as current form of government and political party system, role of government in the economy, political encouragement to foreign firms, political stability, and political risks to business.

2.7.1 Forms of Government and Political Party System

Government in a foreign country can be either parliamentary or absolutist. While the parliamentary type of government is run by people's representatives selected from time to time, the absolutist government assumes the flow of absolute monarchies or dictatorships, and only a select few make policies. In the case of parliamentary government, one needs to know whether it is a single party system or multiparty government system. Single party government is considered to be more stable than the multiparty government.

2.7.2 Political Ideology and Role of Government

Besides political party system, one must have knowledge about the political ideology and government attitudes toward foreign business and investment. In addition to regulatory role, government itself can be directly involved in business. In such cases, government enterprises emerge as dominant players in the market and pose tough competition to the foreign firms. Even supplying goods and services to the agencies is not hassle free. Because of monophonic power of the government organisations, it becomes quite arduous to negotiate prices and other terms with them.

2.7.3 Political Stability

Stability of the government and government policies are a major concern for the international firm. Since business decisions, these days involve huge investments and are irreversible, what the foreign firms look in for is politically stable countries. Political instability can result from either change in the type of government, a shift in political parties that form the government or change in the government policies without change in the government or shifts in political parties.

2.7.4 Political Risk

Political risk which is defined as the vulnerability of a project to the political acts of a sovereign government is a big threat to foreign business. The political acts leading to political risks can range from confiscation, expropriation, nationalisation, domestication to restrictions on transfer of funds. Confiscation occurs when a foreign investment is taken over by a government without any compensation.

Expropriation takes place when the government takes over foreign investment but some compensation is paid. The compensation may or may not equate with the market value of a firm. Nationalisation affects the entire industry rather than a single company, and involves transferring ownership of the confiscated or expropriated business to a national firm or government entity.

2.7.5 Domestication

It is a mild form of intervention and involves transfer of control of foreign investment to national ownership to bring the firm's activities in line with national interest. It differs from expropriation in the sense that it is gradual encroachment of the freedom of operation of a foreign operator. Domestication can be either firm initiated, government initiated or predetermined. Whereas firm initiated and predetermined domestication entail low levels of risk, government initiated domestication is quite risky and is ranked with expropriation.

Another type of risk relates to a temporary or permanent blocking of funds. Unlike other kinds of risks, a business firm under blockage of funds owns the funds and property rights but it cannot remit the funds or earnings back to home country. This was a common problem faced by Indians during Amin's rule in Uganda.

Although the government did not formally make any announcements regarding takeover of property, it became almost impossible for the firms to repatriate their earnings in any form. No doubt black money market operations may exist in any country; it is difficult for such operations to handle large scale of funds involved.

International firms need a proactive approach to deal with political risks. An effective management of risks calls for recognising the existence of various kinds of political types of risks and their consequences, and developing appropriate plans and policies to deal with such risks.

2.8 Technological Environment

Most of the people did not believe the arrangement made by 'Lord Sri Krishna' to 'Dhruv' to get the information of 'Kurukshetra War' instantly until the live telecast of 'cricket match' through TV became reality. Similarly, we did not believe the power of god's 'Divine Vision' (Divya Drushti) until the video conferencing was introduced. Similarly, the power of the 'click-the-mouse' and 'get whatever you need at your door step' became reality while some of us did not believe the power of God waving his hand in the air like clicking the mouse on the computer and fulfilling the desire of his devotees.

The days of 'touring-the-world within hours' like 'Narada' are not far-off. In fact, NASA has been researching in this direction and came up with an aeroplane, which could reach from one part of the world to the other part of the globe within two hours. Thus, the illusions are becoming reality mostly due to technology. Man of the third millennium is able to see any part of the world, get any product from any country, get messages from all over the globe with bare minimum cost by simply staying at his home or office. The distance is shrunk among the countries due to technology. All this, 'once-upon-a-time's' illusion has become reality.

The latest information technology has dissolved the national boundaries and the advancements of transportation technology have reduced the distance among the world nations. These technological changes enabled international business to take the shape of transnational business through the concept of global business. International business, in fact, gained significance due to the amazing advancements in technology. Technological environment has significant and direct influence on business in general and international business in particular. Technology is the application of knowledge.

J. K. Galbraith defines technology as “a systematic application of scientific or other organised knowledge to particular tasks”. Technology advanced phenomenally during the past 50 years. Technology changes at a faster rate. In fact, it brings change in the society, economy and politics. Technology affects all walks of life, all countries and the entire globe.

As stated by Alvin Toffler, “Technology feeds on itself. Technology makes more technology possible.” Thus, technology is self-reinforcing. Technology brings the globe closer. Technology flows from the advanced countries to the developing world through the multinational corporations (MNCs), joint-ventures, technological alliances, licensing and franchising.

2.8.1 Influence of Technology

Technology influences the way we live, we cook (electric rice cooker), we drink even water (filtered and mineral water), communicate (telephone, fax, e-mail, video conferencing, e-mail chatting etc.), preparing for a class or a case or reading a newspaper through the internet, marriage alliances through the internet, computer aided design, production, selling (e-commerce), satellite networks, electronic fund transfers, lasers, fibre optics, unmanned factories, miracle drugs, new diagnostic methods. New studies in technology like eye replaces the password and using the remote for car driving will take place.

2.8.2 Investment in Technology

Advanced countries spend considerable amount on research and development for further advancement of technology. Germany spends 50% of its R&D budget on product innovation and the remaining 50% on process innovation. Japan spends only 30% on product innovation and the remaining 70% on process innovation. In contrast, the USA spends 70% on product innovation and only 30% on process innovation.

The Japanese auto manufacturers gained incredible competitive advantage over the US counterparts by reducing new product's time to market. Japanese companies introduce the products in three year whereas the US firms need five years for the same job. Japanese are investing money in innovations and creations in biotechnology. Others also follow Japan as this is an emerging area.

2.8.3 Technology and Economic Development

Technology is one of the significant factors which determine the level of economic development of a country. The difference between the nations is mostly reflected by the level of technology. For example, though India had vast natural resources, it remained as a major importing country due to its low level technology before 1991. Japan with its high level technology could export finished goods to India, by importing the raw materials from India itself.

Thus, though Japan is endowed with poor natural -resources, the Japanese became rich and advanced due to technology. As such, developing countries allow MNCs entry into their countries in order to have benefits of the latest technology and to develop the domestic industry. But often, it is criticised that the MNCs transfer obsolete technology to developing countries.

2.8.4 Technology and International Competition

Nations develop economically when they translate science into useful technology and in turn create wealth from innovations. Innovation is the useful adaptation of science or knowledge including invention of new products or processes. Invention is creation of entirely new. A few companies or people invent but many companies adapt scientific knowledge to generate wealth by application and commercialisation. Major inventions or discoveries do not remain properly for a longer period. The inventions or innovation process and global competitiveness are two determinants of a nation's wealth.

Japan concentrates on process innovation in automobiles, steel, telecommunication and microelectronics while Germany concentrates on innovations in chemicals, pharmaceuticals, automotive engineering, medical instruments and machine tools. Italy concentrates on innovations in textiles and leathers.

2.8.5 Technology Transfer

Technology and global business are interdependent. International business spreads technology from advanced countries to developing countries by: establishing the subsidiaries in developing countries establishing joint ventures with the host country's companies acquiring the country's firms host country's companies technology transfer as innovation or by merging with the host arranging technological transfer to the companies of developing countries through technological alliances.

Technology transfer as an innovation

Technology transfer is mostly concerned with the introduction of existing technology to other countries, preferably to a less advanced country through international business operations. Procter & Gamble introduced less costly products like soaps and shampoos for Chinese in China in 1988 rather than diapers and sanitary napkins - that gave the company market advantage over the competitors.

Companies take the familiar products in the home market to the foreign markets that are new there. Colgate-Palmolive introduced wide range of its products to developing countries. In this process, MNCs bring new products, new processes and technologies to the host countries. These may be old in the home countries, but relatively new in the host countries. Therefore, various developing countries invite the MNCs to bring technology to their country that is non-available there.

Managing technology transfer

Foreign companies, when they establish manufacturing facilities in host countries bring technology, technical know-how, machinery and equipment, management knowhow, marketing skills etc., to the host country. They train the local employees in carrying out various operations including production. They design process technologies and products either in home country or host country.

However, they take all precautions in protecting intellectual property. Other information and knowledge is transferred to the local employees. Technology transfer takes place to a larger extent in joint ventures. However, the parent companies normally will not part with the significant part of the technology in order to safeguard their interest and profit.

2.8.6 Technology and Location of Plants

In addition, MNCs relocate their manufacturing facilities based on technology. In other words, MNCs locate the plants with high technology advanced countries and establish the labour driven manufacturing facilities developing countries, in order to get the advantages of cheap labour.

Scanning of technological environment

The level of the technology is not the same in all the countries. Advanced countries enjoy the fruits of the latest technology while the developing nations face the consequences of obsolete or outdated technology. Therefore, the MNCs have to understand the technology, analyse it before entering the foreign markets. MNCs have to procure the technological environmental information regarding: The level of technology of the industry in the home country. If the technology is not compatible, then select the appropriate technology for the host country, if possible. If not, select the host country's technology that suits the home country's technology. Study the compatibility of the technology to the culture of the host country including the taste and preferences of the host country's customers. Study the transfer host country's governmental policies regarding technology Study the modes of technology transfer like joint ventures, technological alliances etc. Study the impact of the technology on the environment of the home country including the laws pertaining to environmental pollution.

Appropriate technology

As indicated earlier, technology that suits one country may not be suitable to other countries. As such the countries develop appropriate technologies which suit their topographical conditions, climatic conditions, soil conditions, conditions of infrastructure etc. For example, Japanese automobile industry and Korean automobile industry design different types of cars which suit the Indian roads.

2.8.7 Technology and Globalisation

The industrial revolution resulted in large-scale production. Added to this, the recent technological revolution led to the production of high quality products at lower costs. These factors forced the domestic companies to enter foreign countries in order to find markets for their products. Thus, technology is one of the important causes for globalisation.

Information technology and globalisation

As indicated earlier, the information technology redefined the global business through its developments like internet, www sites, e-mail, cyberspace, information super highways. Computer Aided Design (CAD), Computer Aided Production (CAP) and on-line transactions brought significant development to the global business. These facilities, according to M.J. Xavier, help the global companies in:

- Reducing the size of inventories
- Reducing delivery time
- Reducing unproductive waiting time
- Reducing the incidents of stock-outs and lost sales
- Responding to market changes at a faster rate
- Reducing rush orders.
- Cutting down over production
- Reducing unnecessary movements of forwarding and back-tracking
- Reducing paper work and wasteful process
- Planning production levels accurately
- Reducing/avoiding physical movement of employees, suppliers, and customers.

MNCs have to understand and analyse more of economic environment of the foreign countries for strategy formulation.

2.9 Legal Environment

Every business firm operates within the jurisdiction of legal system. This is true of domestic as well as international firms. But the problem for the international firms is that the laws that they face in their home countries might be different from those encountered in the host countries. Advertising laws in West Germany, for instance, are so strict that it is best advised for the international marketer to get himself good legal counsel before framing his advertising strategy in West Germany. Similarly, there exist laws in European countries preventing promotion of products through price discounting. These laws are based on the premise that such practices differentiate buyers.

- Different laws exist not only in the area of marketing mix variables but also for other business decisions like location of plant, level of production, employment of people, raising money from the market, accounting and taxation, property rights including immovable, property and patent and trade marks, cancellation of agreements.
- Besides directly influencing firm's business operations, laws affect the environment within which a firm operates in the foreign country. Thus while one country may promote competition within its markets through its legal system, another country might try to protect its industry and thereby restrain competition. In the United States, for instance, 'anti-trust legislation influences all mergers, take-overs, and business practices which are in restraint of trade. Court's verdicts in this respect are governed by paragraph one of Sherman Act. Gillette, for example, was prevented from taking over Braun A.G. of West Germany which was an electric razor manufacturer on the grounds that it would distort competition.
- A major problem with laws in different countries is that the legal systems of the world are not harmonised and are in fact based on contradicting legal philosophies. The legal systems that exist in different countries of the world are antecedents of one of the two legal philosophies, viz., common law and code law.

- Common law finds its roots in Britain and is practised today in the United States, United Kingdom and Canada. Code law, on the other hand, is based on Roman law and is an all inclusive system of written rules that encompass all eventualities. One important business implication of the two legal philosophies is that the judgements awarded in the case of a commercial dispute can be radically different.
- To illustrate, take the interpretation of non-fulfilment of required conditions of a contract under 'Act of God'. What constitutes an 'Act of God' in code law is not necessarily the same under common law. Thus while strike by workers may be looked upon as an 'Act of God' in code law, it will definitely not be a reason for non-fulfilment of the contract under the common law.
- In last few decades, efforts have been made to evolve international laws, International laws deal with upholding orders. Originally these laws recognised only nations as entities, but today these laws also incorporate role played by individuals.
- International laws may be defined as a set of rules and regulations which the nations consider binding upon themselves. This definition brings out two important characteristics of international law. One there is absence of the existence of a comprehensive legal system. There is truly no comprehensive body of law because as stated earlier international commercial law is of recent birth. This has had a direct bearing upon the existing administering authorities.
- As of today, there are only a few international bodies for administering justice. These include the international Court of Justice founded in 1946 and the World Court at Hague. Second characteristic of the international law relates to the fact that no nation can be forced into these rules as stated in the phrase 'consider binding upon them'. Since all nations recognise the sovereignty of the legal systems, international judgements are, therefore, based on the premise of good humanity and not on the basis of any particular country's legal system.
- In the absence of laws having jurisdiction over sovereign countries, a major problem faced by the international business firms is which country's laws, viz. home country's or home 'country's or third country's laws, shall be binding in the case of a dispute. Firms also need to be aware of different modes of the settlement of trade disputes and role of international Chamber of Commerce' Court of Arbitration.

2.10 Ecological Environment

Ecology refers to the pattern and balance of relationships between plants, animals, people and their environment. Earlier there was hardly any concern for the depletion of resources and pollution of the environment. Smoke stemming from the chimneys and the dust and grime associated with factories were accepted as a necessary price to be paid for the development.

But in recent years, the magnitude and nature of the 'pollution overload' have assumed such alarming proportions that pressures have built up all over the world to do something urgently lest the situation gets out of control. In almost all the countries, there exist today legislations and codes of conduct to preserve the earth's scarce resources and put a halt to any further deterioration in the environment. Business considerations of the international firms are no exceptions and have been brought under such regulations. Recently, the United States government imposed a ban on exports of marine products from countries including India which did not have special devices fitted into fishing trawlers to free the tortoises trapped during fishing expeditions. Similarly, restrictions have been put on garment exports using cloth processed through the use of AZO dyes. Germany today is perhaps the country with most stringent environmental laws in the world.

The concept of industrial progress and development has also undergone paradigm shifts. Corporations today are judged in terms of not only financial returns, but also conservation of environmental resources and reduction in pollution levels. Green technologies, green products and green companies are highly valued in today's global market place.

Summary

- Factors that affect International Business include Social and Cultural factors (S), Technological factors (T), Economic factors (E), Political/Governmental factors (P), International factors (I) and Natural factors (N).
- Micro external environmental factors include: competitors, customers, market intermediaries, and suppliers of raw materials, bankers and other suppliers of finance, shareholders, and other stakeholders of the business firm.
- Micro environment can be defined as the actors in the firm's immediate environment which directly influence the firm's decisions and operations. These include: suppliers: various market intermediaries and service organisations such as middlemen, transporters, warehouses, advertising and marketing research agencies, business consulting firms and financial institutions; competitors, customers and general public.
- Various dimensions one needs to consider while attempting an economic and financial analysis include: foreign country's level of economic development, income, expenditure pattern, infrastructure including financial institutions and system, inflation, foreign investment in the country, commercial policy, balance of payments account, accounting systems and practices, and integration of the foreign country's foreign exchange, money and capital markets with the rest of the world.
- Social groups and organisations mould the pattern of living and interpersonal relationships of people in a society. They influence the behavioural norms, codes of social conduct, value systems, etc., that may be of relevance to the international business managers in their decision making.
- In some countries like the USA, Canada, Germany and Switzerland the messages that the people convey are explicit and clear. They use the actual words to convey the information. These cultures are called 'low-context cultures'.
- Cultures which handle information in a direct, linear fashion are called, "monochronic."
- In some countries, communication is mostly indirect and the expressive manner in which the message is delivered becomes critical. Much of the information is transmitted through non-verbal communication. These messages can be understood only with reference to the context. Such cultures are referred to as, "high-context cultures."

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Self Assessment

1. _____ defined the term environmental analysis as, “the process by which strategists monitor the economic, governmental/legal, market/competitive, supplier / technological, geographic and social settings to determine opportunities and threats to their firms.”
 - a. Reginald Revans
 - b. Vincent Bollore
 - c. William F. Glueck
 - d. Douglas McGregor

2. _____ can be defined as the factors in the firm’s immediate environment, which directly influence the firm’s decisions and operations.
 - a. Micro environment
 - b. Macro environment
 - c. Mini environment
 - d. Major environment

3. An analysis of _____ enables a firm to know how big is the market and what its nature is.
 - a. geographical environment
 - b. economic environment
 - c. social environment
 - d. political environment

4. _____ is one of the variables related to the country’s monetary and fiscal policies and have a substantial impact on the costs and profitability of business operations.
 - a. Deployment
 - b. Inflation
 - c. Deflation
 - d. Employment

5. Match the following:

1. Culture	A. Sum total of man’s knowledge, beliefs, art, morals, laws, customs and any other capabilities and habits acquired by man as a member of society.
2. Balance of Payment Accounts	B. Throws light on the country’s exports and imports as well as its major sources of imports and destinations of exports.
3. Capital Stock	C. Reveals stocks of foreign investments, borrowings, lending and foreign exchange reserves.
4. Elements of Culture	D. Language, aesthetics, education, religions and superstitions, attitudes and values, material culture, social groups and organisations, and business customs and practices.

- a. 1-D, 2-C, 4-A, 5-B
- b. 1-A, 2-B, 3-C, 4-D
- c. 1-D, 2-C, 3-B, 4-A
- d. 1-B, 2-A, 3-C, 4-D

6. According to Ball and McCulloch, _____ refers to all manmade objects and its study is concerned with how man makes things and who makes what and why.
 - a. technological culture
 - b. spiritual culture
 - c. mechanical culture
 - d. material culture
7. Cultures, which handle information in a direct, linear fashion are called “_____.”
 - a. Monochronic
 - b. Polychronic
 - c. Dichronic
 - d. Semichronic
8. In some countries like the USA, Canada, Germany and Switzerland the messages that the people convey are explicit and clear. These cultures are called _____.
 - a. low-context cultures
 - b. high-context cultures
 - c. minimum context cultures
 - d. peripheral context cultures
9. _____, which is defined as the vulnerability of a project to the political acts of a sovereign government is a big threat to foreign business.
 - a. Political risk
 - b. Climatic changes
 - c. Social change
 - d. Terrorism
10. _____ is a mild form of intervention and involves transfer of control of foreign investment to national ownership to bring the firm's activities in line with national interest.
 - a. Instability
 - b. Political unrest
 - c. Sovereignty
 - d. Domestication

Chapter III

International Business Theories

Aim

The aim of this chapter is to:

- introduce the international business theories
- explain the international trade theories
- highlight the efficiency in international trade

Objectives

The objectives of this chapter are to:

- explicate the leontief paradox
- analyse the foreign direct investment theories
- elucidate the intra industry trade and theories

Learning outcome

At the end of this chapter, you will be able to:

- discuss trade in intermediate goods
- understand the eclectic paradigm
- enlist different types of investment for internationalisation

3.1 Foundations of International Business

The analytical framework of international business is built around the activities of MNEs enunciated by the process of internationalisation. The FDI, on the part of an MNE attempts to overcome the obstructions to trade in foreign countries. The strategies relating to the functional areas, such as production, marketing, finance and price policies, are adopted by the MNEs in such a manner that an amicable relationship between home and host nations is created.

Foreign direct investment can be distinguished from the other forms of international business, such as exporting, licensing, joint ventures and management contracts. Basically, it reacts to the restrictions in foreign trade, licensing, etc., and its growth at the global level has taken place. This is due to the imperfections in the world markets and protective trade policies pursued by different countries for the sake of protecting their economies. There are different ways in which the MNEs have provided challenges to the imperfections and restraints in the world markets from an important part of the conceptual methods underlying the expanding role of international business.

Before the emergence of the MNEs, foreign trade and international business were regarded as synonymous, and international trade doctrines based on labour cost differentials and free trade guided the international transactions among different trading partners. The multinationals undertook FDI abroad, and their innovative efforts in technological development and management techniques, in a way, refuted the traditional trade theories. Several FDI theories have been developed in support of international business for the improvement and welfare of world economies. The fast growth of international business has also been conducive to foster close international economic relations among different countries of the world.

Now, the world economy is not only interdependent but also inter-linked, and any kind of R & D taking place in any part of the world has its impact on the entire global economy. The multinationals are to keep a constant surveillance on the fluctuating foreign exchange rates and inflation as these have a direct bearing on the profitability of international operations. The socio-cultural, political and economic environments of host countries also affect the investment decisions of foreign investors.

3.2 International Trade Theories

International business began with international trade operations, facilitated by the laissez faire in the world economy. It improved the well-being of many nations, and the imposition of trade barriers reduced the gains from trade, giving rise to the search for alternate avenues to exporting. The latter resulted in the establishment of subsidiaries in foreign countries through FDI. In this context, it is pertinent to understand the determinants of and the effects of international trade and FDI on the trading partners, international operations of multinationals and the economies of the home and host countries. Several theories have been formulated, from time to time, which form the bases of international trade and FDI.

3.2.1 Theory of Mercantilism

During the sixteenth to the three-fourths of the eighteenth centuries, the world trade was being conducted according to the doctrine of mercantilism. It comprised many modern features like belief in nationalism and the welfare of the nation alone, planning and regulation of economic activities for achieving the national goals, curbing imports and promoting exports.

The mercantilists believed that the power of a nation lied in its wealth, which grew by acquiring gold from abroad. This was considered possible by increasing exports and impeding imports. Such reasoning gathered support on the ground that gold could finance military expeditions and wars, and the exports would create employment in the economy. Mercantilists failed to realise that simultaneous export promotion and import regulation are not possible in all countries, and the mere possession of gold does not enhance the welfare of a people. Keeping the resources in the form of gold reduces the production of goods and services and, thereby, lowers welfare. The concentration in the production of goods for domestic consumption by using resources in a less efficient manner would also mean lower production and smaller gains from international trade.

The theory of mercantilism was rejected by Adam Smith and Ricardo by stressing the importance of individuals, and pointing out that their welfare was the welfare of the nation. They believed in liberalism and enlightenment, and treated the wealth of the nation in terms of the “the sum of enjoyments” of the individuals in society. Any activity, which would increase the consumption of the people, was to be considered with favour. Their trade doctrines were based upon the principles of free trade and the specialisation in the production of those goods where resources were most suitable.

3.2.2 Theory of Absolute Cost Advantage

The theory of absolute cost advantage was propounded by Adam Smith (1776), arguing that the countries gain from trading, if they specialise according to their production advantages. His doctrine may be understood with an example presented in the following table.

	One Unit of Goods A	One Unit of Goods B
Country I	10	20
Country II	20	10

Table 3.1 Labour cost of production (in hours)

(Source:<http://www.egyankosh.ac.in/bitstream/123456789/35341/1/Unit-2.pdf>)

The table shows that, in the absence of trade, both the goods are produced in both the countries, because of their demand in the domestic markets. The cost of production is determined by the amount of labour required in the production of the respective goods. The greater the amount of labour, the higher will be the cost of production, and the commodity will have a larger value in exchange. The pre-trade exchange ratio in country I would be $2A=1B$ and in country II $1A=2B$.

If trade takes place between these two countries then they will specialise in terms of absolute advantage and gain from trading with each other. Country I enjoys absolute cost advantage in the production of good A and country II in good B. One unit of good A may be produced in country I with 10 hours of labour, whereas it costs 20 hours of labour in country II. The production of the unit of good B costs 20 hours of labour in country I and 10 hours of labour in country II. After trade, the international exchange ratio would lie somewhere between the pre-trade exchange ratio of the two countries. If it is nearer to country I domestic exchange ratio then trade would be more beneficial to country II and vice versa.

Assuming the international exchange ratio is established $1A=1B$, then both the trading partners would be able to save 10 hours of labour, which may be used either for the production of other goods and services or may be enjoyed by the workers as leisure, which improves their welfare in either way. The terms of trade between the trading partners would depend upon their economic strength and the bargaining power.

3.2.3 Theory of Comparative Cost Advantage

Ricardo (1817), though adhering to the absolute cost advantage doctrine of Adam Smith, pointed out that cost advantage to both the trade partners was not a necessary condition for trade to occur. It would still be beneficial to both the trading countries even if one country can produce all the goods with less labour cost than the other country. According to Ricardo, so long as the other country is not equally less productive in all lines of production, measurable in terms of opportunity cost of each commodity in the two countries, it will still be mutually gainful for them if they enter into trade.

	One Unit of Goods A	One Unit of Goods B
Country I	80	90
Country II	120	100

Table 3.2 Labour cost of production (in hours)(Source: <http://www.egyankosh.ac.in/bitstream/123456789/35341/1/Unit-2.pdf>)**3.2.4 Opportunity Cost Theory**

One of the main drawbacks of the Ricardian comparative cost theory was that it was based on the labour theory of value which stated that the value or price of a commodity was equal to the amount of labour time going into the production of the commodity. Gottfried Haberler gave a new life to the comparative cost theory by restating the theory in terms of opportunity costs in 1933. The opportunity cost of anything is the value of the alternatives or other opportunities which have to be foregone in order to obtain that particular thing. For example, assume that a given amount of productive resources can produce either 10 units of cloth or 20 units of wine. Then the opportunity cost of 1 unit of cloth is 2 units of wine. Thus, the opportunity cost approach defines cost in terms of the value of the alternatives of other opportunities which have to be foregone in order to achieve a particular thing.

According to the opportunity cost theory, the basis of international trade is the differences between nations in the opportunity costs of production of commodities. Accordingly, a nation with a lower opportunity cost for a commodity has a comparative advantage in that commodity and a comparative disadvantage in the other commodity. Suppose that the opportunity cost of one unit of X is 2 units of Y in country A and 1.5 unit of Y in country B. Then Country A must specialise in production of Y and import its requirements of X from B, and B should specialise in the production of X and import Y from A rather than producing it at home.

Assumptions

The opportunity cost theory too is based on most of the common assumptions of the classical theories.

The important assumptions of this theory are as follows:

- Two-country, two-commodity model.
- There are only two factors of production, viz., labour and capital.
- Factors of production are perfectly mobile within a country but immobile between countries. Factors of production are fixed. There is perfect competition in full supply in both factor and product markets.
- The price of each factor is equal to its marginal productivity in each employment.
- The price of each commodity is equal to employment in each country.
- There is no technical change.
- International trade is free.

Merits

The opportunity cost approach is superior to the Ricardian theory in the following ways: It recognises the existence of many different kinds of productive factors (although for simplicity sake the theory considered only two factors) whereas Ricardo considered only labour. The opportunity cost theory tells us that even if we discard the labour theory of value as being invalid and rely on the opportunity cost theory, the comparative cost theory is still valid. The opportunity cost theory considers trade under constant, increasing and decreasing costs, whereas the comparative cost theory assumes constant cost of production. It recognises the importance of factor substitution. It provides a simple general equilibrium model on a number of unrealistic approaches in production of international trade.

Criticisms

The opportunity cost theory is subject to the following criticisms, Jacob Viner, in his *Studies in the Theory of International Trade*, argued that the opportunity cost approach is inferior to the classical real cost approach as tool of welfare evaluation in as much as it fails to measure real costs in terms of sacrifices, disutility's or irksomeness. Viner also argued that the opportunity cost approach ignores the changes in factor supplies. However, V. C. Walsh points out that the changes in factor supplies can be measured in terms of opportunity cost by taking into account changes in commodity price ratio and marginal productivities of factors. Yet, another criticism of the opportunity cost approach by Viner is that it fails to take into account the preference for leisure vis-a-vis income. This criticism has also been refuted by Walsh by arguing that when the trading nations exchange at an international price ratio, there will normally be an increase in real income and part of this will be taken in the form of more leisure, so that the output of both commodities may decrease.

Conclusion

The opportunity cost theory of Haberler is a refinement of the Ricardian theory. As far as the basis of international specialisation and trade are concerned, the logic behind the comparative cost approach and the opportunity cost approach are the same. Paul Samuelson, who has highly appreciated the comparative cost theory makes following observation about Haberler's theory: "the opportunity cost approach is more fertile because it can be readily extended into a general equilibrium system. It is, therefore, not surprising that the opportunity cost approach has gained more and more popularity and it is used by even who, in principle, attack it.

3.3 Efficiency in International Trade

As shown in the above table, country I enjoys absolute cost advantage in the production of both the goods A and B as compared to their production in country II. But country I has comparative cost advantage in good A and country II in good B. We take the help of the concept of opportunity cost in order to know the relative comparative advantage in the production of the goods in the two countries me opportunity cost to produce one unit of good A is the amount of good B which has to be sacrificed for producing the additional unit of good A.

In the example given in the table, the opportunity cost of one unit of A in country I is 0.89 unit of good B and in country II it is 1.2 unit of good B. On the other hand, the opportunity cost of one unit of good B in country I is 1.125 units of good A and 0.83 unit of good A, in country II. The opportunity cost of the two goods are different in both the countries and as long as this is the case, they will have comparative advantage in the production of either, good A or good B, and will gain from trade regardless of the fact that one of the trade partners may be possessing absolute cost advantage in both lines of production. Thus, country I has comparative advantage in good A as the opportunity cost of its production is lower in this country as compared to its opportunity cost in country II which has comparative advantage in the production of good B on the same reasoning.

The gains from trade in terms of Ricardo's doctrine may be understood by distinguishing the terms of trade under 'autarky' (i.e., having no trade with the outside world because of the closed economy) and in terms of trade with the outside world. The domestic exchange ratio is determined by internal cost of production. In the table, the exchange ratio before trade in country I should be $1A=0.89B$ and in country II $1A=1.125B$. If the international exchange ratio prevails between 0.89 and 1.125, the international trade would be gainful to both the countries. Assuming it settles at $1A=1B$ then country I gains 10 hours of labour and country II gains an equivalent of 20 hours of labour.

Both the absolute advantage and comparative advantage theories failed to realise that the welfare of society does not depend only on the gains from the international trade but depends upon the way the gains are distributed. The individual gains under the theories are not guaranteed unless the government adopts an appropriate redistribution policy. There have to be certain incentives for the producers also in order to keep them engaged in the exportable production. These theories have also been criticised on the ground that labour is not the only input determining the cost of production.

Patterns of multilateral trading

Trade patterns in more than two countries involving two or more than two commodities.

Country I	1 unit of A = 0.89 unit of B
Country II	1 unit of A = 1.2 unit of B
Country III	1 unit of A = 1 unit of B

Table 3.3 Domestic exchange ratios

(Source: <http://www.egyankosh.ac.in/bitstream/123456789/35341/1/Unit-2.pdf>)

The above table explains that given the domestic exchange ratios in different countries, the possibilities of multilateral trading among them would depend upon the existing international terms of trade. The limits within which the three countries may be benefited by trade are $0.89B < PA/PB < 1.2 B$. After trade, if PA/PB settles as $PA/PB > 0.89B$ and $> 1B$, then country I exports goods A to both the countries II and III; and imports B from them. All the three trade partners benefit by such trade.

On the other hand, then PA/PB is greater than 1 unit of B but less than 1.2 units of B then both the countries I and III export good A to country II and import good B from these countries. In the case of PA/PB settling equal to 1 unit of B, trade will occur only between country I and country H. Country I will export good A to country H and import good B from country II. Country III would not benefit from its entry into the international trade.

Commodity	Price in Country I in Rupees	Price in Country II in Dollars	Price in Country III in Franks
A	2	10	3
B	5	8	5
C	7	7	7
D	9	5	10
E	13	2	14

Table 3.4 The case of more than two commodities

In the table, prices per unit of different products are given in three countries in terms of their respective currencies. What commodities would or would not be dealt with among the trade partners would depend upon the prevailing exchange rates of their currencies in the market. If $Re = \$1 - Fl$, the price ratio in country II and country III remains the same.

Country I will export commodities A and B to country H and import commodities D and E from this country. In the case of country III, the exports of country I would consist of commodities A, D and E while commodities B and C would be non-tradable between them. Commodity C is non-tradable among all the trade partners.

Along with the change in the exchange ratio in the currencies of the trade partners, the prices of all the commodities in the trading countries are expressed in the same currency and then compared with the prices in the domestic economy. For instance, if Re 1 equals \$2 and Re 1 is also equal to F2 then the prices of different goods in country II and III will be calculated in rupee terms and then compared with the price in country I for the purpose of exports and imports.

Efficiency in international trade

Efficiency may be achieved in international trade and gains maximised if a country trades in those goods where it has comparative advantages determined by the international price ratios. Given the competitive market system, a country under non-trade situation would be optimising its production and the welfare of its people when the marginal rate of substitution in consumption (MRS) equals the marginal rate of transformation (MRT) in production, and it

is, in turn, equal to the relative price of the two goods, say A and B, P_A/P_B . The supply side of the economy of a country is illustrated by production possibility curve (PPC) and the preferences of the consumers are given by the community indifference curve. The efficiency in the production situation and the optimisation of the welfare of a country under autarky trade policies may be understood from the figure below.

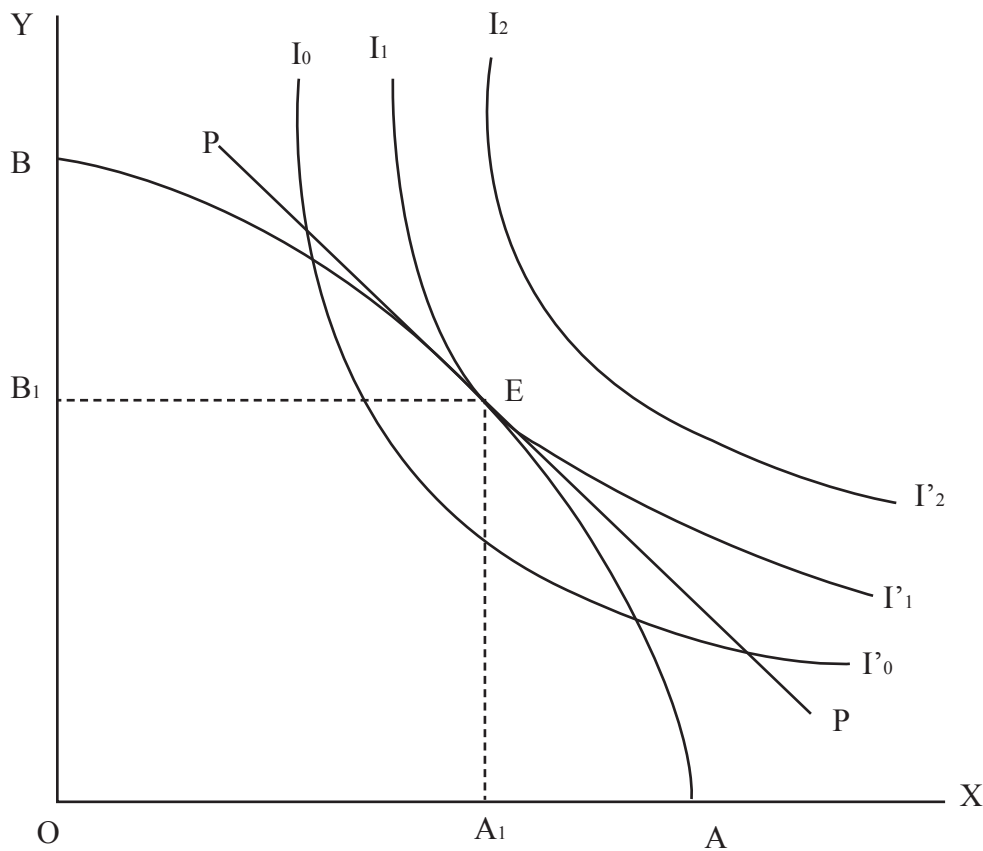


Fig. 3.1 Efficiency under Autarky

(Source: <http://www.egyankosh.ac.in/bitstream/123456789/35341/1/Unit-2.pdf>)

In the figure, the production limits of a country are explained by the AB Production Possibility Curve. There are two goods A and B. Good A which may be assumed an agricultural commodity, is measured along the X axis and good B, a manufacturing commodity is measured along the Y axis. Given the resources and the techniques of production, the country may either produce OA amount of good A or OB amount of good B. Equilibrium in the domestic economy is achieved at point E where the price line PP is tangent to the production possibility curve and the community indifference curve I_1 is also tangent to the price line at the same point.

$MRS = MRT = P_A/P_B$. On either side of E, the consumer will get on a lower indifference curve and lower welfare, which is not a preferred situation when the same resources can yield higher satisfaction. The country will not have resource allocation inside the PPC, because it will end up with low production of goods. The efficiency in both production and consumption in a closed economy will be at point E.

The country will experience gains from trade, if the international terms of trade differ from the domestic terms of trade and the resources are reallocated towards the production of the commodity having remunerative price in the foreign market. The efficiency and the gains from international trade may be illustrated in the figure.

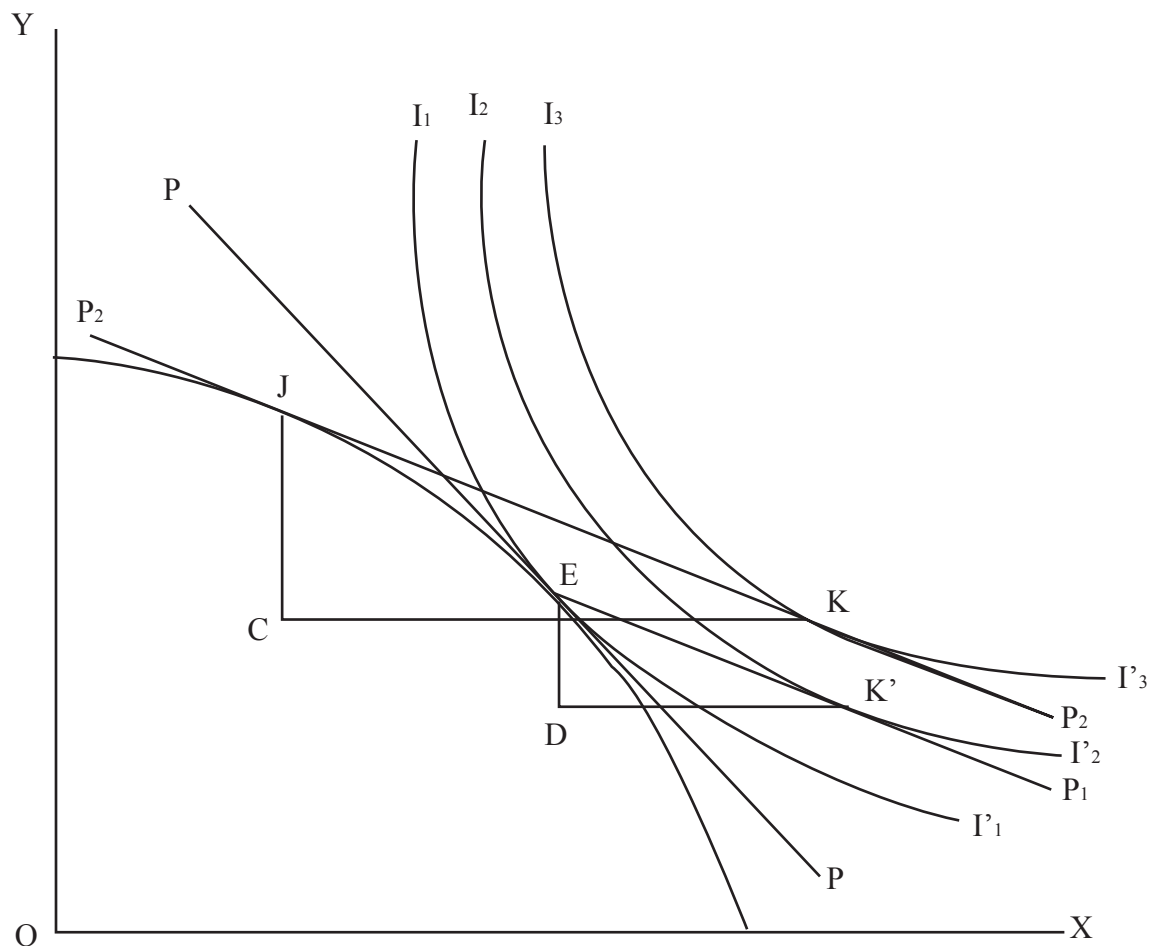


Fig. 3.2 Efficiency under international trade

(Source: <http://www.egyankosh.ac.in/bitstream/123456789/35341/1/Unit-2.pdf>)

The above figure examines the possibilities of trading and achieving efficient production and consumption in an economy which is opened to world trade. Before trade, the country produces and consumes at point E with welfare contour I_1I_1' . Under trade, the world price is given by P_2P_2 showing the exports of goods A which are being more profitable in the international market. The production is oriented towards good B where the country now enjoys competitive advantage and produces at J, which is the point of tangency between PPC and the world price line. At point J, the $MRT = \text{the international terms of trade, i.e., } PTA/PTB$. The consumption is at K where the highest I_3I_3' is tangent to the international price line P_2P_2 . Here, $MRS = PTA/PTB$.

The gains from trade are apparent by the movement of the country from indifference curve I_1I_1' to I_3I_3' , which is a higher social welfare curve. The gains from trade arise because of two reasons:

- the possibility of exchanging goods on favourable terms in the foreign exchange markets
- the possibility of specialisation in exportable products.

If a country is unable to change its production structure, the trade will still be gainful due to the higher prices abroad. For instance, the $K'D$ amount of goods A may be imported by exporting only the ED amount of good B while production continues at E. This places the country at I_2I_2' , indifference curve, which is higher than I_1I_1' , and yields a higher amount of welfare. EP_1 is the world price line, and it is drawn parallel to P_2P_2 world price line, which means that trading is taking place at the international price line I_2I_2' and the indifference curve is tangent to the EP_1 world price line at K' . The movement from E to K' is the gain from trade arising from the possibility of exchange.

However, this would not be the optimal situation. The country would be maximising gains if it could produce more of good B by withdrawing resources from good A and produce at J and consumes at K. Both the community indifference curve and the PPC are tangent to the world price line P_2P_2 , and $MRT = MRS$. The movement from K1 to K represents the gains arising from the possibility of specialisation in production. There is a balance in trade, i.e., the exports of the country are equal to its imports: $P_B \times JC = P_A \times CK$; P stands for the price of the tradable goods.

3.3.1 Heckscher-Ohlin Trade Model

Adam Smith and Ricardo's trade models considered labour as the only factor input and the differences in the labour productivity determining the trade. Eli Heckscher (1919) and Bertin Ohlin (1933) developed the international trade theory (H.O. Trade Model) with two factor inputs, labour and capital, pointing out that different countries have been bestowed with different factor endowments, and the differences in factor endowments cause trade between the trading partners.

- The theory is based on the assumption that there are impediments to trade, and that there is perfect competition in both the product and factor markets. Further, the theory is based on the comparative advantage in terms of the relative factor prices.
- A country specialising in the production of the goods which require its abundant factor can export them. Thus, if a country is rich in capital, it will produce capital intensive products and export them in exchange for the labour intensive products. On the other hand, another country, rich in labour, will produce labour intensive goods and export them. It will import capital intensive goods.
- In the H.O. trade theory, the factor abundance has two meanings the factor abundance in terms of the factor prices, and the, factor abundance in terms of the physical amount of the factors. Assume there are two countries: I and II, then the richness of the country in terms of factor prices means relatively low price of the factors of production.
 - Country I is rich in capital as compared to country II, if $P_{ic}/P_{il} < P_{2c}/P_{2l}$. P_{ic} is the price of capital in country I and P_{il} is the price of labour in country I, and P_{2c} is the price of capital in country II and P_{2l} is the price of labour in country II.
 - The second definition of the factor abundance compares the overall physical amount of labour and capital. Country I is capital rich, if the ratio of capital to labour in this country is larger. $C_1/L_1 > C_2/L_2$, where C_1 and L_1 are the total amount of capital and labour in country I, and C_2 L_2 are the total amount of capital and labour in country II, respectively.
 - The H.O. trade theory holds good, if the factor abundance is defined in terms of factor prices, because of the incorporation of the demand factor in it.
- In the overseas market, the price is given by the P_2P_2 international price line. Now, the countries move to the points J and K tangent to the international price line, and country I is producing more of good A and country II more of good B. By exchanging goods of their specialisation under free trade, they reach to the I_2II_2 indifference curve at point E and enjoy gains from the international trade as E lies on the higher indifference curve.
- As in the case of the classical trade model, the H.O. trade theory also cannot guarantee the (desired) income distribution among different classes in the country. In country I, the returns to capital are higher and, in country II, the returns to labour are higher because of the greater demand for producing respective goods for the world market.
- The basic trade models are based upon certain assumptions, such as no transportation cost and free flow of information to all the producers and consumers. They do not take into account the effect's of trade on the world prices. These trade theories are static, and ignore the effects of technological progress on the growth of the world economy. These are the real issues and need to be incorporated in a modified version of the classical and neo-classical theories.
- If a nation has monopoly in certain products, it may influence the world price. It may enhance its gains by "optimum tariffs", which seek to maximise the welfare of the country. Trade may complicate the growth process. It may affect the employment and may even reduce the welfare of the country. This may occur in the case of immerse rising growth (when benefits from the higher output are neutralised by the unfavourable terms of trade).

- The country ends up with lower real income after growth because the gains arising from higher output are wiped out by the deteriorating terms of trade. It may, however, be noted that the modified version of the basic theory does not alter the conclusion that a country produces and exports the commodity in which it has comparative advantages, and uses the abundant factor in its production. Trade benefits the nation, but the distribution of gains may be skewed. Adjustment to trade is not costless but the short-term cost to adjustment should be weighted against the long-term gains from trade.

3.3.2 The Leontief Paradox

There was a setback to the proponents of the H.O. trade theory in the early 1950's, when Leontief tested his hypothesis that capital rich countries export capital intensive goods and import labour intensive goods and vice versa with the help of the input-output data of the United State's economy. His results refuted the H.O. contention. It was shocking news for the economists that the U.S. being a capital rich country should be exporting labour intensive goods and importing capital intensive goods. Several explanations were looked into for resolving the Leontief paradox. The key factors identified in support of the Leontief paradox were: U.S. protective trade policy, import of natural resources and the investment in human capital.

William P. Travis examined the Leontief theory in terms of the U.S. tariff policy. When Leontief tested his hypothesis, the U.S. was importing more of such items as crude oil, paper pulp, primary copper, lead, metallic ores and newsprint, which are capital intensive. Thus, according to Travis, the U.S. protective trade policy was responsible for Leontief's findings.

The U.S. imports of natural resources like minerals and forest products and the exports of farm products further support the Leontief presentation. Investment in human capital raises the productivity of labour. That is why the exports of the U.S. consisted of labour intensive products and its imports were of capital intensive nature.

3.4 Foreign Direct Investment (FDI) Theories

The search for FDI theories is a recent phenomenon, despite the domination of world production and trade by the MNEs in the post Second World War period. It was in 1960, when Stephen, H. Hymer, in his doctoral dissertation. *The International Operations of National Firms: A Study of Direct Investment* (published in 1976) revealed that the orthodox theories of international trade and capital movements are unable to explain the involvement of MNEs in foreign countries. Their existence owed to the local firms wielding market power, and who acted as their agents. The approaches which explain the activities of multinational enterprises may broadly be classified into four groups.

- Firstly, there is market imperfection approach whose theoretical framework considers certain specific advantages, also known as ownership advantages, enjoyed by an enterprise. The FDI is controlled through these advantages and the international companies also enter into collusion with other firms for increasing their profits,
- Secondly, Product Life Cycle model examines the various stages of the firm. There are sequential stages in the life cycle of the products innovated by a particular company.
- Thirdly, the failure of the orthodox theories of international trade and capital movements based upon the assumption of perfect competition and its prevalence in different segments of international market provide adequate explanation for the substitution of the FDI. It gave rise to the transaction cost theory of the FDI that the firms undertake foreign investments for raising their efficiency and reducing the transaction costs.
- Fourthly, the eclectic paradigm encompassing other FDI theories which provide an analytical framework to the analyst for carrying out empirical investigations most relevant to the problem at hand. The eclectic paradigm is not a theory in itself but some sort of synthesis of the conflicting theories.

3.4.1 Market Imperfections Approach

The rise of the MNEs continuously puzzled the minds of neoclassical economists as to how these enterprises could make profits in foreign countries where production costs are more than at home. Being generally unaware of the host country's environment, it should be rather difficult to take advantage there. It may be better for the foreign company to pass on its advantages to the local entrepreneurs who, together with other local (inherent) advantages, could produce at a lower cost than the foreign investors.

The answer to this paradoxical situation is available in the presence of the imperfect market in the foreign countries. Hymer presented a case for market imperfection approach. According to him, the orthodox theories of the international trade and capital movements were inadequate to explain the involvement of MNEs in international business. Their presence is due to market imperfections. The advocates of this approach thought that the prevailing market imperfections were 'structural' (imperfections of monopolistic nature), and arose from the innovation of superior technology, access to capital, control of distribution system, economies of scale, differentiated products (by the introduction of different advertising methods) and superior management. These factors enabled the foreign enterprises to more than offset the disadvantages from their operations in the foreign environment and the additional cost incurred there.

Hymer was basically concerned with the market power of the MNEs, which restricted the entry of other firms. The market power arises from collusion with others in the industry to avoid competition: which results in the larger profits. There is one way casual link between the behaviour of the firm and the imperfect market structure. The market power is first developed in the domestic country and, after the profit margin becomes lower in the home country, the firm invests abroad and controls the foreign markets by its patent rights.

3.4.2 Product Life-Cycle Approach

The product life-cycle approach is associated with the work of Raymond Vernon. Published in 1966, it deals with the evolution of the U.S. multinationals and foreign direct investment patterns. In Vernon's model, three stages are followed in the introduction and establishment of new products in the domestic and foreign markets, with emphasis on innovation and oligopoly power as being the first basis for export and later for the FDI.

- The first stage in the sequential development of the product is the new product stage which emerges in the home country following innovations as a result of intense R&D activities by the company. The product is introduced in the overseas market through export, and the innovating firm earns excessive profits both from domestic sales and exports abroad because of its monopoly position.
- The second stage is, characterised by the mature product stage, when the demand in the foreign countries expands and the host country firms begin to produce competing products. The home country enterprise is induced to invest abroad for taking advantage of its technology and increasing demand for the product. As the company specific advantages of the firms controlling the technology are much higher than the local firms, the production in the host country would be cheaper. It stimulates foreign investment in subsidiaries.
- In the third stage, the product becomes standardised, and competition grows in, the world market. The MNEs invest even in the LDCs, where the cost of production is lower. The host country, otherwise, has to import these products from abroad because its own production cost is more. The foreign investment may take the form of licensing arrangements also.

The initial analysis of the product life cycle approach gives a good account of the nature of the expansion of the U.S. companies after World War H. The theory was modified by Vernon in 1971 and 1977 in the light of the oligopoly threat arising from global innovative activities. He identified the first stage as the emerging oligopoly, the second stage as the mature oligopoly and the third stage as the senescent oligopoly, referring to the state of production when the standardised product is entirely produced abroad. The home country, where the product was initially innovated, imports all of the goods that it needs. Vernon's PCM model is summarised in the table.

3.4.3 Transaction Cost Approach

Nature of stage product	Produce at Home or Abroad (1966)	Nature of Internal Business	Foreign Investment	Modified (1977)
New product I	Home	Export	Nil	Emerging oligopoly (innovation based)
Maturing II Product	Abroad	Import	FDI (By Subsidiaries)	Mature oligopoly
Standardised III Product	Abroad	Import	(By licensing agreements)	Senescent oligopoly

Table 3.5 Vernon product life cycle approach

3.4.4 Different types of Investment for Internationalisation

Different types of investment for internationalism are explained below.

Horizontal investments

Horizontal investments take place for the internalisation of such assets of the company, which are intangible and cannot be priced in the market. Some of the intangible assets are the firm's specific knowledge, goodwill, management skills and marketing know-how. The basic problem is the protection of the investor's right against the infringement of his patents (in the case of knowledge) and trade marks or brand names of the products creating goodwill for the producers.

If the patent system is such that the host country authorities provide full protection to the patents, then the more prevalent form of international business will be the licensing agreements. When the patent rights are not well-protected and the transfer of knowledge may not be easily codified into patents and the fear of imitation is around, the horizontal investment will be the alternative undertaken by the investor himself for keeping his innovations secret and internalising the foreign market for his particular technology.

Vertical investment

The vertical FDI for integrating the various stages involved in the final production is the most common form of internalisation. It has been found both in backward and forward integrations. The MNEs based in the developing countries have undertaken direct investments for procuring and maintaining smooth supply of such raw materials as crude oil, iron ore and natural rubber needed for their downstream activities. The transaction cost theorists advocate that such backward integration is made when the transaction costs of buying new materials and intermediate products are high. The quality control also becomes possible in vertical integration.

Internalisation of foreign markets also takes place through forward integration in the form of distribution and marketing services. If the distribution and marketing services are left to the distributing agents, these may be problems with regard to their reliability. These may even be defaults in the timely supply of the produce, its demonstration, installation, after sales services, etc. All this bring a bad name to the company. Thus, an MNE invests abroad not only to lower the transaction cost but also to retain its goodwill.

Free standing companies

In the period prior to World War I, many of the European multinationals were free standing companies. They were active in mobilising resources from the capital rich countries like the United Kingdom, and investing them in the capital poor countries. The foreign investment in Malaysia in the rubber plantations and tin manufacturing conforms to this type of investment pattern. Indeed, free standing Arms raise funds freely from the major capital exporting countries, and locate the plants abroad for reducing the transaction -cost. The lenders prefer to invest in equity capital rather than buying foreign bonds, because they can exercise a greater degree of control over the-management of standing firms.

Some writers, such as Fieldhouse, do not include the free standing firms in the transaction cost approach. Their assertion is that the MNEs acquire competence from their R&D activities in the domestic market. These advantages are exploited in the foreign markets later on. The free standing firms do not develop any skill, and they just operate on a little more than a brass name plate somewhere in the city. The incapacibilities and the lack of (Trade) Theories efforts on the part of the free standing firms to develop specific advantages have been found to be the main reasons for the failure of some British and U.S. companies.

Equity joint ventures

Equity joint ventures are also explained by the transaction cost approach and preference for such alternatives as contracts, mergers and acquisitions. Under the equity joint ventures, the management and profits are shared by two or more participants, while in contracts a single party holds the responsibility. The possibility of supplying the low quality input is much under the contract management, as the contract supplier does not share the profit. In the case of equity joint ventures, the party supplying the inferior input is to bear the burden according to its equity stake. Thus, the equity joint venture arrangements are preferable, because they combine the interests of the interacting parties.

The equity joint ventures are in a better position to meet the high transaction cost conditions in contrast to the mergers and acquisitions, when there are complementary assets in the parent and host countries. If such assets are pooled in joint, ventures, the company specific advantages and the country specific advantages are coordinated more efficiently, leading to success. The case of Japanese MNEs is prominent in this regard. They preferred to enter into joint ventures, when their experience of foreign markets was little because of the new businesses being different.

Spot purchases and long term contract

Spot purchases and long-term contracts for the supply of the raw materials and intermediate products are used as the efficient mode of organisation when the predictability of environment is quite satisfactory. It reduces the cost of enforcement, because of the ex-ante arrangement reached between the partners. But the drawback of contractual arrangement is that it operates under uncertainties, and its execution becomes complicated as the degree of uncertainties rises. The contracts are more operative and successful in the case of recurrent trades involving small number conditions and relatively predictable environment.

New forms of investment and counter trade

These are the substitutes of FDI. The transaction cost theorists treat them as an attempt to have greater enforceability of the contracts, which is not possible in the simple type of contracts. Counter trade, which is a recent phenomenon, is not merely a barter trade. It also involves the reciprocity clause and inherent attributes of increasing the enforceability of the contracts. The counter trade constitutes more than 15 per cent of the world trade. It served very well when the FDI was not considered a viable or desirable option.

On the same lines, new forms of investment as contractual substitutes to the FDI, like turnkey contracts, franchising, product sharing and management contracts, have been supported by transaction cost approach as other ways of international business. They have been encouraged by the LDCs to obtain technology, management skills and access to the markets dominated by the MNEs. At the same time, it avoids the cost of environmental uncertainties.

3.4.5 Eclectic Paradigm

The eclectic paradigm was developed by John Dunning in 1979 as an attempt to synthesise the other FDI approaches based on the company specific advantages, internalisation advantages and country specific advantages. As it is a synthesis of some of the foreign investment theories, it does not qualify to be a separate theory itself.

- The main purpose of the eclectic paradigm is to provide an analytical framework to the analyst so that he could choose the most suitable approach for the investigation that he intends to undertake. For example, the transaction cost approach may be most relevant for the investigations relating to the hierarchical coordination of the different stages of the production process. An MNE adopts both backward and forward integrations in this case.

- The eclectic paradigm assumes that the MNEs possess ownership advantages from their intangible assets in the form of technology. This has enabled them to reduce the transaction cost through the internalisation process. Internalisation advantages arise because of the exploitation of technology and the locational and other advantages accruing in the host country.
- Although, the ownership advantages may be transferred to the host country through the licensing arrangements; yet certain advantages are such that non-transferable benefits from them would occur only if they are managed within the MNEs themselves. Such advantages are organisational and entrepreneurial capabilities of the managers of the international firms, their experience of foreign markets, their political contacts and long-term business agreements with other enterprises. The control over technology and its coordination with the host country resources would promote R&D efforts, which can lead to the rapid growth of internationalisation of the world economy.
- The MNEs follow different approaches for reaping the ownership advantages. Some adopt the competitive approach for competing in the international markets, while others pursue the monopolistic approach. According to the competitive approach, the MNEs develop their competitiveness for a place in the foreign countries. In the case of monopolistic approach the ownership advantages arise from the monopolistic competition where the firms sell differentiated products.
- The eclectic paradigm provides merely a comprehensive framework. It does not specifically highlight the advantages of competitiveness in the foreign countries. It also does not take into account any single FDI theory on priority basis. It points out the circumstances which the investigator should take into account in deciding which FDI theory would suit his needs. The relevance of the eclectic paradigm lies in its application to the simultaneous, operation of the market imperfection approach and the transaction cost approach. The former theory helps in identifying the benefits enjoyed by the MNEs due to the imperfections in the foreign countries, and the latter is helpful in the reduction of the cost of transactions.

3.5 Intra Industry Trade and Theories

One important pattern of international trade left unexplained by the H-O theory is the intra-industry trade or the trade in the differentiated products, i.e., products which are similar but not identical (for example, different models of motor cars). A large proportion of such trade takes place between the industrialised countries. Historically, the pattern of international trade has undergone major changes. Until about the mid nineteenth century, an overwhelming proportion of international trade was constituted by inter-sectoral trade where primary commodities were exchanged for manufactured goods. This trade was, to a significant extent, based on absolute advantage derived from natural resources or climatic conditions. During the period 1950-1970, inter-industry trade in manufactures, based on differences in factor endowments, labour productivity or technological leads and lags, constituted an increasing proportion of international trade.

- Since 1970, intra-industry trade in manufactures, based on scale economies and product differentiation, has constituted an increasing proportion of international trade. Intra-industry trade now accounts for a major share of the international trade. As indicated above, intra-industry trade refers to the trade between countries in the products of the same industry. For example, a country simultaneously exports and imports steel, exports and imports motor cars, etc. Intra-industry trade is highly prevalent in the case of trade between developed countries. Developing countries, however, have been increasingly participating in intra-industry trade. India, for example, has been exporting as well as importing motor cars, electronic products, electrical equipments, crude oil, petrochemicals, textiles and clothing, cardamom, sugar and so on.
- The North-North trade growth has been driven mostly by intra-industry trade. The intraEEC trade has grown much faster than the average growth in the global trade. The trade growth between the members of the European Union has mostly been due to intra-industry trade rather than inter-industry trade. As Krugman and Obstfeld observe, “intra-industry trade tends to be prevalent between countries that are similar in their capital-labour ratios, skill levels and so on.

- Thus, intra-industry trade will be dominant between countries at a similar level of economic development. Gains from this trade will be large when economies of scale are strong and products are highly differentiated. This is more characteristic of sophisticated manufactured goods than of raw materials or more traditional sectors (such as textiles or footwear). Trade without serious income distribution effects, then, is most likely to happen in manufactures trade between advanced industrial economies.
- Estimates of the indices of intra-industry trade for US industry in the early 1990s has shown that it is more than 90 per cent for inorganic chemicals, power generating machinery, electrical machinery and organic chemicals, more than 80 per cent for medical and pharmaceutical and office machinery and more than 60 per cent for telecommunication equipment and road vehicles. On the whole, “about one-fourth of world trade consists of intra-industry trade, that is, two-way exchange of goods within standard industrial classifications. Since the major trading nations have become similar in technology and resources there are often no clear comparative advantage within an industry, and much of international trade therefore takes the form of two-way exchanges within industries - probably driven in large part by economies of scale - rather than inter-industry specialisation driven by comparative advantage.”
- Krugman and Obstfeld observe that “intra-industry trade produces extra gains from international trade, over and above those from comparative advantage, because intra-industry trade allows countries to benefit from larger markets ... by engaging in intra-industry trade a country can simultaneously reduce the number of products it produces and increase the variety of goods available to consumers. By producing few varieties, a country can produce each at large scale, with higher productivity and lower costs. At the same time consumers benefit from the increased range of choice.”

Intra-industry trade theories

- The interest in the intra-industry trade was largely stimulated by the studies done in the 1960s on the impact of the EEC on the trade flow between the member countries. These studies have shown that the major chunk of the trade is intra-industry trade. This encouraged economists to develop theoretical explanations for the growing intra-industry trade. There are indeed a variety of models, which seek to explain the reasons for intra-industry trade. Sodersten and Reed point out that these models, despite their variety, have the following common features: First, while it is possible to deduce that intra-industry trade will emerge, it is often impossible to predict which country will export which good(s).
- Second, diversity of preferences among consumers, possibly coupled with income differences, plays an important role. Third, similarity of tastes between trading partners may play a major role. Fourth, economies of scale are a frequent element of intra-industry trade models, and may be an important source of gains from trade. Finally, in many of these models the move from autarchy to free trade will involve lower adjustment costs than would be the case with inter-industry trade. The explanations for the intra-industry trade vary from simple reasoning to intricate analysis. One of the simple explanations of the intra-industry trade is the transportation cost. For example, in the case of geographically very vast country like India, the cost of transporting goods from one end of the country to the other extreme end would be very high and cross border trade will be beneficial for two adjoining regions of neighbouring countries, other things remaining the same.
- Another simple explanation is the seasonal variations between different countries in the production of a particular commodity. Factors such as transport cost, seasonal variations etc. cover a small proportion of the intra-industry trade. Another explanation for the intra-industry trade is that producers cater to ‘majority’ tastes within each country leaving the ‘minority’ tastes to be satisfied by imports. Such minor market segments which are overlooked or ignored by the major market players but have potential for other players are referred to as market niches in marketing management parlance. Such niches often provide an opportunity for entering the market by new or small players. For example, the large companies in the United States had ignored the market segments for small screen TVs, small cars, small horse-power tractors, etc. This provided a good opportunity for the Japanese companies, for whom these products had a large domestic market, to enter the US market. It may be noted that niche marketing has been a very successful international marketing strategy employed by Japanese companies.

- Over a period of time, sometimes consumer tastes and preferences, and demand patterns may change and a 'minor' market segment may become a large segment. Thus, the oil price hike substantially increased the demand for the fuel efficient compact cars in the US and the Japanese companies enormously benefited from it. Through shrewd marketing strategies a company could succeed, in many cases, in expanding a minor segment of the market into a large segment. Further, it has also been observed, particularly with regard to the Japanese companies, that after consolidating their position in a market segment, with the strength and reputation they have built up, they may gradually move to other segments and expand their total market share.
- Another reason for the failure of the basic H-O model to explain the intra-industry trade is, as Kindleberger and Lindert observe, "to recognise the inadequacy of lumping factors of production into just capital, land and couple of types of labour. In fact, there are many types and qualities of each. Further, there are factors specific to each sub-industry or even each firm.
- Heterogeneity is especially evident in the higher reaches of management and other rare skills." In short, the H-O theory can be extended to the inter-industry trade if we recognise the existence within each industry of number segments with distinctive characteristics and enlarge the definition of factor endowments to include such factors as technology, skill and management also. Disaggregating the factors of production into finer groupings could add to the explanatory power of the H-O emphasis on factor proportions. Sectors of the economy are bound to look more different in their endowments once finer distinctions are made.
- In the extreme, endowments of factors of production that are specific to each sector can be very unequal across countries and very intensively used in their own sectors, thereby suggesting explanations for trade patterns. Search for the reasons for intra-industry trade led to the development of a number of models in the imperfect competitive environment, which are often referred to as new trade theories. These explanations of the intra-industry trade revolve around factors such as product differentiation, economics of scale, monopolistic competition or oligopolistic behaviour, strategies of multinational corporations, etc.

3.5.1 Economies of Scale

The H-O model is based on the assumption of constant returns to scale. However, with increasing returns to scale (decreasing costs), i.e., when economies of scale exist in production, mutually beneficial trade can take place even when the two nations are identical in every respect.

- In fig. 3.2, PEC represents the production possibility curves of both the Countries A and B (both the nations are assumed to have identical endowments and technology). The production possibility curve is convex to the origin implying economies of scale. In the absence of trade, both nations produce and consume at point E on indifference curve I.
- Since production is subject to increasing returns to scale, it is possible to reduce the cost of production if one country specialises in the production of wheat and the other rice. For example, Country A may specialise completely in the production of wheat (i.e., move from E to P in production) and country B may move production from E to C, specialising completely in rice. By doing so both nations gain 10 units of wheat and 10 units of rice, as shown by the new equilibrium point N on the indifference curve II, although the production possibilities of both the nations remain the same.
- Even if all countries are identical in their production abilities and have identical production possibility curves; there could be a basis for trade as long as tastes differ.
- The production possibility curve shown in the figure represents the production possibility curve for wheat and rice of country A as well as of B because the production possibilities of both the countries are the same. In other words, both the countries can produce wheat or rice equally well. We assume that A is a wheat preferring country and B is a rice preferring country. In the absence trade, the preference for wheat and the resultant increase in the demand for wheat will increase the price of wheat in country A.
- Similarly, a higher price for rice will prevail in the rice preferring country B. International trade alters the price structure and establishes a new equilibrium price ratio, FP . Producers in both the countries will shift their production so as to make their marginal costs equal to the same international price ratio. Since the production possibilities are the same for both the countries they will both produce at the same point E where the price line is tangent to the production possibility curve.

- The wheat preferring country will satisfy its greater demand for wheat by importing wheat. Its new consumption point C at a higher indifference curve implies that trade enables it to attain a higher level of satisfaction with the same productive resources. Similarly trade enables the rice preferring country B to reach the point O on a higher indifference curve than the pre-trade situation. Thus, even if production capabilities remain same for two or more countries when tastes differ, mutually beneficial international trade could take place.
- There are two models which explain international trade based on technological change, viz.,
 - The Technological Gap Model
 - The Product Life Cycle Model
- In the case of both the models, the key element that causes the trade is the time involved acquiring the technology by different nations. According to the Technological Gap Model propounded by Posner, a great deal of trade among the industrialised countries is based on the introduction of new products and new production processes. In other words, technological innovation forms the basis of trade.
- The innovating firm and nation get a monopoly through patents and copyrights or other factors which turns other nations into importers of these products as long as the monopoly remains.
- However, as foreign producers acquire this technology they may become more competitive than the innovator because of certain favourable factors (like low labour cost, for example). When this happens, the innovating country may turn into an importer of the very product it had introduced. Firms in the advanced countries, however, strive to stay ahead through frequent innovations which make the earlier products obsolete.
- The Product Cycle Model developed by Vernon represents a generalisation and extension of the technological model. According to this model an innovative product is often first introduced in an advanced country like the USA (because of certain favourable factors like a large market, ease of organising production, etc.). The product is then exported to other developed countries.
- As the markets in these developed countries enlarge, production facilities are established there. These subsidiaries, in addition to catering to the domestic markets, export to the developing countries and to the United States. Later, production facilities are established in the developing countries. They would then start exports to the United States - a TV receiving set is one such example.
- The international product life cycle model is described basically as a trickle-down model (Kenichi Ohmae has termed it as water fall model of world trade and investment - a new product is first introduced to the high-income-country markets and subsequently to the middle income and low-income countries. An alternative to the trickle-down approach shower approach, according to which the new product is simultaneously introduced in all the markets (high income, middle income and low income countries) of the world markets. This approach is relevant because of the emergence of the global village and fast obsolescence of the product.

3.5.2 Availability and Non Availability

The availability approach to the theory of international trade seeks to explain the pattern of trade in terms of domestic availability and non-availability of goods. Availability influences trade through both demand and supply forces. In a nutshell, the availability approach states that a nation would tend to import those commodities which are not readily available domestically and export those whose domestic supply can be easily expanded beyond the quantity needed to satisfy the domestic demand. Kravis argues that Leontief's findings that the United States' exports have a higher labour content and a lower capital content than United States' imports can be explained better and more simply by the availability factor. Goods that happen to have high capital content are being bought abroad because they are not available at home. Some are unavailable in absolute sense (for example, diamonds), others in the sense that an increase in output can be achieved only at much higher costs (that is the domestic supply is inelastic). When availability at home is due to lack of natural resources (relative to demand), the comparative advantage argument is perfectly adequate.

According to Kravis, there are other facets of the availability explanation of commodity trade pattern that cannot be so readily subsumed under the rubric 'comparative advantage.' One of these is the effect of technological change. Historical data for the United States suggest that exports have tended to increase most in those industries which have new or improved products that are available only in the United States or in a few other places, at the most. Product differentiation and government restrictions are some of the other factors tending to increase the proportion of international trade that represents purchases by the importing country of goods that are not available at home. According to Kravis, there are, thus, four bases of the availability factor, namely,

- natural resources
- technological progress
- product differentiation
- government policy

The first three of the four bases - natural resources, technological progress and product differentiation - probably tend, on the whole, to increase the volume of international trade.

The absence of free competition, a necessary condition for the unfettered operation of the law of comparative advantage, tends to limit trade to goods that cannot be produced by the importing country, argues Kravis. The most important restrictions on international competition are those imposed by the governments and by cartels. Those imports that are unavailable or available only at formidable costs are subject to the least government interference. Kravis thinks that the quantitative importance of the availability factor in international trade must be considerable. This appears to apply especially to half of world trade that consists of trade between the industrial areas, on the one hand, and primary producing areas, on the other. The availability approach has, undoubtedly, considerable merit in its explanation of the pattern of trade.

3.5.3 Trade in Intermediate Goods

Intermediate goods constitute a substantial share of the international trade. Intermediate goods is fostered by the growing trends of global sourcing. Trade in most manufactured final goods embody several intermediate goods (or manufactured inputs). For example, hundreds of components/parts go in to the production of an automobile. These intermediate goods may be manufactured in-house or outsourced (i.e., obtained from independent intermediate goods producers).

For a long time, there had been a trend towards vertical integration (i.e., manufacturing more and more of the intermediates in-house). However, in the last few decades the trend has been just the opposite, i.e., de-integration (also known as hol/owing of the corporation) or outsourcing even what were earlier manufactured in-house. Outsourcing has been increasingly assuming global dimensions because global sourcing enables firms to procure the intermediates from the best source anywhere in the world (in terms of price, quality, features etc.).

Trade in intermediate goods has, therefore, been growing in importance and volume. It would this context be useful to understand the meaning of certain terms which are relevant in Gross Production and Net Production: Gross production or gross output is the total quantity of a good produced by a sector. A part of this output, may, however, go to other sectors as intermediate good. Net production is that part of the output of the sector, which goes for final consumption (i.e., gross production less that which goes to other sectors as intermediate good).

- Value Added: Value added is the difference between the price at which a final good is sold and the cost of the outsourced intermediates used in the production of the final good.
- Inputs and Factors of Production: The term input is sometimes used very broadly to include even the factors of production (such as labour, land and capital). However, sometimes a distinction is made between inputs and factors of production so that inputs mean those goods used in the production of other goods. Value addition takes place when a final good is made out of these inputs using the factors of production.

- **Condition for Production of Intermediate and Finished Products:** An intermediate good will be produced in a country only if its cost of production is less than or equal to the international price. For example, an intermediate good, I , will be produced in the country only if the following condition is satisfied. $I_c \sim I_p$ Where I_c is the cost of production of the intermediate good in the country and international price of that good. A finished good embodying intermediate good will the following condition is satisfied. Free trade tends to increase trade in intermediate goods in two ways. If the domestic cost of producing the intermediate good is more than its international price, imported intermediate good will be used in the finished good for the domestic market. Similarly, imported intermediate good will be used in the finished good for exports. Free trade in intermediate goods tends to increase the trade in finished good.

In the absence of free trade in intermediate good, a country will not be able to export the finished good if the cost of the intermediate good plus the value added is higher than the international price of the finished good. However, when there is free trade in intermediate good, if the availability of the intermediate good at international price enables the country to produce the finished good at a cost (cost of intermediate plus value added) lower than the international price; the country can export that product. Indeed, it is the international sourcing of intermediates that enables many firms to achieve international price competitiveness for their finished products.

Non-price factors (such as quality, delivery etc.) also encourage international sourcing. Intermediates are relatively labour intensive than the finished products. This provides a comparative advantage for the developing countries, where labour is comparatively cheap, in the production of intermediate goods. Many developed country firms, therefore, outsource manufactured inputs from the developing countries.

Summary

- The analytical framework of international business is build around-the activities of MNEs enunciated by the process of internationalisation. The FDI on the part of an MNE attempts to overcome the obstructions to trade in foreign countries.
- The theory of mercantilism was rejected by Adam Smith and Ricardo by stressing the importance of individuals, and pointing out that their welfare was the welfare of the nation. They believed in liberalism and enlightenment, and treated the wealth of the nation in terms of the “the sum of enjoyments” of the individuals in society.
- Ricardo (1817), though adhering to the absolute cost advantage doctrine of Adam Smith, pointed out that cost advantage to both the trade partners was not a necessary condition for trade to occur. It would still be beneficial to both the trading countries even if one country can produce all the goods with less labour cost than the other country.
- Efficiency may be achieved in international trade and gains maximised if a country trades in those goods where it has comparative advantages determined by the international price ratios.
- Eli Heckscher (1919) and Bertin Ohlin (1933) developed the international trade theory (H.O. Trade Model) with two factor inputs, labour and capital, pointing out that different countries have been bestowed with different factor endowments, and the differences in factor endowments cause trade between the trading partners.
- The key factors identified in support of the Leontief paradox were: U.S. protective trade policy, import of natural resources and the investment in human capital.
- A Study of Direct Investment (published in 1976) revealed that the orthodox theories of international trade and capital movements are unable to explain the involvement of MNEs in foreign countries.

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Self Assessment

1. _____ was propounded by Adam Smith (1776), arguing that the countries gain from trading, if they specialise according to their production advantages.
 - a. The theory of absolute cost advantage
 - b. The theory of comparative cost advantage
 - c. Theory of mercantilism
 - d. Leontief Paradox

2. _____ was rejected by Adam Smith and Ricardo by stressing the importance of individuals, and pointing out that their welfare was the welfare of the nation.
 - a. The theory of absolute cost advantage
 - b. The theory of comparative cost advantage
 - c. Theory of mercantilism
 - d. Leontief Paradox

3. Trade patterns in more than two countries involving two or more than two commodities are called _____.
 - a. the theory of absolute cost advantage
 - b. the theory of comparative cost advantage
 - c. Theory of mercantilism
 - d. Patterns of Multilateral Trading

4. How many models explain the international trade based on technological change?
 - a. Two
 - b. Three
 - c. Four
 - d. Five

5. The eclectic paradigm was developed by John Dunning in _____.
 - a. 1979
 - b. 1969
 - c. 1989
 - d. 1997

6. _____ model examines the various stages of the firm.
 - a. Product Life Cycle
 - b. Horizontal investments
 - c. Vertical Investments
 - d. Periodic investments

7. _____ investments take place for the internalisation of such assets of the company, which are intangible and cannot be priced in the market.

- a. Horizontal
- b. Vertical
- c. Foreign
- d. Capital

8. Match the following:

1. Free Standing Companies	A. raise funds freely from the major capital exporting countries, and locate the plants abroad for reducing the transaction cost
2. Equity Joint Ventures	B. management and profits are shared by two or more participants, while in contracts a single party holds the responsibility.
3. Spot Purchases and Long Term Contract	C. used as the efficient mode of organisation when the predictability of environment is quite satisfactory.
4. Eclectic Paradigm	D. developed by John Dunning in 1979

- a. 1-D, 2-C, 4-A, 5-B
- b. 1-A, 2-B, 3-C, 4-D
- c. 1-D, 2-C, 3-B, 4-A
- d. 1-B, 2-A, 3-C, 4-D

9. _____ is the total quantity of a good produced by a sector.

- a. Gross throughput
- b. Gross input
- c. Gross mean
- d. Gross output

10. According to the _____ propounded by Posner, a great deal of trade among the industrialised countries is based on the introduction of new products and new production processes.

- a. Product Life Cycle Model
- b. The theory of absolute cost advantage
- c. Technological Gap Model
- d. The theory of comparative cost advantage

Chapter IV

Export Import Trade Regulatory Framework

Aim

The aim of this chapter is to:

- define legal framework that regulates import and export
- introduce the export import policy
- explore the general provisions with regards to export and import

Objectives

The objectives of this chapter are to:

- explain the documentation with relation to export and import
- elucidate the importability of goods by the EOU/EPZ/EHTP/STP unit
- explicate the types and functions of the documents

Learning outcomes

At the end of this chapter, you will be able to:

- enlist the interpretations, compliances and exemptions granted from the export import policy
- understand export import trade regulatory framework
- comprehend standardisation of import/export documentation

4.1 Introduction

In a developing country like India, trade policy is one of the many economic instruments, which is used to suit the requirements of economic growth. The twin objectives of India's trade policy have been to promote exports and to restrict the level of imports to the level of foreign exchange available to the government. The basic problem of a country like India happens to be non-availability or acute shortage of crucial inputs like industrial raw materials, capital goods and technology. The bottleneck can be removed only by imports. In the short run, import can be financed through foreign aid, borrowings, etc; but in the long run, import must be financed by additional export earnings. The basic objective of the trade policy, therefore, revolves round the instruments and techniques of export promotion and import management.

4.2 An Overview of Legal Framework

Legal framework of export import trade is explained below.

4.2.1 Foreign Trade Act, 1992

The foreign trade of a country consists of outward and inward movement of goods and services giving rise to inflow and out-flow of foreign exchange. While the foreign trade of India is governed by the Foreign Trade (Development and Regulation) Act, 1992 and the Rules and Order issued there under, the payments for export and import trade transactions in terms of foreign exchange are regulated under the Foreign Exchange Management Act, 1999. The physical operation of the foreign trade transactions of export and import of other goods and services through various modes of transportation is conducted and regulated under the Customs act, 1962.

In order to project the image of the country as a producer and exporter of quality goods and services, a detailed programme of quality control and pre-shipment inspection is also in vogue under the Export (Quality Control and Inspection) Act, 1963. Besides the above four major Acts governing the foreign trade operation of the country, there are a number of other rules and regulations relating to export of commodities, modes of transportation, cargo insurance, international conventions, etc., which need to be strictly observed while conducting the export and import business.

4.2.2 Foreign Exchange Management Act, 1999

'The exchange control in India was introduced on September 3, 1939 as a war time measure in the early period of Second World War under the powers conferred by the Defence of India Rules. The emergency powers were subsequently replaced by the Foreign Exchange Regulations Act, 1947 which came into operation on March 25, 1947. This Act witnessed comprehensive revision in the wake of the changed needs of the economy during the post-independence period and was replaced by the Foreign Exchange Regulations Act, 1973 known as FERA.

The onset of the era of liberalisation of the external sector of the economy and the industrial licensing followed by Partial Convertibility of Rupee and full convertibility on current account necessitated the need for further extensive amendments in the FERA. which were brought about by the Foreign Exchange Regulations (Amendment) Act, 1993. FERA has been replaced by Foreign Exchange Management Act (FEMA), 1999.

FEMA has been brought to consolidate and amend the law relating to foreign exchange. The basic objective of this act is to facilitate external trade and payments and to promote the orderly development and maintenance of foreign exchange market in India. This act deals with various regulations of foreign exchange like holding and transactions of foreign exchange, export of goods and services, realisation and repatriation of foreign exchange, etc. The role of authorised person, the provisions of contravention and penalties and the procedures of adjudication and appeal, and the power of the directorate for enforcement are dealt at great length in this act.

4.2.3 The Customs Act, 1962

The consolidated and self-contained Customs Act, 1962 came into operation on December 13, 1962 repealing the earlier three Acts known as Sea Customs Act, 1878. Land Customs Act, 1924 and the Aircraft Act, 1934, each one of which was related to a particular mode of transportation. This comprehensive Act provides the legal framework, guidelines and procedures related to all situations emerging from the export and import trade transactions. The primary objectives of this Act are to

- regulate the genuine export and import trade transactions in keeping with the national economic policies and objectives
- check smuggling,
- collect revenue
- undertake functions on behalf of other agencies
- gather trade statistics.

Details about the rate and nature of customs duty leviable on any item, as decided by the Central government, are specified in the First and Second Schedule of the Customs Tariff Act, 1975 with regard to imports and exports, respectively.

4.2.4 Export (Quality Control and Inspection) Act, 1963

The Export (Quality Control and Inspection) Act was enacted in the year 1963 with a view to strengthening the export trade through quality control and preshipment inspection. The Act empowers the Government not only to notify the commodities which may be subject to compulsory quality control and/or inspection prior to export but also specify the type of quality control or inspection. The Act prohibits the export of sub-standard goods as well as the goods, which do not fulfil the requirements as laid down under the Act.

For smooth operation of the Export (Quality Control and Inspection) Act, 1963, the Government of India established the Export Inspection Council (EIC) on January 1, 1964, and the Export Inspection Agencies (EIAs). While the EIC acts as an advisory body to the Government on matters related to quality control and inspection, the EIAs are the actual agencies, which inspect the goods and issue the export-worthiness certificates.

All out encouragement is given to the trade and industry for the purpose of upgrading the quality of products under the current Export-Import Policy so as to project the image of the country as a producer and exporter of world-class quality products. The various categories of export houses recognised under the Export-Import Policy are exempt from the requirements of this Act.

4.3 Export-Import Policy

The Export-Import policy is detailed below.

Objectives

Government control import of non-essential item through an import policy. At the same time, all-out efforts are made to promote exports. Thus, there are two aspects of trade policy; the import policy, which is concerned with regulation and management of imports and the export policy, which is concerned with exports not only promotion but also regulation. The main objective of the Government policy is to promote exports to the maximum extent. Exports should be promoted in such a manner that the economy of the country is not affected by regulated exports of items specially needed within the country. The export control is, therefore, exercised in respect of a limited number of items whose supply position demands that their exports should be regulated in the larger interests of the country. In other words, the policy aims at:

- promoting exports and augmenting foreign exchange earnings; and
- regulating exports wherever it is necessary for the purposes of either avoiding competition among the Indian exporters or ensuring domestic availability of essential items of mass consumption at reasonable prices.

Export-Import Policy (1992-1997)

The government of India announced sweeping changes in the trade policy during the year 1991. As a result, the new Export-Import policy came into force from April 1, 1992. This was an important step towards the economic reforms of India. In order to bring stability and continuity, the policy was made for the duration of 5 years. In this policy, import was liberalised and export promotion measures were strengthened. The steps were also taken to boost the domestic industrial production. The major aspects of the export-import policy (1992-97) include:

- introduction of the duty-free Export Promotion Capital Goods (EPCG) scheme,
- strengthening of the Advance Licensing System,
- waiving of the condition on export proceeds realisation,
- rationalisation of schemes related to Export Oriented Units and units in the Export Processing Zones.

The thrust area of this policy was to liberalise imports and boost exports.

Export-Import Policy (1997-2002)

The need for further liberalisation of imports and promotion of exports was felt and the Government of India announced the new Export-Import Policy (1997-2002). This policy has further simplified the procedures and reduced the interface between exporters and the Director General of Foreign Trade (DGFT) by reducing the number of documents required for export by half. Import has been further liberalised and efforts have been made to promote exports.

The new EXIM Policy 1997-2002 aims at consolidating the gains made so far, restructuring the schemes to achieve further liberalisation and increased transparency in the changed trading environment. It focuses on the strengthening the domestic industrial growth and exports and enabling higher level of employment with due recognition of the key role played by the SSI sector.

It recognises the fact that there is no substitute for growth which creates jobs and generates income. Such trade activities also help in stimulating expansion and diversification of production in the country. The policy has focussed on the need to let exporters concentrate on the manufacturing and marketing of their products globally and operate in a hassle free environment. The effort has been made to simplify and streamline the procedure.

The principal objective of Export Import Policy 1997-2002 are:

- To accelerate the country's transition to a globally oriented vibrant economy with a view to derive maximum benefits from expanding global market opportunities.
- To enhance the technological strength and efficiency of Indian agriculture, industry and services, thereby improving their competitive strength, while generating new employment opportunities. It encourages the attainment of internationally accepted standards of quality.
- To provide consumers with good quality products at reasonable prices.
- The objectives will be achieved through the coordinated efforts of all the departments of the government in general and the Ministry of Commerce and the Directorate General of Foreign Trade and its network of regional offices in particular. Further, it will be achieved with a shared vision and commitment and in the best spirit of facilitation in the interest of export.

4.3.1 Registration Formalities and Export Licensing

The registration formalities and export licensing are explained below.

Importer-Exporter Code Number

No export or import shall be made by any person without an Importer-Exporter Code (IEC) number unless specifically exempted. An application for grant of IEC numbers shall be made by the Registered Head office of the applicant to the Regional Import-Export Licensing Authority along with the following documents:

- Profile of exporter/importer
- Bank receipt in duplicate DD for Rs. 1000 as fee
- Certificate from the banker of the applicant
- Two copies of the passport size photograph of the applicant duly attested by banker If there is any non resident interest in the applicant firm and NRI investment is with full repatriation benefits, provide full particulars and enclose photocopy of RBI approval for such investment.
- Declaration on applicant's letterhead about applicant's non-association with a caution listed firm.

The Licensing Authority shall issue an IEC no in the prescribed format. There is no expiry date on IEC No, hence, this number once allotted shall be valid till it is revoked. IEC No is to be filled in the Bill of entry (for import), Shipping Bill (for export) or in any documents prescribed by the rules.

Registration cum Membership Certificate

Any person, applying for a licence to import or export or for any other benefit or concession under this policy shall be required to furnish Registration-cum-Membership Certificate (RCMC). RCMC may be obtained from any one of the Export promotion Councils Commodity Boards (except Central Silk Board), FIEO, APEDA, MPEDA, Administrative authorities of EHTPI STP units. Export of the registered exporters having valid RCMC will only qualify for the benefits provided in the EXIM policy.

Export Licensing

All goods may be exported without any restriction except to the extent such exports are regulated by the Negative List of exports. The Negative Lists consist of goods, the import or export of which is prohibited, restricted through licensing or otherwise or canalised. The Negative list of exports is divided into three parts which are as follows:

- Part-I: Prohibited Items: These items can not be exported or imported. These items include: Wild life, exotic birds, wild flora, beef, human skeletons, tallow, fat and oils of any animal origin including fish oil, wood and wood products in the form of logs, timber, stumps, roots, barks, chips, powder, flakes, dust, pulp and charcoal.
- Part-II: Restricted Items: Any goods, the export or import of which is restricted through licensing, may be exported or imported only in accordance with a licence issued in this behalf.
- Part-III: Canalised Items: Any goods, the import/export of which is canalised, may be imported or exported by the canalising agency specified in the Negative Lists. The Director General of Foreign Trade may, however, grant a licence to any other person to import or export any canalised goods. Hence, barring a few items which are totally prohibited for exports, other items in the Negative lists can be exported under a licence or through a designated agency or under specified conditions.

Procedure to obtain export licence

An application for grant of export licence may be made in the prescribed form to the Director General of Foreign Trade or its Regional Licensing Authority. The application shall be accompanied by the documents prescribed therein. There is no application fee on export licences/permits.

4.3.2 Procedure to Obtain Export Licence

An application for grant of export licence may be made in the prescribed form to the Director General of Foreign Trade or its Regional Licensing Authority. The application shall be accompanied by the documents prescribed therein. There is no application fee on export licences/permits.

For restricted item an application is to be made in duplicate in the appropriate forms. There are two different export licence application forms:

- Application for export of restricted items except special chemical and special materials, equipments and technologies. This form is sent to the Director General of Foreign Trade, New Delhi.

- Application for grant of export license for export of special chemicals, etc. Applications are to be sent to the DGFT. An interministerial group under the chairmanship of the DGFT shall consider applications for the export of these items.

For canalised items, applications are made to the DGFT in the prescribed form. For samples/exhibits exports exceeding ceiling limits, an application may be made to the DGFT. For gifts/spares/replacement goods in excess of ceilings, an application is to be made to the DGFT in the prescribed format.

4.4 General Provisions Regarding Exports And Imports

Provisions regarding exports and imports are explained below.

Exports and imports free unless regulated

Exports and Imports shall be free except to the extent they are regulated by the provisions of this policy or any other law for the time being in force. The item wise export and import policy shall be specified in ITC (HC) published by Director General of Foreign Trade (DGFT).

Compliance with law

Every exporter or importer shall comply with the provisions of the Foreign Trade (Development and Regulation) Act, 1992 and the rules and orders made thereunder. They are also required to comply with the provisions of this policy, terms and conditions of any licence granted and provisions of any other law for the time being in force.

Interpretation of policy

If any question or doubt arises in respect of the interpretation of any provision of the EXIM policy, it shall be referred to the Director General of Foreign Trade whose decision shall be final and binding.

Exemption from policy/procedure

Any request for relaxation of the provisions of this policy or procedure on the ground of hardships or an adverse impact on trade, may be made to the Director General of Foreign Trade.

Trade with neighbouring countries

The Director General of Foreign Trade may issue from time to time, such instructions or frame such schemes as may be required to promote trade and strengthen economic ties with neighbouring countries.

Trade with Russia under Debt Repayment Agreement

In the case of trade with Russia, under the debt repayment agreement, the Director General of Foreign Trade may issue from time to time such instructions.

Transit facility

Transit of goods through India from or to countries adjacent to India shall be regulated in accordance with the treaty between India and those countries.

Execution of Bank Guarantee /Legal Undertaking

Wherever any duty free import is allowed, or where otherwise specifically stated, the importer shall execute a legal undertaking or bank guarantee with the customs authority before clearance of goods through the customs.

Free movement of export goods

Consignments of items allowed for exports shall not be withheld or delayed for any reason by any agency. In case of any doubt, the authorities concerned may ask for an undertaking from the exporter.

Import/Export of samples

Import and export of samples shall be by the provisions of EXIM Policy.

Third party exports

A licence holder may export directly or through third parties.

Clearance of goods from customs

The goods already imported/shipped/arrived in advance but not cleared from customs may also be cleared against the license issued subsequently.

Green Card

All status holders and manufacturer exporter exporting more than 50% of their production subject to a minimum turnover of Rs. 1 crore in preceding year, shall be issued a green card by Directorate General of Foreign Trade. This card will also be issued to the service providers rendering services in free foreign exchange for more than 50% of their services turnover, subject to a minimum value of Rs. 35 lakhs in free foreign exchange in the preceding year. This card provides automatic licensing, automatic custom clearance and other facilities mentioned in the EXIM policy.

Electronic data interchange

In an attempt to speed up transactions and to bring about transparency in various activities related to exports, electronic data interchange would be encouraged. Applications received electronically shall be cleared within 24 hours.

4.5 Exports and Imports

Imports and Exports are explained below.

4.5.1 Exports

- **Free Exports:** All goods may be exported without any restriction except to the extent such exports are regulated by ITC (HS) or any other provision of this policy or any other law for the time being in force.
- **Denomination of Export Contracts:** All export contracts and invoices shall be denominated in freely convertible currency and export proceeds shall be realised in freely convertible currency. Contracts for which payments are received through the Asian Clearing Union (ACU) shall be denominated in ACU dollar.
- **Realisation of Export Proceeds:** If an exporter fails to realise the export proceeds within the time specified by the Reserve Bank of India, he shall be liable to action in accordance with the provisions of the Act and the policy.
- **Export of Gift:** Goods including edible items of value not exceeding rupees one lakh in a licensing year may be exported as a gift. Those items mentioned as restricted for exports in ITC(HS) shall not be exported as gift without a licence except edible items.
- **Export of Spares:** Warranty spares, whether indigenous or imported, of plant, equipment, machinery, automobiles or any other goods may be exported up to 7.5% of the FOB value of the exports of such goods along with the main equipment or subsequently. This shall be done within the contracted warranty period of such goods.
- **Export of passenger baggage:** Bonafide personal baggage may be exported either along with the passenger or if unaccompanied, within one year before or after the passenger's departure from India. Those items mentioned as Restricted in ITC (HS) shall require a licence except in case of edible items.
- **Export of imported goods:** Goods imported in accordance with this policy, may be exported in the same or substantially the same forms without a licence. This can be done provided that the item to be imported or exported is not mentioned as restricted for import or export in this ITC (FIS), except items imported under Special Import Licence.
- **Export of replacement Goods:** Goods or parts thereof on being exported and found defective/damaged or otherwise unfit for use may be replaced free of charge by the exporter. Such goods shall be allowed clearance by the customs authorities provided that the replacement goods are not mentioned as restricted items for exports in ITC (HS).

- Export of repaired goods: Goods or parts thereof on being exported and found defective, damaged or otherwise unfit for use may be imported for repair and subsequent re-export. Such goods shall be allowed clearance without a licence and in accordance with customs notification issued in this behalf.
- Private bonded warehouse: Private bonded warehouse exclusively for exports may be set up Export-Import Trade in Domestic Tariff Area as per the norms and conditions of the notifications issued by Department of Revenue. Such warehouse shall be entitled to procure the goods from domestic manufacturers without payment of duty. The supplies made by the domestic supplier to the notified warehouses shall be treated as physical exports provided the payments for the same are made in free foreign exchange.

Deemed exports

Deemed exports refer to those transactions, where the goods supplied do not leave the country. The following categories of supply of goods by the main/sub-contractors shall be regarded as deemed exports under the policy, provided the goods are manufactured in India.

Deemed exports shall be eligible for the following benefits.

- Advance licence for intermediate supply/deemed export
- Deemed exports drawback
- Refund of terminal excise duty

Export of services

Services include all the 161 tradable services covered under the General Agreement on Trade in services where payment for such services is received in free foreign Exchange. The service providers shall be eligible for the facility of EPCG scheme. They shall be eligible for the facility of EOU/EPZ/SEZ/STP scheme of the EXIM policy. Service providers shall also be eligible for recognition as Service Export House, International Service Export House, International Star Service Export House, International Super Star Service Export House, achieving the performance level as prescribed in the policy.

Export of services

- Supply of goods against advance licence DFRC under the duty exemption/remission scheme.
- Supply of goods to units located in EOU/EPZ/SEZ/STP/EHTP.
- Supply of capital goods to holders of licences under EPCG scheme.
- Supply of goods to projects financed by multilateral or bilateral agencies/funds as notified by the Ministry of Finance.
- Supply of capital goods which are used for installation purposes till the stage of commercial production and spares to the extent of 10% of the FOR value to fertiliser plants.
- Supply of goods to any project or purpose in respect of which the Ministry of
- Finance permits the import of such goods at zero customs duty coupled with the extension of benefits under this chapter to domestic supplies.
- Supply of goods to the power and refineries and coal hydrocarbons, rail, road, port, civil aviation, bridges other infrastructure projects provided minimum specific investment is Rs. 100 crores or more.
- Supply of marine freight containers by 40% EOU (domestic freight containers manufacturers) provided the said containers are exported out of India within 6 months or such further period as permitted by the customs, supply to projects funded by UN agencies.

4.5.2 Imports

- Actual user condition: Capital goods, raw materials, intermediates, components, consumables, spares, parts, accessories, instruments and other goods, which are importable without any restriction, may be imported by any person. If such imports require a licence, the Actual user alone may import such goods unless exempted.
- Second hand goods: All second hand goods shall be restricted for imports and may be imported only in accordance with the provisions of EXIM Policy.
- Import of gifts: Import of gifts shall be permitted where such goods are otherwise freely importable under this policy.
- Import on export basis: New or second hand jigs, fixtures, dies, moulds, patterns, press tools and lasts, construction machinery, container packages meant for packing of goods for export and other equipments, may be imported for export without a licence on execution of legal undertaking/bank guarantee with the customs authority.
- Re-import of goods abroad: Capital goods, aircraft including their components, spare parts and accessories, whether imported, or indigenous may be sent abroad for repairs, testing, quality improvement, or upgradation of technology and re-imported without a licence.
- Import of machinery and equipment used in project abroad: After completion of the projects abroad, project contractors may import used construction equipment, machinery, related spares up to 20% of the CIF value of such machinery, tools and accessories without a licence.
- Sale on high seas: Sale of goods on high seas for import into India may be made subject to this policy or any other law for the time being in force.
- Import under lease financing: Permission of licensing authority is not required for import of new capital goods under lease financing.
- Export promotion capital goods scheme: New Capital goods including computer software systems may be imported under the Export Promotion Capital Goods (EPCG) scheme. Under this provision on capital goods including jigs, fixtures, dies, moulds and spares up to 20% of the CIF value of the capital goods may be imported at 5% customs duty. This import is subject to an export obligation equivalent to 5 times CIF value of capital goods on FOB basis or 4 times the CIF value of capital goods on NFE basis to be fulfilled over a period of 8 years. This period is reckoned from the date of issuance of licence. Import of capital goods shall be subject to actual user condition till the export obligation is completed.
- Duty Exemption/Remission Scheme: The duty exemption scheme enables import of inputs required for export production. The duty remission scheme enables post export replenishment/remission of duty on inputs used in the export product.
- Duty exemption scheme: Under duty exemption scheme, an advance licence is issued to allow import of inputs which are physically incorporated in the export product. Advance licence is issued for duty free import of inputs as defined in the policy subject to actual user condition. Such licences are exempted from payment of basic customs duty, surcharge, additional customs duty, anti-dumping duty and safeguard duty, if any. Advance licence can be issued for
 - physical exports
 - intermediate supplies
 - deemed exports

Under the scheme of advance licence for intermediate supply, advance licence may be issued for intermediate supply to a manufacturer-exporter. This is done for the import of inputs required in the manufacture of goods to be supplied to the ultimate exporter/deemed exporter holding another advance licence.

Under the scheme of advance licence for deemed export, advance licence can be issued for deemed export to the main contractor. This is done for the import of inputs acquired in the manufacture of goods to be supplied to the categories mentioned in the policy.

- **Duty Remission Scheme:** This scheme consists of duty free replenishment certificate and duty entitlement passbook scheme.
- **Duty Free Replenishment Certificate (DFRC):** Duty free replenishment certificate is issued to a merchant-exporter or manufacturer-exporter for the import of inputs used in the manufacture of goods without payment of basic customs duty, surcharge and special additional duty. Such inputs shall be subject to the payment of additional customs duty equal to the excise duty at the time of import.
- **Duty Entitlement Passbook Scheme:** For exporters not desirous of going through the licensing route, an optional facility is given under duty entitlement passbook scheme. The objective of DEPB scheme is to neutralise the incidence of customs duty on the import content of the export product. The neutralisation shall be provided by way of grant of duty credit against the export product. Under this scheme, an exporter may apply for, credit as specified percentage of FOB value of exports, made in freely convertible currency. The credit shall be available against such export products and at such rates as may be specified by Director General of Foreign Trade. The DEPB shall be valid for a period of 12 months from the date of issue. The DEPB and/or the items imported against it are freely transferable. The exports under the DEPB scheme shall not be entitled for drawback. The holder of DEPB shall have the option to pay additional customs duty in cash as well.

Importability of goods by EOU/EPZ/EHTP/STP unit

Export Oriented Units (EOU), units in Export Processing Zones (EPZs), Special Economic Zones (SEZs), Electronics Hardware Technology Parks (EHTPs) and Software Technology Parks (STPs) unit may import all types of goods without payment of duty. This includes capital goods as defined in the policy, required by it for manufacture, services, trading or in connection therewith. These goods should not be prohibited items.

4.6 Export-Import Documents

Documentation for export-import are mentioned below.

4.6.1 Rationale of Documents

Export documentation is commonly considered to be the most complex and difficult part of overseas marketing. You may have come across such comments, which tend to discourage people from entering into export business. It is, therefore, necessary to emphasise that documentation is as much of an important activity as the conclusion of an export order and its fulfilment.

If one is doing domestic business, one knows or can easily know the commercial practices, which bind the buyer and the seller. Similarly, the possibility of business both the buyer and the seller know/or can easily know laws governing contracts. However, when the buyer and the seller are operating in two countries, both the commercial practices and legal processes are different. Thus, for the protection of the respective interests of the buyer and the seller are protected, certain documentary formality by the country has its own laws governing imports and exports.

Consequently, the exporter has to comply with laws in his country through documenting formalities. At the same time, he has to send some documents to the importer, which will enable him to take possession of the goods after getting permission from the concerned government department (i.e., the customs authorities). There is yet another reason for documentation in export trade. Such documentation is linked with the claim of export incentives given by almost all countries world over.

Since most of these incentives are to be claimed after shipment) the exporter has to give documentary proof of the fact of shipment. Documentation formalities are necessary to enable the importer to get the contracted goods and the exporter to get sale value as well as to secure export incentives. In other words, export documents are needed to comply with commercial, legal and incentive requirements. .

Commercial perspective

Trade between two business firms located in different countries begins with the conclusion of an export contract. Under the contract, the duty of the exporter is to ship the corrected goods in the agreed form (for example, packing) and by agreed mode of transport as well as according to agreed time schedule. On the other hand, it is the duty of the importer to remit sale value to the exporter according to agreed terms of payment. In this process of physical movement of goods from the exporter to [the importer and remittance of sale value in the reverse order, neither the exporter nor the importer is personally and physically involved. Instead goods are handed over to a shipping company or an airline which issues a receipt for these goods.

Further, since goods in transit may be damaged or lost due to some accident, the exporter may be required to get an insurance policy. While these two documents will protect the interests of the importer, the exporter will ensure that these documents are not in the possession of the importer unless he has either paid for the goods or he has made a promise to make payment at a later date. For this purpose, physical possession of the good will be linked with the acceptance of a payment document by the importer.

In actual practice, a set of documents given proof of shipment and cargo insurance coverage along with a bill for payment is sent by the exporter to the importer through the banking channel. This set of documents symbolises ownership in goods. This will be handed over to the importer by the bank. in his country, which lie has received it from the bank in the exporting country only when he has honoured the bill. In other words, the importer will get delivery of the goods from the carrier on the basis of the transport document, which is obtained through the bank, after he has complied with the agreed terms of payment.

Legal perspective

Besides commercial necessity, documentation for exports has a legal perspective. All over the world, laws regulating export-import trade as well as movement of foreign exchange has been enacted. In some countries, the regulations are few, which are enforced through simple procedural and documentation formalities. In other countries, the regulations are many and the enforcement procedures are complex.

Why should there be regulations in foreign trade? There is perhaps no country in the world where movement of goods and money is absolutely free. 'The minimum regulations that one can think of are the one to record the movement of goods from and into a country. For this purpose, the exporter has to declare on a document the details of goods being exported by him. Other than this basic minimum requirement, the governments all over the world regulate movement of goods to protect political, economic, cultural and other interests and policies for implementing trade agreements with other countries.

- Some countries do not have political relations with the others. As a result, goods originating from such a country are not allowed to be imported. Thus, a country, which does not permit flow of goods from certain countries, has laid down the requirement of Certificate of Origin, which states that the goods are of the country, which is exporting them. For example, some of the countries in West Asia do not allow imports from countries or companies having any relation with Israel.
- Documents are needed for protecting the economic and social interests of the trading countries. For example, under the Indian Export policy, the government has listed out products, which either cannot be exported or can be exported after obtaining permission from the designated agencies. Some of the products are subject to restrictions because of their short supply in the country. Consequently, these products can be exported only after obtaining a quota, for which a documentary proof is to be submitted to the customs, authority for shipment purposes.
- Similarly, there are a number of government regulations governing quality, standards, foreign exchange flows, valuation of goods for calculating customs duties, etc. Compliance with these regulations necessitates documentation.
- Documents are also needed for fulfilling requirements under bilateral and multilateral trade agreements. For example, an Indian exporter will need to obtain GSP, Certificate of Origin for exporting certain specified products to those countries which operate the Generalised System of preferences. Under this System, the developed country accord preferential duty treatment to specified goods originating from developing countries. The GSP certificate will enable the importer to pay concessional duty.

Incentive perspective

Export assistance and incentive measures have become an integral part of policy in larger number of countries. Since these incentives are to be given only to the export activity and documentary proof to this effect is required to be given by the claimant to the disbursing, authorities. Such a documentary proof should state that the claimant is eligible to receive the incentive, that the goods will be or have been exported according to the export contract and that the claim has been filed in the manner specified in the policy.

In other words, bonafides of the claim have to be established for receiving incentives and assistance. You may also note that for making a claim, the exporter has to file an application on the specified form that summarises the shipment and other details. This application is to be accompanied by a number of supporting documents to enable the incentive disbursing authority to check the authenticity of details given in the application.

4.6.2 Kinds and Functions of Documents

Types and functions of documents for export-imports are explained below.

Commercial documents

Commercial documents, also known as shipping documents, enable the exporter and the importer to discharge their obligations under an export contract. In specific terms, these documents ensure that the exporter makes shipment of the goods according to requirements of the contract and the importer makes payment for goods shipped in the manner as given in the contract. When goods are shipped by the exporter, he has a set of documents, which entitles him or its legal holder (example, agent, importer, bank) to the goods at the destination or in the event of damage or loss to compensation by insurance.

For a consignment under a c.i.f. contract, a set of commercial documents comprise:

- Certificate and Bill of exchange
- Commercial Invoice
- Bill of Lading
- Airway Bill
- Post Parcel Receipt
- Insurance Policy

Certificate and bill of exchange: In addition to these documents, a particular shipment may necessitate additional commercial documents such as packing list, certificate of inspection, certificates of quality etc. You must also note that for receiving payment from the importer, additional documents, satisfying the regulatory needs in the importing country, will have to be obtained by the exporter and sent to the importer. Let us discuss various commercial documents.

Commercial invoices: This is the first basic and the only complete document among all commercial documents for the shipment. Besides fulfilling the obligation under the export contract, the exporter needs this document for a number of other purposes including:

- obtaining export inspection certificate
- getting excise clearance
- getting customs clearance and
- securing incentives

Thus, this document is prepared at both the pre-shipment and post-shipment stages.

- In the first place, Commercial Invoice is a document of contents that describes details of goods sent by exporter. It is the statement of account, which must contain identification marks and numbers, description of goods and quantity of goods.

- Every shipment has identification marks, which identify the cargo with various documents. These are private marks, which are made on the packages. These marks could be either in the form of symbols (say, a star, triangle, rectangle, etc.) or numerical. Similarly, every package under a shipment is numbered, usually written serially. The commercial invoice must specify the serial numbers given in a particular consignment.
- Commercial invoice must describe the goods shipped by the exporter. The description of goods must correspond exactly with the description given in the contract or the letter of credit. It means that there's not to be any difference (including spelling) between these descriptions, thus, if a contract describes the goods as "Ten Thousand Pairs of Blouses and Skirts", the exporter should not describe them as "Ten Thousand Blouses and Ten Thousand Skirts", though logically both the descriptions mean the same.
- Sometimes description of the goods includes the number of packages and the type of packing material. Thus, if the contract specifies shipment to be made in "ten new gunny bags", the exporter should send the contracted goods and describe them as needed. If the commercial invoice wrongly describes the shipment as "ten gunny bags" instead of "ten new gunny bags", the bank may refuse to honour shipping documents and not pay for them.
- The quantity described on the commercial invoice should neither be less or more than the contracted quantity. In other words, the exporter should not ship less than contracted quantity, unless the contract permits part shipment. However, if the goods are being shipped under a letter of credit, part shipment is permitted, unless it is specifically prohibited. On the other hand, quantity shipped should not be more than the contracted quantity. This is so even if the exporter may not be charging for the additional quantity. Second function of the commercial invoice is that it is the seller's bill given to the buyer.
- As a bill, it must contain the name and address of the buyer, unit price, amount and authorised signatures with designation. Unless required by the buyer, the total invoiced value should be net of any commission or discount; in other words, it should be the realisable amount of goods as per the trade terms. Sometimes a contract requires a detailed breakup of the amount to be recorded on the invoice for enabling the customs authority in the importing country to calculate import duty.
- The name and address given in the commercial invoice should be the same as given in the export contract or the letter of credit, as the case may be. Under a letter of credit, unless otherwise specified, the commercial invoice must be made out in the name of the applicant of the credit. As in the case of quantity to be recorded on the invoice, the amount should neither be less nor more than the stipulated amount in the contract or the letter of credit. The only exception is that if the contract or the letter of credit permits part-shipment, an individual invoice can be less than the total amount. The commercial invoice also sets forth the terms of sale (i.e. fob/cif/c&f) etc. mode and date of shipment and terms of payment. It can also serve as a packing list and a certificate of origin. A packing list shows details of goods contained in each pack of shipment. When the law in an importing country does not specifically require a separate certificate of origin issued by a third party, it can be self- certified by the exporter on the commercial invoice. The format of Commercial invoice is devised by exporters themselves according to the requirements of their business. Look at Annexure 1 where the format of Commercial invoice has been given.

Bill of lading: Bill of lading is issued by the shipping company or its agents stating that goods are either being shipped or have been shipped. Essentially a transport document, it serves many purposes in international commerce. Bill of lading serves the following three distinct functions.

- This document evidences the contract of affreightment (transport) between the shipping company and the shipper (exporter or importer).
- It is a receipt given by the shipping company for cargo received by it.
- It is a document of title (This is the most significant function of the bill of lading).

The meaning of the term affreightment is “evidence of the contract of affreightment”. When goods are to be carried by any carrier (say, a ship), the contract of affreightment will apply carriage terms and conditions. In particular, this contract will mention the responsibility of the carrier (example, ship owner) in providing space, receiving, loading, carrying and unloading of the cargo. Thus, if there is any loss or damage to the cargo when it is in the custody of the carrier, the contract will provide for the circumstances in which the carrier can be held liable for the loss or damage. Further, in case the carrier is to be liable for loss or damage, the contract will provide to the amount of claim which carrier will be required to pay to the cargo owner. A bill of lading also contains printed terms and conditions of the contract of affreightment on it.

However, it is not considered as a contract by itself; instead it is the most important evidence of the contract. Law courts all over the world have held that in case of a dispute, the aggrieved party may produce any other evidence which may controvert a printed clause in the bill of lading. Any other evidence could be a specific agreement in which for example, the ship owner may have agreed to a higher amount of liability than the standard amount. Thus, in such cases, the ship owner does not have a defence that his maximum liability is as printed in the bill of lading.

Bill of lading is a receipt issued by the shipping company on its agents. Law requires that as a receipt, it must contain leading identification marks, number of packages or quantity or weight or any other unit of account, and apparent order and condition of the goods. Bill of lading is the only evidence to file a claim against the shipping company in the event of non-delivery, defective delivery or short-delivery of the cargo at the destination.

As a result, this document indicates that the contracted goods have been either given into the charge of the shipping companies or shipped by the exporter by the named ship on the date specified on the bill of lading. If shipment is according to the contract terms, the exporter gets the right to demand the sale amount from the importer while the importer is entitled to get delivery of the goods at the destination.

As a receipt, the bill of lading can be of various types as discussed below:

- Received for Shipment B/L: It is issued by the shipping company when goods have been given into the custody of the shipping company but have not yet been placed on board the ship.
- On Board Shipped B/L: It certifies that the goods have been received on board the ship.
- Clean B/L: It indicates a clean receipt. In other words, it implies that there was no defect in the apparent order and condition of the goods at the time of receipt or shipment of goods by the shipping company, as the case may be.
- Claused or Dirty B/L: This bill bears a superimposed clause an annotation, which expressly declares a defective condition of the goods. The clause may state “package number 20 broken” or “bale number 20 hook-damaged”. By superimposing such clauses on the B/L, the shipping company limits its responsibility at the time of delivery of goods at the destination. It is very important to note that only a clean BIL is acceptable for negotiation of documents with the bank.
- Combined B/L: It covers several modes of transport for performing the complete journey from the exporting country to the importer’s warehouse. For example, part of the journey may be completed by ship while subsequent parts may be undertaken by road; rail and air.
- Through B/L: It covers goods being transhipped en route but where the first carrier has the responsibility as the principal carrier for all stages of the journey. For example, goods may be shipped from Bombay to Dubai and transhipped from Dubai to a port in Latin America.
- Trans-shipment B/L: It has similar characteristic as the Through BIL except that in this case the first carrier acts only as an agent for effecting Trans-shipment of cargo.
- Charter Party B/L: It covers shipment on a chartered ship. The contract or the letter of credit will specify the nature of bill of lading that the exporter has to procure for the importer. Generally, the importers insist on the “clean on-board shipped” bill of lading, with the prohibition of the trans-shipment of goods.

Bill of lading is a document of title that will enable the lawful holder of any of the original BIL to take delivery of the goods at the stipulated port of destination. Thus, a claimant of title to goods is required to surrender an original B/L (also popularly known as negotiable copy of BIL) for claiming goods from the shipping company or its agents. A bill of lading is not a negotiable instrument, though it is transferable by endorsement and Policies delivery. What is the purpose of transferability of the bill of lading?

Transferability

Transferability enables the banks to pay money to the exporter against surrender of shipping documents, including BIL, even before the goods reach the destination. Similarly, it enables the goods to be resold by the importer before goods reach the destination. For creating transferability, the bill of lading has to be made in such a way that the goods are consigned to the 'order of a party. The party could be either the exporter himself, or a negotiating or paying bank or any other party as provided in the contract or letter of credit. For example, if BIL is prepared in the following way, it can be transferred through endorsement in the same manner as in a cheque. There are three main columns in BIL. These are Consignor (Shipper); Consignee or Order of and Notifying party. Notifying party is the party to whom the shipping company is to send "notice of arrival". Transferability can be created by filling- up these columns in the following manner:

- Consignor: ABC Company, New Delhi
- Consignee: (Or Order of) Bank of XYZ, New Delhi
- Notifying Pam: KNM, London

By not striking-off the words "Or Order Of" and writing the name of the negotiating bank, the bank becomes the first endorsee. Title to goods will be transferred from the negotiating bank to the paying bank to importer on endorsements by the negotiating and the paying banks in succession.

In contrast to the "Order BIL" is the consignee-named B/L. The consignee-named B/L is made out in the name of a specific party. Hence, title to goods cannot be transferred to a third party. The exporter should not ship goods under this kind of BIL as goods can be released by the shipping company at the destination without the presentation of the 'original' B/L. Thus, if payment from the importer has not been secured, the exporter may lose hold over goods and may not get paid. However, if payment in advance has been received or if goods are being shipped under irrevocable letter of credit, the consignee named BL is a valid document.

According to international commercial practice, BL along with other shipping documents must be presented to the bank not later than twenty- one days of the date of shipment as given in BIL. Sometimes the buyers may also specify the last date or the number of days after shipment by which the documents must be submitted to the bank. Where this stipulation is not followed by the exporter, the documents are said to have become "stale" and B/L in such case will be known as Stale B/L. A Stale B/L, is one which is tendered to the paying bank at so late a date that it is impossible for it to be dispatched to the consignee in time to reach him before the goods themselves arrive at the destination port.

Airway bill: In air carriage, the transport document is known as the airway bill (AWB). This document constitutes prima facie evidence of the conclusion of the contract of affreightment, of receipt of goods and of conditions of carriage. This document, therefore, performs the triple functions as a forwarding note for the goods, receipt for the goods tendered and authority to obtain delivery of goods. By itself, AWB is not a document of title, nor is this document transferable. However, AWB can be made into a transferable document by which it can be transferred to a third party by 'endorsement like the BIL. But, by and large, the business and commercial practice does not treat the AWB as a document of title.

Functions of airway bill

The functions of AWB are similar to BIL in regard to its characteristics as an evidence of contract and as cargo receipt.

- The AWB may be given as a receipt either for cargo given to the carrier pending shipment or for cargo loaded on board the aircraft. It may either be a clean receipt or a claused receipt.
- As regards the document of title characteristics, AWB is not a document of title, but this feature can be incorporated in it by making an Order AWB.
- General practices in the trade are to get the consignee-named AWB.
- Consequently, goods are delivered to the consignee named in the AWE. The consignee will have to identify himself as the party named in AWB and goods may be delivered to him without any hindrance. But if the interests of the exporter have not been protected, the consignee may get hold of the goods and may also not pay for them.
- Hence, exporters provide for a clause in the contract, which requires AWE to be made in the name of the paying bank, which will ensure exchange of goods for payment, by the importer.
- On the other hand, the importer can protect him against the seller's re-routing of the goods by obtaining the consignor's copy of the AWB (marked "Original 3 for Shipper"), which is sent to him through the banking channel by the exporter along with other shipping documents.

Post parcel receipt: Post parcel receipt (PPR) evidences merely the receipt of the goods exported through postal channels to the buyer. It does not evidence the title to goods. The parcel is consigned to the consignee named in the contract between exporter and importer. The consignee can identify himself with the postal authorities at the destination and obtain delivery of the goods.

Insurance policy or certificate: Cargo Insurance Policy (also called marine insurance policy) provides protection to cargo owners in the event of loss or damage to cargo in transit. This loss or damage is caused by accidents, which cannot be known in advance and against which no protection is possible. These may be caused by natural calamities as well as by man-made accidents. It is, therefore, necessary that the risk of loss or damage to the cargo be minimised by obtaining a suitable insurance cover from an insurance company.

There are different types of insurance policies for different categories of risks to be covered. We may emphasise that different types of risks to be covered will require different policies. Thus, the prevalent practice all over the world is to fix insurance on five types of policies. These are:

- Institute Cargo Clauses A
- Institute Cargo Clauses B
- Institute Cargo
- Clauses C
- Institute Strikes Clauses
- Institute War Clauses

Among the three cargo clauses, Cargo clauses A provide the maximum cover, clauses B provide less cover while clauses C provide the least cover. When war and strikes clauses are attached to cargo clause's A, the cargo owners are given protection against all kinds of risks admissible under the law.

It must be pointed out that insurance cover is given irrespective of the mode of transport used including sea, air, and road and rail carriers. Further, insurance cover can be secured for cargo going from the warehouse of the consignor, to the warehouse of the consignee. Generally, the export contract determines the party (exporter or importer) that will procure insurance cover. In the F.O.B. and C& F contracts, importer obtains insurance cover after the goods have been laid on board on carrier. On the other hand, in a CIF contract, it is the obligation of the exporter to insure goods.

Sometimes, the export contract specifies the submission of 'insurance certificate' instead of the policy to bank for negotiation of documents. Insurance certificate, which is one stage prior to insurance policy, comes into being when a large and regular exporter obtains an open cover or concludes an open policy. Under these two arrangements, insurance certificates are issued on declaring shipments by the exporter as and when these are affected. Insurance certificate has an advantage as it cuts downtime in getting the insurance document from the insurance company.

Bill of Exchange: Bill of exchange or draft is "an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to or to the order of a person or to the bearer of the instrument. Further, the person to whom it is addressed is to pay either on demand or at fixed or determinable future.

Bill of exchange (B/E) is an important commercial document, which bridges the time gap between shipment of goods and receipt of sale amount. This document is prepared by the exporter and given to the bank along with other shipping documents for securing the sale amount. In this sense, B/E is attached to other documents, which will be given to the bank to make payment at a future date.

Simply stated, the maker of B/E is the exporter (drawer) and the person who is directed to pay is the importer (drawee), while the person who is entitled to receive payment is the exporter (payee) or anyone directed by him. The sum of money to be paid by the drawee is the amount billed in the commercial invoice and recorded in B/E.

B/E is to be honoured either on demand or on presentation to the drawee or at a determinable future. Where B/E is to be honoured on demand, a 'Sight bill' is drawn while in the second case 'Usance bill' is drawn. In the first case, the exporter does not give a credit facility to the importer. In the second case, he extends this facility for an agreed time period. Sight bill is drawn under DP (Documents against payment) terms of payment. For one shipment, two sets of shipping documents including B/L are mailed to the foreign correspondent (bank) through a bank in the exporting country for presentation to the drawee (importer). Each one bears a reference to the other. When anyone of the B/E is paid for by the drawee, the second B/E becomes null and void.

Combined Transport Document

Combined Transport Document (CTD) is a document for multi-modal movement of goods in container. The movement is carried out by more than one mode, for example, rail and ship. The Foreign Exchange Dealers Association of India (FEDAI) has brought out brochure No.081 and 082 to facilitate export of goods in containers from specified inland centres in India. A CTD provides an alternative to establishing a series of separate and non-uniform contracts for each segment of the total transport process. It is acceptable for negotiation under L/C.

Legal regulatory documents

These documents may be divided into two categories, i.e., documents needed in the exporting and the importing countries. Let us first discuss regulatory documents needed in India.

Legal documents for exports from India

Regulatory export documents are of two types. Documents needed for different kind of registration of the firm and documents, which are specific to a shipment.

- In the first category are included applications and supporting document for obtaining (i) Importer-Exporter Code Number valid for the firm's life-time, and (ii) Registration-Cum-Membership Certificate, (RCMC) from the relevant export promotion council, Commodity board, development authority etc., valid for a specified time period. RCMC is strictly not a legal requirement for exporting from India, but is needed for claiming some of the important export incentives. The applications of the Importer-Exporter Code Number (IEC) is to be made in the prescribed form to the Regional Licensing Authority. RCMC is obtained from the concerned registering authority, which may either be an Export Promotion Council, or Commodity Board or a Development Authority. Application is to be made on the prescribed form available from the registering authority.

- In the second category are the documents, which an exporter or his agent has to prepare for shipment of goods. These documents are:
 - Foreign Exchange Regulations requires that all exports other than exports to Nepal and Bhutan, shall be declared on the following forms:
 - GR Form: It is required to be filled in duplicate for all exports in physical form other than by post.
 - PP Form: It is required to be filled in duplicate for all exports to all countries made by post parcel, except when made on “value payable” or “cash on delivery” basis.
 - VPICOD Form: It is required to be filled in one copy for exports to all countries by post parcel under arrangements to realise proceeds through postal channels on “value payable” or “cash on delivery” basis.
 - SOFTEX Form: It is required to be prepared in triplicate for export of computer software in non- physical form.

All these documents serve the purpose of monitoring the realisation of sale amount by the exporter in the stipulated manner. For goods that are subject to the Export Trade Control policy of the Government of India, documents in the form of application have been specified.

On the basis of that, the concerned authorities will grant documents either an export licence or an export permit will be granted by the concerned authorities. Licence or permission is generally given on the customs document known as shipping bill. For obtaining export licence from the licensing authorities the application is either the A-X Form or B-X Form which is submitted along with the Shipping Bill and other documents, if any. In many cases, specific permission may have to be obtained from particular government ministries departments, in which case exporter has to apply on his letter head.

For a number of products under the Export (Quality Control and Inspection) Act, 1962 and various other regulations, it is obligatory for an exporter to obtain Inspection Certificate from the notified agencies. For obtaining this certificate, the exporter has to apply in a document called intimation for inspection along with supporting documents (commercial invoice, technical specifications, etc.) to an Export Inspection Agency. Thereafter, a certificate of inspection will be issued, which along with other documents will be submitted to the customs authorities before permission to ship goods is given.

Under the Indian Customs Act, goods cannot be loaded on board the carriers unless permission from the customs authorities has been obtained. This permission is accorded on a document prescribed by the customs authorities. When goods are sent by sea or by air, this document is known as Shipping Bill. When goods are exported by land or by rail it is called Application for Export. Post parcel consignment requires custom declaration form to be filled in.

There are four types of shipping bills. These are:

- Free shipping bill: Usually printed on white paper, it is used for export of goods which neither attract any export duty or cess nor are entitled to the duty drawback (an export incentive).
- Dutiable shipping bill: Printed on yellow paper, it is used in case of goods which are subject to export duty excess.
- Drawback shipping bill: It is usually printed on green paper and is used for export of goods entitled to duty drawback.
- Shipping bill for shipment ex-bond: It is printed on yellow paper for use in case of imported goods for re-export which are kept in the customs bonded warehouses.

Application for export is used for seeking customs permission of export goods to the neighbouring countries like Bangladesh by road, river or rail. This is of Three Types, namely, for export of “Free”, “Dutiable” and “Drawback” cargos. Customs declaration form for goods sent by post parcel is a standard form for all types of cargo. However, for claiming duty drawback, the exporter has also to file another document known as “Form D”.

Port authorities in India have specified documents for bringing the cargo into the shed for shipment as well as for payment of port charges. This document is called port - trust copy of shipping bill in Bombay dock challan in Calcutta and Export application in Madras and Cochin. Like the shipping bill, this document is prepared by the clearing and forwarding agent of the exporter.

Legal documents in importing countries

Some of the well-known documents needed in the importing countries because of the legal necessity are discussed below. These documents are, however, obtained by the exporter to be sent to the importer.

- Consular invoice: usually issued on the specified form, it is signed and stamped by the local consulate of the country to which goods are exported.
- Customer invoice: it is also made out on a specified form prescribed by the customs authority of the importing country. The details given in the document will enable the customs authority of the importing country to levy and charge import duty.
- Legalised/visaed invoices: these invoices constitute a sworn affidavit by the exporter about the genuineness and correctness of the sale. These could be sworn before the appropriate consulate or the chamber of commerce, as the case may be, which will put their stamp on them.
- Certified invoice: this is the self-certified invoice by the exporter about the origin of the goods.
- Certificate of origin: this certificate is issued by independent bodies like the chamber of Commerce on a prescribed form.
- GSP certificate of origin: goods which get the benefit of preferential import duty treatment countries which implement the Generalised System of Preferences should be accompanied by the GSP Certificate of Origin. This certificate is given on the forms prescribed by the importing countries.
- Health/veterinary/sanitary certificates: these certificates are needed in a couple of countries, certifying that the goods are fit for human consumption.

Documents for claiming incentives

For providing a number of facilities and incentives to the export goods, a number of documents are required to be made out by the exporter. Some of the important facilities and incentives and the corresponding documents are discussed as follows:

- Priority allotment of wagons: the railways in India allot wagons to export consignments moving to ports for shipment on a priority basis. For this purpose, the exporter has to file forwarding note (a railway document), Wagon registration fee receipt and shipping order, which is issued by the shipping company on reservation of space on the ship.
- Rebate in central excise: main documents are invoice and ar4/ar5 forms.
- Duty drawback: For claiming this incentive, the main document is the customs attested drawback copy of shipping bill. This is usually to be supported by drawback payment order (format prescribed by the customs authorities), a copy of the final commercial invoice and a copy of bill of lading/airway bill.

4.6.3 Standardised Pre-Shipment Export Document

Although documents are essential in export operations, much of the documentation is overlapping in nature. Forms of documents prescribed by different agencies/bodies differ in size and layout even though much of the information is common. Consequently, these documents are required to be prepared individually and separately. This method of preparation of documents caused delays in processing of documents by the concerned agencies bodies besides resulting in errors and discrepancies.

Considering the problems caused by the non-standardised documentation, a number of countries have been following a system of documentation known as the “Aligned Documentation System. This system is based on the “UN Layout Key” and is in use in a number of countries where exporters have been benefited because of economy, speed, accuracy and convenience in documentation work. By adopting the similar system, Government of India has developed Standardised Preshipment Export Documents. With the help of this systems, as many as 17 of the 25 documents can be prepared from only 2 Master Documents.

In this method, the information is created on a set of standardised form printed on paper of the same size. This is done in such a way that items of identical information occupy the same position on each of them.

Commercial documents: As you know that these documents are required for effecting physical transfer of goods and their title from the exporter to the importer and the realisation of export sale proceeds. These documents can be divided into

Principal export documents are:

- Commercial invoice
- Packing list
- Bill of lading/Combined transport document
- Certificate of inspection/Quality control
- Insurance certificate of policy
- Certificate of origin
- Bill of exchange
- Shipment advice

Auxiliary export documents are:

- Proforma/Invoice
- Intimation for inspection
- Shipping instructions
- Insurance declaration
- Shipping order
- Mate receipt
- Application for certificate of origin
- Letters to the bank for collection/negotiation of documents

Out of above mentioned 16 documents, 14 documents have been standardised. Two documents, shipping order and bill of exchange have not been standardised. The standardised system involves the use of standardised trade documents, which are also aligned in relation to one another. The documents are prepared on the same size of paper, which have the requisite information in a standard format. Commercial documents are to be prepared as under:

- Standard size of paper
- Paper: A4
- Size: Length - 297 mm
- Width - 210 mm
- Margins: Top - 10 mm
- Left - 20 mm
- Right - 6 mm
- Bottom - 7 mm

- Inside Measurements
- Length - 280 mm
- Width - 184 mm

Tolerance limits

Since these documents are aligned to one another, a Master Document is first prepared containing the information common to all documents. Thereafter, individual documents are prepared from the master documents with the help of a suitable marking and reproduction technique.

Regulatory documents: As you know that different Government department or organisations like central excise, customs, RBI, Export Inspection Council etc., require these documents. Following documents are required at pre-shipment stage.

Central excise:

- Invoice
- AR41AR5 Forms

Customs:

- Shipping bill/Bill of export
- Port Authorities (Port Trust)
- Export Application/Dock challan | Port Trust copy of Shipping Bill
- Receipt for payment of port charges

RBI:

- GRIPP Form

Others:

- Freight payment Certificate
- Insurance premium

Out of these 9 pre-shipment regulatory documents only 3 documents have been standardised. These three documents are:

- Shipping Bill/Bill of Export
- GR Form
- Export Application/Dock Challan/Port Trust copy of Shipping Bill
- including receipt for payment of port charges.

Regulatory documents are to be prepared as under:

- Standard size of paper
- Paper: Full scape size
- Length - 34.5 CMS
- Width - 21.5 crns
- Margins:
- TOP - 1.5 cms
- Left - 1.8 crns
- Right - 0.5 cms
- Bottom - 1.5 crns

- Inside Measurements
- Length - 31.5 cms
- Width - 19.2 cms
- Tolerance limits

4.6.4 Import Documents

Other important documents include:

- Importer Exporter Code (IEC) Number: No person can import goods without obtaining an Importer-Exporter Code (IEC) Number unless he has been specifically exempted, The IEC Number is obtained from the Regional Licensing Authority.
- Bill of Entry: It is a document on which clearance of imported goods is effected. All goods discharged from a vessel, from foreign or coastal ports are cleared on Bill of Entry in the prescribed form. The Bill of Entry form has been standardised by the Central Board of Excise and Customs.

Four copies of bill of entry are submitted. Original and duplicate for customer departments, triplicate is owner's copy and the fourth copy is for the purpose of foreign exchange to be submitted to bank. There are three types of Bill of Entry as discussed below:

- Bill of entry for home consumption (white in colour): where an importer wants to get his goods cleared in one lot, he has to present the Bill of entry for home consumption.
- Bill of entry for warehousing (into bond, yellow in colour): Where an importer wants to shift goods to a warehouse and thereafter gets his goods cleared in small lots, he has to present 'into bond' bill of entry. Reason may be that he is unable to pay duty leviable on all goods at one instance or may be because of storage problem.
- Ex-Bond Bill of Entry (Green in Colour): When an importer wants to remove goods from the warehouse, he has to present an Ex-bond bill of entry which is green in colour.

Bill of Entry is not required in the following cases:

- passengers baggage
- favour parcels
- mail box and post parcels
- boxes, kennels of cargos containing live animals or birds
- unserviceable stores, for instance, dunnage wood, empty bottles, drums etc. of reasonable value
- ship's stores in small quantities for personal use
- cargo by sailing vessels from customs ports when landed at open bundles only

For imports through the medium of post there is no bill of entry. Instead, a way bill is prepared by the foreign post office for assessment of duty.

Summary

- The onset of the era of liberalisation of the external sector of the economy and the industrial licensing followed by partial convertibility of rupee and full convertibility on current account necessitated the need for further extensive amendments in the FERA which were brought about by the Foreign Exchange Regulations (Amendment) Act, 1993. FERA has been replaced by Foreign Exchange Management Act (FEMA), 1999.
- The consolidated and self-contained Customs Act, 1962 came into operation on December 13, 1962 repealing the earlier three Acts known as Sea Customs Act, 1878. Land Customs Act, 1924 and the Aircraft Act, 1934, each one of which was related to a particular mode of transportation.
- For smooth operation of the Export (Quality Control and Inspection) Act, 1963, the Government of India established the Export Inspection Council (EIC) on January 1, 1964, and the Export Inspection Agencies (EIAs).
- The new EXIM Policy 1997-2002 aims at consolidating the gains made so far, restructuring the schemes to achieve further liberalisation and increased transparency in the changed trading environment. It focuses on the strengthening the domestic industrial growth and exports and enabling higher level of employment with due recognition of the key role played by the SSI sector.
- Commercial documents, also known as shipping documents, enable the exporter and the importer to discharge their obligations under an export contract. In specific terms, these documents ensure that the exporter makes shipment of the goods according to requirements of the contract and the importer makes payment for goods shipped in the manner as given in the contract.
- Commercial Invoice is a document of contents that describes details of goods sent by exporter. It is the statement of account, which must contain identification marks and numbers, description of goods and quantity of goods.

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Self Assessment

1. Under _____, the consignee can identify himself with the postal authorities at the destination and obtain delivery of the goods.
 - a. Post parcel receipt
 - b. Airway bill
 - c. Bill of lading
 - d. Commercial invoice

2. _____, also known as shipping documents, enable the exporter and the importer to discharge their obligations under an export contract.
 - a. Commercial documents
 - b. Bill of lading
 - c. Airway bill
 - d. Commercial Invoice

3. Only ____ of the 16 principal export documents have been standardised.
 - a. 10
 - b. 11
 - c. 13
 - d. 14

4. _____ are among the group of units that may import all types of goods without payment of duty.
 - a. Small scale industry
 - b. Large scale industry
 - c. Electronics Hardware Technology Parks (EHTPs)
 - d. Software firms

5. _____ is a receipt issued by the shipping company on its agents.
 - a. Bill of lading
 - b. Bill of receipt
 - c. Airway bill
 - d. Commercial invoice

6. _____ covers several modes of transport for performing the complete journey from the exporting country to the importer's warehouse.
 - a. Combined bill of lading
 - b. Charter party bill of lading
 - c. Clean bill of lading
 - d. Claused bill of lading

7. Match the following:

1. On Board Shipped Bill of Lading	A. Goods have been received on board the ship.
2. Through Bill of Lading	B. Covers goods being transhipped en route but where the first carrier has the responsibility as the principal carrier for all stages of the journey.
3. Trans-shipment B/L	C. The first carrier acts only as an agent for effecting Trans-shipment of cargo.
4. Received for Shipment Bill of Lading	D. It is issued by the shipping company when goods have been given into the custody of the shipping company but have not yet been placed on board the ship.

- 1-D, 2-C, 4-A, 5-B
- 1-A, 2-B, 3-C, 4-D
- 1-D, 2-C, 3-B, 4-A
- 1-B, 2-A, 3-C, 4-D

8. Which statement is true?

- A bill of lading is a document of title.
- An airway bill is a document of title.
- A post parcel receipt is a document of title.
- A commercial invoice is a document of title.

9. What does the acronym AWB stand for?

- Airway bill
- Action withheld bill
- Act wisely bill
- After way bill

10. _____ enables the banks to pay money to the exporter against surrender of shipping documents, including BIL, even before the goods reach the destination.

- Transferability
- Migration
- Motility
- Distribution

Chapter V

International Marketing Management

Aim

The aim of this chapter is to:

- elucidate the concept of international marketing
- explain the evolution process of global marketing
- discuss the scope of international marketing

Objectives

The objectives of this chapter are to:

- describe international marketing challenges
- analyse the reasons for entering into international markets
- discuss the evolution process of global marketing

Learning outcome

At the end of this chapter, you will be able to:

- describe the stages, decisions and factors affecting international marketing
- identify international marketing, planning, organisation and control
- understand the concept of globalisation

5.1 Concept of International Marketing

International marketing is not the same thing as international trade. Only a part of the international trade flows represent international marketing. Further, there is a category of international marketing, which is not captured by the international trade statistics. Walsh, who states international marketing is perhaps best regarded as a shorthand expression for the special international aspects of marketing, defines international marketing as: “the marketing of goods and services across national frontiers, and the marketing operations of an organisation that sells and/or produces within a given country when: that organisation is part of, or associated with, an enterprise which also operates in other countries; and there is some degree of influence on or control of the organisation’s marketing activities from outside the country in which it sells and/or produces. Another view is that international marketing is simply an attitude of mind, the approach of a company with a truly global outlook, seeking its profit impartially around the world, “home” market included, on a planned and systematic basis. Another definition of international marketing is that it is the marketing function of multinational companies. This author would define International Marketing as marketing in an internationally competitive environment, no matter whether the market is home or foreign. For example, although its market is confined almost entirely to India, the competition which Nirma encounters is indeed international. Its major competitors include MNCs like Unilever, P&G, Colgate Palmolive, etc. Besides, there is also competition from imported products. Thus, many firms in their own home market face the technological, financial, organisational, marketing and other managerial prowess of the multinationals.

The sale abroad of a good produced in India is international trade but from a truly managerial point of view it can be regarded as international marketing if it is sold to the ultimate buyer under the brand name of the exporter. Many of India’s exports are repacked or further processed and sold to the ultimate buyer under foreign brand names. For example, the spices imported in bulk from India are packed in consumer pack, after processing or in the same condition as it was imported, and sold under foreign brands.

Even products exported in consumer packs from India are repacked abroad, without any further processing, and sold under foreign brand names. In such cases, the Indian exports represent international trade but not international marketing. It may also be noted that a considerable share of several products sold abroad under the Indian brand names, like pickles and curry powders, are bought by the ethnic population (i.e., the Indian population abroad).

5.1.1 Globalisation

Globalisation is a term frequently used by many but is vaguely defined. One finds trouble in even finding two authors who defines globalisation in the same, exact way. But even that being the case, there is no denying that global markets, in particular emerging ones, offer attractive potential. For many organisations it is the only approach for growth as existing markets mature with few chances for profitable opportunities. As global markets open through the increasing use of the Internet and with improved supply chains, it is likely that there are many untapped segments around the world that would open to a multinational company, regardless of the industry. More and more, the world is becoming an available global market place.

To stop marketing activities at one’s home-base borders is not only arbitrary, but also short-sighted. International marketing is often defined largely in terms of the level of involvement of the company in the global marketplace, and export, multinational and global marketing are most widely considered. Multinational enterprises (MNEs) develop international marketing strategies in order to improve corporate performance through growth and strengthening their competitive advantage.

However, MNEs differ in their approach to international marketing strategy development and the speed and the progress they make in achieving an international presence. There is a focus on the effects of globalisation to international marketing strategies with reference to PepsiCo, the parent company of Pepsi-Cola and Frito Lay.

5.1.2 Concept of International Marketing

A common approach to marketing is to regard it as the function of finding customers for goods that the firm has already decided to supply. Thus, management select products that are economical to put on the market relative to production cost and resource availabilities and then sets up a marketing department to persuade customers to purchase the goods. This approach although fairly common, does not accord with the marketing concept.

The alternative approach is for the firm to evaluate the marketing opportunities before it decides the product characteristics to offer, assesses potential demand for various items, determines the product attributes most needed and desired by consumers, predicts the prices consumers are willing to pay., and then supplies goods corresponding to these requirements. Firms that adopt marketing concept are more likely to sell their products because these will have been conceived and developed to satisfy customer demands. The marketing concept, then, is the proposition that the supply of goods and services should depend on the demands for them. Even the most vigorous advertising and other promotional campaigns will fail if people do not want the products.

The international marketing concept implies a shift away from looking for foreign customers who appreciate the firm's products and towards a focus on the supply of the goods that foreign consumer's desire. Manifestations of the latter approach include:

- Careful research into foreign consumer behaviour.
- Willingness to create new products and adapt existing products to satisfy the needs of world markets. Products may have to be adapted to suit the tastes, needs, purses and other characteristics of consumers in specific regions. Firms cannot assume that an item that sells well in one country will be equally successful in others.
- Integration of the international side of the company's business with all aspects of its operations.

International marketing considerations must be taken into account when designing and developing products, when selecting transport and distribution system, when dealing with banks, advertising agencies and so on, and when structuring the overall organisation of the firm. The international marketing manager needs to be involved in corporate planning, sales forecasting, the recruitment and training of marketing personnel, and the control of salespeople 'in the field'.

5.1.3 Evolution Process of Global Marketing

Whether an organisation markets its goods and services domestically or internationally, the definition of marketing still applies. However, the scope of marketing is broadened when the organisation decides to sell across international boundaries, this being primarily due to the numerous other dimensions which the organisation has to account for. For example, the organisation's language of business may be "English", but it may have to do business in the "French language". This not only requires a translation facility, but the French cultural conditions have to be accounted for as well. Doing business "the French way" may be different from doing it "the English way". This is particularly true when doing business with the Japanese.

Defination

Let us, firstly define "Marketing" and then see how, by doing marketing across multinational boundaries, differences, where existing, have to be accounted for.

S. Carter defines marketing as:

"The process of building lasting relationships through planning, executing and controlling the conception, pricing, promotion and distribution of ideas, goods and services to create mutual exchange that satisfy individual and organisational needs and objectives".

The long held tenets of marketing are

- customer value
- competitive advantage
- focus

This means that organisations have to study the market, develop products or services that satisfy customer needs and wants, develop the “correct” marketing mix and satisfy its own objectives as well as giving customer satisfaction on a continuing basis. However, it became clear in the 1980s that this definition of marketing was too narrow.

Strategic marketing

Preoccupation with the tactical workings of the marketing mix led to neglect of long term product development, so “Strategic Marketing” was born. The focus was shifted from knowing everything about the customer, to knowing the customer in a context which includes the competition, government policy and regulations, and the broader economic, social and political macro forces that shape the evolution of markets. In global marketing terms this means forging alliances (relationships) or developing networks, working closely with home country government officials and industry competitors to gain access to a target market. Also the marketing objective has changed from one of satisfying organisational objectives to one of “stakeholder” benefits - including employees, society, government and so on. Profit is still essential but not an end in itself.

- Strategic marketing according to Wensley (1982) has been defined as: “Initiating, negotiating and managing acceptable exchange relationships with key interest groups or constituencies, in the pursuit of sustainable competitive advantage within specific markets, on the basis of long run consumer, channel and other stakeholder franchise”.
- Whether one takes the definition of “marketing” or “strategic marketing”, “marketing” must still be regarded as both a philosophy and a set of functional activities. As a philosophy embracing customer value (or satisfaction), planning and organising activities to meet individual and organisational objectives, marketing must be internalised by all members of an organisation, because without satisfied customers the organisation will eventually die. As a set of operational activities, marketing embraces selling, advertising, transporting, market research and product development activities to name but a few. It is important to note that marketing is not just a philosophy or one or some of the operational activities. It is both.
- In planning for marketing, the organisation has to basically decide what it is going to sell, to which target market and with what marketing mix (product, place, promotion, price and people). Although these tenets of marketing planning must apply anywhere, when marketing across national boundaries, the difference between domestic and international marketing lies almost entirely in the differences in national environments within which the global programme is conducted and the differences in the organisation and programmes of a firm operating simultaneously in different national markets.

Post-modern era of marketing

It is recognised that in the “postmodern” era of marketing, even the assumptions and long standing tenets of marketing like the concepts of “consumer needs”, “consumer sovereignty”, “target markets” and “product/market processes” are being challenged. The emphasis is towards the emergence of the “customising consumer”, that is, the customer who takes elements of the market offerings and moulds a customised consumption experience out of these. Even further, post modernism, posts that the consumer who is the consumed, the ultimate marketable image, is also becoming liberated from the sole role of a consumer and is becoming a producer. This reveals itself in the desire for the consumer to become part of the marketing process and to experience immersion into “thematic settings” rather than merely to encounter products. So in consuming food products for example, it becomes not just a case of satisfying hunger needs, but also can be rendered as an image - producing act. In the post modern market place the product does not project images, it fills images. This is true in some foodstuffs. The consumption of “designer water” or “slimming foods” is a statement of a self image, not just a product consuming act.

- Acceptance of postmodern marketing affects discussions of products, pricing, advertising, distribution and planning. However, given the fact that this textbook is primarily written with developing economies in mind, where the environmental conditions, consumer sophistication and systems are not such that allow a quantum leap to postmodernism, it is intended to mention the concept in passing. Further discussion on the topic is available in the accompanying list of readings.
- When organisations develop into global marketing organisations, they usually evolve into this from a relatively small export base. Some firms never get any further than the exporting stage. Marketing overseas can, therefore, be anywhere on a continuum of “foreign” to “global”. It is well to note at this stage that the words “international”,

“multinational” or “global” are now rather outdated descriptions. In fact “global” has replaced the other terms to all intents and purposes. “Foreign” marketing means marketing in an environment different from the home base, its basic form being “exporting”. Over time, this may evolve into an operating market rather than a foreign market. One such example is the Preferential Trade Area (PTA) in Eastern and Southern Africa where involved countries can trade inter-regionally under certain common modalities. Another example is the Cold Storage Company of Zimbabwe.

Case 1.1 Cold Storage Company Of Zimbabwe

The Cold Storage Company (CSC) of Zimbabwe, evolved in 1995, out of the Cold Storage Commission. The latter, for many years, had been the parastatal (or nationalised company) with the mandate to market meat in Zimbabwe. However, the CSC lost its monopoly under the Zimbabwean Economic Reform Programme of 1990-95, which saw the introduction of many private abattoirs. During its monopoly years, the CSC had built five modern abattoirs, a number of which were up to European Union rating. In addition, and as a driving force to the building of EU rated abattoirs, the CSC had obtained a 9000 tonnes beef quota in the EU. Most of the meat went out under the auspices of the Botswana Meat Commission. For many years, the quota had been a source of volume and revenue, a source which is still continuing. In this way, the CSC’s exporting of beef to the EU is such that the EU can no longer be considered as “Foreign” but an “Operating” market.

In “global marketing” the modus operandi is very different. Organisations begin to develop and run operations in the targeted country or countries outside of the domestic one.

The four stages of global marketing are as follows:

- Stage one: Domestic in focus, with all activity concentrated in the home market. Whilst many organisations can survive like this, for example raw milk marketing, solely domestically oriented organisations are probably doomed to long term failure.
- Stage two: Home focus, but with exports (ethnocentric). Probably believes only in home values, but creates an export division. Usually ripe for the taking by stage four organisations.
- Stage three: Stage two organisations which realise that they must adapt their marketing mixes to overseas operations. The focus switches to multinational (polycentric) and adaption becomes paramount.
- Stage four: Global organisations which create value by extending products and programmes and focus on serving emerging global markets (geocentric). This involves recognising that markets around the world consist of similarities and differences and that it is possible to develop a global strategy based on similarities to obtain scale economies, but also recognises and responds to cost effective differences. Its strategies are a combination of extension, adaptation and creation. It is unpredictable in behaviour and always alert to opportunities.

There is no time limit on the evolution process. In some industries, like horticulture, the process can be very quick.

Management emphasis	Stage one Domestic	Stage two International	Stage three Multinational	Stage four Global
Focus	Domestic	Ethnocentric	Polycentric	Geocentric
Marketing strategy	Domestic	Extension	Adaption	Extension
Structure	Domestic	International	Worldwide area	Adaption creation matrix/mixed
Management style	Domestic	Centralised top down	Decentralised bottom up	Integrated
Manufacturing stance	Mainly domestic	Mainly domestic	Host country	Lowest cost worldwide

Investment policy	Domestic	Domestic used worldwide	Mainly in each host country	Cross subsidisation
Performance evaluation	Domestic market share	Against home country market share	Each host country market share	Worldwide

Table 5.1 Stages of domestic to global evolution

5.1.4 Towards Glocal Marketing

The traditional notion of a ‘mass market’ is no longer relevant. A homogenous mass market of ‘more-or-less’ equivalent consumers is today splintered into many small sub-segments. Each sub segment demands services and products customised to their highly specific needs. Companies can deliver on this need today thanks to cutting edge technology that enables cost effective production in small quantities – virtually any time/anywhere.

Thanks to the instant global reach of the web, today’s web savvy customer is spoilt for choice. The consumer wants marketing messages to be of global standards yet be locally relevant – all at the click of a mouse. The ‘Glocal’ approach to online branding is more challenging than ever. ‘Glocal’ (a term coined by Akio Morita, founder of Sony Corporation) stands for ‘marketing locally in the context of global village economy’.

Pepsi, for example, markets globally, yet tailors its messaging to appeal to local tastes. It sells its localised food products through promotions that use local location names, people and references. Increasingly, technology is facilitating custom delivery of brand promotions to sub segments defined geographically, psychographically, demographically, lifestyle or even entertainment preferences. While offline branding can have the luxury of time, Internet branding needs to evolve and be relevant to changing needs and tastes instantly.

5.1.5 Glocal Marketing Strategy

Consumers want both global and local brands – brands that make them feel part of wider international community yet they should be aligned to their home tastes and culture. Companies need to follow a five-stage plan to develop an effective glocal marketing strategy. These are:

- Forecast future trends
- Predict evolving consumer need
- Build sub-customer group core competencies
- Develop a collaborative work culture
- Localise marketing strategies

At the same time at each of the above stages, organisations need to adopt four critical perspectives – technological view, economic view, social view and political/ideological understanding. These help the company deliver effective strategies for re-aligning its offerings and promotions to effectively capitalise on future market needs of its targeted customers.

Future trends in glocal marketing

In the not so distant future, the new age ‘glocal’ era will be very different from anything that organisations have experienced so far. Rapid socio-economic changes are fragmenting the markets. Future market segments will be more focused and smaller – right down to the smallest possible target market level: the individual customer.

Evolving consumer behaviour is driven by the customers’ unique biographical subculture. This is largely determined by 3 general yet personally-diverse constituents – ethnic identity, generational identity and gender identity. In fact there is no such thing as a ‘melting pot’; as root culture lives across many generations. Today cultural and ethnic identification is a strong and pervasive market force that just cannot be ignored by smart marketers.

A culture today is both the source and adopter of different values, ideas, and innovations. Culture is now a product of social mixing – and we all are mixing to create new Glocal opportunities. The global flows of people, money, and information into local markets are creating a multi-ethnic glocal smorgasbord. This trend is fuelled by the following irreversible trends:

- Growing global free trade is opening up new markets with unprecedented ease and speed
- Tele-computer revolution has vastly improved productivity and quality of output; and
- Globally prevalent low inflation and a higher savings rate is boosting consumerism.

Friendly adaptive branding

Glocal strategies are facilitated by online marketing that has the advantage of instantly contacting global customers with real-time localisation – at a fraction of offline business costs. However this has its own localisation challenges. People do not change their preferred choices for the sake of limited offerings of a business; they simply go to the competitor. Online branding thus needs to be adaptive to localised needs instantly. For example an online garments store needs to offer its customers in different geographic regions varied choices as per their local needs.

The majority of consumers dislikes dramatic changes and appreciate brands that are friendly and adaptive to their changing needs i.e. speak their regional language and are simple. Depending on the local IP of the Internet visitor the online promotion web page presents locally relevant branding (culture, tone) and product offerings. Different types of online promotions can even allow online customers to engage in web chat with other users for making a better informed choice. Online branding leverages technology to add new paradigms to localised customer convenience.

5.1.6 Reasons /Motives of International Marketing

There are several answers to the question ‘why firms go international?’ The factors which motivate or provoke firms to go international may be broadly divided into two groups, viz., the pull factors and the push factors. The pull factors, most of which are proactive reasons, are those forces of attraction which pull the business to the foreign markets. In other words, companies are motivated to internationalise because of the attractiveness of the foreign market. Such attractiveness includes broadly, the relative profitability and growth prospects. The push factors refer to the compulsions of the domestic market, like saturation of the market, which prompt companies to internationalise. Most of the push factors are reactive reasons. Important reasons for going international are described below.

Profit motive

One of the most important objectives of internationalisation of business is the profit advantage. International business could be more profitable than the domestic. As pointed out earlier, there are cases where more than 100 per cent of the total profit of the company is made in the foreign markets (in which case the domestic operation, obviously, is incurring loss). Even when international business is less profitable than the domestic, it could increase the total profit. Further, in certain cases, international business can help increase the profitability of the domestic business. This is illustrated with the help of below given figure.

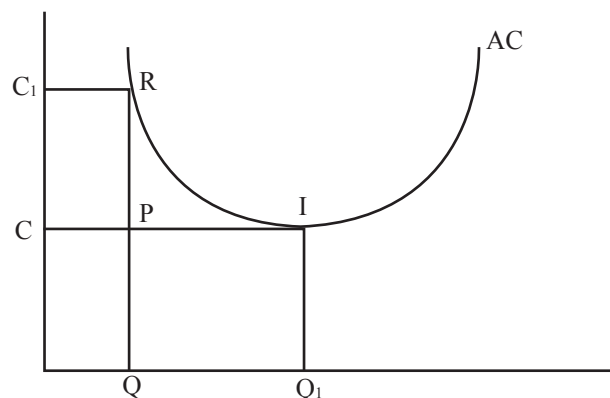


Fig. 5.1 Impact of exports on average unit cost

One of the important motivations for foreign investment is to reduce the cost of production (by taking advantage of the cheap labour, for example). While in some cases, the whole manufacturing of a product may be carried out in foreign locations, in some cases only certain stages of it are done abroad. A significant share of the merchandise imported into the United States is manufactured by foreign branches of American companies. Several American companies ship parts and components to overseas locations where the labour intensive assembly operations are carried out and then the product is brought back home. The North American Free Trade Agreement comprising the U.S., Canada and Mexico is expected to encourage large relocation of production to Mexico where the labour is substantially cheap.

Growth opportunities

The enormous growth potential of many foreign markets is a very strong attraction for foreign companies. In a number of developing countries, both the population and income are growing fast. It may be noted that several developing countries, the newly industrialising countries (NICs) and the Peoples' Republic of China in particular, have been growing much faster than the developed countries. Growth rate of India has also been good and the liberalisation seems to have accelerated the growth. Even if the market for several goods in these countries is not very substantial at present, many companies are eager to establish a foothold there, considering their future potential. Similarly, when the East European economies have been opened up, there has been a rush of MNCs to establish a base in these markets.

Domestic market constraints

Domestic demand constraints drive many companies to expanding the market beyond the national border. The market for a number of products tends to saturate or decline in the advanced countries. This often happens when the market potential has been almost fully tapped. In the United States, for example, the stock of several consumer durables like cars, TV sets etc. exceed the total number of households.

Estimates are that in the first quarter of the 21st century, while the population in some of the advanced economies would saturate or would grow very negligibly, in some others there would be a decline. Such demographic trends have very adverse effects on certain lines of business. For example, the fall in the birth rate implies contraction of market for several baby products.

Another type of domestic market constraint arises from the scale economies. The technological advances have increased the size of the optimum scale of operation substantially in many industries making it necessary to have foreign market, in addition to the domestic market, to take advantage of the scale economies. It is the thrust given to exports that enabled certain countries like South Korea to set up economic size plants.

In the absence of foreign markets, domestic market constraint comes in the way of benefiting from the economies of scale in some industries. Domestic recession often provokes companies to explore foreign markets. One of the factors which prompted the Hindustan Machine Tools Ltd. (HMT) to take up exports very seriously was the recession in the home market in the late 1960s. The recession in the automobile industry in the early 1990s, similarly, encouraged several Indian auto component manufacturers to explore or give a thrust to foreign markets.

Competition

Competition may become a driving force behind internationalisation. A protected market does not normally motivate companies to seek business outside the home market. Until the liberalisations which started in July 1991, the Indian economy was a highly protected market. Not only that the domestic producers were protected from foreign competition but also domestic competition was restricted by several policy induced entry barriers, operated by such measures as industrial licensing and the MRTP regulations.

Being in a seller's market, the Indian companies, in general, did not take the foreign market seriously. The economic liberalisation ushered in India since 1991, which has increased competition from foreign firms as well as from those within the country, have, however, significantly changed the scene. Many Indian companies are now systematically planning to go international in a big way.

Many companies also take an offensive international competitive strategy by way of counter-competition. The strategy of counter-competition is to penetrate the home market of the potential foreign competitor so as to diminish its competitive strength and to protect the domestic market share from foreign penetration.

“Effective counter-competition has a destabilising impact on the foreign company’s cash flows, product related competitiveness and decision making about integration. Direct market penetration can drain vital cash flows from the foreign company’s domestic operations. This drain can result in lost opportunities, reduced income, and limited production, impairing the competitor’s ability to make overseas thrusts.”

Thus, IBM moved early to establish a position of strength in the Japanese main frame computer industry before two key competitors, Fujitsu and Hitachi, could gain dominance. Holding almost 25 per cent of the market, IBM denied its Japanese competitors vital cash flow and production experience needed to invade the U.S market. They lacked sufficient resources to develop the distribution and software capabilities essential to success in America. So the Japanese have finally entered into joint ventures with U.S. companies having distribution and software skills (Fujitsu with TRW, Hitachi with National Semi-conductor).

In fact, in Fujitsu’s case, it was an ironic reversal of the counter-competitive strategy by expanding abroad to increase its economies of scale for the fight with IBM back home. The Texas Instruments established semi-conductor production facilities in Japan “to prevent Japanese manufacturers from their own markets”. Even after much development work, the Japanese producers could muster neither the R & D resources nor the manufacturing capability to compete at home or overseas with acceptable product in sufficiently large quantities.

Government policies and regulations

Government policies and regulations may also motivate internationalisation. There are both positive and negative factors which could cause internationalisation. Many governments give a number of incentives and other positive support to domestic companies to export and to invest in foreign countries. Similarly, several countries give a lot of importance to import development and foreign investment. Sometimes, as was the case in India, companies may be obliged to earn foreign exchange to finance their imports and to meet certain other foreign exchange requirements like payment of royalty, dividend, etc.

Further, in India, permission to enter certain industries by the large companies and foreign companies was subject to specific export obligation. Some companies also move to foreign countries because of certain regulations, like the environmental laws in advanced countries. Government policies which limit the scope of business in the home country may also provoke companies to move to other countries.

Here is an interesting case: In the early seventies, having failed to make any headway within India, the only alternative left for the Birla Group was to set up industries in other countries and it put up several successful companies in all the ASEAN countries. “This was surely a paradox.

The same government which refused us permission to set up manufacturing capacities within the country allowed us to set up industries outside the country for the same products for which it has said ‘no’ in India. Thus, we set up a viscose staple fiber plant in Thailand, and started exporting fiber back to India.”

According to one study, “the evidence suggests that one of the most important motivations behind foreign direct investment by Indian firms has been -the desire to escape the constraining effects of Government of India’s policy. It appears that a number of Indian locally domiciled foreign collaboration industries, those involved in manufacturing at least, go overseas to avoid a policy environment that restricts their domestic growth and undermines their competitiveness.

To the extent that foreign direct investment from India takes place for such negative reasons, the phenomenon may be regarded as disguised form of capital flight from India.” With the recent changes in the government of India’s economic policy, the situation, however, has changed. Many Indian companies are entering international market or are expanding their international operations because of positive reasons.

Monopoly power

In some cases, international business is a corollary of the monopoly power which a firm enjoys internationally. Monopoly power may arise from such factors as monopolisation of certain resources, patent rights, technological advantage, product differentiation etc. Such monopoly power need not necessarily be an absolute one but even a dominant position may facilitate internationalisation. As Czinkota and Ronkainen observe, exclusive market information is another proactive stimulus. This includes knowledge about foreign customers, market places, or market situations not widely shared by other firms. Such special knowledge may result from particular insights by a firm based on international research, special contacts a firm may have or simply being in the right place at the right time (for example, recognising a good business situation during a vacation).

Although such monopoly element may give an initial advantage, competitors could be expected to catch up soon. Spin-off Benefits International business has certain spin-off benefits too. International business may help the company to improve its domestic business; international business helps improve the image of the company. International marketing may have pay-offs for the internal market too by giving the domestic market better products. Further, the foreign exchange earnings may enable a company to import capital goods, technology etc. which may not otherwise be possible in countries like India. Another attraction of exports is the economic incentives offered by the government.

Strategic vision

The systematic and growing internationalisation of many companies is essentially a part of their business policy or strategic management. The stimulus for internationalisation comes from the urge to grow, the need to become more competitive, the need to diversify and to gain strategic advantages of internationalisation. Many companies in India, like several pharmaceutical firms, have realised that a major part of their future growth will be in the foreign markets. There are a number of corporations which are truly global. Planning of manufacturing facilities, logistical systems, financial flows and marketing policies in such corporations are done considering the entire world as its, and a single, market - a borderless world.

5.1.7 Internationalisation stages

Most companies pass through different stages of internationalisation. There are, of course, many companies which have international business since their very beginning, including 100 per cent export oriented companies. Even in the case of many of the hundred per cent export oriented companies, the development of their international business would pass through different stages of evolution. A firm which is entirely domestic in its activities normally passes through different stages of internationalisation before it becomes a truly global one. There are many companies which enthusiastically and systematically go international as part of their corporate plan.

However, in the case of many firms the initial attitude towards international business is passive and they get into the international business in response to some external stimuli. For example, a sample survey of U.S. firms exporting industrial products revealed that most of them first began exporting through the action of an outside party - about 48 per cent responded to unsolicited orders and 44 per cent were approached by foreign distributors.

In the earlier surveys, the percentage of the total number of firms which began exporting responding to unsolicited orders was much higher. A firm may start exports on an experimental basis and if the results are satisfying it would enlarge the international business and in due course it would establish offices, branches or subsidiaries or joint ventures abroad. The expansionary process may also be characterised by increasing the product mix and the number of market segments, markets and countries of operation.

In the process the company could be expected to become multinational and finally global. In short, in many firms overseas business initially starts with a low degree of commitment or involvement; but they gradually develop a global outlook and embark upon overseas business in a big way. The important stages in the evolutionary process are the following:

Domestic company

Most international companies have their origin as domestic companies. The orientation of a domestic company essentially is ethnocentric. A purely domestic company “operates domestically because it never considers the alternative of going international. The growing stage-one company, when it reaches growth limits in its primary market, diversifies into new markets, products and technologies instead of focusing on penetrating international markets.”

However, if factors like domestic market constraints, foreign market prospects, increasing competition etc. make the company reorient its strategies to tap foreign market potential, it would be moving to the next stage in the evolution. A domestic company may extend its products to foreign markets by exporting, licensing and franchising. The company, however, is primarily domestic and the orientation essentially is ethnocentric. In many instances, at the beginning exporting is indirect. The company may develop a more serious attitude towards foreign business and move to the next stage of development, i.e., international company.

International company

International company is normally the second stage in the development of a company towards the transnational corporation. The orientation of the company is basically ethnocentric and the marketing strategy is extension, i.e., the marketing mix ‘developed’ for the home market is extended into the foreign markets. International companies normally rely on the international division structure for carrying out the international business.

Multinational company

When the orientation shifts from ethnocentric to polycentric, the international company becomes multinational. In other words, “When a company decides to respond to market differences, it evolves into a stage three multinational that pursues a multidomestic strategy. The focus of the stage-three company is multinational or, in strategic terms, multi domestic (That is, the company formulates a unique strategy for each country in which it conducts business).” The marketing strategy of the multinational company is adaptation. In multinational companies, “each foreign subsidiary is managed as if it were an independent city state. The subsidiaries are part of an area structure in which each country is part of a regional organisation that reports to world headquarters. “

Global transnational company

According to Keegan, global company represents stage four and transnational company stage five in the evolution of companies. However, several people use these terms as synonyms and by global corporation they refer to the final stage in the development of the corporation. According to Keegan, “the global company will have either a global marketing strategy or a global sourcing strategy but not both. It will either focus on global markets and source from the home or a single country to supply these markets, or it will focus on the domestic market and source from the world to supply its domestic channel.” However, according to the interpretation of some others, all strategies - product development, production (including sourcing) marketing etc. - will be global in respect of the global corporation.

The “transnational corporation is much more than a company with sales, investments, and operations in many countries. This company, which is increasingly dominating markets and industries around the world, is an integrated world enterprise that links global resources with global markets at a profit.”

5.1.8 International Marketing Decisions

A firm which plans to go international has to make a series of strategic decisions. They are broadly the following:

International business decision

The first decision a company has to make, of course, is whether to take up international business or not. This decision is based on a serious consideration of a number of important factors, such as the present and future overseas opportunities, present and future domestic market opportunities, the resources of the company (particularly skill, experience, production and marketing capabilities and finance), company objectives, etc.



Fig. 5.2 International marketing decisions

Market selection decision

Once it has been decided to go international the next important step is the selection of the most appropriate market. For this purpose, a thorough analysis of the potentials of the various overseas markets and their respective marketing environments is essential. Company resources and objectives may not permit a company to do business in all the overseas markets. Further, some markets are not potentially good, and it may be suicidal to waste company resources in such markets. A proper selection of the overseas market(s), therefore, is very important. (iii) Entry and Operating Decisions: Once the market selection decision has been made, the next important task is to determine the appropriate mode of entering the foreign market.

Marketing mix decision

The foreign market is characterised by a number of uncontrollable variables. The marketing mix consists of internal factors which are controllable. The success of international marketing, therefore, depends to a large extent on the appropriateness of the marketing mix. The elements of the marketing mix - product, promotion, price and physical distribution - should be suitably designed so that they may be adapted to the characteristics of the overseas market. More details are given in some of the following chapters.

International organisation decision

A company which wants to do direct exporting has also to decide about its organisational structure, so that the exporting function may be properly performed. This decision should necessarily be based on a careful consideration of such factors as the expected volume of export business, the nature of the overseas market, the nature of the product, the size and resources of the company, and the length of its export experience. The nature of the organisation structure of the company will depend on a number of factors like its international orientation, nature of business, size of business, future plans etc.

5.1.9 Participants in International Marketing

There are different categories of participants in International Marketing. Important categories are the following: Private Firms. The bulk of the international transactions are carried out by private firms - MNCs; other large firms, and SMEs.

Multi National Company's

MNC's account for a large part of the international marketing. About one third of the international trade is estimated to be intra-company transfers, i.e., trade between affiliates or divisions of the MNC's located in different countries. Besides, they market large quantities of products to international customers.

Other Large Firms

Besides MNC's, there are a large number of large firms active in international marketing. Although, they do not qualify to be regarded as MNC's, many of them have manufacturing and other operational facilities in foreign countries.

SMEs

Small and medium enterprises also play a very significant role in international business. A very large number of them do considerable business abroad. There are many in this category which is hundred per cent or primarily export oriented. In the case of USA and Germany, the largest exporting nations, more than half of the exports are contributed by small firms. About 35 per cent of India's exports come from village and small industries.

Public sector undertakings

In several countries, public sector also plays a very important role in foreign trade. State trading was the rule in the communist countries. State trading was prominent in socialist countries. Even in some of the mixed economies like India, state trading had an important place. There was substantial canalisation of foreign trade of India {a canalised item can be exported/imported only by a public sector undertaking}. The liberalisation has very significantly reduced the role of state trading. The share of canalised items in the total business of state trading agencies like STC and MMTC has substantially come down. They now have to do business mostly on their own, like private trading corporations.

Besides, the state trading agencies, a number of public sector undertakings do significant international trade, like marketing their products and buying their requirements. Trading Companies There are, many trading companies, including public sector (like STC and MMTC), which are specialised in foreign trade. They are merchant exporters, (i.e., those which export products manufactured by other firms). Trading companies in countries like Japan do very huge volumes of trade. A large number of individuals also do international marketing.

One of the very significant contributions of the worldwide web and the internet is the empowerment of individuals and small firms to start business and to expand their business horizon. They are now able to easily access information from throughout the world and get into direct contact with buyers/sellers globally.

5.1.10 Future of International Marketing

It may be predicted that in future the word international will disappear from international business or international marketing because business international business international business and marketing international marketing so that there is no need for the adjective international. As pointed out earlier, international competition in the 'domestic' market is so pervasive that international marketing may be defined as marketing in an internationally competitive environment, whether the market is foreign or domestic. There are several trends that would make globalisation and international marketing more pronounced in future.

- Globalisation of supply chain and operations management: The growing trend towards globalisation of supply chain and operations management will increase the importance of international marketing.
- International investments: The continuing high levels of international investments and increasing international production tend to increase the importance of international marketing. Information surge and consumer choice Because of the information surge, consumers are fairly well aware of the galaxy different categories of products available across the world. The consumer affluence make consumers more demanding, generating cross boarder

demand. Keegan, who observes that the world economy has undergone revolutionary changes during the past 50 years, points out that the following six major changes will continue well into this century.

- World growth: World economy would grow fairly fast. The developing countries have been growing much faster than the developed ones and this trend would continue.
- Domination of the world economy: One of the major changes is the emergence of the world economy as the dominant economic unit and the resultant decline of the power of nations like the United States to pressurise policies and behaviours of other nations.
- Trade-cycle decision rule: The old trade-cycle model, which implied that as a product matures the location of production must shift to low-wage countries, has been clarified.

Keegan points out that the location of production is not dictated exclusively by wage levels. For any product in which labour is less than, say, 15 per cent to 20 per cent of total costs, the location of production of mature products may be anywhere in the world. Factors such as transportation costs, availability of skilled labour, market responsiveness, and market access and high levels of innovation in product design and manufacturability may all indicate that the best location for production is a high-income, high-wage country. It may be pointed out that, as against the above observations, that shift of production location happens in case of many products even now. Although Keegan has taken automobile as an example to support his point, it should be noted that the production of low end models has been shifting to developing countries like India. This trend increases the scope of international marketing.

Pervasiveness of free markets

The fall of communism and socialism and the resultant ubiquitous market economy and globalisation are stupendously expanding the scope of international marketing.

- Accelerating growth of global markets. Global markets would grow at rates that were once thought impossible, driven by the high rate of growth in both the high and low-income countries.
- The rise of the Internet and information technology. International marketing is boosted by such factors as the advances in information technology and the rise of the internet. There are also some factors which tend to hamper international marketing, like the restraining forces mentioned earlier. Policies of domestic protection could restrain the growth of international marketing. For example, countries like the U.S., which were champions of free trade, are increasing domestic protection when they see that their interests are adversely affected by free trade.

5.2 Challenges and Scope of International Marketing

5.2.1 Domestic Market Expansion Concept

The domestic company that seeks sales extension of its domestic products into foreign markets illustrates this orientation to international marketing. It views its international operations as secondary to and an extension of its domestic operations. The primary motive is to dispose of excess domestic production. Domestic business is its priority and foreign sales are seen as a profitable extension of domestic operations. While foreign markets may be vigorously pursued, the orientation remains basically domestic. Its attitude toward international sales is typified by the belief that if it sells in Peoria, it will sell anywhere else in the world.

Minimal, if any, efforts are made to adapt the marketing mix to foreign markets. The firm's orientation is to market to foreign customers in the same manner the company markets to domestic customers. It seeks markets where demand is similar to the home market and its domestic product will be acceptable. This Domestic Market Expansion Strategy can be very profitable. Large and small exporting companies approach international marketing from this perspective.

5.2.2 Multi Domestic Market Concept

Once a company recognises the importance of differences in overseas markets and the importance of offshore business to their organisation, its orientation toward international business may shift to a Multi-Domestic Market Strategy. A company guided by this concept has a strong sense that country markets are vastly different (and they may be, depending on the product) and that market success requires an almost independent programme for each country. Firms with this orientation market on a country-by-country basis with separate marketing strategies for each country.

Subsidiaries operate independently of one another in establishing marketing objectives and plans. The domestic market and each of the country markets have separate marketing mixes with little interaction among them. Products are adapted for each market with minimum coordination with other country markets, advertising campaigns are localised as are the pricing and distribution decisions.

A company with this concept does not look for similarity among elements of the marketing mix that might respond to standardisation. Rather, it aims for adaptation to local country markets. Control is typically decentralised to reflect the belief that the uniqueness of each market requires local marketing input and control.

5.2.3 Global Marketing Concept

A company guided by this new orientation or philosophy is generally referred to as a global company, its marketing activity is global marketing, and its market coverage is the world. A company employing a Global Marketing Strategy strives for efficiencies of scale by developing a standardised product, of dependable quality, to be sold at a reasonable price to a global market (that is, the same country market set throughout the world). Important to the Global Marketing Concept is the premise that world markets are being "driven toward a converging commonality" that seek much the same ways to satisfy their needs and desires and thus, constitute significant market segments with similar demands for the same product the world over. With this orientation a company attempts to standardise as much of the company effort as is practical on a world-wide basis. Some decisions are viewed as applicable worldwide, while others require consideration of local influences. The world as a whole is viewed as the market and the firm develops a global marketing strategy.

5.2.4 Institutions

International Institutions

An international institution is an organisation whether or not established by a treaty, in which two or more states (or government agencies or publicly funded bodies) are members and in which a joint financial interest is overseen by a governing body. The purpose of such an international institution could be to achieve international cooperation in dealing with issues of an economical, technical, social, cultural or humanitarian character.

This could be co-operation in the field of governance, security, finance, scientific research, environment or the realisation of joint technical, economical, financial or social projects. The global financial system (GFS) is a financial system consisting of institutions and regulations that act on the international level, as opposed to those that act on a national or regional level. The main players are the global institutions, such as International Monetary Fund and Bank for International Settlements, national agencies and government departments, example, central banks and finance ministries, and private institutions acting on the global scale, example, banks and hedge funds. Deficiencies and reform of the GFS have been hotly discussed in recent years. The history of financial institutions must be differentiated from economic history and history of money. In Europe, it may have started with the first commodity exchange, the Bruges Bourse in 1309 and the first financiers and banks in the 1400-1600s in central and western Europe. The first global financiers the Fuggers (1487) in Germany; the first stock company in England; the first foreign exchange market; the first stock exchange.

Milestones in the history of financial institutions are the Gold Standard (1871-1932), the founding of International Monetary Fund (IMF), World Bank at Bretton Woods, and the abolishment of fixed exchange rates in 1973. The most prominent international institutions are the IMF, the World Bank and the WTO: The International Monetary Fund keeps account of international balance of payments accounts of member states.

The IMF acts as a lender of last resort for members in financial distress, e.g., currency crisis, problems meeting balance of payment when in deficit and debt default. Membership is based on quotas, or the amount of money a country provides to the fund relative to the size of its role in the international trading system. The World Bank aims to provide funding, take up credit risk or offer favourable terms to development projects mostly in developing countries that couldn't be obtained by the private sector. The other multilateral development banks and other international financial institutions also play specific regional or functional roles. The World Trade Organisation settles trade disputes and negotiates international trade agreements in its rounds of talks (currently the Doha Round).

Government institutions

Governments act in various ways as actors in the GFS: they pass the laws and regulations for financial markets and set the tax burden for private players, e.g., banks, funds and exchanges. They also participate actively through discretionary spending. They are closely tied (though in most countries independent of) to central banks that issue government debt, set interest rates and deposit requirements, and intervene in the foreign exchange market.

5.2.5 Reasons and Motivations Underlying International Trade and International Business

There is growing contraction of the world because of better communication and transportation facilities, and the rapid development of domestic economies and concomitant increases in purchasing power of the people. The current interest in international marketing and foreign trade can be explained in terms of changing structures and dynamic changes in demand characteristics of world markets. Both, the firm and country have reasons for entering into international business and foreign trade.

International business

While the reasons are often inter-linked, each has its own premise. The vast domestic markets have provided the firms, an opportunity for continued growth which finally reaches a point where the possibility of continued expansion levels off. The survival of these firms has come into question, for it has become increasingly difficult for these firms to sustain customary rates of growth as demanded by their shareholders.

These companies have been forced by the 'economic criterion' to locate international markets to sell their surplus production and to gain cost advantages. Besides this, foreign markets may offer high profit margins, which gives added impetus for going international. Most of the firms world over are gearing up for action for besides these reasons the Governments of various countries are providing support and incentives to firms involved in foreign trade.

5.2.6 Reasons for Entering into International Markets

Although profit is the underlying motive, most of the firms are directed into International markets because of any of the following five reasons as identified by Vern Terpstra

- **Product life cycle:** A product may be at the end of its life cycle in one market and not even introduced in another. The unwillingness of the firm to write off its productive assets may force it into international markets
- **Competition:** In an effort to avoid competition, which may be intense in the domestic market, the firm may choose to go international.
- **Excess capacity:** In an effort to minimise its fixed cost per unit, the firm may undertake foreign orders.
- **Geographic diversification:** This has to do with the strategy that a firm may adopt. Instead of extending its product line the firm may just choose to expand its market by going international.
- **Increasing the market size:** In an effort to expand its operation a firm may choose to go international.

International trade

With the growth of materialism, every individual has become interested in improving his/her standard of living in terms of material comforts. This has forced the governments into foreign trade to yield the underlying economic benefits and thereby improving the standard of living of its people.

The gains from international trade arise from the local production advantages which in itself is a function of differences in availability and the cost of factors of production.

Thus the difference in factors like the capital availability and cost of capital, specialisation of labour, their wage factor, availability of managerial talent, determine the area of product specialisation that a country will enter into to gain the cost advantage. The production specialisation will lead to an improvement in productivity and thereby an increase in the real income-if the countries indulge in free trade. This explains the reason for importance of balance of payment of a nation and exchange rate.

Theories of international trade

Historically, nations have been trading with each other for hundreds of years for profit or because they do not have enough resources (land, labour and capital) to satisfy all the needs of consumers.

For example, Japan has a highly skilled labour force that use technologically advanced equipments to produce cars and electrical equipment, however it does not have its own oil fields. Saudi Arabia has large supplies of oil, but lacks the resources to produce cars and electrical equipments.

Trade between Saudi Arabia and Japan will allow both countries to obtain goods and services that they cannot produce themselves. Specialisation and trade can then deliver higher living standards to all countries as resources are being used more efficiently.

In economics, three theories have been propounded for explaining the reason for foreign trade. These theories are equilibrium theory. Underlying each of these theories is the theory of relative advantage.

5.2.7 Nature of International Marketing

The task of marketing manager is to mould the endogenous and exogenous factors in the light of opportunities and threats facing the company.

These endogenous and exogenous factors might again be controllable or uncontrollable. Therefore the manager is basically framing his controllables in the light of uncontrollables.

The controllables for a marketing manager include the four P's of marketing and resources within the company. Whereas, the uncontrollables can further be classified into domestic uncontrollables and foreign uncontrollables.

Which markets first?

Many businesses expect to expand internationally by targeting countries. But one country may comprise several markets. Which markets within that country do you target first?

Which country first?

For a start, that's the wrong question. As you already know, Indian and American aren't languages, but rather names for the denizens of India and America. Therein lies the problem.

5.3 International Marketing, Planning, Organising and Control

A multinational corporation manufacturing and marketing a consumer durable product was faced with a problem. The CEO and the corporation has portrayed the following scenario The corporation has just entered into the French market, investing heavily in developing the manufacturing facilities. Since, the idea was to gain economies of scale, the corporation resorted to penetration pricing. It was at this time that the country manager for 'France' revealed to the CEO that the French market share of 80% was being rapidly eroded by competition, Competition, according to the country manager, was eating into the market share from two directions, On the one hand, the substitute product instead had developed rapidly and, on the other hand, the only competitor, who was manufacturing a differentiated product, had stepped up his advertising expenditure. The country manager wants to introduce a substitute product and undertake an aggressive promotion programme to combat competition on both sides. He believes that he can to approve the country manager's proposal or not.

From the above example, it becomes clear that every organisation needs to direct and coordinate its marketing effort. For undertaking this, it must frame a marketing plan. While the task of developing a domestic marketing plan is in itself complex, it gets further compounded when a firm gets into international operation; for international marketing entails a multi country scenario necessitating marketing planning at two levels viz., country level and corporate level. Having developed the marketing plan, the corporation must implement them again at two levels i.e., at country level and at the corporation level. These are the issues that have been addressed in this unit.

5.3.1 Developing a International Marketing Plan

As already pointed out, the marketing plan must be developed at two levels i.e., at the country level and at the international level.

At the country level, the marketing plan resembles any domestic marketing plan, in the sense that it lays down the strengths and weaknesses of the organisation and the opportunities and threats faced by the organisation. It proceeds to set an objective along with the assumptions. Having done the above, it lays down a broad action plan, the organisation structure and the control system necessary for accomplishing the above plan.

The international marketing plan is more than a mere integration of the country plans, for it seeks to direct and coordinate the activities of the corporation on a global basis and at a country level.

These variables are as follows.

- Knowledge of the market.
- Knowledge of the product.
- Knowledge of the marketing systems.

The corporation must decide how it will obtain information about all these variables on global and country basis. This information will then be formalised into a marketing plan to provide guidance to each country manager.

5.3.2 Issues in Framing the Multi- National Marketing Plan

One of the issues that have to be faced while framing the multinational marketing plan relates to the marketing strategy that has to be adopted. Every organisation must decide whether to follow a standardised marketing approach or a multi-domestic marketing approach or a blend of the two approaches.

Standardised approach

This refers to standardisation in four major decision areas decision, price decision, promotion decision and the distribution decision. The organisation should decide about this as a policy. The underlying premise of the standardised approach is in recognition of the globalisation of market. Theoder Levitt in his article on 'The Globalisation of Market' points out that because of technological and communication revolution, consumers in one country would know about the products that are available in other countries and would seek to procure them through formal or informal channels. Once this premise is accepted, it should become possible for an organisation to encash the advantages of standardisation, which include cost saving in all areas right from manufacturing (because the message becomes common as demonstrated by Exxon's 'put a tiger in your tank').

The corporation also has the advantage of maintaining the international customer, a class which is growing as demonstrated by the increase in international air traffic, for, wherever he goes in the world, he is sure of getting the same product. However, this approach is not free from limitations. Although theoretically, a corporation may demand standardisation in practice, it is not always possible because of heterogeneity of the markets. Thus, tariffs dumping laws, retail maintenance laws etc. may limit standardisation of price variable and non-availability of media vehicles may limit standardisation of communication variables.

Since this approach has, however, found many advocates within practising managers, they attempt standardising variables partially. Thus, in the case of promotion variables, the messages are unified very often the movies shot are standardised as demonstrated by Ogilvy and Mather. The brand variable is also standardised and in the case of product variables certain major parts are standardised so that cost savings can be taken advantage of, while at the same time, the heterogeneous characteristics of the markets are also not ignored.

Multi- domestic approach

The multi-domestic approach to market planning emanates on the basis of the assumption that markets are heterogeneous and therefore the marketing strategy decision in a country should specifically cater to the needs of that country. This approach is rated as the true marketing approach by some multinational companies. This approach however, fails to explain the existence and prosperity of large multinational companies and the success of their global strategies. Though markets are heterogeneous, standardisation is possible in many areas. The existence of common brand names like IBM, Levis, etc., and their popularity the world over proves this. But it must be remembered that even these organisations may not standardise all their variables and/or may not cater to heterogeneous markets.

5.3.3 Organisation for International Marketing

Planning will not give success unless it is properly implemented, Therefore, once the plan has been prepared it becomes necessary to implement it, For this, resources have to be deployed and efforts have to be directed to utilise resources effectively. This is possible only when a structural framework exists for allocating the requisite authority and responsibility. This structure should be capable of meeting the varying challenges inherent in international marketing. It is, perhaps, for this reason, that international marketing organisations are characterised by flexibility. Development of such organisational structure should be preceded by development of a plan. Such a plan is undertaken at the corporate level and, normally, the following parameters are considered:

- Company objectives and history
- Government policies influencing the firm's operations
- Marketing Operations
- Decision-making policy and the levels involved in decision-making
- Length of chain of command
- Degree of control
- Degree of involvement in the marketing functions.

These parameters, along with the available resources are aligned with objectives on a production or a function or a geographical basis. The basis also takes into account the method of decision-making.

Historically, organisational structures were designed around the production function. However, in the present global economy where organisations fight intensively to attract and retain customers, it is the finance and marketing functions which give rise to the organisational structure. Most of the existing organisations can be identified as belonging to one of the three categories: centralised, decentralised or regionalised.

5.3.4 Framework for International Marketing Planning

As noted earlier, planning in the international context is more difficult than planning for domestic operations, partly because there are more unknowns in the former than in the latter. However, conceptually it encompasses all the steps used in the preparation of any typical marketing plan. To reiterate, a marketing plan shall normally consist of the following steps:

- Diagnosis of the situation or situation analysis,
- Identification of corporate strengths and weaknesses as well as environmental opportunities and threats.
- Definition of the objectives.
- Forecasted estimates of sales, costs, and profits.
- Designing an appropriate marketing programme based on objectives and estimates.
- Deciding on the relevant appropriations for the plan.

Definition of the objectives is considered by some as the first step in the marketing planning process. Others feel that realistic objectives should be set only after the Strengths, Weaknesses, Opportunities, Threats (SWOT) analysis and in the light of the information and data thrown up by situation analysis. What is, however, important to bear in mind is that since marketing planning is an iterative process, it requires monitoring, revaluation and adaptation of objectives and strategies in the light of constantly changing environment. Strategic planning in the international marketing should encompass the following decision areas:

Commitment decision

Considering the resource position of the firm and its home market situation, does the international market offer an attractive opportunity worth striving for?

Area of operation decision

Which country/countries present the most attractive alternative(s) as potential target markets?

Entry mode and operation decision

What could be the most effective entry technique for entering the international markets and conducting the marketing operations?

Marketing mix strategy

Which possible combination of the marketing mix elements would be suitable to achieve the objectives in the given environment?

International marketing organisation

What is the best possible organisational arrangement which will guarantee sufficient flexibility in and effective control over operations?

5.3.5 International Marketing Control

International marketing displays an interesting paradox with respect to control situations. While control of multinational operations is far more formidable and poses additional challenges, not many business firms exercise control over international operations as thoroughly as they should. The additional difficulty in control of international activities emanates from a number of reasons. The speed and width of environmental change in a multinational company is a factor dependent on each of the markets in which the company operates.

As the rate of exchange and the characteristics undergoing change differ in each of these national markets, this dimension becomes complex. In addition, the far greater heterogeneity of environmental challenges' makes the task of the marketing controller more difficult. In larger companies, the size of international operations necessitates formation of intermediate headquarter, creating an additional organisational level for the control mechanism.

Further, international operations present unique communication problems emanating from the distance between markets and corporate headquarters, and variations in languages, cultures and business practices across the national markets. Thus time lags, cultural lags, communication lags and varying objectives contribute to the problem of establishing and managing effective international marketing control systems. In order to perform at optimum profit levels consistently, all functional areas need systematic control and coordination. While the requirements of an international marketing control system are similar to those of the domestic system; the specific challenges posed by the former necessitate that consideration be given to the following:

- Since international control can seldom be as complete as that of domestic operations, the tools used need to be reasonable and realistic. A cumbersome or complex system is likely to become non-functional soon.
- The cost of control system must be commensurate with the benefits accruing from it.
- In order to be effective in meeting the challenges posed by the rapidly changing environments in heterogeneous market places, the control system must be sensitive and quick so that the organisation retains the flexibility to react to environmental opportunities and challenges.
- The control system may need variation according to the needs posed by different subsidiaries. Though this sounds a simple theoretical principle, most companies tend to adopt a standardised system regardless of the type of country and location in which the system is to be operationalised.
- The control system in the international markets needs to be streamlined enough so that the corporate headquarter is not inundated with masses of data, but only key variables are presented to alert the organisation to departures from the planned performance.

5.3.6 Control Sequence

The control operations in international operation follow similar logical sequence as that in domestic marketing though the implementation may vary depending on the relationships among the steps involved in the control process. Figure below shows the international marketing control systems.

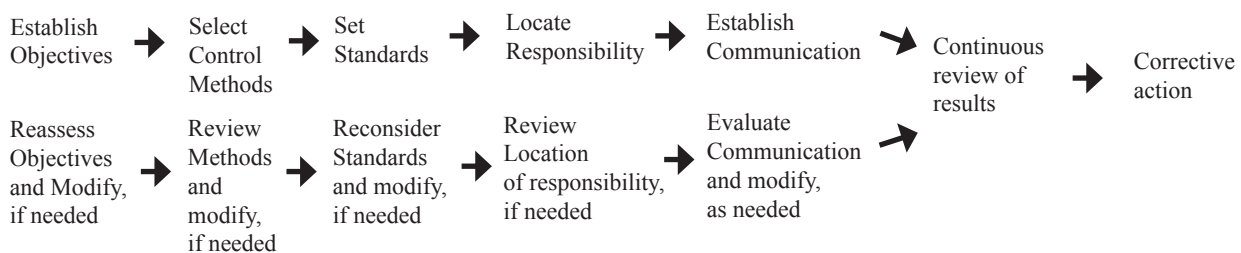


Fig. 5.3 International marketing control system

- Companies may differ in the entry objectives they seek in international markets. For the purpose of designing adequate control systems, management needs to clearly outline its specific long run and short run objectives in respect of specific international markets. Companies with distant foreign subsidiaries often fail to communicate enough about the firm's objectives and goals relating to specific operating units. Unless objectives are conveyed explicitly they cease to have relevance to the operating units.
- The methods chosen for international control may be direct or indirect. Direct control methods include contractual arrangements and equity sharing. Communication and competition are used as indirect control methods. Organisations vary in the extent and degree of control, regardless of the method of control used.
- While contractual arrangements represent a mechanism for direct control, their existence does not automatically generate control. Quota provision and licence requirements therefore are applied by international marketers in the contractual arrangements, to facilitate direct control. Most parent companies also augment these control provisions with other methods.

- When the parent company participates in the policy making and/or administration of its foreign subsidiaries, more effective control is ensured. Similarly, ownership participation enables the parent company to exercise closer control on international operation. Depending upon the objectives to be achieved, standards of performance are used to evaluate performance of the operating units.
- The standards can be in relation to profits, sales volume, channel performance, market share and other such measures deemed relevant. Revenue and expense budgets both form part of the standards set for international operations. There may be a tendency on the part of companies to understate expenses and overstate revenue. It is advisable that country specific research and analysis of budget estimates precedes formation of these standards. In order to provide for an overall comprehensive control system, standards should be set at all levels of operation. These should be reviewed to ensure realism and consistency with corporate goals.
- Location of ultimate responsibility for international operation is usually a difficult problem because of complexity of international organisation. Coordination between the respective functional area of the parent company and the foreign subsidiary becomes imperative. The need for coordination becomes more important when a multinational company organises its international operations on product basis. As far as possible, to facilitate centralised action and coordination, the primary responsibility for control should be located with one person.
- Formalised, defined communication systems become imperative in the context of international control procedures, in contrast to the domestic marketing, where informal communication is quite often utilised in addition to the formal ones.
- An important ingredient of the communication system comprises the tools used for information collection. The approaches used are examination of company records, routine reporting periodic enquiry and field audits.
- **Company records:** Depending on the information needs, some companies use primarily the analysis of the aggregate sales or profit figures of their overseas business units supplemented by the routine reporting system information. This type of analysis may give an idea of the overall position of the firm's international operations.
- **Periodic enquiry:** Most parent companies including those who have entrusted their overseas operations control to the subsidiaries themselves, institute a system of periodic enquiry about their marketing operations and their effectiveness. The sources of information could be organisational, including functional departmental heads or non organisational including customers and channel members. This sort of periodic enquiry, especially if it is in the context of specifically defined objectives, helps in sensitising the parent organisation to the variation from the planned performance and even the possible reasons for it.
- **Routine reporting or monitoring system:** Parent companies, which prefer centralised control, tend to develop and implement a monitoring system consisting of standardised report formats, submitted periodically. The reporting formats are designed to make interpretation of variance possible. These monitoring systems include routine reports by field sales personnel and channel members. A routine reporting is time consuming. The system should be periodically reviewed to ensure that it is economical, accurate and relevant.
- **Field audits:** It may be felt at some times that reported information is not adequate enough to provide a full, in-depth understanding of international business scene. Without perceptual understanding of the location and environment, it may be difficult to appreciate some of the peculiarities of the situation that the management may have to deal with. A system of periodic field visits may provide the organisation with greater insights into the marketing problems unique to a given external market. The periodicity of the audit visit would depend upon the number and kinds of problems encountered in the foreign market, the profit potential of the area, the capabilities of the local managerial personnel and the cost of these visits. To make effective use of the field audit as a control tool, the field auditor must plan in advance, an audit checklist.

- **Evaluation and corrective action:** This final step in the control process involves the comparison of actual performance with planned performance. Information generated from the markets needs to be compared with predefined, established norms and standards for different operational areas. If the expected and the actual results vary, corrective action: needs to be taken in terms of modifying either operations and procedures or the standards and objectives, if they seem to be unrealistic in the context of the altered circumstances. In the case of issues involved in international marketing, there is a greater possibility of time lag between initiation and implementation of corrective action. It is, therefore, important that both evaluation and remedial action be initiated as continuing, iterative activities. An additional safeguard against the possibility of time lag is the development of contingency plans to meet unanticipated market conditions.

5.4 International Marketing Entry Decisions

Companies intending to undertake international business must determine the type of presence they desire to maintain in every market where they would like to operate. One major choice concerns the technique of market entry. A company may want to produce in its home country and export to the overseas market or alternatively it may prefer to produce overseas and sell it there.

A second major choice involves the extent of direct ownership desired; should the company strive for full ownership of its local operations or should it associate a local firm with its operations? These initial decisions on market entry have short term, medium term and long term implications, leaving little room for change once a commitment has been made. Therefore, it is important that these decisions are taken with utmost care. In this unit we shall discuss the major entry strategy alternatives by exploring each one in detail and citing relevant company experiences.

5.4.1 Entry Modes

One of the critical decisions of international marketing is the mode of entering the foreign market. At one extreme, a company may decide to produce the product domestically and export it to the foreign market. In this case, the company need not make any investment overseas. On the other extreme, the company may establish manufacturing facilities in the foreign country to sell the product there.

This strategy requires direct foreign investment by the company. In between these two extremes, there are several options each of which demand different levels of foreign investment. No matter how mighty your company may be, it is not a practical strategy to enter all markets with a single entry method. With all its power, even a largest company may have to formulate different entry strategies to different countries. You may opt for one entry strategy in one market and another strategy in another market, because one entry strategy may not suit all countries.

As stated already, international marketing activities of business firms can take varied modes ranging from indirect/export on the one hand to direct investment in manufacturing facilities abroad on the other. Each of these strategies require different levels of investment ranging from no additional investment to high investment in production facilities, where the investment is low, the international business firm faces less risk, less control over the foreign market and may not be able to reap all the profits.

On the other hand, when the investments are high in the form of manufacturing facilities abroad, international firm can have full control over the market and reap all the profits, but faces higher risk. Look at the figure below carefully and note various modes of market entry, and the associated risks and advantages.

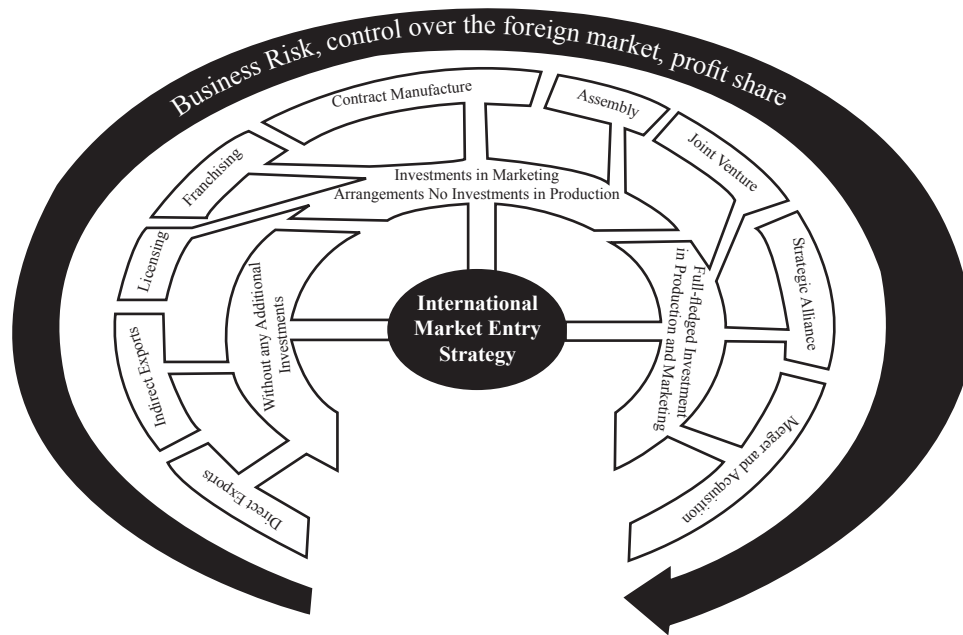


Fig. 5.4 Foreign market entry modes

- Exporting may be appropriate under the following circumstances:
- The volume of foreign markets is not large enough to justify production in the foreign market.
- Cost of production is higher in the foreign market.
- Foreign market is characterised by production bottlenecks like infrastructural problems, problems of materials supply, labour unrest, etc.
- There are political or other risks of investments in the foreign country.
- There is no guarantee of the market available for longer period.
- Foreign investment is not encouraged by the concerned foreign government.
- There is excess production capacity in the domestic market or expansion of existing facility is less expensive and easier than setting up production facilities abroad.
- Very attractive incentives are available in the country for establishing facilities for export production.

Exporting allows a firm to centrally manufacture its products for several markets and obtain economies of scale. Furthermore, when exports represent incremental volume out of an existing production operation located elsewhere, the marginal profitability of such exports tends to be high. The main advantage of an exporting strategy is that it is easy to implement. Risks are least because the company simply exports its excess production when it receives orders from abroad. A firm has the following two basic options in carrying out its export operations: indirect exporting, and direct exporting.

Indirect exporting

When a firm delegates the task of selling goods abroad to an outside agency, it is called indirect exporting. Markets can be contacted through a domestically located middleman (located in the exporter country of operation). Several types of middlemen located in the domestic market assist a manufacturer in contacting foreign buyers. The major advantage of using a middleman lies in the middleman's knowledge of foreign market conditions and avoidance of problems connected with export procedures and documentation or leaving the manufacturer to concentrate on production. For small companies with little or no experience in exporting, the use of a domestic middleman readily provides expertise. The most common types of middlemen are merchant exporter, export house, trading house, and buying house of overseas firms located in the manufacturer's country.

Exporting through a merchant exporter or an export house can confer the following advantages:

- The manufacturer can overcome the problems, of direct exporting such as investment of resources in collecting marketing intelligence for setting up of export department, etc. and can receive instant foreign market knowledge.
- Since the operational cost of export house/merchant exporter will be spread over, several parties, going through export house/merchant exporter will result in saving in unit cost.
- In case the export house works on commission basis, there is incentive for the export house to expand sales.
- In view of the fact that the export house will be effecting consolidated shipments, there is a possibility of reduction in unit freight.
- The reputation of export house will enable the manufacturer to get better representation for his products abroad, ' In case the export house is selling complementary products, sales might increase.

Main disadvantages of involving an export house or a merchant exporter are as follows:

- The export house merchant exporter, in order to earn more through commission, may take an too many unrelated lines resulting in the producer getting neither the expertise nor the attention he is looking for.
- Under this arrangement, there is a possibility of the manufacturer continually depending on the export house and not developing export expertise himself.
- There is also possibility of both the manufacturer and the export house lacking personal involvement in the export business since either party may drop the other at any moment.
- In view of the fact that the export house will be pushing the product abroad on its own name and reputation, the foreign customers may not be able to relate the product with the manufacturer at all. This danger is more if the export house uses its letter-head and brand name.
- Another form of indirect export is the consortium approach i.e., a limited number of manufacturers of the same product joining together and exporting on a cooperative basis. In this arrangement, export management function is performed for several firms at the same time. There is closer cooperation and control as compared to merchant exporter or export house.
- Export orders will be procured on a joint basis and distributed amongst the constituent units.
- The individual units will be permitted to use their own letter-head and brand name. This arrangement confers more bargaining power on the consortium since the parties coming together can bargain over a position of strength. As in the case of exporting through export house, there is a possibility of saving in unit freight on account of consolidated shipment.
- Under-cutting is reduced to a great extent and all the economics of scale associated with joint operation can be reaped.
- The great disadvantage of consortium approach is that for this approach to succeed, there should be perfect understanding among the members and each should put in his best. As is well known, cooperation can succeed only to the extent the individual members want it to succeed. Misunderstanding may arise over many issues and one unscrupulous member is enough to spoil the business of the entire consortium.

Indirect exporting

When a manufacturing firm itself performs the task of selling goods abroad rather than entrusting it to any outside agency it is called direct exporting. Usually a home based export/ international marketing department in the firm is given responsibility for selling abroad. The exporting firm may also establish its own sales subsidiary as an alternative mode. When a manufacturer engages in direct export, he takes more risks but gets more returns. More than anything else, direct export means more involvement for the manufacturer, more control and more expertise within the firm.

Of the about 300,000 manufacturing companies in the United States, about 10 per cent are actively exporting. Almost 85 per cent of the US exports, however, is accounted for by the top 250 US companies, which means that a substantial part of export operations is undertaken by merchant exporters. In Japan also, major share of exports are effected by their “sogashos” which are specialised merchandising firms. While direct exporting operation requires a greater degree of expertise and involvement and involves greater risks. It also provides the company with greater control over its operations than will be the case under indirect exporting.

Licensing

A manufacturer should consider licensing when:

- capital is scarce
- import restrictions, discourage direct entry
- the country is sensitive to foreign ownership

When the company finds it difficult to export and at the same time not ready to invest money in the foreign country, licensing could be suitable strategy. Under licensing, a company assigns the right to undertake production locally using its patent (which protects a product, technology/ process) or a trademark (which protects a product name) to a local company for a fee or royalty. Under this strategy, the company (licensor) gives license to a foreign company (licensee) to manufacture the company’s product for sale in that foreign country and some-times in other specified markets also. Licensing enables a company to gain market presence and Enby overseas without equity investment. The local company or licensee gains the right to commercially exploit the patent or trademark either on an exclusive (the exclusive right to a certain geographic region) or unrestricted basis.

Licenses are signed for a variety of time periods, depending on the period to pay off the initial investment. Typically, the licensee will make all necessary capital investments (such as in machinery and inventory), and market the products in the assigned sales territories, which may consist of one or several countries.

Licensing agreements are subject to negotiation and tend to vary considerably from company to company and from industry to industry. In general, a license cōntract should include these six basic elements:

- Product and territorial coverage
- Length of contract, quality control
- Grant back and cross-licensing
- Royalty rate and structure
- Choice of currency
- Choice of law

Reason for licensing

Companies have used licensing for a number of reasons, Licensing strategy is very flexible as it allows a quick and easy way to enter the foreign market if there are some direct import restrictions in the foreign market. Licensing is a better alternative than exporting when the transportation costs are higher in relation to product value. For one, a company may not have the knowledge or the time to engage more actively in international marketing. The market potential of the target country may also be too small to invest in manufacturing facilities in that country.

A licensee has the advantage of adding the licensed products volume to an ongoing operation, thereby reducing the need for large scale additional investment. For a company with limited resources, it can be advantageous to have a foreign partner for marketing its products by signing a licensing agreement. Licensing not only saves capital since no additional investment is necessary, but it also saves scarce managerial resources. In some cases when the firm’s product enjoys huge demand, it may not be able to satisfy the demand unless licenses are granted to other companies with the required manufacturing capacity. In some countries where the political or economic situation appears uncertain, a licensing agreement will avoid the potential risk associated with investments in fixed facilities under such uncertain conditions, licensing is a suitable entry strategy since both commercial and political risks are absorbed by the licensee.

Disadvantages of licensing

A major disadvantage of licensing is the substantial dependence on the local licensee to generate revenues and pay royalties. Once a license is granted, royalties (usually paid as percentage on sales volume only) will only be paid if the licensee is capable of performing an effective marketing job. Since the local companies marketing skills may be less developed, revenues from licensing may suffer accordingly. Traditionally, Johnson & Johnson, the large US based health care company, had been licensing its newly discovered drugs in markets where it had little penetration. In 1985, the company licensed Hismanal: a non-sedating antihistamine, to Mochida, a Japanese pharmaceutical company. The drug, now selling in some 116 countries and the company's fastest growing drug, earns only thin royalties from the Japanese market. As a result, the company has moved into developing its own sales force in Japan by hiring about 300 sales representatives through its majority-owned affiliate. Several drugs are now in the process of being licensed and none are planned to be licensed to third companies.

Pepsico experienced the limitations on relying on a licensing partner in France. Pepsi was licensed through Perrier, the French mineral water company. However, the retail structure in France changed and supermarkets emerged as important channels. Other French brands, such as Badoit and Evian, did better in those channels. The resulting decline for Perrier also had a negative impact for Pepsi losing almost half of its market share. This led to the breakup of the relationship and Pepsico has decided to develop the French market on its own, in future.

Another disadvantage of the licensing arrangement relates to the incapability of the local firm to produce products of quality standard for which the parent company is known. The parent company's image may suffer if a local licensee markets a product of substandard quality. Ensuring uniform high quality might require additional resources from the licensor, which may reduce the profitability of the licensing activity.

When license is granted, the foreign firm (licensee) gains technological and product knowledge. This is in a way nurturing a prospective competitor. Another problem often develops when the licensee performs poorly. Termination of the license may be a very complicated task when the licensee is performing very unsatisfactorily. If the license is not terminated, it may even prevent the company (licensor) to directly enter the market. If the licensee does not adhere to the quality standards, it can damage the product image.

Franchising

Franchising is a special form of licensing in which a parent company (the franchiser) grants another independent company (the franchisee) the right to do business in a prescribed manner. In this arrangement, the franchisor makes a total marketing programme (including the brand name, logo, and the method of operation) available to the franchisee. Usually, the franchise agreement is more comprehensive than a regular licensing agreement in as much as the total operation of the franchisee is described.

Numerous companies that have successfully exploited franchising as a distribution strategy in their home market are adopting the same strategy to exploit opportunities abroad also. Burger King, McDonalds and other US fast food chains with operations in Latin America, India and European countries are good examples of such firms. Another common form of franchising is where the franchisor supplies an important ingredient (art, material, etc) for the finished product. For example, Coca Cola and Pepsi foods have franchise arrangement with their bottling units all over the world. They supply the concentrated syrup to the bottlers. Similarly, in India you can notice NJIT training centres all over India, which look similar and provide the same training programmes with same fee structure. All these training centres are the franchisees of NJIT.

Some of the major forms of franchising are: manufacturer-retailer systems (such as automobile dealership), manufacturer-wholesaler systems (such as soft drink company with its bottlers), and service for-retailer systems (such as fast food outlets).

Franchising had all the advantages and disadvantages of licensing strategy. One added advantage over licensing is the better control over the product and the franchisee.

Control manufacturing

Under contract manufacturing, a company arranges to have its products manufactured by an independent local company on a contractual basis. A company doing international marketing enters into contract with a local firm in the foreign country to manufacture the product, while retaining the responsibility of marketing. The local manufacturer produces and supplies the product to the international company, while international company assumes responsibilities for sales, promotion, and distribution.

In a way, the international company hires the production capacity of the local firm without establishing its own plant and thus circumvents barriers on import of its products. This strategy is practicable only when there is a foreign producer with the necessary manufacturing capacity and ability to maintain quality. The local producer undertakes manufacturing based on orders from the international firm and the international firm gives virtually no commitment beyond the placement of orders.

Typically, contract manufacturing is adopted with regard to countries with low market potential combined with high tariff protection. In such situations, local production appears advantageous to avoid the high tariffs, but the local market does not support the volume necessary to justify the building of a plant. These conditions tend to exist in the small sized countries of Central America, Africa, and Asia. Usually, contract manufacturing is employed where the production technology involved is widely available and where the marketing effort is of crucial importance in the success of the product.

Contract manufacturing has the following advantages:

- The company does not have to commit resources for setting up production facilities abroad.
- It frees the company from the risks of investing in foreign countries.
- If idle production capacity is readily available in the foreign country, it enables the marketer to get started immediately.
- In many cases, the cost of the product obtained by contract manufacturing is lower than if it were manufactured by the international firm. If excess capacities are available with existing units, it may even be possible to get the product supplied on the marginal cost basis.
- Contract manufacturing is a less risky way to start with. If the business does not pick up sufficiently, dropping it is easy; but if the company had established its own production facilities, the exit would be difficult.

The disadvantages of contract manufacturing are:

- The parent company has to forego the manufacturing profit to the local firm.
- It is always not easy to locate a local party with the necessary capabilities to manufacturing the product up to the requirements of the parent firm.
- The local party gains experience in marketing, and in course of time may pose a threat to the parent company.
- On many occasions, local firms face difficulties in maintaining the quality of the product, up to the standards required by the parent firm.

Assembly

By moving to an assembly operation, the international firm locates a portion of the manufacturing process in the foreign country. Typically, assembly is the last stage of manufacturing and depends on the ready supply of components or manufactured parts to be shipped from another country. Assembly usually involves heavy use of labour rather than extensive investment in capital outlays or equipment.

- Under assembly strategy, most of the components or ingredients are produced domestically and the finished product is assembled in the foreign country. In several cases, parts or components are produced in various countries in order to gain each country's comparative advantage, and labour intensive assembling is carried in another country where labour is abundant and labour costs are lower. It allows the company to be price competitive against cheap imports. For example, US apparel makers ship the pre-cut fabric to a low wage country for sewing before bringing them back to the USA for finishing and packaging. Thus, they achieve price competitiveness in the US markets.

- Motor vehicle manufacturers have made extensive use of assembly operations in many countries. General Motors has maintained major integrated production units only in the United States. In Germany, the United Kingdom, Brazil, Australia and in many other countries, disassembled vehicles arrive and the final product is assembled on the spot. This method of shipping cars as CKDs (completely knocked down) and assembling them in local markets is extensively used by Ford Motor Company, American Motors' Jeep subsidiary, and most European and Japanese car manufacturers.
- Having assembly facilities in foreign markets is very ideal and particularly under two conditions: when there are economies of scale in the manufacture of parts and components, and when assembly operations are labour intensive and labour is cheap in the foreign country. It may be noted that a number of US manufacturers ship the parts and components to the developing countries, get the product assembled there and bring it back home. The US tariff law also encourages this. Thus, even products meant to be marketed domestically are assembled abroad.
- Often, the companies want to take advantage of lower wage costs by shifting the labour intensive operation to the foreign market. This results in lower price of the final products. In many cases, however, it is the local government that forces the setting-up of assembly operations by sometimes banning the imported parts. Often in countries with chronic foreign exchange problems, supply interruptions can occur. In some countries, such as Brazil where some 70 percent of the parts are produced locally, car manufacturers find no option but to engage in assembly operations to produce for the local markets.
- Assembling the product meant for the foreign market in that foreign country itself has certain other advantages, besides the cost advantage. The import duty is normally low on parts and components than on the finished product. Assembly operations would satisfy the 'local content' demand, at least to some extent. Because of the employment generation, the foreign government's attitude will be more in favour than import of the finished product.
- Another advantage is that the investment to be made in the foreign country is very small in comparison with the expenditure required for establishing complete manufacturing facilities. The political risk of foreign investment is, thus, not much.

Joint venture

In the context of international business, an international joint venture is an enterprise formed by the international business company sharing ownership and control with a local company in the foreign country. International joint venture is another alternative strategy you may consider to enter in overseas market.

In countries where fully foreign owned firms are not allowed or favoured, joint venture is the alternative if the international marketer is interested in establishing an enterprise in the foreign market. Many foreign companies entered the communist, socialist and other developing countries by joint venturing. The essential feature of a joint venture is that the ownership and management are shared between a foreign firm and a local firm. In some cases there are more than two parties involved. For example, Pepsi's Indian joint venture involved Voltas and Punjab Agro Industries Corporation. Under a joint venture arrangement, the local company invites an outside partner to join as a owner in the new unit. The terms of participation may vary with companies accepting either a minority or majority stake. A joint ownership venture may be brought about by a foreign investor buying an interest in a local company or a local firm acquiring an interest in an existing foreign firm or by both the foreign and local entrepreneurs jointly forming a new enterprise.

The disadvantages of joint ventures are:

- International marketing
- Entry decision
- Selection
- Entry

A joint venture may go through several points of crisis, caused by the realisation on the part of either (sometimes both) of the partners that its expectations are not being fulfilled and, perhaps, even being negated. Chances of such flash points are more with the flattening out of the gains curve on any of the parameters that govern either partner's decision to be involved in the joint venture. For, at this point, the gains of one of the partners become disproportionate to those of the other, leading the former to re-examine the rationality of retaining the relationship. Such flash points, however, need not necessarily result in the termination of the joint venture. In fact, they may be managed so that there will be more equitable gains from the joint venture.

- Joint ventures involve greater risk.
- They also involve greater investment of a capital and management resources.
- On the other hand, there is a possibility of conflict of interest in joint venture, with the national partner.

A joint venture can succeed only if both the partners have something definite to offer to the advantage of the other, and reap definite advantages and have mutual trust and respect.

Strategic alliance

A more recent phenomenon is the development of a range of strategic alliances.

- Alliances are different from traditional joint ventures in which two partners contribute a fixed amount of resources and the venture develops on its own. In an alliance, two firms pool their resources directly in a collaboration that goes beyond the limits of a joint venture/although a new entity may be formed, it is not a requirement. Sometimes, the alliance is supported by some equity acquisition of one or both the partners.
- In an alliance, partners bring a particular skill or resource, usually one that is complementary to each other. By joining forces, both are expected to profit from each other's experience. Typically, alliances involve either distribution access or technology transfers or production technology, with each partner contributing a different aspect to the venture.
- This strategy seeks to enhance the long term competitive advantage of the firm by forming alliance with its competition is (existing or potential in critical areas), instead of competing with each other. The goals are to leverage critical capabilities, increase the flow of innovation and increase flexibility in responding to market and technological changes.
- Strategic alliance is also sometimes used as a market entry strategy. For example, a firm may enter a foreign market by forming an alliance with a firm in that foreign market for marketing or distributing the farmer's product.
- Strategic alliance, more than an entry strategy, is a competitive strategy. Strategic alliances which enable companies to increase resource productivity and profitability by avoiding unnecessary fragmentation of resources and duplication of investment and effort. Alliances are growing in popularity and are very conspicuous in such industries as pharmaceuticals, computer, nuclear, telematics, etc., which are characterised by high fixed costs in R & D and manufacturing, high technology and fast changing technology.
- **Technology-based alliances:** Exchanging technology for market access was the basis of the AT&T alliance with Olivetti of Italy, entered into in 1984. AT&T needed to enter the European computer market to obtain economies of scale for its US operations. But it did not have any marketing contacts of its own. On the other hand, Olivetti was eager to add larger computers through its extensive distribution system in Europe. In return, Olivetti became the key supplier to AT&T for personal computers and was able to use AT&T as its distribution arm in the US market. Both companies were attempting to benefit from each other's market cess and each other's production and technology resources. However, after a quick start that involved mostly the sale of Olivetti-produced PC's through AT&T sales offices in the United States, the alliance lapsed when the cooperation became too much of one-sided. In 1989, AT&T was able to take a 20 per cent stake in Intel, the Italian state-owned telecommunications equipment company. With this alliance, AT&T hoped to gain better access not only to the Italian market but to other markets in West Europe as well.
- **Production-based alliances:** In the automobile industry in particular a large number of production based alliances have been formed over the past years. These alliances or linkages fall into groups. First, they are in the search for efficiency through component linkages which may include engines or other key components of a car.

Second, companies have begun to share entire car models, either by producing them jointly or by developing them together. In the United Kingdom, the British Rover Group and Honda of Japan produce some cars jointly. Regional cooperation also exists between Volkswagen and Ford in Latin America., Distribution-based alliances: Alliances with a special emphasis on distribution are becoming increasingly common. General Mills, a US based company marketing breakfast cereals, had long been number two in the United States with 27 per cent market share compared to Kellogg's 40 to 45 per cent share. With no effective position outside, the United States, the company entered into a global alliance with Nestle of Switzerland.

Merger and acquisition

Mergers and Acquisitions (M&A) have been a very important market entry strategy as well as expansion strategy. A number of Indian companies have used this entry strategy. In the case of a merger, the international business firm absorbs one or more enterprises abroad by purchasing assets and taking over liabilities of those enterprises on payment of an agreed amount. Similarly, the international business firm may also take over the management of an existing company abroad by taking the controlling stake in the equity of that company at a predetermined price. This is called acquisition.

Merger and acquisition as an entry strategy provides instant access to markets and distribution network. As one of the most difficult areas in international marketing is distribution, this is often a very important consideration for M&A. The General Electric (GE), USA, took over Hungary's light bulb maker Tungsram. Instead of starting a 'greenfield' operation in Hungary by building a new factory and hiring the people needed, why did the multinational giant take over Tungsram, a typical Hungarian enterprise bogged down with so many problems calling for a painful restructuring. The answer is that Tungsram gave GE entry to the East European light bulb market, from which it had been virtually excluded by Philips and Osram. Tungsram's share of the market in the 1980s was a respectable 9 to 10 per cent.

Another important objective of M&A is to obtain access to new technology or a patent right. M&A also has the advantage of reducing the competition. M&A may also give rise to some problems which arise mostly because of the deficiencies of the evaluation of the case for acquisition. Sometimes the cost of acquisition may be unrealistically high. Further, when an enterprise is taken over, all its problems are also acquired with it. The success of the enterprise will naturally depend on the success in solving the problems. It has also been observed that the takeover spree lands several companies in trouble. For example, in the early 1990s a number of Japanese companies began to sell some of the foreign businesses which they had acquired a few years ago. The main reason for this was the financial crunch.

5.4.2 Entry Stage Analysis

You have studied various foreign market entry strategies. You know, each entry strategy had certain advantages and also had certain limitations. Now you have to take a very careful decision in choosing the appropriate entry strategy for your business enterprise. For this a firm must analyse thoroughly and properly all the entry modes so that a proper strategy can be developed. Collection of data is the corner stone of any entry strategy analysis. Sales projections have to be supplemented with relevant cost data and financial requirement projections. Data need to be assembled for all entry strategies for comparison and selecting the most appropriate strategy.

Financial data need to be collected not only on the proposed venture but also on its anticipated impact on the overall operations of the international firm. The combination of two sets, of financial data results in incremental financial data incorporating the net overall benefit of the proposed move to the total company structure. In this section we provide a general methodology for the analysis of entry decisions. It is assumed that any firm approaching a new market is looking for profitability and growth. Consequently the entry strategy must be subordinated to these goals.

Each strategy has to be analysed for the following five factors:

Expected sales

An accurate estimate of sales volume is crucial to the entry strategy decision. Sales depend on the company's market share and the total potential size of the market. The foreign company can influence the market share through a strong marketing mix which, in turn, is also dependent on marketing expenditures. The various types of entry strategies also allow a foreign firm to unfold its marketing strategy to varying degrees. Typically, direct or indirect exporting results in lower market presence. This weaker presence may cause a loss of control over export operations. Also, to some extent, there may be dependence on some independent firms to carry out the company's marketing functions.

Of course, market potential is not subject to the influence of the international firm seeking entry. The size of a local market combined with the expected market share often determines the outcome of an entry strategy analysis. Local assembly or production with correspondingly high levels of assets and fixed costs need large volumes to offset these costs, whereas exporting operations can usually be rendered profitable at much lower sales volumes.

Particularly in markets with considerable growth potential, it becomes essential to forecast sales over a longer period of time. A low expected volume right now may indicate little success for a new entry strategy. Since it is often impossible to shift quickly into another entry mode once a firm is established, special attention has to be focused on the need to ensure that the chosen entry strategy offers a long term opportunity to maximise profits.

Costs

The international firm will have to determine the expected costs of its operation in a foreign country, with respect to both manufacturing and general administration. Unit variable costs may vary depending on local production, assembly, or exporting as the chosen strategy. To establish such costs, you have to take into consideration local material costs, local wage levels and tariffs on imports. Again unit variable costs may be expected to vary according to the entry strategy alternatives considered.

Fixed costs represent another important element in the analysis. Administrative costs tend to be much lower for a sales subsidiary compared to a local manufacturing unit. Through a contribution margin analysis, break even for several levels of entry strategies can be considered. Government regulations or laws may also affect local costs and vary from country to country. Estimating and forecasting costs in the international environment requires a keen sense of awareness of environmental factors of political, economic and legal nature.

Assets

The level of assets deployed greatly influences the profitability of each of the entry strategy. The assets may consist of any investments made in conjunction with the entry into (or exit from for that matter) the new market. Such investments may comprise working capital in the form of cash, accounts receivable, inventory, it may include fixed assets, etc., depending on the particular entry strategy chosen. Exporting or sales subsidiaries require an investment in working capital only with little additional funds for fixed facilities. Local assembly or production demands substantial investments.

Profitability

Conceptually, a company should maximise the future stream of earnings discounted at the cost of capital. Some companies may prefer return on investment (ROI) as a more appropriate measurement of profitability. In either case, profitability is dependent on the level of assets, costs and sales. Several exogenous risk factors influence profitability and, therefore, must be included in the analysis.

Risk factors

Each country hosting a foreign subsidiary may take action of a political, economic or regulatory nature that can completely devastate any carefully drawn up business plan. Political turmoil in many parts of the world have greatly affected business and investment conditions. Departure of the Shah of Iran during the 70s, ethnic problems in Sri Lanka, and Soviet Union's disintegration have harmed the political environment in these countries to such an extent that business could not be conducted in these areas as in the past. Changes in economic systems also add to uncertainties and are reflected in currency changes and/or diverging economic trends. Manufacturing costs are

particularly sensitive to such changes. Many times, a company has shifted production from one country to another on the basis of the latest cost data just to find out few years later that costs have changed due to fluctuations of macro-economic variables beyond the company's control. Local labour costs have fluctuated considerably over the years and are very sensitive to local inflation and foreign currency changes.

5.4.3 Factors Affecting Entry Decisions

The selection of a company's best method of entry into overseas markets depends on several factors, some of which are peculiar to the firm and the industry. A few of these main variables related to the firm are:

- Company goals regarding the volume of international business desired, expected geographic coverage and the time span of foreign involvement.
- The size of the company in terms of sales and assets.
- The company's product line and the nature of its products (industrial or consumer, high or low unit price, technological content).
- Competition abroad

The firm must evaluate these factors for itself case by case.

Beyond the factors peculiar to the firm and the industry, there are other decision criteria that relate more generally to the method of entry into foreign markets. This second group includes factors relatively independent of the firm and the industry. They are briefly discussed below:

Number of markets covered

Different entry methods offer different coverage of international markets. For example, wholly owned foreign operations are not permitted in some countries; the licensing approach may be impossible in some other markets because the firm may not be able to find qualified licensees; or a trading company might cover some markets very well, but may not have representation in many other markets. To get the kind of international market coverage it wants, the firm will probably have to combine different kinds of market entry methods. In some markets, it may have wholly owned operations; a marketing subsidiary in another and local distributors in some other market.

Penetration with markets covered

Related to the number of markets covered in the quality of the coverage a combination export manager, for example, might claim to give the producer access to a number of countries, The producer must probe further to find out if this "access" is to the whole national market or it is limited to the capital or a few large cities. Having a small catalogue sales office in the capital city is very different from having a sales force to cover the entire national market.

Market feedback available

If it is important for the firm to know what is going on in its foreign markets, it must choose an entry method that will provide this feedback. Although, in general, the more direct methods of entry offer better market information, feedback opportunities will depend on how the firm prepares and manages a particular form of market entry.

International Market Selection

In the preceding units we have talked about economic policies of India, methodologies for undertaking political, cultural and economic analysis. All these analysis were essential for answering the question of which market to enter. In this unit the topic is carried further. Here an attempt has been made to answer questions-what should the company's corporate market portfolio look like in terms of number and types of markets held and what is the process for coming to such an answer? Put more simply, the company must answer how many markets will it capture and what would their characteristics be like, and for a particular market it must answer whether it will build, abandon or divest that market.

5.4.4 Factors Influencing International Market Selection

Every company while selecting a particular country as a market, attempts at achieving the best fit between the market requirements and the company's abilities in meeting these requirements. As a result, the factors that come into consideration, while planning the international market selection, are country market factors and company factors. These factors may be studied in greater detail as under.

Country market factors

The country market factors may again be subdivided under three heads viz:

Product factors

The product characteristics and the transaction characteristics play a vital role in market selection and segmentation process. The degree of product specialisation, the value, the level of standardisation and the position in IPLC (International Product Life Cycle) all influence the market selection process. The degree of product specialisation will by itself eliminate several country markets. Thus IBM wishing to market super computers would find small market because of the product specialisation and value factors. On the other hand, Nestle may choose virtually any country as its market.

Similarly, the degree of standardisation may also influence the market selection process. Here standardisation refers to standardisation of both pre transaction and post transaction measures like after sales service. Thus, a company maybe forced to eliminate certain country markets either because the product does not meet with the country specific market requirements or because it does not have an established after sales service.

The position of the product on the PLC (Product Life Cycle Curve) of any given market and on the IPLC also influences the market selection and segmentation process. Most companies in fact enter international markets not by choice but by the fact that they find their domestic markets drying up. The desire to survive and grow forces them to go into international markets. Even then, they must establish the position of the product on the PLC. Thus, product position on PLC influences the market selection process.

Market factors

The cultural, political and economic analysis helps in determining the nature of market for undertaking the market selection and segmentation process. Questions regarding the size, stability, growth potential, uncertainty and competition get answered. These questions help in deciding which markets to eliminate and which markets to concentrate upon. Consideration to such factors is necessary for aligning the market requirement with company abilities through a marketing strategy. Very often a company may have to choose between size and growth potential. The emphasis it lays on a particular variable through its strategy may entirely be an outcome of the company's abilities and goals.

Marketing factors

The Company, being an economic entity, is influenced by economic gains while selecting and segmenting a particular market. It considers the costs and the nature of the costs against profitability of the market or the sales while assessing the choice of the market. The cost is the outgrowth of product characteristics and market characteristics. How much a company spends on each of its four P's of the marketing mix depends upon these factors and the entry strategy adopted. The profitability is judged on the basis of sales made. Two most frequently viewed responses while undertaking cost benefit analysis are the concave sales response function and the S-shaped sales function. In the concave sales response function the highest returns are noticed at the lower levels of marketing expenditure because of the shape of the sales function. This is essentially an outgrowth of the fact that the market is ripe for accepting the product. Here segmentation issues become predominant if maximum gains are to be cropped (reaped).

In case of the S-shaped sales function, it is assumed that a market has to be created therefore the highest returns are yielded just before the diminishing returns set in and after the marketing blocks are overcome.

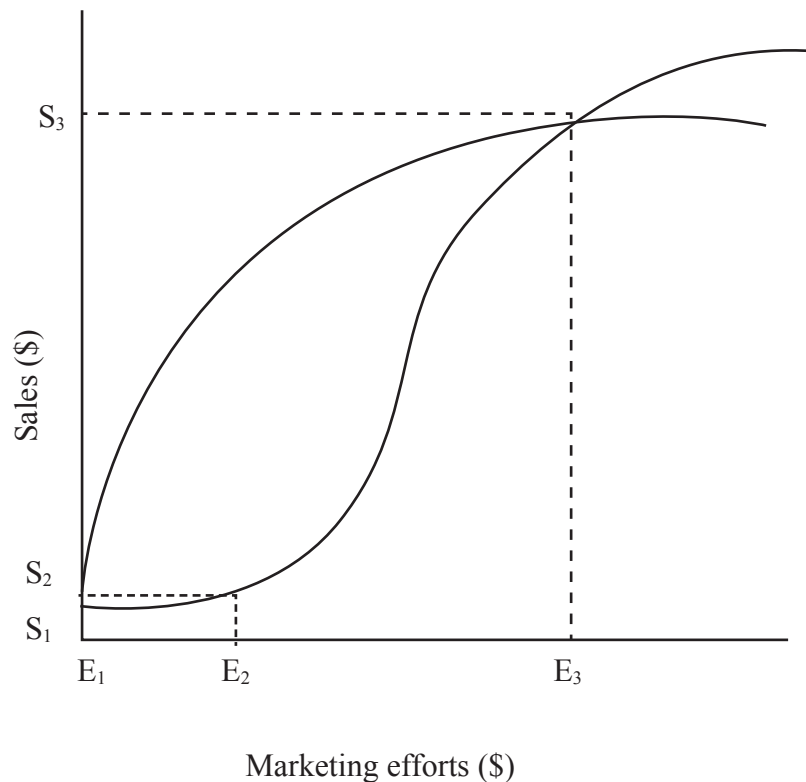


Fig. 5.5 Market efforts

In the exhibit above curve B represents the concave sales function where as curve A represents the S-shaped sales response. With every increase in marketing efforts (E) the sales response (S) can be gauged. The impact of the predicted sales response function on the choice of market is clear, however, it must be pointed out here that marketing efforts by themselves can be of different types, therefore, the response would be dependent upon the type of marketing effort planned. Thus, a company indulging in Mail Order business may observe lower communication costs as against a company wishing to set up its own facilities in the specified market. The analysis must, therefore, revolve around similar marketing efforts.

Company factors

As, the process of market selection involves a match between market factors and company factors, it becomes necessary to understand the company factors. The company factors may be divided under three heads-the management's risk consciousness, the company goals, and the company's resources. The management's risk consciousness determines how the company will perceive various risks while undertaking country market analysis. In fact, subjects like assessment of political risk depend directly on how the company perceives the risk. The company goals can also influence the market selection and segmentation process, for, they provide the foothold for direction. The company's resources both financial and managerial influence the market selection process. In fact the financial strength of a company may force it to choose a mode of entry in spite of its not wanting to do so. Similarly, the management's export market experience may determine the choice of market even when the macro analysis may be against the choice.

The fit between the company factors and the country market factors broadly answer the question as to which country will be selected. But, although they represent the factors, every company must determine a process for market selection.

5.4.5 Process of Market Selection

Every company is forced to address the question of which market to enter and how. Even after entering the markets a company must answer questions like, should it build, divest or abandon the market it has entered; how many such markets should it hold so as to maximise its economic benefits; how best to export to the chosen market?

To answer such questions every company must formulate procedures, policies and adopt strategies which allow it to keep the focus on both; country market factors and company factors. All these require marketing intelligence as indicated in the following table.

Market decision	Market intelligence
Go international or remain domestic	Assessment of global market and firm's potential share in it, in view of local and international competition, compared to domestic opportunities.
Which markets to enter	A ranking of world markets according to market potential, local competition and the political situation
Hot to enter target markets	Size of markets, international trade barriers, transport costs, local competition, government requirements and political stability.
How to market in target market	For each market, buyer behaviour, competitive practice, distribution channels, media, company experience.

Table 5.2 Market intelligence

Since the process of market selection begins with an attempt to match the market requirement with the company's ability, the first step involves defining the market and the company's ability. This step is followed by identifying the section of the market to be captured or market segmentation, and the final step involves determining the number of markets to be held.

Market definition

When a company is forced with heterogeneous international market, it becomes imperative for the company to define the market. Market definition is usually one dimensional, i.e., a company can define the market in terms of country characteristics or in terms of product characteristics. Such a definition must also include a time frame and a reference to competition. The time frame is essential not only from the point of performance measurement and control but also for giving direction. Thus, a short-term market definition would involve a tactical concern. Similarly, defining the competition would help in knowing precisely how the market is not being served, thus it would pave way for the company's positioning. Since market definition precedes segmentation it becomes necessary for it to be specific. Market definition must encompass both served and unserved markets. All this makes it necessary for a company to undertake the mechanical exercise of market definition.

Market segmentation

Having defined the market it becomes necessary for the company to identify the relevant segment. This is done through market segmentation which is the process of dividing the total market into one or more parts, each of which tends to be homogeneous in all significant aspects. The basic criteria for segmenting international markets maybe any one or combination of the following: geographic segmentation, demographic segmentation, psychographic segmentation, behavioural segmentation and benefit segmentation. The process of segmentation must clearly lay down the niche in terms of measurability, accessibility, profitability and actionability. Also, the segments should be conceptually distinguishable from each other, and should respond differently to different marketing mix elements and programmes.

Measurability

This involves identifying the market segment in terms of size, purchasing power and consumer behaviour. Since international markets are heterogeneous, the concept of measurability has been flouted all too often; all the same some effective criteria must be developed by the company.

Accessibility

How effectively can the company reach the identified segment must also be spelled out. Here again, the existence of heterogeneous markets makes the task more difficult.

Profitability

Since the firm is an economic entity, it must make sure that the identified segments are profitable. Here also, the existence of heterogeneous markets compound the task. Many new costs are added while adapting to the identified segments. Market tariffs also influence the cost structure. The company must ensure that the size of the identified segment should be large enough to recover these costs.

Actionability

The last factor but, by no means the least, is actionability. Every identified segment should be capable of being captured through effective marketing programmes. If an identified segment cannot be tapped, it is useless from the point of view of the company, however profitable it may be.

The process of segmentation is the most crucial step for the survival of the firm. It is here that the company's resources are matched with the identified segment. Wrong choices may lead to the decline of the company. This step is more or less in line with the step on market definition. If the definition is based on product characteristics then the segments are identified using product indicators else the segments are identified using general market indicators. It must also be mentioned here that in international marketing the process of segmentation involves two levels viz. Country market level and customer market level.

Determining the markets

The next step in the process is usually associated with companies who have been in the export market for long. They must know which market to build, which to divest and which to abandon in order to optimise their return on investment. In other words they must define the direction of growth.

Most companies use the country attractiveness/competitive strength matrix for market selection as shown in the exhibit below.

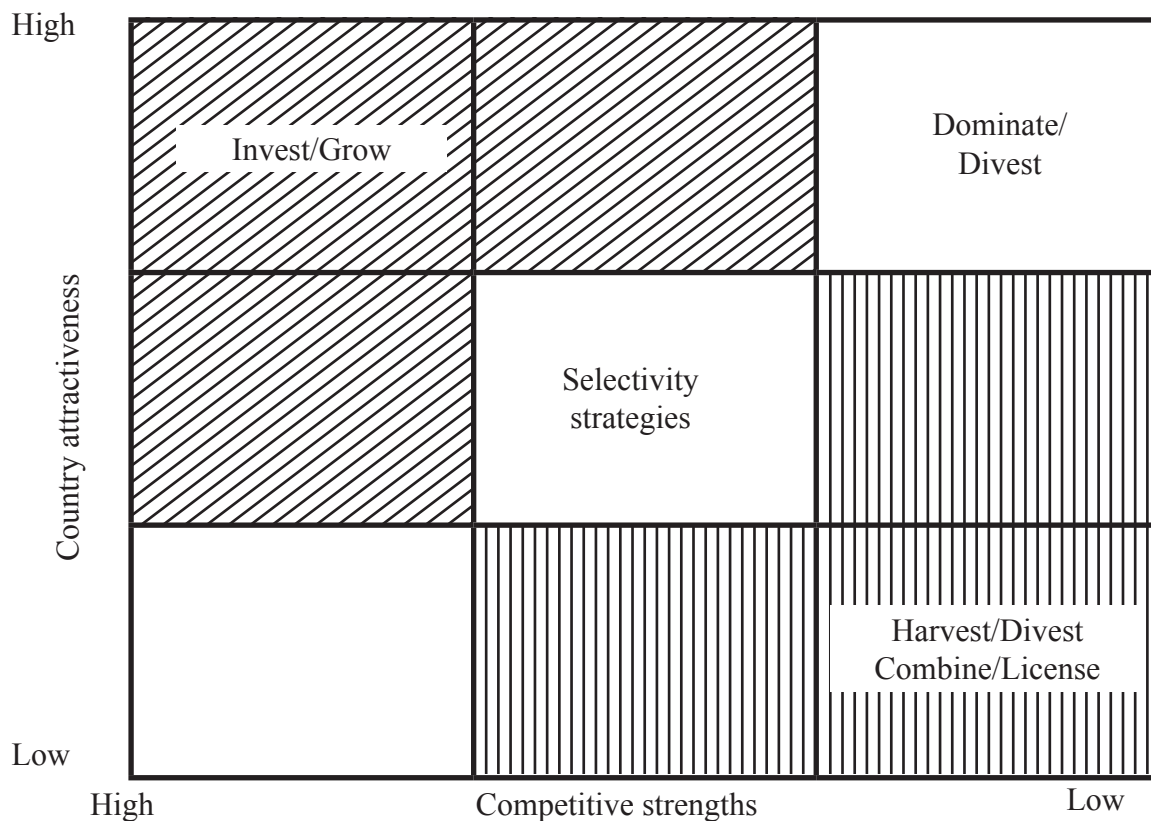


Fig. 5.6 Country attractiveness/competitive strength matrix for market selection

Such a matrix helps in identifying Invest/Grow countries against Harvest/Divest countries. However, before using such a matrix the company must ensure that –

- contributing factors are identified
- their relationship and direction have been established
- weights have been allotted to such factors.

It must also realise that such an analysis does not take into account

- the risk of international operation
- cost of entry into various countries and markets
- shared costs in international marketing.

Keeping these facts in mind it becomes simple for a company to identify the market on the basis of growth, divesture. The various countries that can be identified on such a matrix would fall under any one of the following heads.

Invest/Grow countries

Such countries call for a high level marketing commitment. They represent a large market size which can be tapped through investment in people and capital. Here it becomes necessary to match the products with the marketing requirements.

Harvest/Divest/Licensee/Combine countries

They represent the direct opposite of invest/ grow countries. Because the country attractiveness is low and competitive strength is also low, such a country must be harvested. A growth of market share in such a market would demand an equal increase in marketing effort wiping out the gains if any. Therefore, in such countries it makes more sense to sell out, to maintain a close watch of cash flow and to follow a pricing policy which will minimise the investment till the operations are abandoned.

Dominate/Divest countries

Such countries rank high on country attractiveness but low on competitive strengths. Therefore, the choice rests in either of the alternatives, to sell out or to develop competitive strength to reap the opportunities offered by such a market. If one wants to reap such benefits then he must analyse the market more closely in terms of cash required to build the strength and the potential profits. In such decision time frame and corporate profitability become important issues.

Selectivity countries

Such countries fall in the centre of the matrix representing the fact that they are neither highly attractive countries nor highly unattractive. They also represent in company terms, a position that can be built or broken. In such situation the company can build the market by introducing new product features, through technological upgradations.

Such an analysis helps a company competing in the global scene to use its limited resources more effectively. It knows which markets to divest and which to hold. Even within markets it answers questions regarding which segments to build. In the absence of such an analysis the corporate profitability would fall because of inclusion of losers in the market portfolio and the company's survival itself may come into question.

5.4.6 Some Strategies

While the above procedure broadly outlines the country selection method, various strategies and approaches are available to the management which fit within this framework. Some of the approaches have been discussed as under.

Reactive v/s proactive approach

When an exporter enters into foreign market on the basis of an enquiry received by him, he has resorted to the reactive approach.

Such an approach for market selection reflects absence of plan nine. The enquiries in such cases result from earlier participation in international markets or through contacts established. This approach is frequently used by small and middle-sized firms belonging to countries rated as attractive. The objective underlying such a mode of entry can normally be classified as 'short-term profits'. Thus, many exporters in India who procured enquiries through participation in international trade fairs reflected a passive entry mode or a reactive method of market selection.

In direct contrast to the above approach is the proactive approach where a formal process of market selection is followed. In such an approach the international marketer has to develop an organisation with strong international marketing experience. Such an approach reflects marketing orientation.

While the above approach reflects the theoretical difference, in reality any firm would pursue both the modes of market selection.

Expansive v/s contractible approach

If the firm decides to follow a proactive approach then it has two options for market selection. It can follow the expansive approach as against the contractible approach. The expansive approach presupposes a bench mark, i.e., it either uses the home market or an established market as the base market. All other markets are screened on the basis of the similarities that exist. Thus, it reflects the experience based market selection approach. The clustering technique or the nearest neighbour techniques are examples of the expansive approach. They resort to either environmental proximity or trade policy proximity for eliminating unwanted markets. The other technique which falls under the expansive approach is the temperature gradient approach where the countries are classified as moderate, hot or cold on the basis of seven variables. These variables are political stability, market opportunity, economic development and performance, cultural unity, legal barriers, physiographic barriers and geo-cultural distance.

As against the expansive approach is the contractible approach. In the contractible approach the markets are first organised on the basis of general market indicators and specific product indicators and then screened against knock out factors.

5.5 Emerging Trends and Issues in International Marketing

The fact that international trade has, since many years, been expanding faster than global output is a clear indication that international market has become more important than domestic market for a number of countries, companies, and products.

The rapid growth of the world market has naturally led to growth in competition. The growing competition, in turn, has led to changes in the rules of the game. The war of external trade is no longer fought with the traditional weapons of product, price, place and promotion only. The tremendous growth in technology, particularly in the fields of communication, information and transportation, has provided new weapons in the armoury of countries and companies.

Emergence of large sized multinational firms, particularly in the developed world, and, the large number of mergers and acquisitions across national borders have thrown challenges to and provided opportunities for competing firms. Environmental and ethical considerations are increasingly determining the extent of market access a product can hope to get in an overseas market. Indian firms should increasingly become aware of such developments and adjust their strategies accordingly, if they want to survive and prosper not only in external markets but even in the domestic market.

5.5.1 Emerging Global Competition

Competition is becoming more and more global in an increasing number of industries and markets. With the progressive liberalisation of economic policies in many countries, firms encounter growing competition not only in overseas markets but in domestic markets as well.

5.5.2 MNCs and Global Competition

Many industries are characterised by dominance of multinational corporations (MNCs). The size of operations of MNCs is mind boggling. The annual sales turnover of a number of MNCs is bigger than the Gross Domestic Product (GDP) of most developing nations. The number of MNCs and their subsidiaries has been on rapid increase. A significant share of global investment, production, employment and trade is accounted for by MNCs which number over 50,000 with about 4 lakh affiliates. Their combined sales turnover is estimated to exceed the aggregate GDP of all developing nations, excluding the oil exporters.

- Liberalisation of economic policies across the world has facilitated the market penetration and expansion of MNCs, intensifying and intensifying the global competition. As a result, many firms, whose market is confined to the home country, are forced to face increasing global competition in the domestic market.
- To a considerable extent, MNCs have been able to depress a number of domestic firms. Several local/national firms have been taken over by MNCs and many have downed their shutters or have lost market share due to increasing competition from MNCs.
- Increasing competition from MNCs has on the other hand some favourable effects also on many domestic firms. To cope with competition, they have been forced to improve their efficiency and performance and consequently many of them have become more dynamic and innovative. This has enabled them not only to compete domestically but also to venture into overseas markets.
- There are differences in the portfolio and competitive strategies of MNCs of different countries. MNCs compete in many national markets but the nature of competition they face may differ from market to market. In some major markets, the global competitors are the same. However, their relative market shares and positions may be different in different markets. In some markets they encounter powerful domestic firms.
- Strategic postures and organisational behaviour of MNCs show variations. Several MNCs like Philips, Unilever, and ITT traditionally gave substantial strategic freedom and organisational autonomy to subsidiaries so that their operations were localised to a considerable extent. However, competitive environment has, sometimes, necessitated changes in strategic postures and organisational behaviour. Philips, for example, had to move from a multinational towards transnational approach later.

- A number of companies (particularly the Japanese ones) have developed international operations that are driven more by the need for global efficiency and are more centralised in their strategic and operational decisions. To these companies, which regard the world market as an integrated whole, the global operating environment and worldwide consumer demand are the dominant units of analysis, not the nation, state, or the local markets.

Small firms and global business

The growth in the number and size of MNCs does not imply that small firms have no competitive edge in global business. Indeed, a number of well-known large players (including Microsoft) are of recent origin and had a humble beginning. There are also young Indian firms, like Infosys, which are growing fast in global business.

- Size has advantages as well as disadvantages. Large companies need not necessarily be efficient or highly competitive. The large number of loss-making companies in the Fortune 500 list is an indication of this fact. In the early 1990s, Fortune 500 companies accounted for only about 10 per cent of the American economy, down from 20 per cent in 1970. John Naisbitt observes in the Global Paradox that small and medium size companies are creating the huge global economy. About 50 per cent of the US exports is accounted for by companies with 19 or fewer employees. The same is true of Germany. Well over one-third of India's exports is contributed by the small scale sector.
- Gary Hamel and C.K. Prahalad in their Harvard Business Review article on Strategic Intent point out that several Japanese firms which have grown spectacularly in the global market had fewer resources than their American counterparts. Companies that have risen to global leadership over the recent decades invariably began with ambitions that were out of proportion to their resources and capabilities, but they created an obsession with winning at all levels of organisation and then sustained that obsession over the 10-20 year quest for global leadership.
- This obsession is termed as strategic intent. Hamel and Prahalad point out that on the one hand, strategic intent envisions a desired leadership and establishes the criterion the organisation will use to chart its progress. Komatsu set out to "encircle caterpillar", Canon sought the "beat Xerox", and Honda strove to become the "second Ford". In short, companies with small size and resource constraints can also become important global players with strategic intent and right strategies.

Mergers , and acquisition and consolidation

Several industries across the world have been witnessing significant mergers and acquisitions (M&A's), and the resultant consolidation of market power. There have been a number of mega mergers and many mergers have been international in nature. M&A's have, obviously, implications on all operations of business such as productivity, profits, efficiency, competition, cost reduction, market share, etc.

- Recent years have seen tremendous growth in cross-border mega mergers. According to UNCTAD report, the total value of majority-owned international mergers and acquisitions amounted to \$ 411 billion in 1998, almost twice that of 1997 and three times, the 1995 level. The UNCTAD report also points out that the surge in M&A activity is partly due to increased competition brought about by liberalisation and international business consolidation.
- M&A is also employed as a market entry strategy. According to UNCTAD in 1998, nearly 90 percent of large cross-border M as which do not necessarily require cash or new funds but can be based on a mutual exchange of stocks - took place in developed countries, where this mode of entry is more important than in developing countries. The recent M&As cut across several critical industries such as pharmaceuticals, telecommunications, information technology, food and beverage, automobiles, steel and energy. Several factors have contributed to the growth of M&As.
- The global trend towards 'focus' has been responsible for sale of non-core businesses by many companies. This has been made use of by other companies to consolidate their core business by acquiring the businesses put on the block.
- Several mergers have been the result of the realisation by the respective companies of the need to consolidate their power to effectively fight competition. MAS have obviously been causing changes in competitive equations.

- Since M&A's have the effect of reducing the number of competitors' consumer interest may be adversely affected. The World Investment Report (WIR) 1998 indicates that, in 1997, M&As accounted for more than 85 per cent of all FDI flows. This means a corresponding decrease in the share of green field investments that is those which result in creation of additional productive assets in the host country. This has far reaching competitive implications.
- Thus, in 1997, there were 58 transactions individually valued at over \$ 1 billion each and 90 per cent of these M&A's were by TNCs from the developed countries. The largest number of large-scale mergers seems to have taken place in financial services and insurance, chemical, and pharmaceutical industries, telecom and media industries. This points to major thrust towards international concentration of production, which is especially marked in the developed countries.
- The main consequence of such a drive towards mergers and acquisitions internationally is greater concentration of business in the hands of a few firms in many sectors. In fact, M&A's between dominant TNCs, which result in even larger TNCs, seem to impel other major TNCs to move towards, restructuring or making similar deals. This competitive pressure means that, globally a few: it giant firms emerge, which control the vast share of production in specific sectors. Such monster enterprises are clearly evolving in pharmaceutical, automobile, defence, telecom and financial industries.
- The WIR is even more alarmist about the future. The total number of major automobile makers may well decline to 5-10 by 2010, from its current number of 15. In the pharmaceutical industry, many markets are now controlled by fewer firms, with seven firms having sales of over \$ 10 billion each, accounting for about a quarter of the \$ 300 billion market.
- The WIR points to a shift in the strategic policy of TNCs in focussing on what are called "core activities". Sales of non-core operations have accelerated, and the tendency has been for large TNCs to acquire divisions or affiliates of other firms that are engaged in similar operations to their core activities. However, this may be only a small pan of the explanation for the huge increase in international M&A's in the recent past.
- It is now fairly clear that liberalisation, deregulation and privatisation have been the main forces behind the dramatic growth in the number and value of M&A transactions. This is especially evident in the services sector, particularly financial services. These trends point to potentially, far-reaching changes in the structure of production and distribution both internally and within countries.
- The growing concentration of production within countries is something which has been noted for some time, and in most developed countries there is a complex array of anti-trust and anti-monopoly legislation which is supposed to deal with this. Generally, however, such legislation has not been able to prevent the continued process of concentration and centralisation of production.

Information technology and international marketing

Information technology has been revolutionising marketing operations. Telemarketing has brought about a significant change in the technique of communication with customers and in procurement and processing of orders. The revolutionary changes being ushered in by, the internet is indeed exciting.

- The revolutionary changes in the information technology are sweeping across global business. Developments in telecommunications and information technologies have cut down the barriers of time and place in doing business. It is now possible for customers and suppliers to transact business at any time in any pan of the globe, without having to come together physically, thanks to the developments in optical fibre technology, videophone and teleconferencing facilities. The net has changed the face and pace of business to business marketing and retailing.
- Effective use of information technology helps a company identify and profile customers, reach out to customers quickly and effectively, and make inventory management and distribution system more efficient.

If Indian firms do not keep pace with such contemporary developments, global business, and even domestic business is likely to be largely out of their reach in course of time.

Telemarketing

One of the recent developments even in developing countries is telemarketing. Telemarketing refers to the use of modern telecommunications technology such as telephone, facsimile (fax), television, computer and internet for marketing interaction between buyers and sellers.

- Telemarketing in the past, mostly involved the use of telephone for transacting business so that it was defined as a form of non store retailing in which a sales person initiates contact with a shopper and also closes the sale over phone. Telemarketing blossomed in the US in the late 1960s with the introduction of inbound and outbound Wide Area Telephone Service (WATS) which enabled marketers to offer customers and prospects toll free numbers to place orders for goods and services stimulated by media advertising or direct mail, or to lodge complaints or suggestions.
- Telemarketing has grown in popularity because of the convenience it provides and the savings in cost and time to the buyer and seller. Telemarketing is a very convenient and cost-effective way of personal selling in many situations.
- For consumers, placing routine orders or orders for standardised products, telemarketing saves them the drudgery and time and cost of going to the shop. This also facilitates easy information gathering for the purchase decision making. For companies, it saves the costs involved in storage and display. Telemarketing progressed rapidly with the advances in information technology substantially altering the modus operandi of marketing. Needless to add, it has revolutionised international marketing. It is now easy to identify and profile customers or suppliers across the globe. This has given global competition a new dimension.

Internet and E-business

There has been an explosive growth in the use of internet and e-commerce worldwide. Between 1993 and 1997, the number of internet hosts (computer connected to the internet) grew from 1 million to 20 million; by 2001 that figure is expected to rise to 120 million.

- The value of the global internet commerce is huge. Estimates of it range from 1.3 per cent to 3.3 per cent of gross domestic product by 2001 about \$ 50 to 1000 million. All these statistics indicate the enormous size of the e-commerce and its growing potential. As could be expected, it is the developed countries and the newly industrialised economies that the internet and e-commerce have made rapid strides.
- However, in developing countries across South East Asia, Argentina, Brazil, China and in some island states such as Barbados, Fiji and Tonga, uptake of the internet has also been growing rapidly such about 1996, although the growth continues to be hindered by problems related to telecommunications infrastructure.
- E-commerce is developing in India. Many types of business - grocery to modelling and placement services - are increasingly using the net. The net gives abundance of opportunities to people with imagination and innovative ideas. A great advantage of the net is getting into a business - both traditional and innovative quickly with lower cost and with wide reach. But the net is still an uncharted territory with opportunities, surprises, ideas and traps at every corner, Many with innovative ideas or entrepreneurial skills have become entrepreneurs and splendid opportunities await many more.
- Retailing in developed markets is increasingly becoming net-tailing or e-tailing developing countries will follow the trend sooner or later. The place in the marketing mix is gradually being replaced by (net) space. The channel system is being drastically restructured. T
- he number of intermediaries is falling. An e-tailor may directly deal with the manufacturer and ultimate buyer; direct marketing will also get a boost. A large number of match makers or infomediaries have sprung up. Infomediaries can play a useful role even when there are established dealers for a product, with no need for the match maker to stock the goods.

- The match maker model of e-commerce connects buyers on one side, the sellers on the other, For example, Jaldi.com has set up an online mail for white goods which enables potential buyers to compare price and features across all brands of white goods. The customer can post an enquiry for a model at the site and all the dealers registered with the net marketers will quote the price for it. The customer can then choose the dealer he wants to buy from. Although the dealer will make the sale to the customer, the net marketer will get a commission from the dealer. The net facilitates are quick, easy, and reaches across the globe both for the seller and the buyer. This implies that firms which do not have websites will simply be bypassed by many (in future by most) of the potential customers.
- E-commerce is becoming more popular in business to business marketing. As an international trade centre (ITC) publication points out, using the net to lower communications costs and reduce time-to-market for goods and services makes it a very valuable medium for firms engaged in international trade. Its ability to deliver information of almost any sort in digital format at low cost offers significant efficiencies that firms can pass on to customers in the form of lower prices. It can also help to manage supply chains for goods and services in cross-border trade, cutting overheads associated with logistics.
- The internet also creates new opportunities to raise service levels, which are increasingly the key to successful business-to-business and business-to-customer trading. As internet technology advances and overcomes problems with reliability and speed, It is likely to be used in almost every conceivable way to trade goods and services. Many large firms now integrate in-line technology into their older proprietary Electronic Data Interchangeable (EEDI) systems, and are building new Internet-based business systems for supply chain, management and other inventory control. Other trading systems, such as financial and commodity markets are now in the early stages of moving to an Internet base.
- New supply and demand aggregation services, such as buying-groups and online auctions, are leading markets in directions that were not feasible before the advent of the internet. As more and more countries start using internet for trade, learning and social interactions and as the number of industries affected by it grows strongly, it seems inevitable that the internet's influence on international trade will grow very quickly. Despite its portrayal as a popular communications medium (e-mail, games, chat), there are more business-to business than social transactions on the internet; the ratio is as much as 4 to 1.
- The internet's biggest impact will come from efficiency improvements, it introduces within firms that use the internet to streamline product and market research, improve production and marketing efforts around the world, form and develop business alliances and better integration of the entire value chain, from suppliers to end-customers. These business benefits suggest that the impact on trade will continue to grow and outstrip benefits to individuals. Although the sale of goods - such as books and music - is the most visible area of e-commerce growth, the biggest advances so far are in the supply and distribution of services. These include software, finance, education, entertainment and professional services. Manufacturing companies too are beginning to use the internet to manage global supply chains and radiate from the US, Europe and parts of East Asia.
- Trade distribution and logistics industries deal with two flows: flow of goods and 'counter-flow' of information about the goods and their movement. The efficiency of these industries is being dramatically improved by internet-based methods of moving information, allowing them to reduce transport, insurance and border administrative costs. These supply-chain efficiencies have made direct retailing of consumer products such as clothing, processed foods and health products at global level possible.
- Internet seems set to become a marketing tool for at least some commodities and enable producers; authorities develop close relationships with final overseas customer's flows in price-sensitive markets. By reducing transaction costs, internet provides unprecedented opportunities for small and medium sized firms to trade across borders.
- Lower transaction costs also provide opportunities for many rural and regional communities to revitalise their economic bases. Skilful use of the internet can create opportunities by giving farmer's small business people and communities the capacity to present a regional image to the world, create focal points for inquiries about local businesses and their offerings, create global businesses and develop new products and services.

5.5.3 Social Ethical and Environmental Issues

There are several social, ethical and environmental issues confronting international business.

- While the genuine issues should be appreciated and attended to, the unfortunate thing, however, is that at times these issues are raised deliberately to harass certain firms or countries that do not toe the line of the importers or host countries. They are also used as non-tariff barriers to business, particularly by developed countries against developing countries.
- One of the important social issues in the developed countries in respect of business with the developing countries pertains to treatment of labour and children. Child labour used in the manufacture of products exported from the developing countries is widely criticised by many in the developed countries. There is a protest against this in the developing countries too.
- For example, it is alleged that child labour is used by the carpet industry in India and some other countries and social activists in the developed nations demand ban on the import of goods employing child labour. Consumers are called upon to boycott such goods.
- A similar issue is the sweat labour. The argument here is that goods manufactured by labour working in inhuman/unhealthy working conditions and not getting fair wages should be banned or boycotted. Certain important developing countries exports, like garments, are alleged to be suffering from such a problem.
- Some multinationals are criticised for sourcing products from developing countries benefiting from sweat labour. While some of the criticisms may be valid, it is also a fact that the enterprises in the developed countries, which are adversely affected by the cheap imports from developing countries, blow up the issues to serve their vested interests. A very complex and controversial issue is that of ethics.
- The varying ethical norms and social values many a time make the business environment very intricate and perplexing in international business. The term business ethics refers to the system of moral principles and rules of conduct applied to business. That there should be business ethics means business should be conducted according to certain self-recognised moral standards. There is, however, no unanimity of opinion regarding what constitutes business ethics.
- An international marketer often finds that the norms of ethics vary from country to country. What is ethically wrong or condemned in one nation may not be so in another. In this connection, Peter Drucker very appropriately remarks “There is neither a separate ethics of business, nor is one needed. For, men and women do not acquire exemption from ordinary rules of personal behaviour because of their work or job.
- However, do they cease to be human beings when appointed vice president, city’ manager, or college dean, And there have always been a number of people who cheat, steal, lie, bribe or take bribes, The problem is one of moral values and moral education of the individual, of the family, of the school.” Bribery pay offs or kickbacks are common in business in many countries. However, the extent and intensity of it vary from country to country. In some countries there may be a common practice with government officials and other employees. The law in respect of such practices also varies among countries.
- According to regulations in some countries, while bribing is; illegal within the country, bribing by that nation’s firms in foreign markets to get or conduct business is not illegal because of the feeling that bribing is inevitable in some markets.
- The position appears to be that “morality only exists within a culture. And it is not for us to say what is moral in someone else’s culture”, Several West European countries either condone bribery or look the other way – such expenses are tax deductible upto a certain amount in some countries.
- However, the US Foreign Corrupt Practices Act of 1977 prohibits a firm from making or authorising payments, offers, promises, or gifts for the purpose of corruptly influencing action by governments or their officials in order to obtain or retain orders for a company. American businessmen complain that they are severely handicapped because of the legislation when they have to compete with those who are not so regulated.
- Whatever may be the legal position regarding bribing, it is basically a question of moral values and self-regulation. Some people, who hold that bribing politicians and/or officials to get business is unethical, feel that paying the lower levels is not unfair if the papers don’t move normally otherwise.

- Environmental issues have been engaging increasing discussion in the international business horizon. As in the case of the social issues, the environmental issues that are raised are mostly those which disadvantage the developing countries, ignoring or relegating to the background several serious issues for which the developed nations and firms from such nations can be held guilty.
- Some countries prohibit import of goods which cause ecological damage. For example, the USA has banned the import of shrimp harvested without turtle excluder device because of its concern for the endangered sea turtles. There are other instances of developed countries insisting on use of biologically degradable material for packaging, use of vegetable dyes for printing etc. Countries like India are affected by it.
- Developing countries are affected by the relocation of polluting industries from the developed to the developing ones. Similarly, several products which are banned in the developed nations are marketed in the underdeveloped world.
- The dumping of nuclear and hazardous wastes in developing countries and the shifting of polluting industries to the developing countries impose heavy social costs on them. The indiscriminate exploitation of the natural resources of the developing countries to satisfy global demand also causes ecological problems.
- When the multinationals employ, in the developing nations, polluting technologies which are not allowed in the developed countries or do not care for the ecology as much as they do in their own nations, it becomes essentially a question of ethics. Another problem is that sometimes environmental issues are used mainly as a trade barrier or a coercive measure by the developed countries rather than for genuine reasons.

Summary

- Multinational enterprises (MNEs) develop international marketing strategies in order to improve corporate performance through growth and strengthening their competitive advantage. However, MNEs differ in their approach to international marketing strategy development and the speed and the progress they make in achieving an international presence.
- Firms that adopt marketing concept are more likely to sell their products because these will have been conceived and developed to satisfy customer demands. The marketing concept, then, is the proposition that the supply of goods and services should depend on the demands for them.
- S. Carter defines marketing as “The process of building lasting relationships through planning, executing and controlling the conception, pricing, promotion and distribution of ideas, goods and services to create mutual exchange that satisfy individual and organisational needs and objectives”.
- Strategic marketing according to Wensley (1982) has been defined as: “Initiating, negotiating and managing acceptable exchange relationships with key interest groups or constituencies, in the pursuit of sustainable competitive advantage within specific markets, on the basis of long run consumer, channel and other stakeholder franchise”.
- The factors which motivate or provoke firms to go international may be broadly divided into two groups, viz., the pull factors and the push factors. The pull factors, most of which are proactive reasons, are those forces of attraction which pull the business to the foreign markets.
- Trade distribution and logistics industries deal with two flows: flow of goods and ‘counter-flow’ of information about the goods and their movement.

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Self Assessment

1. _____ develop international marketing strategies in order to improve corporate performance though growth and strengthening their competitive advantage.
 - a. Multinational enterprises (MNE's)
 - b. Small Medium enterprises (SME's)
 - c. Cottage industries
 - d. Private Limited Companies

2. In _____ concept, the firm's orientation is to market to foreign customers in the same manner the company markets to domestic customers.
 - a. Domestic Market Expansion concept
 - b. Multi Domestic Market concept
 - c. Global Marketing concept
 - d. Expansion concept

3. In _____ concept, firms with this orientation market on a country-by-country basis with separate marketing strategies for each country.
 - a. Domestic Market Expansion concept
 - b. Multi Domestic Market concept
 - c. Global Marketing concept
 - d. Expansion concept

4. A company employing a _____ strives for efficiencies of scale by developing a standardised product, of dependable quality, to be sold at a reasonable price to a global market (that is, the same country market set throughout the world).
 - a. Domestic Market Expansion concept
 - b. Multi Domestic Market concept
 - c. Global Marketing concept
 - d. Expansion concept

5. An _____ is an organisation whether or not established by a treaty, in which two or more states (or government agencies or publicly funded bodies) are members and in which a joint financial interest is overseen by a governing body.
 - a. international institution
 - b. institution
 - c. apex body
 - d. avenue

6. _____ refers to standardisation in four major decision areas decision, price decision, promotion decision and the distribution decision.
 - a. Multi-domestic approach
 - b. Standardised approach
 - c. Control sequence
 - d. Theory of equilibrium

7. _____ in the control process involves the comparison of actual performance with planned performance.
- Evaluation and corrective action
 - Field audits
 - Periodic reporting
 - Company records
8. When a firm delegates the task of selling goods abroad to an outside agency, it is called _____ .
- indirect exporting
 - direct marketing
 - direct exporting
 - indirect marketing
9. The systematic and growing internationalisation of many companies is essentially a part of their business policy or _____
- strategic management
 - direct management
 - standardised management
 - business management'
10. Which of the following refers to standardisation in four major decision areas?
- Standardised approach
 - Direct approach
 - Indirect approach
 - Strategice approach

Chapter VI

International Human Resource Management

Aim

The aim of this chapter is to:

- explain internationalisation of human resource management
- discuss the nature of international human resource management
- elaborate on the development of international human resource management

Objectives

The objectives of this chapter are to:

- differentiate between international and domestic human resource management
- explain international human resource function
- elucidate the global recruitment process

Learning outcome

At the end of this chapter, you will be able to:

- understand the concept of IHRM
- describe the training and development needs for global jobs
- define the process of compensation and benefits in IHRM

6.1 Introduction

Most of us have studied human resource management already have a bird's eye view of how human resource management concept is presented. However, a The term human resources can be thought of as, "the total knowledge skills, creative abilities, talents and aptitudes of an organisation's workforce, as well as the values, attitudes and beliefs of the individuals involved." Human Resource Management (HRM) is defined as managing (planning, organising, directing and controlling) the functions of employing, developing, compensating and maintaining human resources resulting in the creating and development of human relations with a view to contribute proportionately (due to them) to the organisational, individual and social goals. Human Resource Management practices vary from country to country due to variations in culture, government policies, labour laws etc. Hence, the study of international HRM needs an altogether different approach.

Recruitment	Traditional sources Modern techniques and sources
Selection process	Selection procedure Selection approaches: Ethnocentric, Polycentric and Geocentric Selection techniques for global jobs
Expatriates	International adjustment Dimensions of international adjustment
Performance appraisal	Objectives 360° appraisal Methods Performance appraisal in global companies
Training and Development	Importance of training and development for global jobs Need for training and development Cross-country training
Compensation	Importance Objectives Compensation in global companies Profit sharing and ESOP
Women in International business	
Dual Career groups	
International Industrial Relations	
Quality Circles	
Participative Management	

Table 6.1 Core functions of international human resource management

6.1.1 Internationalisation of Human Resource Management

As the global economy expands, as more products and services compete on a global basis and as more and more firms operate outside their countries of origin, the impact on various business functions becomes more pronounced. Practitioners in all business functions must develop the knowledge, skills, and experience in the international arena which will enable them and their firms to succeed in this new environment. This new reality is just as true (if not more so, as this book will demonstrate) for the HRM function as it is for other business disciplines, such as finance or marketing, which often get more attention. The purpose of this book is to describe the knowledge, skills, and experiences necessary for the successful management of the IHR function, a function that is increasingly performed by all employees in companies, including HR professionals (in the HR department), managers and non-managers.

6.1.2 Forms of International HRM

In the case of HRM, internationalisation can take many forms. For practical purposes, HR managers in most types of firms can or will confront at least some aspects of internationalisation. This is to say, the globalisation and technology factors that have led to there being “no place to hide” for business, in general, have also led to there being no place to hide for the HR professional. Human resource professionals can find themselves involved in – and therefore must understand – IHRM issues in any of the following possible situations (which include HRM positions in all types of firms, not just international HR positions within the types of firms usually focused on, i.e., working at the headquarters of an MNE or in the parent-country operations). In all cases, the international aspects of the situation increase the exposure and liabilities for HR managers and place on them ever-increasing demands for new, internationally focused competencies. This text is dedicated to helping develop the understanding and competencies necessary for HR managers to succeed (personally and professionally as business contributors) in the international arena.

6.1.3 Nature of International HRM

An international business must procure, motivate, retain and effectively utilise services of people both at the corporate office and at its foreign plants. The process of procuring, allocating and effectively utilising human resources in an international business is called international human resource management (IHRM).

IHRM is the interplay among the three dimensions: human resources activities, types of employees and countries of operation.

- The three broad activities of IHRM, namely, procurement, allocating and utilising, cover all the six activities of domestic human resource management (HRM). The six functions of domestic HRM are: human resource planning, employee hiring, training and development, remuneration, performance management, and industrial relations. These six functions can be dovetailed with the three broad activities of IHRM.
- The three national or country categories involved in the IHRM categories are: the host-country where a subsidiary may be located, the home-country where the company is headquartered and ‘other’ countries that may be the source of labour or finance.
- The three types of employees of an international business include host-country nationals, parent-country nationals, and third-country nationals. Thus, for example, IBM employs Australian citizens in its Australian operations, often sends U.S. citizens to Asia-Pacific countries on assignment, and may send some of its Singaporean employees on an assignment to its Japanese operations.

6.1.4 Global role of the IHR professional

In order to enhance the competitive advantage of global firms, their human resource professionals (managers and staff) need to focus on developing their own international competencies. At the same time, the IHRM function needs to shift from an administrative orientation to one that places primary attention on the processes of internationalisation so that it can help reconcile the types of organisational paradoxes described above that are inherent in the activities of global firms. This not only creates new demands on how specific HR activities are performed but also sets a new agenda for HR professionals and their global roles.

First, HR professionals need to learn about the fundamentals of global business. They cannot assume a global strategic role without understanding global strategy. Second, a solid knowledge of strategy must be complemented by the globalisation of their individual professional expertises. This rests primarily on the acceptance and understanding of the cultural relativity of many HR practices. And that in turn is complemented by an understanding of how their firms’ principal global competitors plan and execute their global HR strategies, what tools and methods they use to build their organisational competencies, and what implications for competitiveness arise from their actions.

This understanding of global strategy, cultural differences, and HR capabilities requires a thorough globalisation of the HR function by developing a cadre of HR professionals with international perspective, knowledge, and experience. Presently, however, the number of HR executives with multicountry experience or who are on an international promotion and development track is quite limited, even in the largest of MNEs.

The lack of international experience among US HR professionals is not surprising, but this must change if IHRM is to be recognised as a strategic partner in the management of global firms. Global firms will need not only to set up regional HR positions and assign global responsibilities to corporate HR managers but also to select, develop, and motivate IHR professionals with very much the same intensity and approach that is currently used for global executives in other areas of management.

Firms that have successfully globalised their human resource activities share several important characteristics:

The global HR role has the strong support of top management in terms of high expectations about the contributions the IHRM function can make to the formulation and implementation of effective global strategies and the readiness of the IHRM function to step up to its responsibilities.

The expectations and support of top management for the IHRM role are usually derived from a longstanding commitment to dedicate management energy and resources to human resource issues as a reflection of a people-oriented corporate culture.

Cultural diversity (including national diversity) is encouraged as a natural way of life. Ambiguity as a way of dealing with the many paradoxes imbedded in global HR issues is also accepted as normal. Not much is seen or accepted as “black or white.” The final condition for a successful implementation of IHRM strategies is the competence and credibility of the IHRM staff.

To earn that credibility, IHR managers must accept the risk and responsibility for putting forward policies and practices that make a difference in the achievement of corporate global strategies.

6.1.5 Development of International Human Resource Management

HR managers, no matter the type of organisation for which they work, can and do confront aspects of IHR. The extent of this involvement will vary according to a number of factors, such as the degree of development of the global strategy of the enterprise, and will invariably, increase with time. But as the general internationalisation of the business increases in extent and intensity, HR managers are being called upon to contribute increasing expertise to that internationalisation.

Some of the HR-related questions that need to be answered within the MNE as it establishes its international strategy include:

- Country selection: Which countries make the most sense for locating international operations and where will the firm be most likely able to recruit and hire the kinds of employees it will need at a competitive wage?
- Global staffing: How many employees will need to be relocated to foreign locations to start up the new operations and how many will be needed to run them (and does the firm have those people or know how to find or train them – or will the necessary people be found locally in the host countries)?
- Recruitment and selection. What will be required to find and recruit the necessary talent to make the new international operations successful?
- Compensation. How will the firm compensate its new global workforce, both the international assignees from the home office as well as the new local employees?
- Standardisation or adaptation. Will the firm want its HRM policies to be uniform across all of its locations, (standardisation or global integration) or will they be tailored to each location (adaptation or localisation)?

Whether the local HR manager is from headquarters, from the host country, or from a third country, he or she will be sandwiched between his or her own culture, and legal traditions and those of the firm, whether headquarters or local affiliate. HR managers at the local, regional, and headquarter level must integrate and coordinate activities taking place in diverse environments with people of diverse backgrounds as well as with their own diverse backgrounds. Plus, they are also frequently looked to for expertise in helping other managers to be successful in their international endeavours, as well.

6.1.6 Difference between International and Domestic Human Resource Management

It should be clear to the reader by now that international HRM differs from purely domestic HRM in a number of ways. Some of these differences include IHR being responsible for:

- More HR Functions and activities, for example, the management of international assignees which includes such things as foreign taxes, work visas and assistance with international relocations.
- A broader expertise and perspective, including knowledge about foreign countries, their employment laws and practices and cultural differences.
- More involvement in people's lives, as the firm relocates employees and their family's from country to country.
- Dealing with managing a much wider mix of employees, adding considerable complexity to the IHR management task – with each of the various types of global employees requiring different staffing, compensation and benefits program.
- More external factors and influences, such as dealing with issues stemming from multiple governments, cultures, currencies and languages.
- As a result, a greater level of risk, with greater exposure to problems and difficulties, and thus, exposure to much greater potential liabilities for making mistakes in HR decisions (for example, political risks and uncertainties, early repatriation of employees on foreign assignments etc.).

In addition to these factors, the geographic dispersion, multiculturalism, different legal and social system(s), and the cross border movement of capital, goods, services, and people that the international firm faces adds a need for competency and sensitivity that is not found in the domestic firm. The personal and professional attitudes of the IHR manager must be greatly expanded to handle the multiple countries and cultures confronted in the international arena – both to manage their IHR responsibilities and to contribute to successful international business strategies by their firms-beyond those which the domestic HR manager must develop.

The typical domestic HR manager does not have the contacts or the networks that become necessary to learn about and to handle the new global responsibilities. He or she does't typically have any experience with the business and social protocols, needed to interact successfully with foreign colleagues or with the form of organisational structure used to pursue international strategies (such as joint ventures or cross border acquisitions). And the still relatively limited body of literature and publicly available seminars and training programs make it much more difficult to develop the competencies needed to manage successfully the IHRM function.

6.1.7 Research on Strategic International Human Resource Management

It has only been recently that researchers have focused on Strategic International Human Resource Management (SIHRM). Although this research has expanded our knowledge of IHRM, not much is known about the factors that influence it. The existing research on SIHRM have found as would be expected, that local culture and national managerial orientation influences the nature of the HR practise, that the degree of global mind-set influences the nature of an MNE's global strategy, and that influences the degree of global focus in the HR strategy. In addition, it has been found that following appropriate global HR practices – rather than using only the parent firm's HR—was associated with the later stage's of an organisation's life cycle (as the MNE matures) and with better organisational performances. And large global Japanese and European MNE's were found to be more likely to pursue global HR practices than was the case for similar American firms. Or, stated the other way around, American firms are more likely to pursue localisation of IHR than are their Japanese or European counterparts.

In general, this research has dealt with some form of linkage between headquarters (corporate) international focus (for example, their degree of ethnocentrism or geocentrism) and HR policy and practice in foreign subsidiaries. If HR strategy must implement corporate strategy, then the extent to which HR practices in foreign subsidiaries reflects corporate international business strategy is an important consideration. But, as is typically observed by researchers, the examination of IHR strategy is in its infancy. Even though a number of models has been put forward to speculate on the possible linkages (with limited supporting data), there is still much more to understand the complexities of SIHRM. Both the responses and the choices are more numerous and complex in practice than these models have yet demonstrated.

6.1.8 Evolving International Human Resource Function

This section will provide an introduction to and an overview of the typical IHRM responsibilities.

Support of the strategic objectives of the multinational enterprise

It is commonly said that strategy is only as good as its implementation. IHRM plays a major role in developing tactical plans to support the organisational objectives. Achieving desirable results from ever more complex global business activities requires MNEs to pay increasing attention to the human aspects of cross border business, to the merger of global work forces and work cultures in the establishment of foreign subsidiaries and in cross border acquisitions, joint ventures and alliances, and to the development of individual employees who represent multiple corporate and national cultures, speak multiple languages, and have widely varying perspectives on customer, product and business issues. It is usually expected that IHR will provide these capabilities and advise the rest of the enterprise on how to ensure performance in this cross-border complexity.

Transactional service at global and local levels

IHR is expected to solve the problems associated with global HR issues, such as global staffing, global compensation, pension and health care systems, management development throughout the global enterprise, global employee and management recruitment and selection, global labour relations, global training programs etc. Many of these HR services will have to be provided at all levels: local, cross-border and global. In the end, the global and cultural aspects of the international business boil down to finding ways for different individuals from varying backgrounds and perspectives to work together; that is, finding ways to develop a corporate “glue” that will hold the organisation effectively together across multiple international boundaries.

This type of organisational glue-effective cross-border assignments, global social and professional networks and effective cross-national task forces and work teams- will need to be increasingly used to pull together employees from disparate country and corporate cultures and far-flung business units. And it is IHR that is expected to provide the global enterprise with the expertise to design and help administer such strategies.

International Human Resource Service to support the Multinational Enterprise Given the many HR problems that MNEs encounter in conducting business on a global scale, IHR is expected to carry out a global agenda.

- Ensure IHR contribution as an integral partner in formulating the global strategy for the firm.
- Develop the necessary competency among the senior IHR staff so that they can contribute as partners in the strategic management of the global firm.
- Take the lead in developing processes and concepts with top management as they develop the global strategy; these contributions might include developing capacities for environmental scanning about HR issues throughout the world (particularly for the countries of existing or contemplated operations), for decision making (particularly related to global HR concerns), and for the learning processes that the firm needs to adapt to new global requirements.
- Develop a framework to help top management to fully understand the increasingly complex organisational structure and people implications of globalisation; that is help management, individually and as a team, develop the necessary global mind set to conduct successful global business.
- Facilitate the implementation of the global strategy by identifying key skills that will be required, assessing current global competencies and creating strategies for developing the skills needed internally or locating them outside.

Distribute and share the responsibilities for IHR; increasingly, IHR will become a shared responsibility, with line management, IHR managers and work teams all sharing in the objective of ensuring effective hiring, development and deployment of the firm's human resources, both at home and abroad.

This may lead to the decentralisation of IHR decision making, possibly even outsourcing the administration of the basic functions, only leaving the strategic role for senior IHR executives. There may be less use of a separate headquarters IHR department, with IHR responsibilities delegated out to the global business units or, at least shared or developed with them. Many of these basic administrative activities (particularly for international assignee program

administration, including relocation, cultural and language training, health and safety orientation and management, (and compensation and benefits administration) will be outsourced to vendors with special expertise in these particular areas of IHRM. At any rate, the senior IHR executive and team will be responsible for ensuring that all of these traditional administrative IHR functions are managed effectively. Thus, the resulting IHRM responsibilities are both strategic and tactical and require that the new IHR professional be competent to play such a global role.

6.2 Global Recruitment

Recruitment means the searching for prospective candidates and stimulating them to apply for jobs. Recruitment attracts a large number of qualified applicants who desire to work in the company. The recruitment information given by the global companies helps the qualified candidates who are willing to work to send their resume, along with a letter expressing their desire to work. It also helps the unqualified candidates to self select themselves out of the job candidacy. Thus, the accurate information provided by the global company attracts the qualified and repels the unqualified candidates. Thus, recruitment helps the global company in finding out potential candidates for actual or anticipated vacancies in the company.

6.2.1 Sources of Global Recruitment

Sources of global recruitment include: Parent country nationals, Host country nationals and Third country nationals.

Parent country nationals

Parent country nationals are employees (of a company or its subsidiaries located in various countries) who are the citizens of the country where the company's headquarters are located. Parent country nationals in international business normally are managers, heads of subsidiary companies, technicians, trouble-shooters and experts. They visit subsidiary companies and operations (ii) to help them in carrying-out their operations to make sure that they run smoothly to provide advice and control them. However, sending parent country nationals involves cost and causes ego and cultural problems. Hence, the North American companies stopped sending the parent country nationals to subsidiary companies operating in other countries.

Host country nationals

Host country nationals are the employees of the company's subsidiary who are the citizens of the country where the subsidiary is located. Employing host country nationals is advantageous as: they are familiar with native culture. They are familiar with local business norms and practices. They manage and motivate the local workers efficiently. They are familiar with local bureaucrats, market intermediaries and suppliers of inputs, familiar with the taste and preference of the local customers. However, there are certain disadvantages associated with the host country. These include: They are not familiar with the objectives, goals and strategies of the parent company. They are unaware of the needs of the headquarters. They view the company only from the local perspective rather than from the global perspective. It would be difficult to train the host country nationals due to variations in the views about achievement, equity, the work ethic and productivity of the host country nationals from those of the parent country nationals.

Third country nationals

For example, Mr. Akhil - an Indian citizen - is working for an American subsidiary in France. Mr. Akhil, is called third country national. Third country national is an employee of a company's subsidiary located in a country, which is not his home country. The software professionals of India who work in American subsidiaries located in various countries of Europe are called third country nationals. The advantages of employing third country nationals include: Less cost with required expertise, skill knowledge and foreign skills. They have a cultural fit due to their experience in working in a multicultural environment. However, the local government may impose conditions and regulate in employing third country nationals.

6.2.2 Global Selection Process

Global business firms need people with higher order skills, balanced emotions, ability to adjust to multi-cultural recruitment, etc. Hence, the selection process of global companies varies from that of a domestic company. Now, we study the selection process of a global firm. Selection process includes selection procedure, selection approach and selection methods.

Global selection approach

Selection policy is vital in global business as it deals with the various types of people, jobs and placement. In fact, selection policy contributes for the achievement of the strategic goal of global business i.e., 'thinking globally and acting locally'. There are three types of approaches followed in selection policies in global business viz., the ethnocentric approach, the polycentric approach and the geocentric approach.

The ethnocentric approach

Under this approach, parent country nationals are selected for all the key management jobs. This approach was widely followed by Procter and Gamble, Philips, Matsushita, Toyota etc. When Philips filled the important vacancies by Dutch nationals, non-Dutch employees referred them to as Dutch Mafia. Some of the international firms follow this approach due to the following reasons: Non-availability of qualified personnel in developing countries. To maintain a unified corporate culture. Japanese firms mainly follow this reason. P&G also preferred this reason. To transfer the core competencies of the company when the core competencies are held by the existing employees of parent country nationals.

The polycentric approach

Under this approach, the positions including the senior management positions of the subsidiaries are filled by the host country nationals. The reasons for adopting this approach include: Host country nationals are including business culture and are familiar with the culture of the country. Level of job satisfaction of the employees of the subsidiaries can be enhanced. It is less expensive as the salary level of host country nationals is lower than that of host country nationals in case of MNCs of advanced countries. It reduces overall cost of staff of subsidiaries. Though this approach is a welcoming factor from the point of view of host country, it suffers from the following limitations: This approach limits the mobility of employees among subsidiaries and between subsidiaries and the headquarters. Organisational culture of the parent company cannot be completely adopted in the subsidiaries. Culture of the subsidiaries and the headquarters cannot be exchanged as it isolates the headquarters from their subsidiaries. These limitations forced some organisations to employ the best candidates from any part of the globe (referred to as geocentric approach).

The geocentric approach

Under this approach, the most appropriate candidates are selected for jobs from any part of the globe. Global firms follow this approach due to the following reasons: To have the most appropriate human resources. To develop the people with multiculture and meet the challenges of cultural diversity. To build multi skilling as a core competency and transfer it to all the subsidiaries. To avert the problems of cultural myopia and enhance local responsiveness of the host country.

Though this approach seems to be superior to the other two approaches, it also suffers from the following limitations: Most of the countries insist that MNCs should employ their citizens. MNCs are allowed to employ foreign nationals only in the rarest cases. Implementation of this policy takes time as the MNC has to train and develop the people in multicultures. Implementation of this policy is also expensive.

Business Implications: MNCs with very limited geographic scope in culturally related countries can adopt the ethnocentric approach, whereas MNCs with wide geographic scope in culturally unrelated countries may adopt polycentric approach. However, the transnational companies whose geographic scope is very wide may adopt geocentric approach. Geocentric approach is appropriate for Coca-Cola, P&G and the like. Companies should take utmost care in selecting the candidates for overseas jobs.

This is because the candidate should be competent in job knowledge, skills and ‘competency in addition to having the skill of adaptability to the new culture and environment. Further, the employee’s adaptability is not enough, what is equally important is the adaptability of the employee’s spouse and family members to the new environment.

The outcome of the research studies indicate that for global jobs she must possess:

- A variety of individual, interpersonal and organisational skills.
- Job performance track record.
- Multi-cultural exposure and cultural fit.
- Relational abilities.

Selection technique for global jobs

Global companies require the human resources adaptable not only to the job and organisational requirements, but also to the emotions of the people of different countries of the world. As such, the selection techniques for global jobs vary from that of domestic jobs. Now, we shall discuss the selection techniques for global jobs.

- Screening the applicant’s background.
- Conducting tests to determine the candidate’s suitability to the job norms.
- Conducting tests to evaluate the candidate’s suitability and adaptability to the new culture and environment.
- Conducting tests to evaluate the suitability and adaptability of “candidates, spouse and family members” to the new culture and environment.
- Predicting the adjustment of the candidate, his spouse and family members to the new job, culture of the company, country and the new environment.

Rosalie Tung proposed a selection method for selection of expatriates.

The candidate should be asked questions relating to:

- His adjustment
- Interaction with the host nationals
- Technical competence
- Cultural novelty
- Family situation
- Communication skills

The company has to measure the candidate on various adjustments. The variables to be measured include:

The Individual Dimension: The variables used to measure the candidate’s suitability in this area include:

- Candidate’s self-efficiency
- Relational skills of the candidate
- Perceptual skills of the candidate
- Job skills
- Stress reduction skills

6.2.3 Expatriates

Global companies, after selecting the candidates place them on the jobs in various countries, including the home country of the employee. But, the employees of the global companies are also placed in foreign countries. Even those employees who are placed initially in their home countries are sometimes transferred to various foreign countries. Thus, the employees of global companies mostly work and live in foreign countries and their family members also live in foreign countries. Employees and their family members working and/or living in foreign countries are called expatriates in the foreign country. Expatriates are those living or working in a foreign country. The parent country

nationals working in foreign subsidiary and third country nationals are expatriates. Large number of expatriates normally has adjustment problems with the working culture of the company, country's culture, laws of the country etc. Some expatriates adjust themselves easily, while some others face severe problems of adjustments. Many Indian expatriate employees in Maldives could not adjust to the culture and returned to India before their assignments were completed. Thus, the major problem with expatriates is adjustment in the new international environment.

International adjustment

The international adjustment is the degree to which the expatriate feels comfortable living and working in the host culture. This significantly influences job performance. The expatriate is completely new to the host country environments, social rules, norms etc. The expatriates have a strong desire to reduce psychological uncertainty in the new environment. Psychological uncertainty is also called cultural shock. Nancy Adler defines cultural shock as, "the frustration and confusion that result from being bombarded by uninterruptable clues."

For example, students in the USA drink beverages in the class-room, students in African countries leave the class immediately after the close of the lecture but before the teacher leaves the class, people in the USA wish you immediately when there is eye-to-eye contact with you. These cultural differences cause cultural shock to Indians. Researchers found that to a large degree culture shock follows the general pattern of a U-shaped curve. This pattern presents the relationship between culture shock and the length of time the expatriate has been working in the host country's culture. The 'U' is divided into four stages, viz., honeymoon, culture shock, adjustment and mastery. Honeymoon stage: like expatriate and his family members are fascinated by the culture of the host country, the accommodation, the transportation facilities, educational facilities to the children etc., during the early stage of arrival. This stage lasts up to 2-3 months period.

Culture shock stage: The company takes care of the new arrivals and completely neglects the previously arrived employee and his family after three months. During this stage, the employee has to take care of himself and his family members. Expatriate gets frustrated, confused and unhappy with living and working abroad. His social relations are disillusioned during this stage. He gets the shock of the existing culture.

Adjustment stage: The expatriate slowly learns the values, norms, behaviour, of the people, their culture etc. He slowly adjusts himself to the culture of the foreign country. Mastery stage: The expatriate after adjusting himself with the culture of the foreign country, can concentrate on working efficiently. He learns and adopts to the new environment completely and becomes like a citizen. He behaves and functions like a citizen at this stage.

Dimensions of international adjustment

International adjustment has three dimensions, viz., adjustment to the overseas workplace, adjustment to interacting with the host nationals and adjustment to the general environment. The research studies discovered certain skills which would help both the individual expatriate and international organisations in dealing with the adjustments. Figure below presents a framework of international adjustment. There are four dimensions of adjustment, viz., individual, job, organisation culture, and non-work.

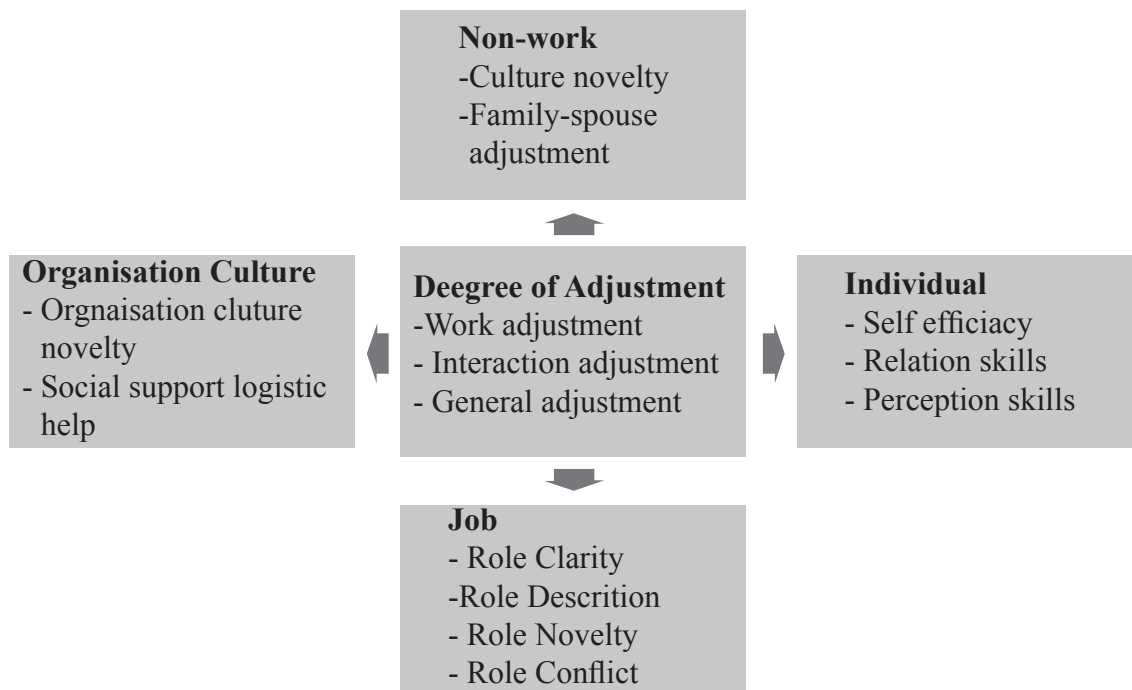


Fig. 6.1 Framework of international adjustment

Individual Dimension: Individual dimension includes the skills and the capabilities that the expatriate possess. These skills include cross-cultural skills. There are three sets of individual skills, viz., self efficacy, relational and perception skills. Now, we discuss these three types of skills. **Self-Efficacy Skills** The expatriate should have self-confidence, self-esteem and mental hygiene. He should be able to keep mental and social health with a feeling of being able to control or deal with surprises from the host cultural environment. Areas of self efficacy are: stress reduction, technical competence and reinforcement substitution.

Stress Reduction: Stress reduction abilities include abilities to deal with interpersonal conflict, financial difficulties, and variations in business systems, social alienation, pressure to conform, loneliness, differences in housing, climate etc. These factors affect the expatriate job performance. Expatriates should have an on-going clear strategy to reduce the stress.

Technical Competence: Technical competence of the employee is an important factor that determines the degree of employee adjustment in the foreign country. **Reinforcement Substitution:** This skill involves “replacing activities that bring pleasure and happiness in the home culture with similar -’yet different - activities that exist in the host culture.” The common interests would be sports, music, art, dance, and social groups. **Relational Skills** Relational skills include expatriate’s ability, desire and tendency to interact, mix or involve and develop relationships with host nationals. The skills in this regard include: Finding

Mentors: The expatriates find the host nationals, who have similar interests and can guide them. My own personal experience, while I was working in Eritrea, I found common interests in Dr. Tesfa-Yesus Mehary and in myself. I also found guiding and mentoring skills in Dr. Tesfa Yesus Mhary and I accepted him as my mentor. He helped me in building relations with other Eritreans and adjust to Eritrea with least problems.

Willingness to Communicate: Fluency in the host country’s language is not a pre-condition for building relations with the foreign nationals. What is more important is making efforts to learn the language as a means for familiarising with the foreign nationals and their culture. Strategically using the proverbs, popular songs, famous incidents from the history, jokes, information about religion, sports of the host country is called, “Conversational Currency.” Using these titbits fastens the process of building the relations with the foreigners.

Perception Skills: These skills include expatriate's ability to understand the behaviour of the host nationals, their practices, culture etc. These skills reduce the degree of psychological uncertainties associated with cross-cultural experiences. The expatriate should not view the host nationals as backward, or stupid or unsophisticated.

Non-work Dimension: The non-work dimensions include culture novelty and family/spouse adjustment. **Culture Novelty:** Culture novelty includes differences in beliefs, values, norms, religious faith, sex roles, etc. The degree of culture novelty is more, if these factors of the host country vary much from those of the home country of the expatriate. The results of the research study conducted by Ingemar Torbiorn regarding host countries ranked according to expatriate satisfaction are presented in Exhibit 6.4.

Family-Spouse Adjustment: The employee may take a decision, to leave the host country before the contract expires, if the employee's spouse and family members fail to adjust to the host country's culture. Some of the Indian housewives fail to adjust to foreign culture regarding sex and marriage system, particularly when their female children enter the teenage and force the husbands to leave the foreign job and country. However, the research studies found that: The spouse was in favour of accepting the assignment from the start. The spouse engaged in self-initiated, cross-cultural training. The spouse had a social support network of host country nationals. The standard of living in the overseas assignment was acceptable to the spouse. The firm sought the spouse's opinion regarding the international assignment from the beginning of the selection process. The spouse could adjust to the degree of culture novelty.

6.2.4 Performance Appraisal

Performance appraisal is a method of evaluating employee behaviour relating to expected work and behaviour, normally including 'both the quantitative and qualitative aspects of job performance. Performance refers to the degree of accomplishment of the tasks that make up an individual's job. Appraising the employee performance on foreign jobs is a highly complicated task as the expectations of global company are multifarious. In addition, employees of various countries view the meaning of jargons quite differently. Added to this, work related practices, organisational culture and job dimensions vary from country to country. Hence, global company should take due care in appraising the performance of employees.

Objectives The objectives of performance appraisal are to create and maintain a satisfactory level of performance, to contribute to the employee growth and development through training and to guide the job changes with the help of continuous ranking.

Appraisers: The appraiser may be any person who has a thorough knowledge about the job content, content to be appraised: standards of content and the one who observes the employee while performing a job. Typical appraisers are:

- Supervisors
- Peers
- Subordinates
- Consultants
- Customers (internal and/or external) Users of services

Performance Appraisal

360° performance appraisal refers to the performance appraisal of an employee by his superiors, subordinates, peers, customers, consultants and users of his services. Methods of Performance Appraisal A number of performance appraisal techniques traditional methods include:

Graphic Rating Scales Ranking Method Paired Comparison Method ' - have been developed. The Forced Distribution Method

- Check List Method
- Essay or Free From Appraisal
- Group Appraisal
- Confidential Reports

Modern performance appraisal methods include: Behaviourally Anchored Rating Scales · Assessment Centres Human Resource Accounting Management by Objectives Psychological Appraisal.

Performance Appraisal in Global Companies Appraising the performance of expatriate employees objectively is very difficult. Performance appraisal of expatriate employees is done by both host nation managers and home country managers. The host nation's managers may be biased due to their cultural frame and expectations. In order to reduce the problems of performance appraisal, the US companies give more weightage to the self appraisal done by the foreign employee for himself rather than by the superiors. Japanese companies introduced participative management in Indian subsidiaries.

Employees in Indian subsidiary felt that Japanese management introduced participative management as Japanese managers are incompetent. Indians view the superiors as experts, if the latter do not ask the subordinates for details. Japanese managers' performance was rated as negative by the host country's (India) superiors. Home country managers also rate the employees with a bias due to lack of face-to-face interaction. Guidelines for Performance Appraisal: The following guidelines help to solve the problems of performance appraisal of expatriate employees. More weight should be given to the rating of the on-site managers' appraisal due to proximity. Host country managers should also give the weightage to the culture of the expatriate employee. Due weight should also be given to self-appraisal.

6.3 Training and Development

It is often said that a good selection process reduces the training effort. It might be true in the case of domestic business. But, the global companies should have enough training and development effort as the candidates are strangers not only to the jobs, but also to the soil, climate, environment, people and culture of foreign country where they are expected to work and live along with their family members. After the candidate is selected and placed on the job, he must be provided with adequate training and developmental facilities. Training is the act of increasing the knowledge and skill of an employee for doing a particular job. Development is a systematic process of growth and by which the executives develop their abilities to manage. In fact, executive development/education has become global.

6.3.1 Importance of Training and Development for Global Jobs

Even the most valuable employees in the global companies fail to work and stay with the company due to poor training and developmental efforts. Global companies should make not only the employee, but also his family members more comfortable with the company, people and the country. Hence, training and development assume greater significance in global companies. Training and development are the most important techniques of human resource development Training and development lead to:

- Improved job knowledge and skills at all levels of the organisation.
- Improved morale of the human resources.
- Improved profitability and/or more positive attitudes towards improved relationship between boss and subordinate.
- Improved understanding of culture of various countries.

6.3.2 Cross- Cultural Training

Cross-cultural training enables the expatriates to learn the cultural norms, values, aptitudes, attitudes, beliefs, behaviours, practices of the host country. The expatriate, after training can use this cross-cultural knowledge to behave according to the cultural requirements of the host country. The adage "Do in Rome as the Romans do" holds good here. The trainee expatriate can transfer the knowledge gained in the training programme into new cognitive and physical behaviour. This process gives the trainee more satisfaction in their foreign assignment. Procter and Gamble trained their selected candidates for their company in Japan regarding the Japanese culture that Japanese like more of informality, they hesitate to say no and they finalise more of their business dealings outside the office and mostly in restaurants in the evenings.

The employees transferred this knowledge into their cognitive and physical behaviours and became successful in dealing with the Japanese. Thus, they became efficient in doing their jobs and interacting with the host country's nationals. However, some companies do not train their expatriates due to the following reasons:

- Brief cross-cultural training programmes are ineffective.
- The failure of such dissatisfaction. programmes in the past resulted in employee
- Lack of enough time between selection and departure
- High cost of training

Though the company cannot provide training before the departure of the employee, it can plan to provide the same in the host country.

6.4 Compensation and Benefits

Compensation is the amount of remuneration paid by the employer to the employees in return to their services and contributions to the company. Compensation is the most important factor in the entire human resource management process. Compensation includes the amount of salary, the different kinds of fringe benefits and employees welfare benefits, bonus, profit sharing, stock options and the like. A number of factors affect the compensation policy of global companies. The important among them are: compensation levels in comparable global companies, company's ability to pay, cost of living in various countries, employer productivity, trade union's pressure and strategies. Global companies give a number of benefits to its employees in addition to the salary. These benefits include: air fare, paid leave, medical allowance, conveyance allowance, educational allowance for employees' children, gratuity, resettlement allowance, profit sharing, employees stock options, etc.

6.4.1 Compensation in Global Companies

Compensation is the amount of remuneration paid to the employees. The two issues involved in compensation management are: national economic differences and payment practices. The second issue is the mode to payment to expatriate managers. There are significant differences in the compensation levels and structures among different countries. This is because, the firms pay the executives of various countries based on the local compensation levels. Expatriate Pay: Expatriate pay is mostly based on the balance sheet approach. Under the balance sheet approach, the compensation package enables the expatriate employees in various countries to maintain the same standard of living.

This approach also provides for offsetting quantitative differences among employment locations. Gratuity: Expatriate employees are paid gratuity at a fixed rate for every year of completion of service in the foreign country. Gratuity is the inducement to the expatriates to work for quite longer period in the foreign country. Allowances: Expatriate employees are paid car allowance, resettlement allowance, housing allowance, cost-of-living allowance, education allowance, etc. various allowances allowance, allowance, like hardship medical Taxation: Some countries pay tax-free salary and/or tax-free gratuity. Most of the countries pay taxable salary and gratuity.

6.4.2 Profit Sharing and ESOP

The multinational corporations in order to motivate the employees for higher performance introduced a scheme of profit sharing. Under this scheme, workers get a right to have a share in the net profit of the company if the profits cross a certain limit. This provision motivates the employees to improve production, sales and profits. Multinational corporations also introduced another plan to motivate the employees and to retain them. The expert and efficient employees go on shifting to the other organisations which pay higher salary and offers better facilities. This problem is more acute in software and information technology firms. These companies introduced the 'Employee Stock Ownership Plan' in order to reduce employee turnover and retain them in the company.

The Employee Stock Ownership Plan (ESOP) allows the employees to purchase the share (or stock) of the company at a fixed and reduced price. Employees are motivated when the company allows them to buy the shares at concessional price. The stock ownership is viewed as performance based incentives. This plan is described as “golden hand-cuffs.” The advantages of stock ownership include: This plan links compensation package closely to performance. The plan enables the MNCs to retain efficient employees with them. It encourages the employees to improve their performance. This scheme establishes significance of team effort among employees. It increases employee involvement and participation. ESOP is used by various companies in India, USA, France, Spain, Sweden, Norway, the UK, etc.

6.4.3 Women in International Business

Women recently started playing a vital role in international business. However, the role of women is not equal to that of men even today. The role of women in economic activities varies from country to country. The following examples indicate the role of women in different countries:

In Saudi Arabia restrictions on women’s freedom to move around make it difficult for women to work. For example, women are not permitted to drive, to travel on an airplane alone, or to stay in a hotel without a male family member. In Japan, women seldom work after marriage; unlikely to progress far within organisations. Consequently, women are In the U.S., women have attained a degree of equality in business, but they are seldom found in top management positions. In Ireland, the constitution has been interpreted to mean that a woman should only join the workforce if her husband is not able to look after the family economically. In St. Vincent, a West Indies island country, the minimum wage for women is lower than for men, regardless of the work performed.

In Canada, the great majority of nurses and secretaries are women while the majority of fire fighters, construction workers, and foresters are men. In the People’s Republic of China women hold many of the same positions as men, but they are required to retire at an earlier age. Ramachandran (1992) gives this example of the role of women in parts of India: in Rajasthan, when a social work organisation wanted to establish a hospital for women, there was a great deal of hostility and resistance. The village men could not understand why so much fuss should be made over women; they insisted that what they really needed was a hospital for their farm animals.”

International business managers should understand the role of women in economic activity and in business in various countries they operate. They have to consider various issues in employing women. Understanding working with women is more complicated than working with men. Therefore, managers should understand the role of women in business in various countries.

6.5 International Industrial Relations

International industrial relations are explained below.

Industrial relations strategies of MNCs

Multinational corporations have to deal with the employees of various countries with varied cultural, social, political and religious environments. The industrial relations strategy of the MNC’s are mostly applied to the environment of only one country and it has to formulate another strategy for another country. Industrial relations are seen in the larger interest of social class struggle in Switzerland, France and ‘ Italy. In most of the other countries this is seen only as the relationship between workers and management. MNCs decentralise their industrial relations policies and practices. MNCs use the strategy of relegating the industrial relations problems like work stoppages, strikes, etc., to the specialists in the various countries. Employees working in various subsidiaries of MNCs formed international trade union.

Current employee relation issues

Ferocious global economic competition has spawned a relentless search by MNCs for the lowest production and operational costs. Their competitive survival often depends on their success in this search. On the supply side, the increasing accessibility of the world’s workers has created a huge pool of labour vying to compete for MNCs’ low-paying jobs, with little ability to refuse the unsafe working conditions that contribute to low operational costs. And many governments, desperate for increased jobs and national economic strength provided by MNC foreign

direct investment, also compete in attracting MNCs for access to cheap and/or skilled labour. Fortunately, market imperatives compete with the tendency to seek the lowest labour cost and help to maintain employment in traditional markets—the advantage of locating business operations near consumers for company recognition and acceptance as well as for logistics savings.

Given this background of global competitive pressure and opportunities for achieving lower labour costs, much of the global labour force is vulnerable to workplace abuse by some short sighted, unethical organisations—those that seek to maximise their benefits at the expense of workers and their communities. Other organisations with no malicious intent may inadvertently contribute to employee workplace difficulties and abuse due to lack of awareness of the impact of their business activities, such as through their distantly managed operations that are outsourced and contracted to foreign companies and state-owned enterprises. We now will examine current critical global ER issues and challenges related to worker protection that companies should be aware of and consider in their ongoing business planning, including in cooperation with local governments, unions, and other parties concerned with employee protection. These issues include forced labour, harmful child labour, workplace discrimination, health and safety hazards, and job insecurity and displacement.

Influence of MNCs and unions on global ER

The practice of ER throughout the world can differ dramatically, and in each business environment context the practice of ER can have several external sources of influence. On the other hand, internal company factors such as company culture, general management philosophy, and prevailing management style also can be very influential in determining ER practices despite heavy government regulation and union presence in the external context, such as the case of McDonald's in Germany.

As mentioned earlier, the parties that constitute the primary employment relationship underlying an organisation's ER are the company and employees, both individually and collectively, such as when employees are organised in a union. Both the employees and the MNC (including managers and executives representing the MNC who determine and carry out company policy) have a principal influence on the nature and duration of the employment relationship in which ER takes place. Although we now will focus on the part played by MNCs in the employment relationship, we want to emphasise the importance of the active voice and participation of individual employees in determining the nature of this relationship and how they are treated and managed in organisations. And although unions are often considered external to the primary company-employee employment relationship, we also will examine their influence on ER because they often represent the voice of employees. Finally, MNCs should also be familiar with other external forces, such as governments, intergovernmental organisations, and NGOs, which can have a powerful impact on MNC ER decisions and activities. International and local NGOs in particular, compared to the overall waning influence of unions, are increasingly vocal and influential in bringing changes and improvements in employee safety and rights protection.

Role of MNCs in global employee relations

How should MNCs be involved with the pressing ER issues and challenges presented earlier? Certainly they should expect to follow local regulations of all kinds, including those regarding the treatment of employees. But do MNCs have an ethical responsibility to respect and adhere to the same home country ER practices in their host country operations, even though the host country might not have any such standards or regulations, or if they have them, ignore them through virtually nonexistent enforcement? In our competitive global economy, the decisions and actions of MNCs entering new countries can become moral dilemmas.

However, as MNC operations come under greater scrutiny around the world, consumers, shareholders, communities, and other stakeholders increasingly demand that corporations play a positive role in promoting and upholding high corporate social responsibility. We believe that for a long-term sustainable strategy of success, companies must adopt as part of their core values common high standards for managing their global human resources, including ER practices, which will meet or surpass individual country standards and regulations. Nike, Wal-Mart, and Reebok are just a few companies that have been under intense pressure to improve their global workforce ER acts, both in their home countries and abroad.

And overall, they have responded very favourably to this pressure, raising the expectations for corporate social responsibility. In its own home country of the United States, Wal-Mart has been charged, based on its own workplace data patterns, with a huge class-action lawsuit for sex discrimination related to compensation and career advancement. Although companies like Wal-Mart may truthfully deny conscious discriminatory practices, their human resource records and data patterns, unless they can be reasonably defended, may still provide sufficient evidence of discrimination and adverse “disparate impact” against a legally protected group, such as women or minorities. Even though business leaders and managers may not intentionally put individuals from one or more groups at a disadvantage, deep cultural influences may still affect human resource decisions leading to systematic unfair discrimination. Disparate or adverse impact, with its focus on actual statistical patterns of ER practice, is a tool to surface unfair discriminatory practice regardless of conscious intention or motive. More recently Wal-Mart agreed to pay \$11 million to settle a lawsuit accusing it of being complicit in contracting janitorial services for its stores where the contracted employees were illegal aliens.

Another lawsuit has sought redress for the undocumented employees, claiming they were underpaid and worked overtime without extra pay. Many of the immigrants from nearly twenty countries, including Mexico, Brazil, the Czech Republic, China, Poland, and Russia, said they generally worked from midnight until 8 A.M. seven nights a week, cleaning and waxing floors. Wal-Mart was held liable despite its claim of not knowing about the illegal status or mistreatment of these contracted workers— they still were held accountable for the quality of ER and treatment of the employees who performed their company-contracted services. Thus, companies must not feel comfortable in merely being unaware of malfeasance and having a clear conscience regarding their ER practices but should actively examine their employment practices on an ongoing basis, including those covering their contracted workers, to ensure that legal and ethical ER practices and standards are followed.

Summary

- Human Resource Management (HRM) is defined as managing (planning, organising, directing and controlling) the functions of employing, developing, compensating and maintaining human resources resulting in the creating and development of human relations with a view to contribute proportionately (due to them) to the organisational, individual and social goals.
- An international business must procure, motivate, retain and effectively utilise services of people both at the corporate office and at its foreign plants. The process of procuring, allocating and effectively utilising human resources in an international business is called international human resource management (IHRM).
- The three broad activities of IHRM, namely, procurement, allocating and utilising, cover all the six activities of domestic human resource management (HRM).
- The six functions of domestic HRM are: human resource planning, employee hiring, training and development, remuneration, performance management, and industrial relations. These six functions can be dovetailed with the three broad activities of IHRM.
- The three types of employees of an international business include host-country nationals, parent-country nationals, and third-country nationals.
- There are three types of approaches followed in selection policies in global business viz., the ethnocentric approach, the polycentric approach and the geocentric approach.

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Self Assessment

1. _____ is defined as managing the functions of employing, developing, compensating and maintaining human resources resulting in the creating and development of human relations with a view to contribute proportionately (due to them) to the organisational, individual and social goals.
 - a. International Marketing Management (IMM)
 - b. Human Resource Management (HRM)
 - c. International Business Management (IBM)
 - d. International Business Environment (IBE)

2. The process of procuring, allocating and effectively utilising human resources in an international business is called _____.
 - a. International Business Management (IBM)
 - b. International Business Environment (IBE)
 - c. International Human Resource Management (IHRM)
 - d. International Marketing Management (IMM)

3. _____ are the employees of the company's subsidiary who are the citizens of the country where the subsidiary is located.
 - a. Host country nationals
 - b. Third country nationals
 - c. Expatriates
 - d. Migrants

4. _____ is an employee of a company's subsidiary located in a country, which is not his home country.
 - a. Host country nationals
 - b. Third country nationals
 - c. Expatriates
 - d. Migrants

5. _____ is vital in global business as it deals with the various types of people, jobs and placement.
 - a. Selection policy
 - b. Education policy
 - c. Health policy
 - d. Transfer

6. Match the following -

1. Ethnocentric Approach	A. Parent country nationals are selected for all the key management jobs.
2. Polycentric Approach	B. Positions including the senior management positions of the subsidiaries are filled by the host country nationals.
3. Geocentric Approach	C. The most appropriate candidates are selected for jobs from any part of the globe.
4. Parent country nationals	D. Employees (of a company or its subsidiaries located in various countries) who are the citizens of the country where the company's headquarters are located.

- 1-A, 2-B, 3-C, 4-D
 - 1-D, 2-C, 3-B, 4-A
 - 1-C, 2-B, 3-D, 4-A
 - 1-B, 2-D, 3-A, 4-B
7. Researchers found that to a large degree culture shock follows the general pattern of a _____.
- Ellipse shaped curve
 - U-shaped curve
 - Circle shaped curve
 - Matrix
8. Psychological uncertainty is also called _____.
- emotional need
 - cultural shock
 - time lag
 - jet lag
9. Which of the following statements is true?
- Adoption skills include expatriate's ability to understand the behaviour of the host nationals, their practices, culture etc.
 - Language skills include expatriate's ability to understand the behaviour of the host nationals, their practices, culture, etc.
 - Relocation skills include expatriate's ability to understand the behaviour of the host nationals, their practices, culture, etc.
 - Social skills include expatriate's ability to understand the behaviour of the host nationals, their practices, culture, etc.
10. _____ is a method of evaluating employee behaviour relating to expected work and behaviour, normally including 'both the quantitative and qualitative aspects of job performance.
- Relocation
 - Performance appraisal
 - Job satisfaction
 - Referral

Chapter VII

International Financial Management

Aim

The aim of this chapter is to:

- explain international finance, currency, creditworthiness and methods of payment
- elucidate international financial management
- compare domestic and international financial management

Objective

The objectives of this chapter are to:

- differentiate between the gold standard and the Bretton Woods exchange rate
- explain theories of exchange rate behaviour
- elucidate differences between domestic and international markets

Learning outcome

At the end of this chapter, you will be able to:

- identify management of international short term financing
- understand the process of short term loans for money market
- understand international debt instruments

7.1 Introduction To International Financial Management

International Financial Management has assumed an important role of the Indian economy, with FDI's, FFI's and FII's playing a key role in the stock and capital markets. The recent estimate is that FIIs hold about 18% of market capitalisation of the listed companies, in the Stock Exchanges in India. Many Indian corporate are listed and traded on Foreign Stock Exchanges. Many foreign banks were permitted to operate in India and Indian banks have become more globalised in their operations. Indian exports are growing at a rate of 12%, as per annum as envisaged in the tenth plan. Nearly more than 50% of the manufacturing output in India is exported on an average. The total of exports and imports trade crossed U.S. \$ 140 billion and its foreign exchange assets are also more than U.S. \$ 130 billion. With such growing importance of global sector, the operations in International Finance are also growing faster than ever before.

World Trade estimated to grow in 2004 at a rate of 6% and that of the developing countries at 8%. The scope of expansion for International Financial Management has increased. India has a major role to play in the world trade and finance. Net capital flows into Emerging Market economies on non-official basis were estimated at U.S \$ 113 billion in 2004 and into India U.S \$ 13 billion. India has emerged as a Creditor Country among the IMF of members. World Bank is reported to be planning to issue rupee bonds in India to raise rupee resources. Indian rupee has shown strength and resilience that it was in demand in International Finance Markets. Many big companies in India have become international market participants and are rated as domestic MNCs in addition to many MNCs of foreign origin in India.

Three major dimensions set international finance apart from domestic finance. They are:

- Foreign exchange and political risks.
- Market imperfections.
- Expanded opportunity set.

The major dimensions of international finance largely stem from the fact that sovereign nations have the right and power to issue currencies, formulate their own economic policies, impose taxes, and regulate movements of people, goods, and capital across their borders.

7.1.1 International Finance

Most of us know that domestic business agreements are concerned with the basic issues like price, quantity and delivery date. But, international business agreements are concerned with other issues, in addition to the issues involved in domestic trade. These issues include:

- Currency to be used in the international business transactions.
- Creditworthiness of the importer.
- Acceptable methods of payment.
- Arranging finance.

Currency to be used

Selecting currency to be used for settling the international business transactions is an important issue in international finance. The exporter prefers to have his home currency or hard currency while the importer prefers to pay in his home currency. If the currency of the importing country is weak, the exporter prefers the payment in hard currencies like US dollars, UK pound, Japanese Yen and French Francs. The exports of most of the developing countries are invoiced in US dollar. Some companies prefer to settle their transactions in US dollar or other hard currencies. As such the hard currencies are the choice of the exporter for settling the transactions in international business. Hence, the importers and countries struggle to earn hard currencies in order to meet their import, bills. Next, the exporter is interested to know the importer's creditworthiness.

Creditworthiness of the importer

The exporter normally first arranges for the shipment of the goods and receives the money at a later stage. There would be an amount of risk involved in the payment of money by the importer. Hence, the exporter either should have a satisfactory business relations with the importer or the exporter may ask the importer to send his credit rating done by an internationally reputed firm. Export-Import Bank of the USA, Export-Import Bank of India and such other organisations provide credit rating information to the exporters by collecting a fee. The exporting firms which do not demand for credit rating face serious problems. For example, one small US manufacturer exported fan blades worth of US \$ 127,000 to a new customer in Africa and failed to get the payment even by handing over the account to a collection agency. After evaluating the creditworthiness of the importer, the exporter and importer should come to an understanding regarding the method of payment.

Methods of payment

Both the exporter and importer should agree on a particular type of payment, after assessing the importer's creditworthiness. The methods of payment include:

Payment in advance

Most of the exporters prefer the advance payment prior to shipment as it involves no risk. This method is most undesirable from the point of view of the importer due to the involvement of heavy risk in getting the delivery of the goods as per the order.

Open account

Under open account the importer first receives the goods and then arranges for the payment. Hence, it is the safest form of payment from the point of view of the importer. This form is undesirable and risky from the viewpoint of the exporter. This method is more suitable when the importer's creditworthiness is certified by an authorised agency or when the exporter has well-established long-term relation with the importer.

Documentary collection

International financial institutions and banks have developed a number of financial instruments due to the risks and problems involved in advance payment and open account. One of the important financial instruments is documentary collection.

Under this method the commercial banks facilitate the payment process. The exporter draws up a document called a bill of exchange, in which payment is demanded from the importer at a specified future date. There are two types of bills of exchange, viz., (a) (b) (a) Sight Bill of Exchange Time Bill of Exchange Sight Bill of Exchange requires payment immediately after the transfer of title of the goods to the importer by the exporter. The importer's bank after receiving the bill of lading and sight bill of exchange from the exporter's bank, asks the importer to arrange for the payment. The bank gives the bill of lading to the importer after the payment is made by the importer. Figure below presents the transactions using a sight bill of exchange.

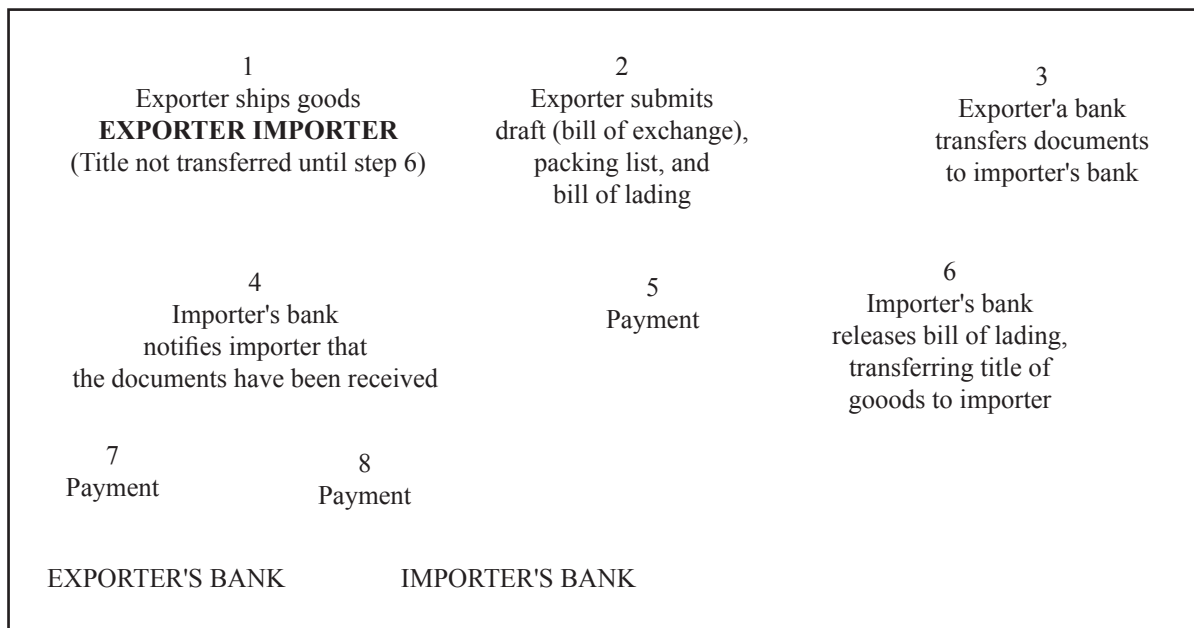


Fig. 7.1 Transactions using a sight bill of exchange

Time Bill of Exchange requires the importer to arrange for the payment after some time (60 days or 90 days) receiving the possession of goods. The importer writes, "Accepted" on the bill of exchange offer after obtaining the bill of lading (i.e., after obtaining the title of goods). This document is called 'Trade Acceptance.' Trade acceptance is legally enforceable by the law of the most of the countries. This is a negotiable debt instrument. . The importer may not keep up his promise and fail to pay to the exporter, under the documentary collection. Thus there is the involvement of risk in this method of payment also. As such the banks developed another method of payment, i.e., Letters of Credit.

Letters of credit

This instrument is carried out to avoid the risk involved in other methods of payment. A letter of credit is an instrument issued by a bank wherein the bank promises the exporter to pay upon receiving the proof that the exporter completed all the necessary formalities specified in the document. This guarantees the exporter regarding payment and hence, the payment is free from risk. The importer bank does this work by collecting a fee from the importer and also after obtaining a security to this effect. Figure below presents the transactions using a letter of credit.

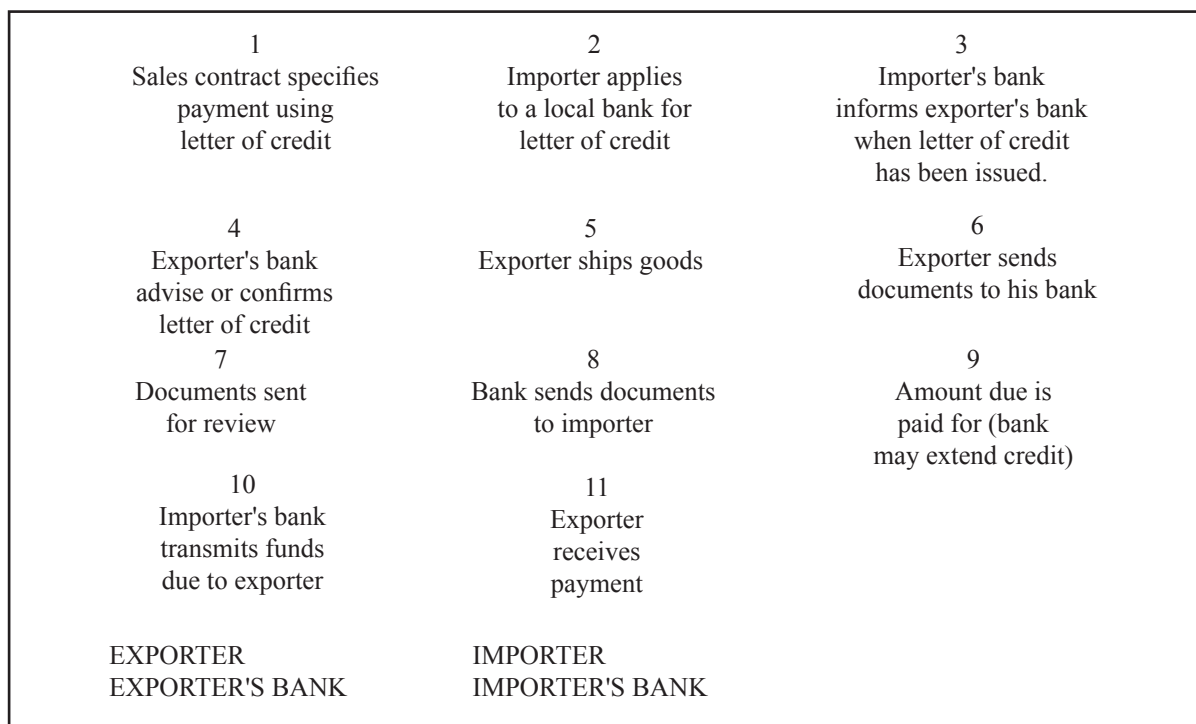


Fig. 7.2 Transactions using letter of credit

However, this instrument is costly for the importer. Hence, another instrument, i.e., credit card is being developed.

Credit cards

Credit cards are used for small international business transactions by the market intermediaries like retailers and also by the customers. Various credit cards include: American Express, Visa and Master Card. The next method of payment is counter-trade.

Countertrade

Counter-trade is an arrangement to pay for import of goods and services with something other than cash. Thus, counter-trade is goods-for-goods deal. Types of counter-trade include: barter, counter purchase, compensation trade, and switch trading, offsets and clearing agreements.

Method	Timing of Payment	Timing of Delivery of Goods	Risk(s) for Exporter	Risk(s) for Importer	Availability of Financing for Exporter	Condition(s) Favouring Use
Payment in advance	Prior to delivery of goods	After payment, when goods arrive in importer's country	None	Exporter may fail to deliver goods	n/a	Exporter has strong bargaining power; importer unknown to exporter

Open account	According to credit terms offered by exporter	When goods arrive in importer's country	Importer may fail to pay	None	Yes, by factoring of exporter accounts and account receivable	Exporter has complete trust in importer, importer is part of the same corporate family
Documentary collection	At delivery if sight draft is used; at specified later time if time draft is used	Upon payment if sight draft is used; upon acceptance if time draft is used	Importer may default or fail to accept draft	None	Yes, by discovering draft from its face value	Exporter trusts importer to pay as specified; when risk if default is low
Letter of credit	After terms of letter of credit are fulfilled	According to terms of sales contract and letter of credit	Issuing bank may default; documentation is wrong	Exporter may honour terms of letter of credit but not terms of sales contract	Yes, by discounting letter from its face value	Exporter lacks knowledge of importer; has good credit with local bank
Credit card	According to normal credit card company procedures	When goods arrive in importer's country	None	Exporter fails to deliver goods	N/A	Transaction size is small
Counter trade	When exporter sells countertrade goods	When goods arrive in importer's country	Exporter may not be able to sell counter traded goods	None	No	Importer lacks convertible currency; importer or exporter wants access to foreign distribution network

Table 7.1 Payment methods for international trade**7.1.2 International Flow of Funds**

We have seen that national economy of a country is composed of a number of sectors, including the foreign sector and the interdependence of these sectors either as suppliers of savings or of factors of production, or of other inputs in the productive process or as consumers of their output leads to economic, commercial and financial transactions as between these sectors. It is such transactions between the domestic sectors and foreign sector that gives rise to the international financial system.

An extension of this principle of mutual interdependence to the case of national economy of one country depending upon that of others lends further support to our thesis that emergence of international financial markets is the result of such interdependence and intra flow of funds.

Thus no modern nation/state is self-sufficient nor is it closed to external forces from other nations and states. This dependence is the result of the expanding civilisation and modern socio-economic systems. It is now well recognised that countries are interdependent in various degrees resulting in economic commercial and financial transactions among them.

Such interdependence is a necessary but not a sufficient condition for the emergence of international financial markets. But the conquering of the distance and time by revolution in Telecommunications, electronic media and information Technology has brought the world together and led to a sufficient condition for emergence of International Financial Management, as an area of vital importance. The interdependence of nations can be ascribed to the following factors:

- Differential factor endowments and natural endowments in different countries, leading to different production functions.
- Different stages of growth economies of these countries,
- Differences in demand functions habits, of industry, agriculture and other sectors in the different levels of savings and investment.
- Differentials in technological advancement, R&D, and economies of scale tastes and consumer preferences, leading to different demand functions.
- Differences in standards of living and incomes, leading to flow of funds through grants, loans, etc.

7.1.3 Goals for International Financial Management

The foregoing discussion implies understanding and managing foreign exchange and political risks and coping with market imperfections have become important parts of the financial manager's job. International Financial Management is designed to provide today's financial managers with an understanding of the fundamental concepts and the tools necessary to be effective global managers. Throughout, the text emphasises how to deal with exchange risk and market imperfections, using the various instruments and tools that are available, while at the same time maximising the benefits from an expanded global opportunity set.

- Effective financial management, however, is more than the application of the newest business techniques or operating more efficiently. There must be an underlying goal. Shareholder wealth maximisation means that the firm makes all business decisions and investments with an eye toward making the owners of the firm—the shareholders—better off financially, or more wealthy, than they were before. \
- Whereas shareholder wealth maximisation is generally accepted as the ultimate goal of financial management in “Anglo-Saxon” countries, such as Australia, Canada, the United Kingdom, and especially the United States, it is not as widely embraced a goal in other parts of the world. In countries like France and Germany, for example, shareholders are generally viewed as one of the “stakeholders” of the firm, others being employees, customers, suppliers, banks, and so forth.
- European managers tend to consider the promotion of the firm's stakeholders' overall welfare as the most important corporate goal. In Japan, on the other hand, many companies form a small number of interlocking business groups called *keiretsu*, such as Mitsubishi, Mitsui, and Sumitomo, which arose from consolidation of family-owned business empires. Japanese managers tend to regard the prosperity and growth of their *keiretsu* as the critical goal; for instance, they tend to strive to maximise market share, rather than shareholder wealth.
- It is pointed out, however, that as capital markets are becoming more liberalised and internationally integrated in recent years, even managers in France, Germany, Japan and other non-Anglo-Saxon countries are beginning to pay serious attention to shareholder wealth maximisation. In Germany, for example, companies are now allowed to repurchase stocks, if necessary, for the benefit of shareholders.
- In accepting an unprecedented \$183 billion takeover offer by Vodafone AirTouch, a leading British wireless phone company, Klaus Esser, CEO of Mannesmann of Germany cited shareholder interests: “The shareholders clearly think that this company, Mannesmann, a great company, would be better together with Vodafone AirTouch.” The final decision belongs to shareholders.

- Obviously, the firm could pursue other goals. This does not mean, however, that the goal of shareholder wealth maximisation is merely an alternative, or that the firm should enter into a debate as to its appropriate fundamental goal. If the firm seeks to maximise shareholder wealth, it will most likely simultaneously be accomplishing other legitimate goals that are perceived as worthwhile.
- Shareholder wealth maximisation is a long-run goal. A firm cannot stay in business to maximise shareholder wealth if it treats employees poorly, produces shoddy merchandise, wastes raw materials and natural resources, operates inefficiently, or fails to satisfy customers. Only a well-managed business firm that profitably produces what is demanded in an efficient manner can expect to stay in business in the long run and thereby provide employment opportunities.
- While managers are hired to run the company for the interests of shareholders, there is no guarantee that they will actually do so. As shown by a series of recent corporate scandals at companies like Enron, WorldCom, and Global Crossing, managers may pursue their own private interests at the expense of shareholders when they are not closely monitored.
- Extensive corporate malfeasance and accounting manipulations at these companies eventually drove them into financial distress and bankruptcy, devastating shareholders and employees alike. Lamentably, some senior managers enriched themselves enormously in the process.
- Clearly, the boards of directors, the ultimate guardians of the interests of shareholders, failed to perform their duties at these companies. In the wake of these corporate calamities that have undermined the credibility of the free market system, the society has painfully learned the importance of corporate governance, that is, the financial and legal framework for regulating the relationship between a company's management and its shareholders. Needless to say, the corporate governance problem is not confined to the United States.
- In fact, it can be a much more serious problem in many other parts of the world, especially emerging and transition economies, such as Indonesia, Korea, China, and Russia, where legal protection of shareholders is weak or virtually nonexistent.
- Shareholders are the owners of the business; it is their capital that is at risk. It is only equitable that they receive a fair return on their investment. Private capital may not have been forthcoming for the business firm if it had intended to accomplish any other objective.
- The massive privatisation that is currently taking place in developing and formerly socialist countries, which will eventually enhance the standard of living of these countries' citizens, depends on private investment. It is thus vitally important to strengthen corporate governance so that shareholders receive fair returns on their investments. In what follows, we are going to discuss in detail: the globalisation of the world economy, the growing role of MNCs in the world economy, and the organisation of the text.

7.1.4 Nature of International Financial Management

International financial management refers to the financial function of an overseas business. Specifically, the finance function of an international business deals with:

- Investment decisions – decisions about what activities to finance.
- Financing decisions- decisions about how to finance these activities.
- Money management decisions – decisions about how to manage the firm's financial resources most efficiently.

The discussions in this chapter centres on the three broad decisions of international financial management. Before describing the three vital decisions, it is useful to draw comparisons between domestic financial management and international financial management. Similarly, a brief explanation about the environment of international financial management is also in order.

7.1.5 Comparison between Domestic and International Financial Management

There are similarities between domestic financial management and financial management of an international business. Objectives of financial management, that is, profit maximisation and wealth maximisation are the same whether the firm serves only the domestic market or does its business in overseas markets. The major decisions a finance manager needs to make remain the same notwithstanding whether the business is domestic or international. The key decisions of financial management are: investment, financing, and asset management. The investment decision refers to the determination of the total amount of assets needed to be held by a firm. Determination of sources of funds to acquire the assets refers to the financing decisions. The third important decision of the firm is asset management decision. Once assets have been acquired and appropriate financing provided, these assets must be managed efficiently. The financial manager of a domestic business or an international business is required to make all the three decisions judiciously.

There are dissimilarities, however, between domestic financial management and international financial management. The motivation to invest funds in a foreign operation, for example, is to provide a return in excess of what is normally expected. There may be gaps in foreign markets where excess return can be earned.

International Financial Management requires an understanding of certain unique risks that are not normally a threat to domestic operations. These unique risks are related to foreign exchange risks and political risks. Foreign exchange risks can raise the cost of capital and lower the optimal debt ratios for international business.

International portfolio investors require a foreign exchange risk premium when valuing the equity and debt of MNC's, especially if those firms have invested heavily in countries with volatile currencies. Contemporary financial analysis incorporates a political risk premium when foreign activities are being evaluated. Banks and investors require a higher rate of return on loans to, and bonds issued by foreign sovereign entities or corporations when they are residents in relatively unstable countries or even in emergent market countries.

7.2 International Financial Environment

Any corporate business unit faces global environment in various forms, particularly if it is an export industry, import dependent industry and import competing industry. Also, units in joint ventures, subsidiaries of foreign companies, and partly or wholly owned foreign companies face the global environment. The major global environmental factors are shown in this chart.

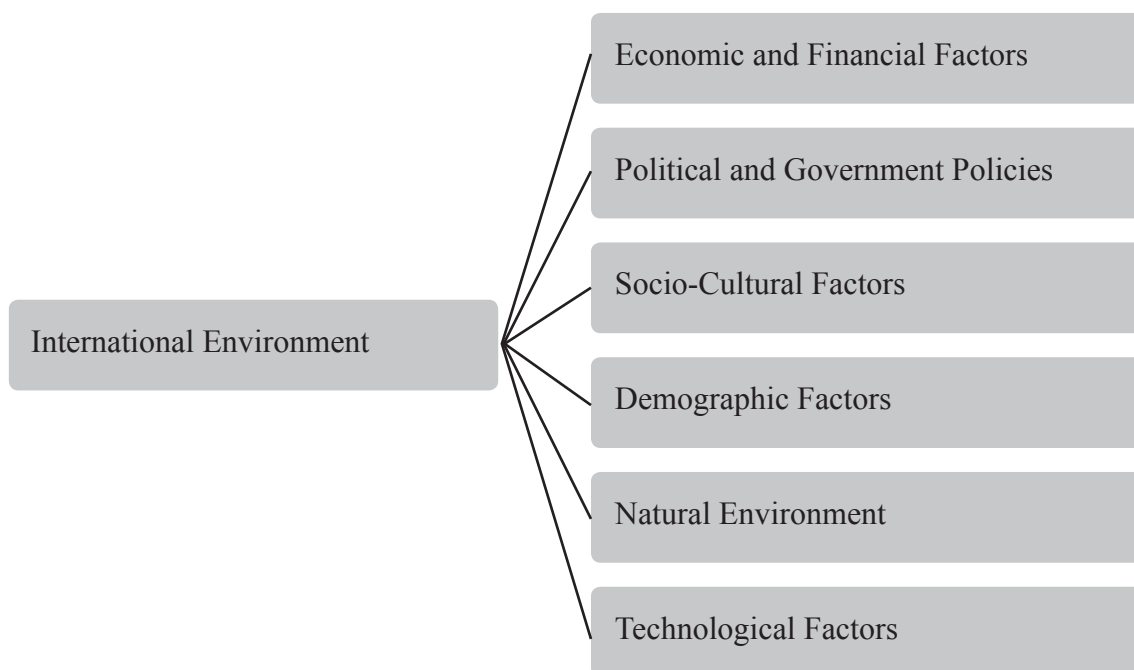


Fig. 7.3 Major global environmental factors

International financial environment influences the size, pattern and direction of international business. Initially, the exchange rates were determined on the basis of the value of metal contained in the coins of the two countries. This system was referred to as the commodity specie standard. This system was followed by gold standard.

7.2.1 Gold Standard

Gold standard experienced a key day between 1870s and 1914, which was suspended during the Great War. However, it was readopted, but was finally abandoned by 1930s. Gold standard was initially adopted by Britain. Later, Germany, Japan, the USA and other countries also adopted gold standard. The US Gold Standard Act of 1900 institutionalised the dollar-gold link. Central Bank was maintaining official parity between its currency and gold and as such needed an adequate stock of gold reserves.

Policy makers viewed external balance not in terms of a current account target but as a situation in which central bank was neither gaining gold from abroad nor losing gold to foreigners at too rapid a rate. Bank notes were exchanged for gold on demand. The price of gold was officially set at which it was bought and sold. The gold exchange standard was liberal as the currency was convertible into gold only through a currency being on gold specie standard. Rouble of Russia was convertible into British Pound and British Pound was convertible into gold. Gold standard allowed free flow of gold among countries and for automatic adjustment in exchange rates and in balance of payments. Deficit in the balance of trade led to the outflow of gold. The fixed supply of gold led to the demise of gold standard.

7.2.2 The Bretton Woods System of Exchange Rate

The collapse of gold standard led to the Conference in July 1944 and the establishment of International Monetary Fund in 1945 and evolution of a new system of exchange rates, which is known as the Bretton Woods System of Exchange Rates. Bretton Woods System of exchange ratio represented a fixed parity system with adjustable pegs.

Under this system, each country was to fix the par value of its currency in terms of gold or US dollar. Monetary authorities were allowed to make adjustments to the extent of ± 1.0 of the fixed par value. Though this system could bring about stability in the exchange rate, it could not sustain for a long time conduct of the Bretton Woods Exchange Rate Regime since 1973. The committee appointed by the IMF suggested four options, in the wake of collapse of the Bretton Woods System of Exchange Rates. These suggestions were accepted by the IMF and incorporated into the text of the Second Amendment to the Articles of Agreement. These suggestions include:

- Floating Rate System: Market forces determine the exchange rate of currencies under floating rate system.
- Pegging of Currency: Under this system, a developing country pegs its currency either to a strong currency or to a currency of a country with which it has a large share of trade. Pegging system provides for fixed exchange rate between the two currencies. However, the exchange rates float with respect to the other currencies.
- Crawling Peg: Crawling peg is a hybrid of fixed rate and floating rate. The exchange rate of a currency with which it is pegged is stable in the short run, but it changes gradually over a period of time in order to reflect the changes in the market. This system has the advantages of stability and flexibility.
- Target-Zone: Arrangement: Under this system the exchange rates are fixed with respect to the currencies of the countries of a particular zone and the exchange rates float with respect to the countries outside the zone. For example, Eastern Caribbean Currency Union, Central African Economic and Monetary Community and Western African Economic and Monetary Union.

7.2.3 Theories of Exchange Rate Behaviour

Theories of Exchange Rate behaviour are classified as follows:

- Monetary approach
- Behaviour: Balance of Payments Approach The theories
 - Monetary approach of flexible-price version of exchange rate
 - Monetary approach of sticky-price version
- Portfolio balance approach
- Balance of payments approach

This theory is proposed by Allen and Kennen. According to this theory, in-flow of foreign exchange takes place under the following two situations : (ii) through export of goods and services when the price level in the domestic country is lower compared to that in foreign countries through foreign investment when the interest rates in the domestic country are higher than that in foreign countries. The increase in in-flow of foreign exchange and foreign capital enhances the value of domestic currency against the foreign currencies. The opposite situations reduce the value of domestic currency against foreign currencies. According to this theory, the value of domestic currencies increases consequent upon increase in exports capital and vice-versa currency against foreign and in-flow of foreign capital and vice versa.

Monetary approach

Frenkel proposed this theory. According to this approach, the exchange rate between two currencies is fixed on the basis of demand and supply of money in the two countries. Thus, the demand for and supply of money in two countries determines the exchange rate of the currencies of these two countries. Demand for money is positively related to prices and output and is negatively related to interest rate. Increase in supply of money results in rising of domestic prices which in turn reduce the value of domestic currency. Higher growth rate of money supply than that of real output results in decline of domestic prices and increase in the value of domestic currency and vice-versa.

Portfolio balance approach

This theory emphasises that the exchange rate is determined based on not only inflow and outflow of foreign exchange, but also the holding of financial assets like domestic and foreign bonds. According this approach, the exchange rate is determined on the basis of the interaction of real income, interest rates, risk, price level and wealth. The investor modifies the portfolio based on the change in any of these rates or variables. This rebuilding of portfolio influences the demand for foreign assets and thereby the exchange rate. Demand for foreign currency reduces the value of domestic currency and vice-versa. Further, the change in the exchange rate brings corresponding change in the portfolio. Thus, the changes portfolio structure influences the exchange rate and the changes exchange rate influence the portfolio. The natural influences continue until equilibrium is reached between these factors.

7.2.4 Global Capital Structure

Capital is the basic resource for any kind of business either domestic or international.

- Capital is of two kinds, viz., equity and debt. Capital provided by the owners is called equity capital. Capital secured in the form of loans from banks and other institutions is called debt capital. Debt capital must be repaid with certain agreed rate of interest over certain agreed period. The company has no obligation to repay the equity capital or any return.
- However, the companies pay dividend to the equity shareholders, whenever, they have surplus or distributable profits. However, equity shareholders enjoy higher returns, whenever the companies enjoy higher rate of profitability. Therefore, the companies prefer high proportion of equity capital and low proportion of debt capital during the early days of inception as well as during the periods of low profitability as they have less commitment of interest payment on debt capital.
- In contrast, the companies prefer high proportion of debt capital and low proportion of equity capital in order to increase the profit share to the equity shareholders and maximise the equity shareholders' worth. Trade-offs between equity and debt plays a vital role in maximising the equity shareholder's worth and also reducing the company's commitments of interest payment. The size of the firm, spread of its operations, stage in firm's life cycle and the strategies it employs determine the proportion of equity capital and debt capital in the total capital.
- The companies should carefully determine the level of equity capital and debt capital as and when they expand, diversify and integrate the operations and activities. They can also 'make use of accumulated profits and generated reserves based on earlier period profits to meet the increased demand for capital.
- International business firms determine the proportion between equity capital and debt capital based on debt-equity structure of partner companies or debt-equity structure of the competitive firms in the host country. The foreign subsidiaries normally prefer higher proportion of debt capital as parent companies view equity capital in a foreign country would be at risk.

- However, financing the foreign subsidiary through debt capital would be at risk as it involves debt servicing those results in cash outflow in fixed schedules to the lenders. The parent company would face a problem of strict controls of repatriation in some countries, if it finances the subsidiaries by means of high proportion of equity capital during the periods of heavy profits.
- The option of high proportion of debt capital has certain limitations. Normally, the debt market is less developed in most of the developing countries. The debt market in 'most of the small countries cannot afford to meet the debt capital requirements of the subsidiaries of MNCs in their countries.
- The third country debt market may not be interested in providing the debt capital in view of the risks involved in it. Therefore, the parent company is forced to provide debt capital also either from its own sources or from its guaranteed sources. The larger MNCs, have their financial subsidiaries to meet their and their subsidiaries capital needs of both equity capital and debt capital. However, the development of money market and capital markets in most of the countries reduces the hindrances for acquiring debt capital in host countries themselves.

Global cash flow management

Working capital management deals with short-term financing. Cash flows in multiple directions in case of a multinational company. MNC's have to plan, organise and monitor the cash inflow and cash outflow in order to maintain proper liquidity. Operating cash flows include direct and indirect cash flows.

- Direct cash flows include inflows and outflows. Operating cash flows are necessary for day-to-day business activities in order to pay for acquiring raw material and other kinds of inputs (accounts payable) including remuneration for employees. Operating cash inflows include the revenue received from sales (accounts receivable).
- The indirect cash inflows include license fee and royalties received and outflows include license fee and royalties paid. In addition to operating cash flows, there are financing cash inflows. Financing cash inflows are essential to service the existing funding sources, servicing debt, payment of dividends to the equity shareholders. Operating cash flows of an MNC are multi-directional.
- For example, a Japanese MNC receives cash from its accounts receivables of the USA and pays cash to its accounts payable in South Korea and finances its Indian subsidiary. The Indian subsidiary in its turn pays cash to its accounts payable in the UK and receives cash from its accounts receivables in Malaysia. MNCs sell either the finished product or semi-finished product to their subsidiaries.
- Similarly, subsidiaries also sell either finished or semi-finished products to their parent companies. The price at which these goods/services are sold either to MNC or subsidiaries is called 'transfer price'. Normally the transfer price is equal to open market pricing. But, it would be difficult to compare the transfer price with open market price as open market price may not be available as MNCs and subsidiaries may transfer such products which are not traded in open market. The transfer price may favour either the parent company or subsidiary or both. But, such price affects the taxes in either of the countries or both the countries.
- Therefore, the governments may not agree with the transfer prices. In addition, the MNCs and subsidiary need to pay license fee and royalties to either of them or to a third party. The license fee and royalties are calculated as a percentage of sales in the host country. Similarly, there are common overhead expenses and management expenses that are to be shared between the parent company and subsidiaries.
- The parent companies provide equity capital as well as debt capital to the subsidiaries. Then subsidiaries have to pay interest to parent company regularly and dividend as and when they declare dividends. Parent companies provide additional equity capital and or debt capital to subsidiaries as and when the latter needs additional capital. Thus, there is a strong need for flow of cash from parent company to subsidiaries and vice versa.

7.3 International Financial Markets

International financial markets and operations comprise exchange deals, i.e., buying/selling currencies; banking transactions, i.e., deposit taking and lending; and capital market operations, i.e., issuance of securities. However, market segments are classified according to the nature of financial operations, they are:

- Money markets or exchange markets: Exchange or exchange related transactions
- Credit markets: Deposit taking and lending
- Capital markets: Issuance of securities
- Equity markets: Issuance of international equities.

Commercial banks are engaged in foreign exchange business and they handle fund flow (either inward or outward) emanating on account of trade between countries, payments for services rendered or servicing of capital market offerings. Such banks are called upon to accept deposits denominated in foreign currencies and deploy them for financing various corporate, industrial or trade activities.

The Euro markets are also closely tied to the foreign exchange markets. But the two markets are quite distinct in functions (almost all Euro banks deal with foreign currency). It has become traditional for borrowers to issue securities – bonds or Euro notes. For organising such business various merchant banking institutions have come to the fore. Such banks are referred to as Investment Banks, Merchant Banks or Securities Houses.

While the choice of raising finance through a variety of instruments is large, comprising of loans, Euro notes and bonds, all markets may not be accessible to all borrowers.

7.3.1 National Markets as International Financial Centres

Each Country has its money and capital markets. Quite similar to their domestic counterpart, international financial markets may be divided into money and capital markets.

- Money markets deal with assets created or traded with relatively short maturity, say less than one year. Capital markets deal with instruments whose maturity exceeds one year (or which lack definite maturity).
- An important channel through which money market flows are influenced is the foreign exchange market. Inflows from abroad into a small country can swamp the domestic money market with excess liquidity. During the 1970's, for example, foreign demand for Swiss francs was very strong because of the weakness of the US dollar. The flow of money into Swiss francs pushed the Euro-Swiss franc deposit market into negative interest rates.
- Subsequently, the Swiss government imposed a 10% per quarter term commission tax. so that foreigners were receiving minus 40% p.a. on Swiss franc deposits. Yet, because the Swiss franc appreciated by 50% during the year such an operation was still worthwhile.
- On the other hand, if a currency is seen to be under pressure, funds will flow out of that currency into others that are perceived to be stronger. The authorities will often then raise interest rates to defend the currency. A classic example was the ERM (Exchange Rate Mechanism) crisis of 1992, when overnight (interbank lending rates in the call market) French franc rates hit 150% p.a. It was reported that overnight Irish pound (punt) reached 48.000% during the crisis.
- Euro-francs were being lent at 5,000% p.a. A related effect arises when the central bank intervenes to support, (or alternatively to lower) the value of its currency. If the central bank intervenes in support of its currency, it buys the domestic currency and sells foreign exchange.
- Thus, the amount of domestic currency in circulation declines, which tends to push up interest rates. Conversely, if it intervenes to lower the value of its currency, it supplies domestic currency to the market. Thus, the supply of domestic currency in the market rises, tending to lower interest rates.
- Again, on lines similar to domestic markets, in the international financial markets also we have primary and secondary markets dealing with issue of new instruments and trading in existing instruments and negotiable debt instrument, respectively.
- The growth of international financial markets has facilitated cross-country flows which contribute to a more efficient allocation of resources. International financial markets can develop anywhere, provided the local regulations permit the market and that the potential users are attracted to it.
- The most important international financial centres are London, Tokyo and New York, all the other major industrial countries have important domestic financial markets as well but only some, for instance, Germany and France, have gained prominence.

- The markets of Switzerland, Luxembourg, Singapore, Hong Kong and the Bahamas serve as financial “entrepôts”. These markets serve as financial intermediaries between non-resident suppliers of funds and non-resident users of funds.
- A big difference between the Euro markets and domestic markets, for instruments in a particular currency, is that all transactions done within the domestic market are directly subject to the rules and institutional arrangements of the local financial system.
- For example, when Australian investors purchase securities in Tokyo, they do so according to the rules, market practices and regulatory guidelines that governs such transactions in Japan. The same applies to those who place their funds in Japan (provided the transactions are not related Euro market).
- Also, a Korean borrower who approaches a Swiss Bank for a Swiss Franc loan borrows at rates and conditions imposed by the financial institutions of Switzerland and are directly effected by the Swiss authorities policy toward lending to foreign residents. Euro markets are free from such regulations.
- It has been observed that, corporations in different countries have different financial appetites. Companies in the UK put an average of 60% to 70% of their funding requirements from internal resources in UK. German companies get about 40% to 50% of their funds from external suppliers.
- In Japan, when their profitability has been low, companies have relied heavily on external finance. In the mid 70’s Japanese companies got almost 70% of their funding requirements from outside sources. This has now changed dramatically, and Japanese companies source 70% of their financing needs from the internal markets.
- In Europe and the US, there has been no comparable transformation. International finance has consistently supplied the major share of financing requirements. The percentage of external finance fluctuates more or less in line with the business cycle; while profits are high, firms are even less reliant on external finance.

Risk difference between domestic and foreign financial markets

There is a clear difference in the risks involved in domestic and foreign markets. Let us take an example. A US depositor in the Eurodollar market holds a claim in one jurisdiction (say, London) but receives payment in another (United States). He could be deprived of his funds at maturity by an action of either the British Government or the US Government.

However, in the case of a domestic depositor, only actions by the US authorities would matter. For a depositor residing in the UK the situation is quite similar. He may own a dollar denominated time deposit in (i) a US bank, directly (ii) a Euro bank operating in Luxembourg or (iii) a London based Euro bank. In all three cases, the safety of his funds depends ultimately on the expectation that the United States will not restrict the disposition and transfer of foreign held dollar funds (i.e., that the US will continue to observe “non-resident convertibility”).

In comparison to the situation of our US investor, the UK investor will face a greater risk, to the extent that the US government may restrict non-resident convertibility more readily than it interrupts domestic bank transfers. Now from the point of view of the borrower of Eurodollars to the extent that the US government may place quantitative restrictions on US banks lending to foreigners (or some other class of borrowers), these borrowers may feel safer borrowing from unregulated Euro markets. Thus the fear of capital controls, could allow Eurodollar lending rates to rise above those in the domestic market.

7.3.2 Euro Market

The major risks in Eurodollar transactions stem from the following:

- the removal of non resident convertibility by the domestic authorities
- the seizing of the assets and liabilities of the Euro banks by the authorities where the Euro banks operate
- the possibility that central banks may not function as lenders of last resort in

The prefix 'Euro' tends to create confusion for many as it denoted a currency used for financial transactions outside the country of origin of that currency, e.g., US dollar were termed as Eurodollars when they formed financial assets and liabilities (denominated in dollars) but, traded outside the United States, Japanese yen traded out of Japan were termed as Euro yen, German marks traded out of Germany were termed as Euro marks, Swiss francs traded out of Switzerland were termed as Eurofranc.

But after launching of the 'Euro' as the official currency of European Monetary Union (or what is also known as Euroland), Eurocurrency (or Euros) denotes the official currency of the European Union or Euroland. The currency used for financial transactions outside the country of the origin of that currency is now no more called Eurocurrency. It is rather known as Eurodollar, Euroyen, Euromarks, Eurofrancs etc. depending on which particular currency is used for financial transaction outside the country of the origin of that currency. The transactions in Eurodollar, Euro yen, Euro marks etc. are known as 'Euro Markets'.

The main differences are that foreign currency markets signify transactions denominated in currency of the country of domicile Euro market centres if there is a shortage of any one currency in Euro market. Although the probability of these events occurring are low, they are of sufficient importance to warrant close examination by international depositors.

Whereas in Euro markets, transactions are denominated in the currency of the system country other than the country of the domicile. For example, when a bank located in the US makes a transaction with a foreigner in US dollar, it is a foreign currency transaction. As against this, when the same bank makes a transaction with a foreigner in a currency other than US dollar, it is Euro transaction. So when Reliance Industries of India takes a term loan, denominated in US dollar, from a New York bank, it is raising foreign currency loan.

As against this, if Reliance takes loan denominated in Yen, from the same bank, it is a Euroloan. Eurocurrency market is the market in the currency of the Euroland. Likewise, Euro banks can be described as a commercial bank dealing in Euro markets. Euro banks are financial intermediaries simultaneously for deposits and make loans in a currency or currencies, other than that of the country in which they are located.

Over the years, Euro markets operations have centred in Asia, Europe and the United States. With the emergence of these centres, a continuous market mechanism has been established. Furthermore, the removal of exchange control and freer movement of capital, international markets have been integrated. Euro markets consist of banks (Euro banks) that offer wholesale deposits and Loans in a favourable jurisdiction (Euro markets) and in a variety of currencies, usually other than that of the country in which the banks are located.

Euro markets consist of banks (Euro banks) that offer wholesale deposits and loans in a favourable jurisdiction (Euro markets) and in a variety of currencies, usually other than that of the country in which the banks are located. The domestic (national) disadvantages that are applicable to the operations of banks in their national markets are based almost exclusively on governmental rule and regulations (Euro banks being free of domestic monetary regulation.)

The Euro markets thrived and grew because national money markets were hobbled with regulations such as interest rate controls, reserve requirements and deposit insurance costs. The major currencies in the recent years have however gained enough non-resident convertibility at a Euro market segment was able to rise.

Euro markets facilitate hedging possibilities for corporate borrowers e.g: American companies operating in the UK or Germany can borrow Eurodollars in the UK or Germany without being required to go in for Sterling or German mark borrowings (that imply currency risk exposure).

An important feature of the Euro market that needs to be noted is that it is basically “deepest” in the short-term market, where 3-6 months deposits are most popular (this does not mean that funds cannot be made available for long-term deployment). Deposit instruments focus on time deposits and negotiable Certificates of Deposits (CDs). As a matter of fact, Eurobanks have always shown a willingness to accept deposits for various maturities-short, medium or long term. The banks take into consideration the borrowers requirements and have devised various instruments for preferred maturity.

The Euro market is a wholesale market (generally restricted to transactions over US \$ 1 million), with participants limited to banks, financial institutions, institutional investors, major corporates and high net worth individuals.

The basic structure in Euro market operations has been medium to long term lending on variable (floating) interest rates, with an option to re-set (roll-over), the interest rate periodically at 3 or 6 months.

7.3.3 International Debt Instruments

Borrowers are the issuers of debt instruments in the form of Promissory Notes, Bonds and Commercial Papers. There are various classes of borrowers having diversified needs for which funds are needed. The needs of borrowers differ in terms of amounts, the length or period for which borrowings are needed (maturities), and the currency in which borrowings are raised.

For example, borrowers may need short term or permanent working capital requirements; corporates may need long term funds for capital expenditure; technological upgradation; plant expansion; project finance; acquisition of aircraft and ships; financing mergers and acquisitions and so on. Governments (referred to as sovereign borrowers) raise debt in the international market to finance infrastructure, purchase of petroleum products or even to shore up foreign exchange reserves.

The decision to source debt finance by any borrower will be dependent on the costs, borrowing terms and covenants imposed by lenders. Project sizes are growing larger to access economies of scale and to withstand international competition. This, together with rising capital intensity necessitates accessing the international markets for both working capital and project finance.

Euro notes

The primary objective of the issuance of Euro notes is to structure a debt instrument with short term maturities, generally 3, 6 or 9 months, tenors (duration) and place it in the market.

However, the borrowing programme could be for medium or long term (say), 5-7 years or more. Banks that act as financial Markets intermediaries agree to underwrite the paper (instrument). In reality, a borrower is able to borrow at short-term interest rates for short periods by issuing the “notes” to investors. At the same time the borrower avails of the benefits and comfort of having a committed medium to long term borrowing facility (underwritten by banks). The funding portion is divided into two separate components.

The first is a long term committed standby lending facility provided by banks. The second is a mechanism for the distribution of short term debt instruments (the Euro note). The former component gives the borrower the long term assurance of availability of funds. The latter is the means by which cost-competitive funding can be achieved (since at any specific time, short term funding is usually cheaper than medium long term funding). Typically, a Euro note issuance programme is referred to as a “Revolving Underwriting Facility” [RLTF] or “Note - Issuance Facility” [PIF], where a group of banks (Syndicate) underwrites a commitment to the borrower.

A revolving credit facility permits the borrower to draw-down (or use) a credit facility and repay and again draw-down and repay, till the agreed upon expiration date of the credit facility. The credit facility could be made available for any duration. Until this time limit expires, the borrower is permitted to use the facility. Under the facility, the borrower can raise funds over periods of 3-10 years by ‘issuing notes in its own name, typically with tenors of 1-6 or 9 months.

Under this arrangement, underwriting banks are committed either to purchase the Euro notes, which the borrower cannot sell or to provide standby credit (at the expiry of an agreed upon selling period say, 3-10 working days). The credit is provided by the banks at a predetermined spread relative to some reference rate such as LIBOR.

If the short term market fails to provide the liquidity to the issuer, the underwriting banks provide the liquidity for the agreed period of the facility. Underwriters when required to do so fund their commitments only for the short term maturity of the notes. The issuer is free to repay at the end of each short period, e.g., 3-6 months, any amount it wishes to - depending on its requirement. The issuer may re-borrow at a later date by first offering to genuine short term investors, before the underwriters are obliged to pick up and provide liquidity again - pro rata to their underwriting commitments. Rarely do banks put the notes on their books and fund these assets. Doing so would be considered a failure of the issue. Instead, banks sell the notes to investors in search of short term paper. High quality borrowers can issue Euro notes even below LIBOR i.e., at around LIBID (which is about 118% below LIBOR).

Underwriting fees are paid on the full amount of the line of credit, regardless of the amount currently drawn. Fees may be 5 basis points & for top borrowers and above, may range up to 15 basis points for less creditworthy borrowers. [Basis Point (bp): one hundredth of one percent (0.01%)].

The notes are generally denominated in amounts of US \$ 100,000, \$ 500,000 or more. The US dollar is the most common currency of denomination. Generally, placements of Euro notes is done through a tender panel (bidding banks are more often investment banks which have placement capacity). This is also called the Uncommitted Facility. The tender panel is merely an arrangement to panel members to promise to show up at the auction but make no commitment to the system, purchase the notes. When they do want the notes (often because they think they can resell them at a small profit), they will bid an interest rate relative to LIBOR. For example a bank may buy Euro notes at a spread of LIBOR, (say) (-) 15 bp, and resell it at LIBOR (-) 18 bp (a lower yield and a higher price). Those who bid the lowest rates get the paper.

It will be noticed from the tombstone's advertisement announcing competition for the issue appearing for the Bigfoot in the newspaper that there is a division of banks into two groups:

- The first group consists of a commitment by a group of banks to provide funds to the borrower if the borrower finds itself unable to raise funds
- The second part is the tender panel members.

Euro commercial paper

An alternate to bank borrowings for large corporations with strong credit ratings is to raise funds by issuing commercial paper (CP). Commercial Paper is a short term promissory note issued on an unsecured basis by commercial and financial institutions. Maturities range between a matter of a few days to 360 days, although on a weighted average basis, the maturities seem to be well below 90 days. In the United States and Canada secondary markets in commercial paper have been established for more than 100 years.

The real expansion in commercial paper took place in the early 60's when banks were strapped for liquidity. To expand their activities, the banks developed the Certificate of Deposit (CD) approach. However, the overall cost of purchasing funds (by the banks) continued to increase. Commercial borrowers were, therefore, encouraged to rely more on the commercial paper market (rather than on bank borrowings).

In these circumstances, commercial paper issued by the primary borrower (commercial institution) to the primary lender (the investor), sometimes through an intermediary (usually an investment bank), was both more flexible and cheaper. The most prominent markets for commercial paper are the United States, Canada, UK, Japan and Australia. Euro market prominence for US \$ Euro commercial, paper markets are in Singapore and the UK.

Although typical issuers of commercial paper are those with high credit ratings, smaller and less well known companies with lower credit ratings have been able to issue paper in recent years (at competitive rates), by obtaining the support from a firm with high credit rating (called credit-supported commercial paper) or by providing an asset as security (collateralising) the issue is called asset backed commercial paper. An example of a "Credit Supported Commercial

Paper” is an issue supported by a letter of credit (or guarantee). The terms of the letter of credit specifies that the bank issuing the letter of credit will pay off the CP when it falls due, if the issuer (borrower) fails to pay. The credit enhancement of a low rated CP issuer can also be backed up by a “surety bond” from an insurance company.

In the United States, some prime automobile manufacturers have formed System subsidiary companies (called Captive Finance Companies), that issue commercial paper in Euro markets to finance customers of the parent. The three major US automobile manufacturers, for example, have captive finance companies: General Motors Acceptance Corporation [GMAC]; Ford Credit; and Chrysler Financial GMAC is the latest issuer of commercial paper in the US.

Commercial Paper is marketed either directly by the issuer or through a dealer (investment bank). A large majority of issuers market their CP directly. These issuers require a continuous source of funds and find it cost effective to establish a sales force in the organisation to sell CP directly to investors. In the case of dealer-placed CP, the issuers use the services of a securities firm or an investment bank. CP's sold in this way are called dealer paper. Competitive pressures have forced dramatic reductions in the fee charged by dealers.

Despite the fact that CP market is larger than markets for other money market instruments (short-term instruments), secondary trading activity is much smaller. The typical investor in CP's is an entity that plans to hold it until maturity. Should an investor's economic circumstances change, such that there is a need to sell the paper, it can be sold back to the dealer, or, in the case of directly placed paper, the issuer will re-purchase it.

CP's are issued at a discount. In other words, if an investor buys a face value of US\$ 1 million of CP, he pays less than the face value, though he receives back on maturity the full face value. The difference between the two represents ‘interest’. The return to an investor is made up by the difference between the purchase price and the redemption amount.

CPT's are generally issued in denomination of US\$ 500, 000 and US\$ 1 million, the latter being more common. Smaller denominations of US\$ 10,000 are also issued, but very rarely.

Calculating Yield On Commercial Paper: The simple discount formula is really a mirror image of the simple interest formula (with the difference that interest is added at the end of the life time and discount at the beginning). It goes without saying that a simple discount produces a higher cost (or profit) than simple interest with the same numerical value. The simple discount formula is the same as the simple interest with one exception that “D” [Discount] substitutes for “r” (rate).

$$\frac{\text{Principal} \times D \times \text{Tenor (Days)}}{360 \times 100} = \text{Discount}$$

Now, if an exporter in the US drew a 90 day bill on a UK importer for US\$ 1million, and the bill was discounted at 10% p.a., the amount that the importer would receive would be the principal minus the discount, i.e.

$$\frac{\$ 1,000,000 \times 10 \times 90}{360 \times 100} = \text{US\$ 25,000}$$

Then the amount to be remitted to the exporter would be US\$ 975,000. It is simple to see that as the discount is deducted at the time of selling the bill, the actual interest p.a. will be higher than the discount rate. In the case of our US exporter, interest rate equivalent of 10% p.a. discount will be

$$\frac{\$ 25,000 \times 100 \times 360}{975,000 \times 90} = 10.25641\% \text{ p.a.}$$

Instead of stating a discount rate of 10% (which hides the true percent per annum cost) the buyer or seller could have negotiated a discount to yield rate of 10.26% p.a. this would be an easier price to compare with the true interest costs in the deposit and loan markets.

Commercial Paper is normally issued on a discount to yield basis. This really means that after applying the discount, the net amount earns (or costs) “x” % p.a.- which is equal to the discount to yield rate.

The main difference between discount to yield and simple discount pricing lies in the fact that a simple discount has to be converted to simple interest p.a., whereas discount to yield states the true cost (or gain).

The “Discount to Yield” or discounted amount equals:

$$\frac{\text{Face Value (Nominal Value)}}{1 + \frac{\text{Discount to Yield Rate} \times \text{Tenor}}{360 \times 100}}$$

To put it in numbers, a commercial paper of US\$ 1 million discounted at a discount to yield rate of 10% would be sold/purchased for

$$\text{US\$ } 975609.75 = \frac{\$1,000,000}{1 + \frac{10 \times 90}{360 \times 100}}$$

To prove that the difference between \$ 1 million and \$ 975, 609.76 represents 10% p.a. should not present a problem any more, as

$$\frac{\$ 24,390.24 \times 360}{\$ 975,609.76 \times 90} = 10\% \text{ p.a.}$$

As no rates are mentioned on commercial paper at discounts (or discounts to yield), the nominal values of the instruments are plain to see. It is easier to market both in the primary and secondary markets.

Medium term notes

Since the early 80’s Medium Term Notes [MTN’s] have emerged as a major source of funding for multinational corporations, supranationals (i.e. the World Bank, Asian Development Bank), and even governments. The market for MTN’s, was established as an alternative to short term financing in the Commercial Paper market and long term borrowings in the Bond market. Hence, the name ‘medium term’. The Euro - MTN market has grown at a phenomenal rate. In mid 90’s outstanding MTN’s in the domestic and international markets was estimated to have grown to over US\$ 350 billion.

Medium Term Notes are in many respects simply fixed rate corporate bonds but for a generally shorter maturity than Euro bonds or domestic bonds. As an investment vehicle, the MTN is often regarded by institutional investors as a temporary investment that can be designed to suit the particular investors choice. The reason is that MTN’s (unlike conventional bonds) are offered on a continuous basis in smaller amounts - as little as \$2 - \$5 million at a time - rather than a single large issue. For example, an investor, such as a Pension Funds (PF) might have \$ 7 million to invest for 11 months in a good corporate name.

The PF will call several MTN dealers to find out which companies are borrowing. When the PF Treasurer makes the choice, the note will be issued specifically for the investors choice. This special feature explains why MTN financing is often described as “investor driven”. In effect, the distribution process in the MTN market resembles a commercial paper issuance programme – but without a “Revolving Underwriting or Guaranteed Facility”.

Under a comprehensive MTN programme, an issuer can raise funds by issuing “fixed rate” or “floating rate” or “deep-discount” paper in any of a number of currencies. Deep Discount Bonds carry very low interest, in most cases zero, and accordingly sold at prices representing “Deep Discount” from their principal amounts. Deep Discount Bonds tend to be more price volatile than full coupon bonds and thus offer greater potential for price appreciation if interest rates should fall. The MTN is a Commercial Paper - like instrument that has a maturities ranging from 9 months to 30 years. Generally, the Notes are unsecured but need not be. They pay interest on a 360 day basis unlike deposits that pay interest actual/360 tenure. Unlike corporate bonds, few are callable. The most distinguishing feature of a MTN from other debt instruments is that their issuance and even maturity is highly investor determined, not issuer determined.

Corporate Bonds are issued infrequently and often entail heavy issuance costs. Therefore, the borrower wants to do an issue in large amounts at a known cost and get it distributed as widely as possible. This means that there must be an underwriting syndicate. This is not the case with MTN's. MTN's are issued through dealers (a) at the time; (b) in the amount; and (c) for the maturity that ‘the investor wants.

MTN's have traditionally been sold on a “best effort basis” i.e. there is no guarantee by the dealer to market the notes. (This is in contrast to an underwriter in the conventional bond market who has guaranteed the subscription.) Through its agents, an issuer of MTN's posts offering rates over a range of maturities. For instance, 9 months to 1 year, 1 year to 18 months, 18 months to 2 years, and annually thereafter. In the Euro markets, MTN rates are generally quoted on a floating rate basis on an index such as the LIBOR. In domestic markets, many

issuers post rates as a yield spread over a Treasury Security of comparative maturity. The yield spread is illustrated as below.

Medium Term Note		Yield Spread of MTN over Treasury Securities	Treasury Security	
Maturity Range	Yield %		Maturity	Yield %
2-3 years	4.35	35	2 years	4.0
3-4 years	5.05	55	3 years	4.50
4-5 years	5.60	60	4 years	5.00

Table 7.2 Yield spread

Let us now illustrate the MTN funding process. Assume, Hoechst A.G (a German pharmaceutical company) tells its Dealers that Hoechst will accept any money in the 1-5 year range at a certain spread relative to the bench-mark Treasury Yields. The Dealers would let their customers know from day to day who was offering MTN's, at what rates and the paper would be sold only on a “best effort basis” (i.e., without a commitment to the ‘issuer for a confirmed sale), if and when an investor wanted it.

Now, consider a Swiss Bank Trust Department calls the Dealer and says: “we'll buy IT\$ 20 million of 3% year Hoechst MTN at over 30” - the deal would be struck there and then. Hoechst's Treasurer will be contacted to confirm the transaction. It will be quite evident that this process is much easier than waiting for the right Eurobond to be issued. It is also cheaper for Hoechst. Although, perhaps less predictable than a \$ 250 million underwritten Eurobond. Hoechst will still gets its funding of its quarter billion, although, perhaps in dribs and drabs!!

The MTN market provides corporations with the ability to raise funds discreetly, because the issuer, agent and the investor are the only participants that have to know about the primary transaction. In contrast, the investment company obtains information about underwritten bond offerings from a variety of sources.

Corporations often avoid the bond market in periods of heightened uncertainty about interest rate and the course of the economy (such as the period after the 1987 stock market crash or the south east Asian financial crisis of 1997). Similarly, corporations in distressed industries (commercial banks in the second half of 1990s), can use the MTN market to raise funds quietly rather than risk negative publicity in the high profile bond market. Thus, during periods of financial turmoil, the discreet nature of the MTN market makes it an attractive alternative to the bond market.

Maturities of MTN's reflect the financing needs of various classes of borrowers (issuers). Financial firms (banks) tend to issue MTN with maturities matched to loans made to customers. Consequently, in the financial sector, maturities are concentrated in a range of 1-5 years and only a small proportion are longer than 10 years. Non financial firms, in contrast, often use MTN's to finance long life fixed assets (plant and equipment). Resultantly, maturities issued by non financial corporations cover a wider range.

Floating rate notes

The Floating Rate Note (FRN) as the name implies, is an instrument whose interest rate floats with prevailing market rates. Like Eurodollars deposits, it pays a 3 or 6-month interest rate set above or below LIBOR. Like international loans, the interest rate is re-set every 3 or 6 months, to a new level - based on the prevailing LIBOR level at the reset date. The term Floating Rate Note is taken to mean an intermediate to long term debt security whose interest rate is pegged to a short term rate or rate index and adjusted frequently.

Floating Rate Notes issued outside the country of the currency of denomination are issued in the form of Euro bonds. This feature makes them in some respects as much a capital-market instrument. The pricing framework really defines the character of the instrument. FRN's are priced 'in part like money market instruments (less than 1 year maturities) and in part like conventional fixed rate, bonds (over 1 year). The bulk of FRNs are held by banks and financial institutions, whose cost of funds varies with short-term rates, because an FRN pays a rate that is tied to changes in short term interest rates. Financial institutions also bought FRN's as medium-term substitutes for loans. Some banks, with a low cost of funds (but a shortage of prime borrower customers), were looking for a way to earn a spread with little risk or effort go for FRNs.

Euro bonds

The International Bond Market consists of the Euro bond market, the Foreign Bond market and those Domestic Bond market (such as the US, Japanese and French markets), in which global bond investors participate actively. The most international of these markets is the Euro bond market. The Euro bond market raises over US\$ 200 billion per annum in new capital for corporations, financial institutions and governments.

Domestic Bonds are usually fixed-interest, fixed-maturity claims with ranging maturities from 1-30 years. They are issued by domestic residents, in the domestic currency, and largely sold to domestic residents. Foreign Bonds are issued within the domestic market of the currency of denomination, but they are issued by non-resident borrowers. For example, a bond issued within the UK by a non resident issuer such as the Asian Development Bank is a Foreign Bond. Euro bonds are usually issued in the market for the borrower by a syndicate of banks from different countries and placed in countries other than the one in whose currency the bond is denominated. If the German firm issued a bond in French francs in England, Switzerland, the issue is a Euro bond.

Companies might need medium and long term funds for expansion, new investments or for acquisition. Banks and financial institutions need longer term money to fund their loan portfolios or to increase their capital base as defined by the regulatory authorities. Euro bond is their popular choice.

The process of issuing a Euro bond begins with a discussion between the borrower and its bankers.

The issuer specifies the following:

- desired currency of denomination
- the amount
- the target rate (an interest rate at which the issuer would be willing to
- borrow)

If the bank obtains a mandate (formal authorisation), this bank becomes the lead manager of the Euro bond issue (there can be more than one lead manager) on the instructions of the issuer (or if the deal is large or complex), lead managers may invite other banks to be co-managers. Together, they form the management group, who negotiate the interest rate and other terms of the deal in such a way to be acceptable to the target investors. The lead managers and their lawyers also prepare the documentation and obtain necessary clearances.

The bond will normally be listed in Luxembourg or in a similar location where listing is cheap and there is no prospects of present or future withholding tax (the listing is a mere formality to satisfy those investors who are permitted to invest in listed securities. Few of the bonds will ever be traded on the Luxembourg exchange).

The key role of the management group is to form an underwriting group of a number of banks, investment banks and security houses (25, 50 or up to several hundreds), from different countries. The managers will undertake the task of sending out an invitation fax or telex to many banks inviting their participation in the deal. The underwriter (which include the management group), are selected on the basis of their ability to place the bonds in different sub-markets of the Euro bond universe. The underwriters demonstrate their confidence in their own ability system by committing themselves to purchase a share of the bond issue at a set price from the issuer.

When a bank underwrites a bond issue, it is in effect giving the issuer a put option (this is called a “put to seller”, when the option writer is obligated to buy the underlying bonds or shares, at an agreed upon price). If an XYZ June 40 were “put to seller” for instance, the Writer (underwriting bank), would have to buy 100 shares of XYZ at \$ 40 a share from the put holder (issuer), even though the current market price of XYZ may be far less than \$ 40 a share.

A third level of participation in the issue is the selling group of banks and dealers who actually sell the bonds to end investors. This selling group consists of the managers, the underwriters and other banks/dealers, who will try to sell the bonds but are not committed to purchasing them if they cannot sell.

A typical Euro bond issuance “Syndicate” consists of three overlapping parts:

- the managers
- the underwriters
- the selling group

A manager’s commitment is a proportional responsibility: i.e., if one of the selling group fails to come up with its allotted amount (to sell and noncommittal), on the closing date, all managers are responsible for paying that amount to the issuer on a pro rata basis. (Each manager is responsible for the amount of its commitment).

Once the syndicate is in place, the bond can be announced - with its features and tentative terms. The preliminary version of the prospectus, called “the Red Herring” will have been prepared. Members of the selling group will now actively canvass the potential investors for [their interest in the deal. The Red Herring will be perused by the “sales-people”, who are calling their clients to solicit interest in the bond. Although the precise terms of the bond remain provisional until the offering date, the bonds may actually begin trading before this date in a sort of “when issued market”, called the Grey market.

The Grey market is a short term forward market, enabling investors to assure them of a certain investment at a known price for the bonds issued. It also allows members of an underwriting syndicate to verify their placement of bonds to be issued. This reduces [the inherent uncertainty in a bond issue and ultimately reducing the spread paid by the issuer. Because the final issue of the bond has not been set, Grey market prices are expressed as a discount (or very rarely as a premium), for instance a World Bank bond may quote a price of “less 318”, which means that it is being offered to sell bonds at 318 percentage points below of final offering price.

Now, if the final offering price is 101, the Grey market dealer will deliver them at 100. A grey market can only work for bonds whose issuers are well known and whose Non price features are established. After a few days or weeks of this preplacement, the selling group members will give a feedback to the Lead managers. Thereafter, the Lead managers would have gained sufficient confidence to return to the issuer with a commitment to the final terms.

The key feature will be tile coupon. If necessary (and market response warrants), the amount or even the maturity of the Euro bond will be adjusted to meet investor preferences. If the bond carries any sweeteners such as warrants or a convertibility feature, the terms may be altered. When the Lead Managers reach agreement with the issuer, the documents are finally signed on the offering day. A final version of the prospectus is printed and distributed and the bonds are publicly are offered. Members of the syndicate will try to sell the bonds at the offer price printed on the front of the prospectus (or a higher price, if they can).

Bonds are often placed at a price below the offer price. Selling Group members buy the securities at the issue price (minus the dealers discount selling commission), and may pass along a higher proportion of that discount to other dealers or even to institutional investors. In short, competition prevails. An important responsibility of the Lead Manager is stabilisation. This is achieved by intervening in the market to support the price of the new issue. The Lead Manager is permitted to undertake stabilisation in the primary market by direct participation and/or by readjusting the amount allotted to various members of the Selling Group. Two weeks after the signing, on the closing date, the securities are delivered to buyers in exchange for cash. The borrower receives the funds.

7.3.4 Euro Issues in India

Indian companies have been raising funds from international financial markets by issuing Euro bonds, Euro convertible bonds and Euro equities. The first GDR were issued by Reliance industries in May 92 with an, issue size of US\$ 150 million. The market at that time for Indian issues was so under developed that Reliance had to give discount up to 17% to GDRs to get the issue fully subscribed. Till March 1997 198 Indian companies could raise US\$5,180 million. Amounts raised by Indian corporates through GDRs and ADRs declined from US\$ 645 million in 1997-98 to US\$ 270 million in 1998-99.

- Depressed capital market, industrial slackness at home and adverse emerging market sentiments affected GDR prospects unfavourably last year. However, there has been a turnaround in the first half of the current financial year with large issues raised in the ADR/GDR market. The successful ADR issues include MIS Infosys Technologies (\$ 75 million), MIS Satyam Infoway Ltd. (\$ 86 million) and M/s ICICI (\$ 3 15 million). To facilitate conversion of its GDRs into American Depository Shares (ADS), ICICI listed the ADS on the New York Stock Exchange with effect from 17 November, 1999 after complying with stringent listing requirements of the Securities and Exchange Commission (SEC) of the USA, including adherence of GAAP standards.
- Considering the enhanced opportunities of Indian software companies for expanding globally, operational norms governing their overseas investments and mode of financing acquisition of overseas software companies have been liberalised.
- In December, 1999 a notification was issued by the Ministry of Finance permitting Indian software companies, which are listed in foreign exchanges and have already floated ADR/GDR issues, to acquire foreign software companies and issue ADRs/GDRs without reference to the Government of India or the RBI up to the value limit of US\$ 100 million, For acquisitions beyond US\$ 100 million, proposals would require examination by a Special ‘Composite Committee in the RBI.
- With a view to further liberalise the operational guidelines for ADR/GDR issues. It has been decided to dispense with the track record scrutiny process for ADR/GDR issues and the two stage approval by the Ministry of Finance. Indian companies would henceforth be free to access the ADR/GDR markets through an automatic route without

the price approval of the Ministry of Finance subject to the specified norms and post-issue reporting requirement. As ADR/GDR are reckoned as part of FDI, such issues would need to conform to the existing FDI policy and permissible only in areas where FDI is permissible. Such ADR/GDR issues would, however, be governed by the mandatory approval requirements under the FDI policy.

- In India, External Commercial Borrowing (ECBs) are governed by guidelines on External Commercial Borrowing Policy and Procedures issued from time to time. The 1996 guidelines were framed to increase the transparency in policy and simplifying the procedures to give Indian industry easier access to external funds to support investment and economic activity.
- One of the basic objectives of these guidelines was to give priority and provide greater flexibility to investors in critical infrastructure sector, to give priority to exporters in accessing ECB resources and to give additional flexibility to these incurring long term debts. The GoI has extended ECB facility for rupee expenditure for infrastructure sector such as roads, (including bridges) ports, industrial parks, and urban infrastructure (water supply, sanitation, sewerage etc.) Previously this facility was given only to power, telecommunication and railways.
- Disbursements under ECB (including US\$ 4230 million from RIBS), were US\$ 7226 million in 1998-99, almost at the same level as in 1997-98 (US\$ 7371 million). Subdued demand for funds from borrowers due to slackness in domestic industry and higher premia for emerging market borrowers in the international market contributed to lower disbursements excluding RIBS.
- However, since repayments fell from US\$3372 million in 1997-98 to US\$2864 million in 1998-99, net overall borrowings showed an improvement from US\$3999 million in 1997-98 to US\$4362 million in 1998-99.
- The sluggish trend in disbursements has continued in the current year. In the first quarter of the current financial year, disbursements were US\$ 621 million against US\$754 million during the corresponding period in the previous year. Repayments at US\$ 631 million were only marginally higher by US\$ 9 million. Therefore, there has been net repayment in the first quarter of 1999-2000 as compared to net borrowing of US\$ 132 million in the corresponding period of the previous year.
- ECB guidelines in 1999-2000 were further liberalised and procedures streamlined to facilitate better access to international financial markets, keep maturities long costs low and encourage infrastructure and export sector financing.
- The third largest recipient of approvals was Ports and Roads with US\$ 80 million. There has been no approval in Telecom, Civil Aviation and Railways so far in the current financial year. It is expected that as the domestic industrial recovery gathers pace and emerging market spreads narrow, ECB will be accessed more in the coming months.

Sector	1997-98 (US \$ MILLION)	1998-99 (US \$ MILLION)	1999-2000 (US \$ MILLION)
Power	3014	3998	1699
Telecom	1482	75	0
Shipping	210	37	27
Civil Aviation	373	0	0
Petroleum and Natural Gas	230	40	218
Railways	179	15	0
Financial Institutions	795	150	50
Ports, Roads, etc.	61	0	80
Others (including exporters)	2358	885	62
Total	8712	5200	2136

Table 7.3 Status of ECB approach

7.4 Management of International Short Term Financing

Management of International short term financing is explained below.

7.4.1 Short Term Markets

Mainly commercial banks provide short-term finance. Short-term markets are divided in two categories.

- **Currency loans from the domestic banks originating from the country of that currency**

Example: Mark loan from domestic Banks in Germany

- **Short-term loans from Euro-markets - loans in Euro-currency from offshore banks.**

Example: Dollar loan raised from the London market.

Whether they are domestic banks or offshore banks, they are the source of all short-term finance for MNCs. The Euro-markets are the single longest source of funds, specifically since the seventies, when the currencies deposited from the Balance of payments surpluses of countries in the offshore Banks began to grow and they are outside the regulatory framework of any Monetary Authority. These are called offshore funds, as they are funds kept with foreign and multinational banks and are not controlled by domestic authorities.

The surpluses of ONGC, STC and G.E. shipping in dollars are credited to their SBI Account in London. But as current Account funds do not yield any return, the SBI, London is instructed to deposit these funds for short-term of 3 to 6 months or at the most upto 12 months, in a Euro-currency Account with Citi Bank in New York. These being short-term deposits, carry interest rates, which are different in different centres.

The Euro-currency market has thus supply coming from the short-term surpluses of dollars and other Convertible Currencies like D.M., Yen, U.K. £, etc. from the Governments, companies and exporting firms and even individuals. It is a wholesale market with funds being accepted and lent in large amounts. The demand comes from those who need funds for short-term shortfalls in income, import payments and working capital purposes. Sometimes even governments borrow for short-term and roll over the loans for medium-term.

Bulk loans are given for short-term as the deposits are also of short-term nature. The demand and supply factors in each of the currencies determine the interest rates. This market has two components:

- Interbank
- Dealings with the public.

Apart from the customer transactions, there is a very active market among banks in these funds. The size of the inter bank market is much larger constituting about 80% of the total bank claims. In the inter bank market, active banks quote two way bids - offers. On the basis of these bid and offer rates the London Inter Bank Bid Rate (LIBID) and the London Inter Bank Offer Rate (LIBOR) have emerged as bench marks for lending and borrowing rates of banks and FIs. These rates change not only from currency to currency but from maturity to maturity.

The LIBID and LIBOR are averages of the leading six international banks dealing in Euro-Currency markets. These are quoted for various major trading Currencies for the major markets, viz., London, Frankfurt, New York etc. and the arbitrage operations bring about uniformity in these rates as between the centres. The margin between the Bid and offer rates which is generally of the order of 1/8 gives the trading margin for the bank. The year is taken as 360 days and the calculation of value dates of maturities of receipts and payments of deposits in the Euro-market is the same as in the case of Foreign Exchange market. A proper value date for a transaction has to be a working day both in the place where the transaction is done and home market of the currency concerned.

7.4.2 Short Term Loans for Money Market

Major short-term credits availed from the Global money markets are export credits and import credits. Export credit is provided by the buyer in foreign countries through the banks to promote exports particularly of capital goods from India or of any other country. Sometimes these credits emanate from the Government or Government sponsored agency like Exim Bank. Sometimes export credit is clubbed with insurance and bank guarantee, the fees for which are payable by the buyer. Export credits are again of two types, namely, supplier's credit and buyer's credit. Supplier's credit is granted by the supplier or his bank to the buyer importer.

Deferred payments, come in this category and are accompanied by bills of exchange and promissory notes, carrying the bank guarantee. Buyer's credit is granted by the buyer importer or his bank to the exporter for his short-term requirements. The Exim Bank makes available supplier and buyer's credits and also extends lines of credit to foreign financial institutions to promote exports of capital goods from India. Importers in India would like to avail of short-term credits from abroad because interest rates for most major currencies are well below the cost of rupee funds. But they will have to face foreign exchange exposure risk.

The overall cost of such short-term import credit comprises of:

- Nominal interest rate in foreign currency.
- Forward premium, if the foreign exchange risk is to be covered in the forward market. Additional commission to the Bank for usance letters of credit as sight credits as the former involves a time period of waiting.
- Stamp duty on usance bills, payable normally.

Export credit is thus an important item of short-term credit from the international money market available to corporate.

7.4.3 Forfaiting

Forfaiting is a commercial source of finance. The claims of the exporter on the buyer are purchased by the forfaiting bank without recourse to him. This is thus a credit sale converted into cash sale. Banks in London are very active in forfaiting business, both in the primary and secondary market. In India, forfaiting business is in initial stages and there is no secondary market in them. Forfaiting has grown in the world only in the recent past, and it is another source of external finance to corporate in developing countries. Its importance lies in converting the book debts in foreign currencies in securitised debt, taken over by a bank or its subsidiary, without recourse. Forfaiting is the purchase at a fixed rate of medium-term claims on the foreign buyer.

Depending on the credit standing of the importer and the country risk, the importer's bank guarantee is needed on the face of the promissory note or bill of exchange. The credit sales of the export are converted into cash and this is used as working capital or production finance in the cycle of productive operations.

7.4.4 International Leasing

Cross boarder leases are now becoming popular. They are an important source of international finance of short and medium-term nature to finance ships, aircraft and capital goods. The asset may be in the ownership of the supplier but its use is with the beneficiary or lessee. This is an off balance sheet item and only lease rentals paid half yearly or quarterly are debited to the current account.

- The Lessor may be from one country, the lessee from another country but the finance can be provided by a third country. The advantages of lease finance depend on the tax benefits in the lessor and lessee countries. The lessor as the owner can provide for capital depreciation which gives a tax advantage.
- The lessor can write off the lease rentals as revenue expenses. The lessee is not normally given a purchase option, as it might then become a Hire purchase deal rather than lease.
- The lease agreements provide for the lessee to renew the contract on a nominal rent to protect the lessee's interest in the residual value of leased asset. During the primary lease period, the entire value or at least 95% of the value of the asset along with the interest on the capital invested is recovered.

- The lessee will then have the use of asset after that period at a nominal rate. Many short-term facilities are availed of from the international markets by the Government, RBI and Commercial and Co-operative Banks in India.
- Government borrows from other Governments, multinational and national and regional bodies for its investment and for its balancing of Balance of payments of the country.
- Similarly, if it has surpluses, it invests in short-term instruments in foreign currencies which are convertible and liquid. The RBI keeps its foreign exchange assets in Treasury bills of foreign Governments, Treasury bonds, deposits with foreign Central banks, B.I.S. (Bank for International Settlements) and securities of world bodies and of foreign Governments with convertible currencies.
- The RBI can borrow from IMF or the central banks of foreign countries or other multilateral agencies. The domestic commercial and cooperative banks, who are authorised to deal in foreign exchange, called Authorised dealers, deal with the public for the exchange requirements of the latter and with the banks in the inter bank markets of domestic and foreign nature for covering operations and hedge and for genuine trade and commercial transactions.
- As per the recently liberalised guidelines of RBI, banks can borrow from abroad for temporary short-term requirements up to some limits which are set by the Bank's Top Managements. They can operate in currencies for import-export trade transactions, hedge in currencies covered in the domestic market and borrow from abroad from multinational banks and dealers in Euro-Currencies.
- Banks can also borrow from their branches abroad or correspondents abroad. Similarly they can invest in short-term instruments abroad up to certain limits or keep deposits with foreign banks and correspondent banks.

7.4.5 Syndicated Loans

MNCs require large loans for project finance and for medium-term. Many governments needed funds for meeting Current Account deficits. Some used these funds for working capital or for meeting the budget deficit. Many borrowers use these funds for national development and investment plans. For such large size loans, no single bank will be in a position to lend or take risk of that order. Hence syndicated loans became popular. The lead bank invites other bank to participate in the loan. Fees payable for syndicated loans include a up-front management fee, commitment fee, agency fees, etc., in addition to other administration expenses. In this, many banks participate in the loan. Tax shared loans, as in the case of India reduce the cost of borrowing. The Double Taxation Avoidance (DTA) agreements between the borrowing and lending countries provide for waiver of withholding Tax, or tax deduction at source. The lender country will give the lender a tax credit, if a withholding tax of 10% is levied by the borrowing country. The tax shared loans lead to better after tax return to the lender country which the lender shares a part with the borrower by the lower interest rates. Most tax shared loans to India have been from Japan and western developed countries which have tightened their tax laws.

Summary

- The Double Taxation Avoidance (DTA) agreements between the borrowing and lending countries, provide for waiver of withholding Tax, or tax deduction at source. The lender country will give the lender a tax credit, if a withholding tax of 10% is levied by the borrowing country.
- Forfaiting is the purchase at a fixed rate of medium-term claims on the foreign buyer. Depending on the credit standing of the importer and the country risk, the importer's bank guarantee is needed on the face of the promissory note or bill of exchange.
- The LIBID and LIBOR are averages of the leading six international banks dealing in Euro-Currency markets.
- The Euro-markets are the single longest source of funds, particularly since the seventies, when the currencies deposited from the Balance of payments surpluses of countries in the offshore Banks began to grow and they are outside the regulatory framework of any Monetary Authority. These are called offshore funds, as they are funds kept with foreign and multinational banks and are not controlled by domestic authorities.
- In India, External Commercial Borrowing (ECBs) are governed by guidelines on
- External Commercial Borrowing Policy and Procedures issued from time to time.
- Domestic Bonds are usually fixed-interest, fixed-maturity claims with ranging maturities from 1-30 years. They are issued by domestic residents, in the domestic currency, and largely sold to domestic residents.

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Self Assessment

1. Under _____, the importer first receives the goods and then arranges for the payment.
 - a. closed account
 - b. open account
 - c. fixed account
 - d. direct account

2. In the _____ method, the commercial banks facilitate the payment process. The exporter draws up a document called a bill of exchange, in which payment is demanded from the importer at a specified future date.
 - a. Payment transfer
 - b. Documentary collection
 - c. Time Bill of exchange
 - d. Letters of credit

3. _____ requires the importer to arrange for the payment after some time (60 days or 90 days) receiving the possession of goods.
 - a. Payment transfer
 - b. Documentary collection
 - c. Time Bill of exchange
 - d. Letters of credit

4. _____ is an instrument issued by a bank wherein the bank promises the exporter to pay upon receiving the proof that the exporter completed all the necessary formalities specified in the document.
 - a. Payment transfer
 - b. Documentary collection
 - c. Time Bill of exchange
 - d. Letters of credit

5. _____ is an arrangement to pay for import of goods and services with something other than cash.
 - a. Counter-trade
 - b. Payment advance
 - c. Letter of credit
 - d. Time Bill of exchange

6. Match the following

1. Keiretsu	A. Many companies form a small number of interlocking business groups
2. Shareholders	B. The ones whose capital is at risk.
3. Money management decisions	C. Decisions about how to manage the firm's financial resources most efficiently.
4. Bretton Woods System	D. Fixed parity system with adjustable pegs

- a. 1-A, 2-B, 3-C, 4-D
- b. 1-D, 2-C, 3-B, 4-A
- c. 1-C, 2-B, 3-D, 4-A
- d. 1-B, 2-D, 3-A, 4-B

7. Which of the following is a hybrid of fixed rate and floating rate?
 - a. Counter trade
 - b. Target zone arrangement
 - c. Crawling peg
 - d. Floating rate system

8. _____ theory is proposed by Allen and Kennen.
 - a. Balance of payment approach
 - b. Monetary approach
 - c. Portfolio balance approach
 - d. Global capital structure

9. _____ are necessary for day-to-day business activities in order to pay for acquiring raw material and other kinds of inputs (accounts payable) including remuneration for employees.
 - a. Operating cash flows
 - b. Revenue
 - c. Capital
 - d. Dividends

10. The markets of Switzerland, Luxembourg, Singapore, Hong Kong and the Bahamas serve as financial _____.
 - a. hubs
 - b. nuclei
 - c. entrepots
 - d. routers

Chapter VIII

International Banking, International Transactions and Balance of Payments

Aim

The aim of this chapter is to:

- explain international money transfer mechanism
- elucidate international syndicated lending systems
- explore correspondent banking

Objectives

The objectives of this chapter are to:

- explain the Edge Act and Corporations
- explore the capitalisation and activities of the Edge Act Corporations
- clarify the intricacies of international payment and balance of payments

Learning outcome

At the end of this chapter, you will be able to:

- analyse the rise of market power
- describe the various adjustment policies
- understand the balance of payment statement and the balance of indebtedness

8.1 Introduction

If you want to make a payment abroad, you will have to deal through a bank operating on international level. Banks around the world are centres for money transfer business. Dealers in securities or exporters and importers make use of services of international banks. With the growth of MNC's, the importance and role of such banks have increased. Such banks also help the developing countries in their economic development. In this unit, you will learn about international money transfer mechanism and syndicated lending arrangements. You will also learn about different money market instruments, prime lending rate and application of yield curve. At the end of the unit, you will study international banking risk and capital adequacy requirements.

8.1.1 International Money Transfer Mechanism

A bank entering in international banking business may enter through one or more of the following organisational forms:

- **Correspondent bank:** A correspondent bank is a bank located elsewhere that provides a service for another bank. A bank which does not have an office in a foreign country maintains a correspondent account with a bank in that country.
- **Foreign branch:** It is a fully fledged office of the home bank which operates subject to banking rules of the home and foreign countries.
- **Foreign agencies:** They are like branches, except that they are not authorised to accept ordinary deposits (although they may accept credit balances of customers doing business with them).
- **Foreign subsidiary bank:** Foreign subsidiary bank is a bank incorporated in a host country and operates under same rules as local domestic banks. In U.S.A., subsidiaries of US banks are called Edge Act or Agreement Corporations.
- **Representative offices:** They are small offices opened up to provide advisory services to banks and customers and to expedite the services of correspondent bank.

Sometimes, a bank may acquire an existing bank in a foreign country. The overwhelming majority of all payments are effected through a transfer of ownership of demand deposits from payer to payee, by sending instructions to the banks involved via cheques, written transfer orders, phone, telegraphic instructions (wire transfers), or, increasingly linked computer networks. Hence, any person (or a corporate treasurer), making or intending to make payment to someone in another country needs first to obtain ownership (directly or indirectly), of a demand deposit in a bank in a foreign country, which can subsequently be transferred to the foreign recipient (payee) of the funds.

Even very large corporations rarely maintain current accounts in foreign countries, because there is no need for it. Major bank maintain demand-deposit accounts with their foreign correspondent banks (overseas). These correspondent banks are chosen to facilitate the business dealings of another bank in another country (or, different location). The correspondent banks are preferably those that are members of the respective national clearing system in the place where they are located. Funds are made available in the current account of the overseas bank with the correspondent bank.

The correspondent bank will then make payment to the respective payee after receiving instructions from the overseas bank. For example, assume a Hong Kong based firm Wing On Company, wishes to pay its Singapore supplier S\$ 1 million. The treasurer from Wing On will contact the foreign exchange trader in his bank, The Hang Seng Bank, Hongkong to sell him (Wing On) S\$ 1 Million at a rate of (say), HK\$ 21 per Singapore dollar.

It will then initiate two simultaneous transfers:

- Hang Seng Bank, Hongkong will debit Wing On's current account in Hongkong dollars for HK\$ 21 million and credit that amount to its correspondent's bank account.
- Hang Seng Bank will then instruct its correspondent bank in Singapore (one in which it keeps a current account balance), to debit Hang Seng's account and credit the amount to the account of the Singapore company within the banking system of Singapore.

This illustrates the fact that international transactions really involve two system simultaneous payments involving each national payment. In our example above

- there was a transfer of funds in the Hongkong system from the payer to its bank and
- a parallel payment within Singapore from the Hongkong bank's account with the Singapore bank to that of the payee. Of course, a receipt of funds would involve two transfers in the opposite direction.

Terms of account

- Two terms of accounts are used in international banking:
- Nostro: This is an account with a correspondent bank abroad in the home currency of that country.
- Vostro: This is the local currency account of a foreign bank.

Thus, the nostro account of the account holder is a vostro account for the bank where it is maintained.

The tying-up of expensive funds in nostro accounts (current accounts held in a foreign country) becomes a much more significant phenomenon. Therefore, in an attempt to minimise both the number of correspondent accounts the banks would need to open (at different centers) and the funds tied up in various nostro accounts (and consequently high costs), international banks have a natural tendency to concentrate their accounts in one country, thus using that country's banking system to clear international transactions.

Consider three currencies: The Japanese yen; Malaysian ringgit and the Thai baht; Now, banks from Malaysia and Thailand do not need to hold working balances with each other, as long as they have accounts in Japan.

If Bumiputra Bank in Malaysia want to sell Ringgit for baht which it needs, to make a payment to Bangkok Bank in Thailand. Bumiputra will use its own currency to purchase yen, and simultaneously sell yen for Thai baht in order to make the payment. To effect these two transactions, the following clearing transfers are necessary:

- An international 'transfer from Malaysia to Japan, involving the debiting and crediting of accounts in Kuala Lumpur and Tokyo respectively;
- A transfer within the clearing system of Japan, involving the debiting and crediting of accounts that Bumiputra and Bangkok Bank maintain with banks in Japan;
- An international transfer between Japan and Thailand, involving the debiting of Bangkok Bank's account in Tokyo and a credit to an account in Thailand.

In the end, there is no need for banks to have account relationship anywhere, except in Japan. Of course, the greater the number of countries in the system, the greater the saving, if all decide to hold working balances in one country. The economics of clearing and the pattern of account relationship have also affected foreign exchange trading practices. Today, most foreign exchange is traded against the US dollar. To a certain extent, this trend has become enforcing because most institutions hold dollar accounts, most transactions in a given currency will be done against the US dollar. Thus, the market is so active and liquid that traders find it advantageous to go through the dollar, whenever they want to obtain a third currency.

The dollars position is further reinforced by the fact that the US banking system provides opportunities for adjusting cash balances until late in the 'world business day' that begins in mid-pacific. In short, a country with an efficient market that provides depth, breadth and liquidity is more likely to be where balances are held.

Clearing house interbank payment

Technology is now central to the clearing of transactions. In the United States a computer based Clearing House Interbank Payments System [CHIPS] handles tens of thousands of payments representing transactions worth several hundred billions dollars each day.

CHIPS can be thought of as a sort of international bankers' "play money". During the day, all international banks making dollar payments to one another pass this CHIPS money to one another in lieu of real money. At the end of the day, the game master totals up everybody's CHIPS money to see the net amount that is owed by who and to whom. Thereafter, the real money (Federal Funds) is transferred in that amount.

The working of CHIPS can best be explained through an example. Assume an Italian businessman needs to pay US dollars for a shipment of Brazilian coffee. He would contact his local bank - Credito Italiano, to make arrangements for the transfer. Credito Italiano will cable the New York correspondent bank (with whom it has an account relationship), to credit the bank of Brazilian coffee exporter Banco do Brazil. For simplicity, assume that the exporters bank has a correspondent one of the more than 100 CHIPS members, (say) Chemical Bank and importer's bank's correspondent bank is Citibank.

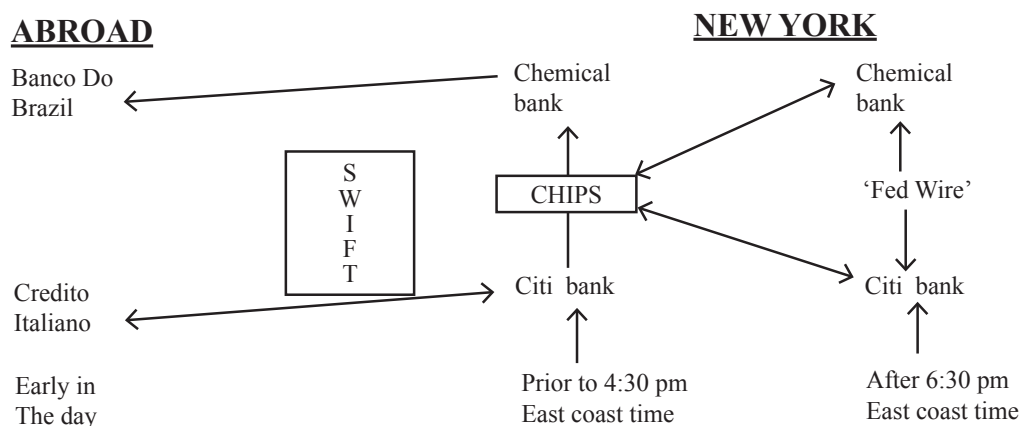


Fig. 8.1 International clearing and payments Balance

Steps in the transfer of funds:

- Credito Italiano instructs Citibank using SWIFT (as discussed), to debit its account and transfer the dollar funds to Chemical Bank "for credit to the account of Banco do Brazil".
- Citibank Debits Credit Italiano's account and transfers funds through System CHIPS it sends the equivalent of an electronic cheque to CHIPS, where Chemical Bank's account is credited the same very day.
- At the end of tile day, any debits and credits between Citibank and Chemical Bank are-settled by a transfer of "Fed Funds" - i.e., deposits held by member banks at various branches of the Federal Reserve system (counter part of the Central Banking authorities like the Reserve Bank of India).
- Chemical Credits Banco do Brazil's account and notifies the bank through the SWIFT system.

The schematic flow of steps in the transfer of funds is shown in Figure 8.1. The illustration in the flow chart shows how a hypothetical payment between Credito Italiano and the Banco do Brazil would run through the US Clearing system. Citibank either confirms that Credito Italiano has sufficient funds, or, through authorisation by its offices, extends credit to it. In either case, the computer prompts payment of the appropriate amount to the correspondent bank of the payee's bank.

Society for world-wide interbank financial telecommunications

Society for World-wide Interbank Financial Telecommunication (SWIFT), a specialised non-profit co-operative owned by banks, is the most important private message courier. SWIFT transmits messages in standardised formats and many interbank funds transfer systems (like CHIPS), have been designed to reformat SWIFT messages electronically for execution through the clearing house. Over the years, SWIFT has become an integral part of many interbank payment systems. Banks in India are also connected to the SWIFT network. SWIFT consists of national data concentration centres, which are connected by leased telephone lines to operating centres in Belgium, the Netherlands and the United States.

Computer terminals at the participating banks are linked to the national concentration centres, with SWIFT, a message can be sent from one bank to another as speedily as with a telex but error free, more securely and at lower cost. SWIFT has largely replaced interbank transfers made by cheque or draft because of the advantage of speed, at the same time providing for immediate verification and authenticity. The system has over a thousand members in several dozen countries, giving essentially global coverage. In essence, SWIFT provides member banks (that would alternatively operate through correspondent banks), the same payment service as that available to a few multinational banks that have an extensive net work of wholly owned affiliates.

8.1.2 International Syndicated Lending Arrangements

The syndicated lending process has emerged as one of the most popular and notable financing instruments in the international financial markets. Compared to other funding techniques, a syndicated credit remains by far the simplest way for different types of borrowers to raise financing from the international markets. While the technique of syndicated loan has been tried and accepted in various national markets, the Euro market remains by far the biggest source of such credits.

Euro market evolved the concept of lending funds for medium-to-long term on “variable” (or floating) interest rate basis, thereby protecting themselves against constantly changing interest rates. This concept soon acquired ready and large acceptance as it ably satisfied both depositors and borrowers. A variable or floating rate loan carrying an interest rate that may move up or down, depending on the movements of an outside standard, such as the rate paid on US Treasury Securities or the ruling LIBOR rate which is the London Interbank Offered Rate.

The rate may be specified as LIBOR +1 %. This means that the margin over LIBOR is 1%. This type of variable loan may also be referred to as an adjustable rate loan. The lender can increase or decrease the interest rate on this type of loan at specified intervals e.g.: 3, 6 or 9 months intervals, depending upon the arrangement with the borrower. This periodical adjustment is done by the lender to keep pace with changing interest rates on funding sources i.e., deposits. Euro banks, playing their role of financial intermediaries, could earn their income by way of margins charged. This margin varies according to market forces.

Loan syndicate

Simply put, it is a highly structured group of financial institutions (primarily banks), formed by a manager (or a group of co-managers), that lends money on common terms and conditions to a borrower.

Loan syndication typically involves a small group of knowledgeable and well capitalised banks that agree initially to provide the entire loan. These banks can then sell portions of their share of the loan to a much wider range of smaller banks. (They may however prefer to retain their shares if they so desire.)

Loan syndication provides borrowers with certainty about the amount and the price of funds, while allowing wide distribution. If many banks are able to share in small parts of different loans, their ‘risk’ will be more diversified and they will be willing to make more loans. In the Euro market, a borrower may come from one country, with its own regulations and accounting norms, while lenders are from other nations. Much of the risk reduction is performed not only by credit analysis, monitoring and control, but by taking smaller amounts of more diversified assets (loans), and by relying on the monitoring role of the ‘lead bank’ or banks.

Syndicate process

The syndication process commences with an invitation for bids from borrowers. Sophisticated borrowers invite bids from Euro banks by defining important loan parameters, e.g., amount, currency preferred, final maturity, grace period and preferred amortisation.

Bids are generally invited on a fully underwritten basis opposed to a best effort basis. As the term indicates, fully underwritten bids convey the commitment of bidders to provide funding, irrespective of the market response. On the other hand, bidders submitting bids on a best effort basis are not confident of raising the finance from the market.

The bid letter will be addressed to the borrower and signed by prospective banks spelling out broadly the terms and conditions on which each bidding bank would be prepared to accept the role as an arranger or lead manager for the syndication arrangement.

Thereafter, the borrower will carefully examine the bid submitted by each bank. Each bank that submitted its bid will be called separately to discuss the terms and conditions submitted in their respective bids. The borrower will not reveal the terms of a bid submitted by one bank to the other banks. A strict confidentiality is maintained.

The borrower will then select the bid that suits it most. It must be carefully understood that the criteria for choosing a bid is not dependant on the lowest cost but other factors are equally important. These factors (terms and conditions) would be best understood and appreciated after reviewing all relevant features that are included in a bid format and are integral in tying-up a syndicated credit arrangement.

The principal terms and conditions that are included in a bid format submitted by a bidding bank to a borrower are:

Borrower: ABC Company Ltd.

Guarantor (if any): Unconditional guarantee of another bank or another company

Amount: US\$50 million

Maturity: 7 years from date of loan agreement

Repayments: The loan will be repaid by 8 equal $\frac{1}{2}$ yearly instalments after the yearly payments.

Grace period: Three years from date of loan agreement.

Drawdown: The borrower can drawdown the loan amount after fulfilling conditions precedent to the drawdown.

Drawings may be made in tranches of US\$ 5 million. Or multiples thereof, by giving 3 clear days notice of drawdown and within 12 months from the date of the loan agreement. Loan amounts undrawn at the end of 12 months will be automatically cancelled.

Prepayment

The borrower will have the right to prepay all or any part of the outstanding loan amount without any penalty. Such prepayment has to be in minimum amounts of USD\$ 5 m. or multiples thereof, on any interest roll-over dates by giving a minimum of 30 days notice. Any amounts prepaid will be applied to repayment schedule in inverse order of maturity.

Interest

The borrower will have the option of choosing interest period of 3-6 months LIBOR. The borrower will pay interest equal to LIBOR as applicable on US dollars for 3 or 6 month maturities plus a margin of one percent (1%). Interest calculated on the above basis is to be paid at the end of each interest period in arrears, on the basis of 360 days.

Reference banks

The loan agreement will specify three banks, two of which will be participants in the loan and whose quotas will be obtained to establish the LIBOR rate to be applied.

Commitment fee

The borrower will pay a commitment fee of 14% p.a on undrawn amount of the loan, commencing from the date of loan agreement. Such fees will be payable semi-annually in arrears calculated on the basis of actual number of days elapsed in a year of 360 days.

Front end fees

The borrower will pay a flat fee of $\frac{1}{4}$ % of the loan amount for arranging the syndication, execution and documentation. It is payable not later than 30 days from the date of execution.

Withholding tax

The borrower is to make all payments free and clear of any present or present or future, withholding taxes, duties or other deductions. Should the authorities impose any taxes, the borrower is to make necessary tax payments to the tax authorities and tender the amount to the lenders without any deductions whatsoever.

Out of pocket expenses

The borrowers shall reimburse all the lenders all out of pocket expenses incurred in arranging the transactions. Such expenses are to be reimbursed upto an amount of \$30,000 upon relevant billing.

Agency fees

The borrower is to pay an agency fee at the rate of \$5,000 per annum on each anniversary of signing of loan agreement.

8.2 Correspondent Banking

The correspondent banking system has been the dominant form of interbank relations for most of U.S. history, and it continues to play an important role.

- Correspondent banking involves a small bank's maintaining deposits with a larger bank, in exchange for a variety of services. The larger bank may, in turn, have as correspondent's large banks in money-market centres. By means of this pyramidal structure banks throughout the country are linked in an informal network. The chief, but by no means only, service provided by correspondent banks is the clearing of checks.
- In the nineteenth century, prior to the creation of the Federal Reserve System, correspondent banking flourished because of the need for banks to maintain funds with other banks for the redemption of bank notes.
- Later, as maintenance of deposits became an acceptable practice, the major service performed was check clearance. Although smaller banks received services in exchange for maintaining deposits with their correspondents, in the nineteenth century the correspondents also paid interest on the deposits they had for other banks.
- During the 1930's, the payment of interest on these deposits was prohibited; additional services replaced the interest compensation. The National Bank Act of 1863 allowed national banks to include balances with correspondents in their required reserves.
- With creation of the Federal Reserve System, this practice was prohibited for member banks, although many states continued to allow it for their non-member, state-chartered banks. Then the enactment of DIDMCA in 1980 extended the Federal Reserve System's control over reserve requirements to non-member banks and other depository institutions, including foreign banks.
- The chief function of correspondent banking has been to provide a channel for check clearing. Prior to the creation of the Federal Reserve System, virtually all checks written on one bank and deposited in another were cleared through exchanges among correspondent banks in an informal network that often involved round-about routing of checks.
- Even after the Federal Reserve offered this service, many banks continued to rely on their correspondent banks for check clearing, since this channel was often considerably faster.
- In the early 1980s, the Federal Reserve began charging for its check-clearing services, reinforcing the preference for correspondent banks. Correspondent banking allows small banks to overcome many of the limitations imposed by their size. First, it enables small banks to offer their customers services that would otherwise be prohibitively expensive. Second, it provides direct services to the small banks themselves.
- A small bank in effect purchases from its correspondent services that are too expensive for it to offer on its own. If a customer wishes a larger loan than a small bank is permitted (or considers wise) to make, the small bank may share the loan with its correspondent in an arrangement known as loan participation.
- Small banks may also participate in loans originated by their correspondents. In addition, the correspondent relationship makes it more economical for a small bank to extend to its customers services, such as trust management or international banking that it lacks the expertise and funds to provide.

- The correspondent bank relationship also helps small banks perform many internal functions in which economies of scale can be realised. At any particular time a small bank may have a relatively small amount of cash to place in the federal funds market or may need a small amount of funds. Trading in small volumes is expensive, however and by going through its correspondent, the small bank can participate in this market more effectively.
- Banks may also loan to or borrow from each other, or buy and sell earning assets from each other. This service is especially important to banks that wish to avoid borrowing from the Federal Reserve System.
- In addition, the correspondent may provide management and investment counselling. It may help the small bank manage its assets and acquire capital. It may share credit information, evaluate loans, perform audits, purchase and hold securities, or through electronic data systems process the small bank's instalment loans, deposit accounts, and other information.
- Some of these services are similar to those provided by a home office for its branches. However, the correspondent bank system provides the advantages of communication and pooled resources without creating a risk of overcentralisation.
- Maintaining a profitable correspondent bank relationship requires careful management by both parties. Payment for the services rendered by the correspondent may be through direct fee or through maintenance of compensating balances.
- In the latter case the level of balance required fluctuates with changes in the interest rate, since the cost of the services the correspondent bank provides must be covered by the dollars of interest the deposited funds earn for the correspondent.
- Alternatively, the respondent bank may receive fewer services in times of low interest rates and more services when interest rates are high. The correspondent banking system provides an elaborate web of communication among U.S. Banks.
- New York banks may act as correspondents to hundreds of banks in cities across the country because of New York's importance as the leading financial centre of the country. Banks in other cities may have as customers in many smaller banks in their region.
- In addition, many U.S. Banks have correspondent relationships with banks in foreign countries. They maintain accounts with these banks in order to facilitate conversion of currency for their customers who travel or conduct business abroad. The correspondent bank network is thus an integral part of the U.S. banking system.
- Correspondent banks are large banks that provide the gamut of banking products and services to other banks in exchange for fees and/or deposits. Banks that deal extensively in international trade also use correspondent banks on a regular basis.
- For example, a US bank may use the Bank of Tokyo - Mitsubishi Ltd. as its principal correspondent in Japan if it does a lot of business in Japan. Accordingly, payments to or collections from other banks in Japan will be routed through the Bank of Tokyo, Mitsubishi Ltd. Likewise, the US bank maintains correspondent relationships in other money centres of the world. Such networks provide the channels that facilitate the efficient flow of funds in the capital markets throughout the world.
- Establishment and furtherance of correspondent banking relationships are highly specialised tasks. The sections or departments that establish and maintain these relationships carry enormous responsibilities on behalf of the entire organisation. These responsibilities are sometimes carried out as integral part of the functions of the department looking after the business of international banking for the whole bank.
- All banks consider the correspondent banking as a natural extension of the international banking business. However, the more reputed and large international banks have full-fledged correspondent banking divisions: Working as specialised business units or profit earners. These departments have total focus on relationship management and business development on a global basis. The critical functions, responsibilities and benefits of a well organised correspondent banking are evident from the functioning.

8.2.1 Functions

It should not be presumed that correspondent banking comprise only international payments and funds transfers. Actually, the correspondent banking network is of immense help in transacting a wide range of other banking businesses. The correspondent bank's strength, expertise and network can also be utilised to offer products and services to large corporate entities which otherwise would have been beyond the reaches of most banks. Some of other types of businesses that correspondent banks handle, for their banker clients are as follows:

- Collection of clean instruments (viz., cheques, payment orders, cashier's cheques, traveller's) Documentary collections
- Issuing and advising letters of credit
- Confirmations of LCs
- Reimbursements under LCs.
- "Lines" for trade finance business and treasury operations (financial markets)
- Bill discounting and rediscounting, banker's acceptance, buyer's credit, supplier's credit.

Further, it may be noted that correspondent banking do not include opening accounts with each other. The arrangement is confined to what is termed simply as Agency Arrangement.

8.3 Branches

Banks have foreign branches in the same fashion that they have domestic branches. That is, a branch represents the parent bank at some distant location. Some branches are service branches offering a full range of banking services to their customers, while other branches offer only limited services. The full range of services includes taking deposits and making loans and investments.

8.3.1 Representative Offices

A representative office is a quasi sales office. Representative offices cannot book loans or take deposits, but they can develop business for the head office and arrange for these things to happen elsewhere. They also establish a bank's presence in an area where the business not sufficient to justify the cost of establishing a branch, or where new branch offices are not permitted due to local regulations.

8.3.2 Subsidiaries

Domestic commercial banks and bank holding companies may acquire an equity interest in foreign financial organisations such as banks, finance companies and leasing companies. They may own all or part of the stock. The affiliated may be subsidiaries or joint ventures. One advantage of foreign affiliates is that the affiliate is foreign in its own country. This may have tax, political and marketing advantages. On the other side of the coin, a bank with minority-ownership is subject to the same problems as any minority stockholder. Minority stockholders may have little influence in the operating policies of a corporation.

In US, as per Edge Act of 1919, national banking organisation are permitted to have subsidiary corporations that may have offices throughout the United States, to provide a means of financing international trade, especially exports. Their activities include making loans and taking deposits strictly related to international transactions. Accordingly, a California bank can have Edge Act offices located in New Orleans, New York or Chicago, but those offices are restricted to dealing in business strictly related to international transactions. International Banking Act of 1978 amended the Edge Act to permit domestic banks to acquire foreign financial organisations. To establish reciprocity, foreign financial organisations were permitted to acquire domestic banks. It also permits foreign banks to establish Edge Act banking offices.

8.3.3 Offshore / Shell Banks/ International Banking Facilities

These are the banks those book transactions offshore or shell banks first opened in Bahamas and Cayman Islands. The Federal Reserve Board of USA permits domestic and foreign banks to establish International Banking Facilities (IBF) to take deposits and make loans to non-residents and serve as a record keeping facility. In reality, an IBF is a set of accounts in a domestic bank that is segregated from the other accounts of that organisation. In other words, an IBF is not a bank per se, it is an accounting system. IBF accounts do not have the same reserve requirements as domestic banks and they are granted special tax status by some states. The tax breaks are inducements by the states to encourage the development of international financial centres. IBFs are subject to some restrictions that do not apply to foreign branches of US banks. For example, they are not permitted to accept depositor make loans to US residents. They cannot issue Negotiable Instruments because they might fall into the hands of US residents. Non-bank customers' deposits have a minimum maturity of 2 days so they cannot act as substitutes for domestic demand for non-bank customers is \$1,00,000. Because of the minimum size of the deposits, they are not covered by the Federal Deposit Insurance Corporation's deposit insurance.

Agency

As per International Banking Act, 1978, an agency is any office or any place of business of a foreign bank located in any state of the US or District of Columbia at which credit balances are maintained, cheques are paid or money lent, but deposits may not be accepted for a citizen or resident of the US. Agencies are used primarily to facilitate international trade between the US and the foreign bank's native land.

Foreign Investment Company - Investment Companies owned by foreign financial organisations are similar to state-chartered commercial banks with the exceptions of –

- Securities such as common stock, while banks are not permitted to invest in stocks can lend more than 10% of its capital and surplus to one customer,
- While banks have limitations relative to capital on the amount they can lend.
- Cannot accept deposits,

Encompasses a variety of services and operations facilitating international trade, money flows for investment and payments, and loans to governments and official institutions as well as to the private sector.

8.4 International Activities of US Banking Organisations

The board of governors has three principal statutory responsibilities in connection with the supervision of the international operations of U.S. banking organisations:

- To issue licences for foreign branches of member banks and regulate the scope of their activities;
- To charter and regulate Edge Act corporations
- To authorise and regulate overseas investments by member banks, Edge Act corporations, and bank holding companies.

Under provisions of the Federal Reserve Act and Regulation K, member banks may establish branches in foreign countries, subject in most cases to the board's prior approval. In reviewing proposed foreign branches, the board considers the requirements of the governing statute, the condition of the bank, and the bank's experience in international business. In 1981, the board approved the opening of 21 foreign branches. By the end of 1981, 156 member banks were operating 800 branches in foreign countries and overseas areas of the United States, a net increase of 11 for the year. A total of 121 national banks were operating 674 of these branches, while 35 state member banks were operating the remaining 126 branches.

8.4.1 International Banking Facilities (IBF)

Effective from December 3, 1981, the Board of Governors of the Federal Reserve System amended its Regulations D and Q to permit the establishment of international banking facilities (IBFs) in the United States. IBFs may be established, subject to conditions specified by the board, by U.S. depository institutions, and by Edge Act and agreement corporations. These facilities may also be set up by U.S. branches and agencies of foreign banks. IBF

is essentially a set of asset and liability accounts that is segregated from other accounts of the establishing office. In general, deposits accounts from and credit extended to foreign resident or other IBF's can be booked at these facilities free from domestic reserve requirements and limitations on interest rates. IBF's will be examined along with other parts of the establishing office, and their activities will be reflected in the supervisory reports submitted to the bank regulatory agencies by that office. By year-end 1981, 270 offices had established IBF's.

8.4.2 Edge Act and Agreement Corporations

Under Section 25 and 25(a) of the Federal Reserve Act, Edge Act and agreement corporations may engage in international banking and foreign financial transactions. These corporations, which are usually subsidiaries of member banks, provide their owner organisations with additional powers in two areas: (1) they may conduct a deposit and loan business in states other than that of the parent, provided that the business is strictly related to international transactions; and (2) they have somewhat broader foreign investment powers than member banks, being able to invest in foreign financial organisations, such as finance companies and leasing companies, as well as in foreign banks. In 1981, the board approved the establishment of 19 Edge Act corporations and an agreement corporation and the operation of 47 branches by established Edge Act corporations.

8.4.3 Capitalisation and Activities of Edge Act Corporations

The International Banking Act (IBA) removed the statutory limit on liabilities of an Edge Act corporation under which the corporation's debentures, bonds, and promissory notes could not exceed ten times the corporation's capital and surplus. The board established a new capital requirement of 7% of risk assets for Edge Act corporations engaging in international banking in the United States, to permit these corporations to compete more effectively with other international organisations that are more highly leveraged. Effective July 29, 1981, the board amended its regulation dealing with Edge Act corporations to provide that, with board approval, subordinated capital notes or debentures, in an amount not to exceed 50% of non-debt capital, may be included for determining capital adequacy in the same manner as for a member banks. Two other important changes arising from the IBA permitted Edge Act corporations:

- to be owned by foreign banks; and
- to establish branches within the United States

8.5 International Transactions and Balance of Payments

Balance of payments is an accounting system that measures economic transactions between the residents of given country and the residents of the other countries during a given period of time. Economic transactions include export and import of goods and services; gifts between the countries and international movements of financial assets and liabilities. The balance of payment position of a country is important as it helps to predict country's market potential. In this unit, you will learn about the concept of balance of payment, accounting for international transaction in balance of payments and the format of balance of payment. You will also learn about the relationship between balance of payments and exchange markets, balance of indebtedness and the adjustment policies vis-a-vis balance of payments.

8.5.1 Balance of Payments

The concept of balance of payments has emanated from commercial and financial transactions between nations. The balance of payments comprises three types of financial flows.

- First, the value of visible exports can be balanced against the value of visible imports to determine trade balance. Trade in merchandise represents these visible items like grain, oil, jewellery, garments and machines.
- Second, the value of invisible exports can be balanced against the value of invisible imports to determine invisible balance. Invisible trade is represented by services like shipping, insurance, tourism and consultancy. When merchandise exported from India is carried in foreign ships or insured by foreign underwriters, the charges paid for these services constitute invisible imports or say import of services.

- On the other hand, charges received by Indian ships or underwriters for carrying foreign merchandise, or for insuring it, get counted as invisible exports or say export of services. Likewise, foreign tourists visiting India generate invisible exports for her, while Indian tourists going abroad create invisible imports for their country.
- When foreign consultants are hired by Indian firms, Governments or other agencies, consultancy fees amount to invisible imports. As against this, when fees for such services are received here by Indians from abroad, these fall in the category of invisible exports.
- Total visible and invisible exports balanced against visible and invisible imports are called current account balance. If these combined exports exceed these combined imports, there is favourable current account balance. In case, such imports exceed such exports, we have unfavourable current account balance. It is rare that both these variables are just equal or perfectly balanced.
- Thirdly, the balance of payment consists of balance of investment and other capital flows, called capital account balance. If such inflows into a country exceed the outflows there from, the amount of “net inflow” would either push up the (otherwise) favourable ‘current account balance’ into a more favourable balance of payments, or the (otherwise) unfavourable current account balance would be transformed into a less unfavourable balance of payments.
- Conversely, when there is net outflow on capital account, an unfavourable current account balance would turn into a more unfavourable balance of payments. In case there had been a favourable current account balance it may either become less favourable BOP, or an unfavourable BOP, depending on whether the net outflow is smaller or bigger than the erstwhile current account balance.
- Sometimes, a distinction is made between market balance of payments and accounting balance of payments. The latter may be defined as a periodic statement summarising all the external (commercial and financial) transactions in which a country is involved during a year or any other period of time.
- The net result may be favourable (surplus/plus) or unfavourable (deficit/minus), to be appropriated or financed in some way so that the two sides of the account are always equal, even if a suspense account has to be raised to cover up some discrepancy (say, funds in transit) or accounting error.
- This is in line with the conventional code of double entry book-keeping. The market balance of payments signify the current or ongoing relationship between what comes in (inflows) and what goes out (outflows) as a result of both capital and current (visible and invisible) account transactions.
- In effect, BOP signifies supply and demand of foreign currency (say, US dollar, British pound sterling or Japanese yen). The supply is generated, in the normal course, through (visible and invisible) exports and capital inflows, while demand emanates from (visible and invisible) inputs and capital outflows may be diminished when foreign exchange accounts get blocked in emergent situations such as wars or hostile policies of certain countries. By the same token such supply may get augmented when blocked or frozen accounts are permitted to melt (like the release of India’s sterling balances accumulated during the
- Second World War with the Bank of England) demand, too, may get augmented when special or extraordinary payments have to be made to a foreign country or in a foreign currency (say, reparation payments imposed on Germany after the First World War or subscription to United Nations and its Agencies since 1945).
- Likewise, the demand may diminish when certain (re)payments are rescheduled or waived (wholly or in part) to give relief to a country stricken by droughts, floods, earthquakes, epidemics or other mishaps. Whether guided by humanitarian or political consideration, other (donor) countries may even make a (discretionary/ex gratia) transfer payments which may strengthen the current account position of the (donee) country.
- In effect, the demand and supply relationship may reflect itself in an upward or downward movement of the exchange rate and/or in the level of external reserves.
- For example, the cost of one US dollar went up from about 35 to roughly 40 Indian rupees between August 1997 and February 1998. Till then there was some loss of foreign exchange reserves when the Reserve Bank of India intervened to resist fall in the external value of the rupees.
- As such, official reserves account stands separately from current account and capital account. Official reserve account measures charges in the holdings of foreign currency, SDRs and gold by the central bank of the country.

- In all these three accounts currency inflows may be viewed as credits, while outflows as deemed to be debits. During any period of time aggregate credits should be equal to aggregate debits. That is why deficits/surpluses in current and capital accounts lead to depletion/augmentation of official reserves.
- In the ultimate analysis, balance of payments summarises all the economic transactions between residents of the home country (say, India) and residents of all other countries and signify demand and supply of foreign currency/currencies.

The BOP can be expressed as follows:

$\text{BOP} = \text{CRA} + \text{CPA} + \text{ORA}$ <div style="display: flex; justify-content: space-around; font-size: small;"> (current account balance) (capital account balance) (official reserve account balance) </div>
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The BOP must always balance, since it is an accounting identity in a fixed exchange rate system. If the sum current account and capital account is not zero then the government must take action by adjusting the official reserve account to balance BOP. It does so by buying or selling foreign currency and gold depending upon the situation, up to a total that equals the difference between current account and capital account.

In a floating rate system, market forces act to adjust the exchange rate as necessary to force the BOP back to zero.

8.5.2 Nature of International Transaction

Let us now briefly understand the nature of international economic transactions.

- There is a basic difference between domestic and international transactions. In a domestic deal, the two (or more) parties belong to the same country, so that the foreign exchange problem does not come into the picture (unless the dream itself is drawn in terms of a foreign currency).
- When two (or more) individual organisations belonging to two (or more) different countries enter into an international transaction, it is usual to take note of the foreign exchange element with its several dimensions
- First, the particular currency (or currencies) in which the amounts are to be stated would need to be agreed upon. This problem could be avoided if a common currency (say, Euro in the European Union) is used (and all the individuals/organisations concerned belong to that very Union).
- Second, the cross-currency rates of exchange may have to be identified (for the present, and possibly, for the future also) along with risks of fluctuations being covered by hedging or some other mechanism.
- Third, foreign currency may have to be bought, sold or surrendered in conformity with governmental regulations through authorised banks or other agencies.
- Sometimes, the international monetary mechanism may be obviated or short-circuited by adoption of barter trade or smuggling. When two nations (or their traders) are unable to arrive at an agreement regarding the monetary value of certain goods/services, or in respect of some commonly acceptable rate of exchange (conversion), they may resort to barter arrangements.
- Here there are three main possibilities. First, goods of one country may be exchanged for goods of another country (say, Indian rice for Russian oil). Second, goods may be exchanged for services (like consultancy). Third, services may be exchanged for services (like those of teachers under the cultural exchange programme).
- Even those international transactions which are, in a micro-sense, based on monetary values, may, at the macro-level, appear to be close to barter arrangements. That is, central bank (or other foreign exchange agencies) of two countries tend to settle their accounts only in aggregates and not for each individual transaction in isolation.
- Moreover, in the absence of a perfectly free multilateral trading system, even a country with an overall surplus in its balance of payments may fall short of a particular foreign currency. For example, if (imagine that) India has a surplus BOP with Russia (and also an overall surplus globally), she (India) may still fail to get enough imports from the USA (on monetary basis), if Russian rouble is not freely convertible into US dollar.

- In his model, there are only two countries (for the sake of simplicity). Transactions revolve around goods, services and money, while settlements (besides barter) are made via current account, capital accounts, and official reserves account. In this process, money has a dual role, first as a medium of transfer payments which constitute a part of the current account (the other two constituents being goods and services), and, secondly, as a balancing device under all the three accounts (current, capital and official reserves).
- Country A has more goods than services, while country B has more services than goods. This dissimilarity may be deemed to indicate (though not necessarily) that Country B is more developed or advanced than country A. This may be further supported by the fact that country B has a bigger official reserves account than country A.

Perhaps, for the same reason country A is trying to encourage capital inflows not only to build up a bigger capital account (for investment needs), but also to meet current account requirements. However, there is an apparent similarity in the matter of transfer payments from country A to country B and vice versa, as also with regard to the overall size of the current account.

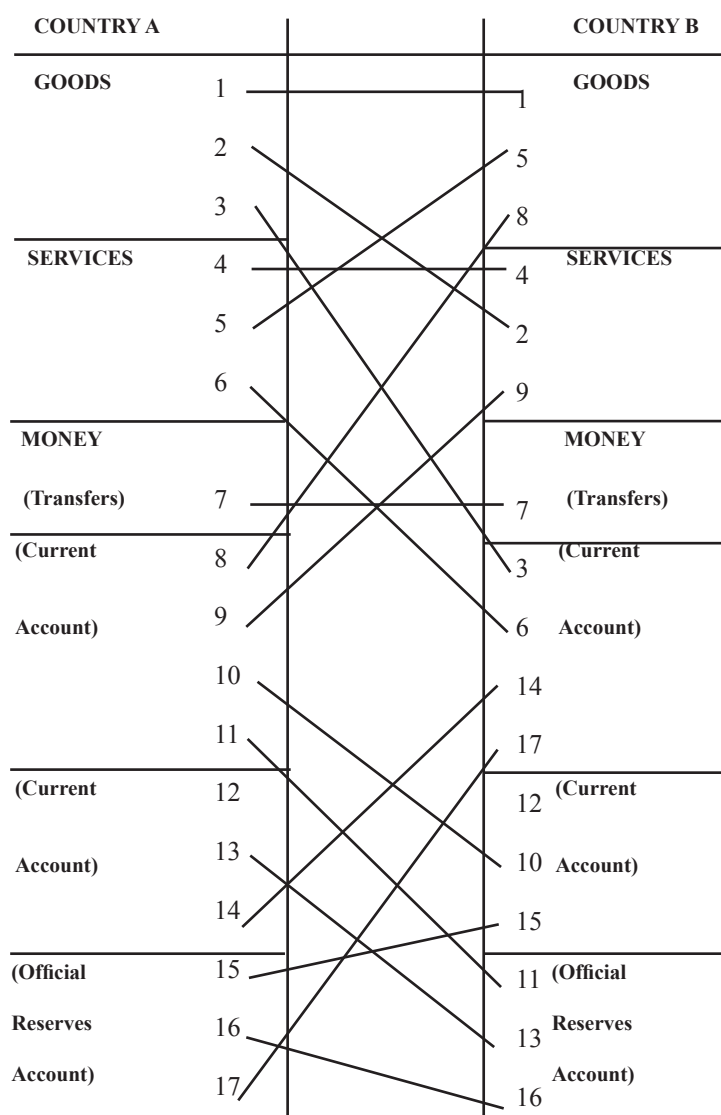


Fig. 8.2 Two country model

- In the figure above, barter transactions are represented by Line 1 (goods for goods), Line 2 (goods for services), Line 4 (services for services) and Line 5, (services for goods). Line 3 represents goods for money (current account), while - Line 6 represents services for money (current account). Transfer payments between country A and country B are typified by Line 7.

- For country B, Line 8 indicates exchange of goods for money (current account), while Line 9 refers to exchange of services for money (current account). Line 10 may mean country B's support, from its capital account, to country A's current account (which may be in deficit). Similar support can be visualised to country A's current account, from Country B's official reserves account, through Line 11. As against this, Line 12 symbolises straight capital flows between country A and country B.
- Normally, one may expect bigger inflows into Country A (less developed) from country B (more developed). But, there may be fairly substantial cross-flows, particularly when the disparity between the (relative) levels of development in the two countries is not too much (as appears to be in the instant case), or each country has unique expertise (and capacity for capital investment) in different types of goods/services.
- Again, in the event of a stock exchange crisis or other manifestation of shaking financial confidence, there could be massive outflow of funds from capital importing countries. The (South/East) Asian financial crisis of 1997-98 is a case in point. In 1996, the five most (adversely) affected countries (Indonesia, the Philippines, Malaysia, South Korea and Thailand) had received an aggregate of net capital inflows amounting to \$ 93 billion. They suffered a net outflow of \$ 12 billion during 1997.
- The above figure refers to the possibility of a link between the official reserves account of country B and the capital account of country A. Such a link could mean that a part of official reserves flow to another country by way of investment; or, that capital inflows from another country (A) are used to build official reserves by the capital importing country (B).
- This may not be surprising even if B is manifestly more advanced a country; for, these inflows may be repatriation or withdrawal of capital (as also profits) earlier invested. Again, adverse BOP may be in store for an advanced country whose currency (like U.S. dollar) is widely in demand and held as reserve by a host of other countries.

8.5.3 Balance of Payments Statement

Double-entry book-keeping is the basic tenet behind the balance of payments statement. Every transaction, as visualised in Figure 8.3, gets recorded as a credit on one side and as an offsetting debit on the other side. As such, the two sides of the BOP format should tally. This is to be so even if, on the last day of the accounting period, some goods and funds are in transit, for there is an arithmetical error in recording/adding up (for, which a suspense account may have to be raised and maintained until the discrepancy is ironed out). For example, if India exports ten million (one crore) readymade shirts to the USA at a price of one dollar for each piece, and the exchange rate is Rs. 40 for a dollar, India's foreign exchange earnings amount to \$ 10 million or Rs. 40 crore. For this item the following entry can be passed:

Private foreign assets (Debit)	Rs. 40,00,00,000
To Goods exporter (Credit)	Rs. 40,00,00,000

If these earnings are required to the Reserve Bank of India (RBI), another journal entry may be made as follows:

Official foreign assets (Debit)	Rs. 40,00,00,000
To private foreign assets (Credit)	Rs. 40,00,00,000

In case, India imports the services of American consultants from the USA costing \$12 million or Rs. 48 Crore, this international transaction may be entered in the following manner (presuming that the RBI has agreed to release this amount from the official holdings of foreign currency).

Services importer (Debit)	Rs. 48,00,00,000
To official foreign assets (Credit)	Rs. 48,00,00,000

Now, if these are the only two commercial transactions between India and the USA during a certain accounting period, there is an adverse balance of trade on services (invisible) account which is more than the favourable balance of trade (visible) on goods account by two million US dollars (or eight crore Indian rupees). This can be met either by drawing from the official reserves account (of the RBI) or through some unilateral transfer from the USA. The relevant entries, with appropriate narrations, are given below (presuming that official reserves account is separate from official foreign assets account):

Particulars	Amount (Rs)
FIRST SITUATION	
Official foreign assets (debit)	8,00,00,000
To official reserves account (credit)	8,00,00,000
(For drawing from reserves to meet current account deficit)	
SECOND SITUATION	
Official foreign assets (debit)	8,00,00,000
To unilateral transfer (credit)	8,00,00,000
(For unilateral transfer of funds from the USA)	

The BOP statement in the two situations will be:

Debits					Credits
	US\$ (million)	Rs. (crore)		US\$ (million)	Rs. (crore)
Services imported	12	48	Goods imported	10	40

Table. 8.1 First situation

Debits					Credits
	US\$ (million)	Rs. (crore)		US\$ (million)	Rs. (crore)
Services imported	12	48	Goods imported	10	40
			Unilateral transfer from abroad	2	8
TOTAL	12	48		12	48

Table 8.2 Second situation

Both the above-mentioned situations contain only current account transactions (goods, services and unilateral transfer from abroad). Of course, the uncovered current account deficit impinges on the official reserves account in the first situation. Now, we can extend the example to capital account transactions also. These go to determine the 'wealth' of a nation along with an indication of 'net debtor' or 'net creditor' position based on public lending, private lending and investment activities. Reference may be made to the following three well-known categories of such activities:

Foreign Direct Investment

Credits

Foreign direct investment (FDI), which is supposed to build up a lasting-relationship (say, for a decade or more) between two (or more) countries. The major medium for such investments may be multinational corporations through their subsidiaries. These may be wholly owned by foreigners as now permitted in India in a number of cases as part of the economic reforms initiated in 1991. The earlier (cautious) approach sought to limit foreign control to 24%, so that the Indian partners in a joint venture could retain not the power to pass an ordinary resolution with bare 51% majority but also a special resolution with 75% majority in terms of the Companies Act. Under the US rules, at least 10% of the equity has to be owned by the investors under a FDI arrangement which has management control as its distinguishing feature. It is also looked upon as the most visible form of investment manifesting itself in the establishment or extension of existing entities designed to produce goods or provide services.

8.5.4 Balance of Indebtedness

It is a concept used to measure and assess the burden of external debt for a country.

- The total debt liabilities of a debtor nation are measured by 'debt stock' or 'debt outstanding and disbursed'. Payment obligations arising there from are symbolised by 'debt service' comprising interest and principal (re) payments.
- This, in turn, is influenced not only by the quantum of debt stock, but also by the maturity structure, interest rates, currency revaluations and other variables of an economic, financial or commercial character. Political factors, too, may creep into the picture.
- As a measure of the balance of indebtedness, the term 'net flows' stands for disbursements minus principal repayments. If an indebted country is still having net inflows, it means that new financing is more than the (old) debt retired, so that the total quantum of debt is going up.
- Conversely, if there are net outflows, it is an indication that the total amount of indebtedness is going down: the term "net transfers" takes interest payments also into the reckoning. So, it can be represented as: Disbursement - (interest + principal repayments).
- Net transfers may be negative or positive. If a nation is experiencing net negative transfers, it means that total debt service payments exceed gross inflows, so that real resources are being transferred abroad.
- To counter balance such capital account deficits, it may be incumbent to build up (or augment) current account surplus, that is, favourable (visible/invisible) trade balance.
- Conversely, if there are net positive transfers from abroad in favour of a country, the implication is that net real resource are flowing to it from foreign countries. That has been India's position between the years 1991-92 and 1997-98. As against a fall in reserves by (US) \$ 1,278 million in 1990-91, there was an increase in reserves to the tune of \$ 3,756 million during 1991-92. The current account deficit was reduced from \$ 9,680 million in 1990-91 to \$ 1,178 million in 1991-92. Capital account surplus also fell (from \$ 8,402 million to \$ 4,754 million), but, while it fell short of current account deficit in 1990-91, the surplus on capital account during 1991-92 was higher than the deficit on current account, thus resulting in an increased level of reserves.
- The changeover at the cut-off point (1991, when Economic Reforms were introduced in the current context), as also the position in 1994-95 is depicted in the below table with regard to the balance of indebtedness:

Year 1990-1991			
Debits	US million dollars	Credits	US million dollars
Current account deficit	9680	Capital account surplus	8402
		Decrease in reserves	1278
	9680		9680
1991-1992			
Debits	US million dollars	Credits	US million dollars
Current account deficit	1178	Capital account surplus	4754
Increase in reserves	3576		
	4754		4754
1994-1995			
Debits	US million dollars	Credits	US million dollars
Current account deficit	2624	Capital account surplus	7381
Increase in reserves	4757		
	7381		7381

Table 8.3 Changeover at the cut-off point from 1990 to 1995

- However, it needs to be noted clearly that these increases in reserves are ‘borrowings-based and not earnings-based. As such a surplus on capital account may be followed, in the years to come, by a deficit on capital account. Even the tiger economies of Asia have experienced this discomfiture during 1997-98; hence, the need to build up current account surplus (favourable balance of trade).
- It is also important that external assistance, whether in the form of (concessional) loans or (outright) grants, is fully/appropriately utilised; otherwise, it creates a national burden bereft of benefit, besides its inflation-potential. Aid authorised to India was at the fairly high level of \$ 6,503 million in 1989-90; but, only about ‘ half of it (\$ 3,485 million) was utilised.
- By 1995-96, authorisation had fallen to \$3,649 million, but the utilisation ratios rose to about 90% (\$ 3,306 million). India’s external debt had continuously risen from \$ 75,857 million in 1989-90 to \$99,008 million in 1994-95. But, as March 31st, 1996, it was lower at \$92,199 million. However, the rupee burden in this regard has increased thereafter on account of the marked fall in the external value of the Indian rupee during 1997-98. The ratio of India’s external debt to GNP stood at 33%, and to NNP at 37%, during 1995-96., (visible) export earnings were only about one-sixth of the rupee burden of external debt as on March 31st, 1996 (Rs. 3,15,435 crore).

8.6 Adjustment Policies

What kinds of adjustments are required when a country is faced with an enormous and/or persistent adverse balance on current account and/or capital account or balance of indebtedness? Some measures, designated as reforms or structural adjustments, can be adopted by the concerned country unilaterally, such as taxation and budgetary policies. Of course, other countries may be (adversely) affected by such adjustments and they may retaliate or follow suit. Bilateral measures are those which require some kind of an agreement with another country. For example, India and Nepal may permit free trade, transit and even acceptance of currencies (in circulation). Regional adjustments require an organisation of a number of neighbouring countries such as the European Union or SAARC to promote economic liberalisation on a cooperative basis. Multilateral arrangements are global in character, such as the World Trade Organisation which became operational in January 1995.

8.6.1 Unilateral Adjustments

Almost every economic measure can be unilateral, at least on the face of it, such as fiscal policy, monetary policy, commercial policy (including exchange rate adjustment), price policy, wage policy, industrial policy (including privatisation, foreign investment, role of multinationals, technology and infrastructure development), rural agricultural policy, as also the approach toward small scale enterprises and employment. But in many cases, these policy measures have been influenced by persuasive or even coercive impact of international agencies like IMF, IBRD, IDA, as also of affluent nations like the USA.

Exchange rate adjustment is a case in point. Very often, it is another name for devaluation, say of the Indian rupee, on so many occasions during 1991-98. At times, official spokespersons have argued that, under a floating exchange rate, system, there is no formal devaluation or up valuations; and those ups and downs: emanate from market forces of demand and supply. But this is only a half-truth. There is no free floating, for the RBI and many other central banks have intervened time and again. It is often the case of “a snake in the tunnel” that is, floating is permitted only within limited bands. Again, semantics apart, there is no difference between “de jure” and “de facto” devaluation, so far as its impact on the BOP position is concerned.

Now, let us face the basic question, “whether devaluation can correct an unfavourable balance current account. Suppose that the choice is between Rs.40 and Rs. 45 as the cost of one US dollar. We have to ascertain if India’s dollar earnings will be higher through exports, and whether the import bill in terms of US dollars would be lower, if the rupee is devalued (and the cost of a dollar goes up from Rs.40 to Rs.45). Such expectations can materialise only when the (price) elasticity of demand (of our exports in foreign countries, and of our imports in India) is greater than one (>1).

Otherwise, the BOP gulf may further widen, since the import bill may stay near-constant in dollar terms (and be much higher in rupee terms), while export earnings may fall phenomenally in dollar terms (and may be near-constant or rise only marginally in rupee terms). This may be because our essential imports like oil may not be curtailed to any significant extent in spite of their higher rupee cost. On the other hand, if the price of a readymade shirts (made in India and exported to the USA) falls from, say, \$ 2.25 to \$ 2.00, and we still sell the same number of skirts (say one million), our export earnings will actually, fall (from \$ 2.25 million to \$ 2 million). Even if the exports rise to 1.1 million shirts, the export earnings will be lower (at \$2.20 million as against the erstwhile figure of \$ 2.25 million). However, if the sales can be pushed up to, say, 1.2 million shirts, the foreign exchange earned would stand higher at \$ 2.4 million. Again, it is also necessary to take note of the inflation potential of devaluation which may, as well, boil on exports through higher costs. In this process, the nation may fall into a vicious circle, “devaluation leading to inflation, and further devaluation”. The plight of the Indonesian rupiah during 1997-98 is an instant case in point.

8.6.2 Bilateral Adjustments

In the midst of a BOP crisis, two countries may enter into barter agreements for the exchange of essential imports/ exports. These may, as well, offer ad hoc solutions when exchange rates are highly volatile. Alternatively, two countries may, explicitly or implicitly, agree to keep the exchange rate between their currencies pegged at a particular level. For example, India devalued her rupee in 1949, and again during 1966, in sympathy with the devaluations of British pound sterling. Such a following suit may not, necessarily, be based on the love for a leading nations; it may, often, be more in the nature of a defensive response of a less developed country highly dependent on a developed one (which may be a major trading partner).

At times, the more advanced country may purposely appear to be benevolent and make free gifts or concessional loans by way of aid to a (relatively) backward economy. Such unilateral (capital) transforms, obviously be guided by the need, to preserve or promote cordiality in bilateral relations. In effect, however, they may perpetuate economic dependence. A country receiving “tied aid” may be obliged to buy goods or services from the donor country even though it is not the cheapest or best source of supply. The donee nation may also be called upon to part with some of its essential primary produce so that it is, at the same time, exporting (relinquishing), its employment potential (in terms of opportunities for employment in the value added sectors) to the donor country.

8.6.3 Regional Adjustments

We world had witnessed too many barriers to trade during the period of about three decades elapsing between the beginning of World War I and end of World War II. The volume of World Trade Index (1913=100) was as low as 82 during 1921-25 and 93 during 1931-35. Foreign exchange earnings of some countries were frozen in Hitler's Germany under the banner of "blocked accounts". It could be looked upon as a reaction to the huge repatriation payments which Germany had been called upon to make (though later put under a moratorium). So, the balance of payments problem was at the top of global agenda from 1945 onwards. Besides the birth of multilateral agencies like IMP, regional cooperation also manifested itself in a big way through the connotations like common market, customs union, and free trade area. The European Union, emanating from the Treaty of Rome (1957), has been in existence for more than four decades under a variety of nomenclatures. When a common currency (Euro) gets freely circulated amongst member countries, the foreign exchange problem might be resolved in a big way. This gives a cue to the creation of a "Rupee Area" with India as its nucleus, notwithstanding the Asian financial crisis of 1997-98.

8.6.4 Multilateral Adjustments

Numerous efforts have been made to ensure multilateral convertibility of currencies since 1944, when the Bretton Woods conference prepared the ground for the creation of an International Monetary Fund, designed to correct temporary disequilibria in the balance of payments, and other sister agencies like the World Bank. Britain's Labour Government, which came into power with a thumping majority in 1945 (almost synchronising with the end of World War II), also attempted to address itself in a big way to the problem of dollar shortage and other hard currencies so much in demand at that time.

But, Great Britain had to suspend the free convertibility of sterling on August 18, 1947, suddenly through a radio broadcast. The British Minister, Sir Stafford Cripps, uttered the following warning in October 1947: We have begun to dip into our reserve of gold and dollars, a reserve which is none too big and which serves the whole sterling area; unless, therefore, there is some new availability of dollars before long, we shall be obliged upon further cuts. Other countries are faced with the same problem and indeed will not be able to feed their people. Take the problem of feeding India and Pakistan. The food may only be available in South America in which case it can only be bought for dollars."

However, the quarter-century following the General Agreement on Tariffs and Trade (GATT) of 1948 could be looked upon as the golden age of global trade, whose volume index (1913=100) touched a high watermark of 520 in 1971 when President Nixon's emergency measures of August 15, 1971 sought to close the gold window, followed by the devaluation of US dollar in December 1971. Prior to that, a system of Special Drawing Rights had become operational in 1970 with a view to augmenting international liquidity. However, these book-entries (being proportional to the respective quotas of member countries) did not improve the relative position of poor countries vis-a-vis the rich world. Two important developments followed during the next three years: first, the floating exchange system became fashionable; and, second, it was the phenomenal rise in oil price (kindling a Great Inflation) in 1973, at the instance of OPEC (Organisation of Petroleum Exporting Countries).

Though formally established as early as 1960; OPEC came into limelight only in the (nineteen) seventies. Of course, it also provided loans through the OPEC Special Fund to finance both BOP deficits and development projects in non-OPEC developing countries during the following quarter-century (1973-98), the OPEC magic witnessed both its waxing and 'waning. As a case in point, Saudi Arabia's current account balance rose from a paltry \$ 71 million (favourable) to a mammoth \$41,503 million (favourable) in 1980. By 1995, it had turned unfavourable to the tune of \$ 8,108 million. Her merchandise exports had dwindled from \$ 109,000 million in 1980 to \$46,624 million in 1995. The WTO accord which, after prolonged negotiations, became operational in 1995, seems to have shifted the focus from trade as such to investments, intellectual property rights (patents in particular), social clauses (like child labour and human right) and adjudication of complaints/disputes (over 100 during the first three years-1995, 1996 and 1997). Commotion has been created by the patenting, in the USA, of native Indian plants/produce like Haldi, Neem (since annulled) and Basmati rice (under dispute since February 1998).

8.7 Rise of Market Power

According to survey results published by the Bank for International Settlements (Basel, 1996), the daily average of trading volume on foreign exchanges (global figure) was \$ 1.19 trillion as against \$0.26 trillion a decade back (1986) and only \$0.01 trillion about a quarter century back (1973). Thus, foreign exchange market grew well over four times since 1986 and much more than one hundred times since 1973. Both the size of the market and its growth are staggering and unique. There may not be a parallel case over the entire financial horizon of this globe. The three biggest foreign exchange markets are London (with a daily turnover estimated at \$ 464 billion for 1995), New York (\$244 billion) and Tokyo (\$161 billion). A small city state like Singapore occupied the fourth place (with a turnover of about \$ 100 billion), followed by Hong Kong, Zurich, Frankfurt and Paris. Of course, there have been major ups and downs. On October 19, 1987 (Black Monday), the New York Stock Exchange recorded a turnover of only \$21 billion (less than one-tenth of its own daily average for 1995). The 1997 crisis was even deeper, specially in (South East) Asian markets. At the Wall Street, Bill Gates (the Microsoft Chairman, reported to be earning Rs. 157 crore a day) is said to have lost \$1.76 billion (about Rs 7,000 crore) on October 27, 1997, and to have regained \$1.25 billion (about Rs. 5,000 crores) on October 28, 1997.

In terms of Indian rupees, the daily turnover in world's foreign exchange markets (at Rs.40 for one US dollar) amounts to roughly Rs.50,00,000 crore (more than five times of India's gross domestic product for the year 1995-96). In relation to USA's GDP for 1995 (\$7.3 trillion), the daily (global) turnover of foreign exchange was about one-sixth. As compared to global trade amounting to \$5.2 trillion for the year 1995, the daily turnover in foreign exchange market of the world (\$1.19 trillion) was in the neighbourhood of one-fourth. As compared to the daily average of global trade, which works out at about \$ 15 billion, operations in foreign exchange markets are roughly 80 times.

It means that bulk of business in foreign exchange is for non-trade purposes even if invisible imports (services) are taken into account. The centre stage has come to be occupied by cross-country capital flows (mostly short-term money) and speculation. By way of defence, the role and power of the central bank interventions (whether wise or otherwise) have become limited. The power of the market progress, particularly, speculations have been on the rise. The powers of people like George Soros, with US \$400: billion under his hand, are immense. The power of the central banks of quite a few countries having foreign exchange reserves, all put together, much lower than US \$ 400 billion, shows the limits of the government to government adjustments.

Summary

- A correspondent bank is a bank located elsewhere that provides a service for another bank. A bank which does not have an office in a foreign country maintains a correspondent account with a bank in that country.
- Foreign subsidiary bank is a bank incorporated in a host country and operates under same rules as local domestic banks. In U.S.A., subsidiaries of US banks are called Edge Act or Agreement Corporations.
- A nostro account is an account with a correspondent bank abroad in the home currency of that country. Vostro is the local currency account of a foreign bank.
- Loan syndication typically involves a small group of knowledgeable and well capitalised banks that agree initially to provide the entire loan. These banks can then sell portions of their share of the loan to a much wider range of smaller banks.
- A representative office is a quasi sales office. Representative offices cannot book loans or take deposits, but they can develop business for the head office and arrange for these things to happen elsewhere.
- The Federal Reserve Board of USA permits domestic and foreign banks to establish International Banking Facilities (IBF) to take deposits and make loans to non-residents and serve as a record keeping facility.

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Self Assessment

1. _____ are small offices opened up to provide advisory services to banks and customers and to expedite the services of correspondent bank.
 - a. Foreign branch
 - b. Correspondent branch
 - c. Representative offices
 - d. Foreign Subsidiary Bank

2. In the United States, a computer based system called _____ handles tens of thousands of payments representing transactions worth several hundred billion dollars each day.
 - a. CRAY – The Supercomputer
 - b. MEGA -
 - c. Clearing House Interbank Payments System [CHIPS]
 - d. TALLY 9.0

3. _____ is an accounting system that measures economic transactions between the residents of given country and the residents of the other countries during a given period of time.
 - a. Balance of transactions
 - b. Balance of payments
 - c. Balance of trade
 - d. Balance of stock

4. The balance of payment consists of balance of investment and other capital flows, called _____.
 - a. capital influx
 - b. capital overflow
 - c. capital account balance
 - d. capital net inflow

5. _____ is a concept used to measure and assess the burden of external debt for a country.
 - a. Balance of payments
 - b. Balance of trade
 - c. Balance of indebtedness
 - d. Balance of excess

6. Match the following.

1. A specialised non-profit co-operative owned by banks	A. Society for World-wide Interbank Financial Telecommunication (SWIFT)
2. U.S clearing house for Interbank Payment	B. Clearing House Interbank Payments System [CHIPS]
3. Global Agreement on Tariffs	C. General Agreement on Tariffs and Trade (GATT)
4. Group of oil-producing nations who control oil prices	D. Organisation of Petroleum Exporting Countries (OPEC)

- a. 1-A, 2-B, 3-C, 4-D
- b. 1-D, 2-C, 3-B, 4-A
- c. 1-C, 2-B, 3-D, 4-A
- d. 1-B, 2-D, 3-A, 4-B

7. An _____ is a set of accounts in a domestic bank that is segregated from the other accounts of that organisation.
- Foreign investment company
 - Agency
 - Representative offices
 - International banking facility
8. As per International Banking Act, 1978, an _____ is any office or any place of business of a foreign bank located in any state of the US or District of Columbia at which credit balances are maintained, cheques are paid or money lent, but deposits may not be accepted for a citizen or resident of the US.
- agency
 - representative office
 - foreign investment company
 - correspondent branch
9. _____ subsidiary bank is a bank incorporated in a host country and operates under same rules as local domestic banks
- Foreign
 - International
 - Local
 - Correspondent
10. Which of the following is the basic tenet behind the balance of payments statement?
- Double-entry book-keeping
 - Single-entry book-keeping
 - Data-entry book-keeping
 - Book keeping

Case Study I

Emergence of New Industry: Story of Indian BPO

Trade theories advocate optimum utilisation of resources and reducing the cost of production globally. This leads to a new tendency, which we call outsourcing less important or back-office works to low wage countries like India and China. The growing demand for backup, is adding a dimension to the quickly proliferating outsourcing industry. Traditionally, conservative businesses such as insurance companies and mortgage brokers are contracting out back-office and customer service work, mirroring the way corporate titans such as IBM and General Electric moved such tasks away from the US several years ago. As new clients are handing over duties to third party companies rather than to their own subsidiaries, and in countries where they often have little experience, they feel more comfortable with suppliers who have good backup plans.

Role of educational institution

Clearly there are things that the educational institutions can do to help that. Some of the institutions have taken initiatives to get there and some are waiting to see how these experiments shape up. There is also a lot of talk about the need for the industry and academia to come together so that it will eventually help the industry better. But not much seems to be happening in this area. The orientation (of the academic institutions) will have to be a little different than the existing one, view the industry as their customers and do what's good for the industry and get rated by the industry.

Unless the academia has that kind of an alignment with customer interests, it's difficult for them to devise the most appropriate curricula and syllabi. It is only when the academic institutions realise that they are serving "a certain customer base and they need to fulfil the needs of that customer base and take proactive action internally, that the situation would improve. But, at this point of time, it appears as though the entire onus is on the industry to do it. Today, the academia seems to say if you want these people you come and do whatever it is to make these people suitable for companies.

Rising demand

The huge pool of human resources in India is much talked about and chunk of the human resources from the engineering colleges. The mistake companies commonly make is to underestimate the human potential that is available, and not providing them with the right type of opportunities. We must remember that the IT industry recruits the top 1 per cent of the brain power that is available in this country. This number is small compared to the ones "that go to school, and the ones that graduate. So it means it's the cream of the cream that gets into this industry. And so in terms of brainpower, it is quite unmatched.

Unlikely, for the next several years, it's not going to be uncompetitive. The wage increase is only marginal, and the productivity improvement that happens year after year compensates for the bulk of the increase that happens. To that extent, it's not a factor to worry about, at least for the next four to five years. Nasscom report (May 2004) predicts that within few years, there will be less supply of qualified human resource in India compared to the demand. Forrester (May 2004) says that by 2010, 3.3 million jobs will be created in IT and IT-related areas in India, That's a lot of people. This means many companies may not go after the top 1 per cent, and they would expand it to the top 5 per cent, for which, the educational institutions have to change and intensify the courses, and should be meritocracy-based. People who score good marks or are more intelligent do get into higher schools.

In search of talents

In order to get a comprehensive mix of capabilities and high talent, companies decided to look at outside universities as well. They went to Carnegie Mellon, Stanford, MIT, and Columbia for recruitment. These are all Ivy League schools that attract top talent. Earlier, people hesitated to come to India. A couple of years back, many Indian companies went to recruit but they were not interested in coming to India and spending some time here.

The beginning of 2003 was a turning point when the media turned their attention to off shoring in a big way. The visibility was very high and everybody was suddenly talking about India. There is a lot more that gets outsourced to China in terms of manufacturing than to India, but India got far greater share of that visibility. That's when people realised that there is so much happening in India, and wanted to be a part of it.

But when a company goes to these schools, ask for a GPA-based filtering of candidates, say a GPA of over 3.5 or 3.8, most of them are Indians. Indians somehow seem to have mastered the trade of how to get high GP A. So, companies had to do a different mix in order to make sure they have a good mix of people who have gone from India to study in the USA as well as the local people, and people from other countries.

Chennai, the BPO Hub

Offshore projects accounted for over 70 per cent of the total software exports of Tamil Nadu during 2003-4, according to Software Technology Parks of India, Chennai. Tamil Nadu's total IT exports stood at Rs. 7,621.50 crore (Rs. 7621 billion) during the last fiscal, including exports from STPI, MEPZ, and other units.

Chennai and its suburbs continued to be the major software exporting locations in the state. Exports from these locations stood at Rs. 7,557.64 crore (Rs. 75.58 billion), followed by Coimbatore region at Rs. 45.76 crore (Rs. 457.6 million), and Tiruchi at Rs. 13.42 crore (Rs. 134.2 million). Application software and system software accounted for 60 per cent of total exports, followed by consultancy services at 28 per cent, and ITES at 8 per cent. Tata Consultancy Services was the top exporter from Tamil Nadu, followed by Infosys Technologies, HCL Technologies, Cognizant Technology Solutions, Wipro, and Polaris Software. Tamil Nadu's hardware exports crossed Rs. 100 crore (Rs. 1 billion), and stood at Rs. 118.88 crore (Rs. 1.19 billion) in 2003.

(Source: Pune University, 2007. *International business Management* [Online] Available at: <<http://www.careerbricks.com/international-business-management-question-papers-pune-university>>. [Accessed 17 October 2011].)

Questions

1. To what extent does the theory of Comparative Advantage explain the rise of the Indian BPO industry?

Answers

The theory of Comparative Advantage is also known as the Classical theory of International Trade. According to this theory, each country would tend to produce those commodities that are best suited to its resources. This is the comparative advantage which means the special ability of the country in question to provide a particular commodity or service relatively cheaper than other commodities or services. Therefore, a country would concentrate on producing commodities and providing services in which it has special cost advantage and exchange them with the goods and service for which it is less suited as compared to other countries.

The theory of Comparative Advantage explains the rise of Indian BPO industry with respect to following important points.

- i. Growing talented IT recruits.
- ii. All the I.T work strength has been homogenous.
- iii. Growing tendency of global companies to outsource less important or back office work to low wage countries like India and China.
- iv. Competitive costs of Indian BPO companies for providing outsourcing services to their Global clients.
- v. Country like India has huge pool of talented human resources to satisfy the growing demand of outsourcing Industry.
- vi. The difference between Indian Rupee and Us dollar

2. To what extent does the Heckscher-Ohlin theory explain the rise of the Indian BPO industry?

Answers

The Heckscher-Ohlin theory states that a country will specialise in the production and export of those good (and/or services), whose production requires a relatively large amount of the factor with which the country is well endowed. Therefore, logically a country like India would export Labour intensive goods and a country like U.S.A will export Capital intensive goods. Thus the Heckscher Ohlin theory explains the rise of the Indian BPO industry with respect to following points.

- i. Technological knowledge between the two countries (India and USA) is the same.
- ii. Demand and preferences are also the same to some extent in both the countries.
- iii. Constant returns to scale.
- iv. No significant trade barriers between the two countries.
- v. Non- reversible factor intensities.
- vi. Perfect competition.
- vii. Full employment of Resources.
- viii. Perfect mobility of factors of production within each region.
- ix. The production function are the same in both the countries for the same goods and/ or services.

3. Use Michael Porter's diamond to analyse the rise of the Indian BPO industry. Does this analysis help explain the rise of this industry?

Answers

According to Micheal Porter., countries should be exporting products from those industries, where all the components of the diamond are favourable and importing those products, where all the components of the diamond are not favourable.

Indian's I.T. strength lies in its highly trained I.T.personnel; it must take advantage of this situation and satisfy the growing demand of I.T. and BPO industry across the globe. Indian I.T. personnel are like gems and Diamond of the country and India must capitalise on that.

Case Study II

Localisation of Global Companies: Korean Experience

Countries tend to be more concerned about large companies than small ones because of their greater potential impact on national economic and political objectives. But not all companies operation internationally is large. In fact, the number of new MNEs is growing at about 4,000 to 5,000 per year. These are generally smaller companies with smaller foreign investments. Generally, they have to do less to justify their entry and operations. Because they are assumed to have less impact on host societies, countries often treat their entries differently. Further, many LDC governments prefer the entry of smaller companies because they may be more willing to yield to host -country wishes, increase competition because of their numbers, and supply smaller-scale technology more suited to LDC needs.

Internationalisation is viewed as a process leading to the outcome of a competitive environment that in turn induces efficiency in production and optimality in resource allocation. A few economists refer to internationalisation as a surrogate to indicate the level of cross-border production by Multi-National Corporations (MNCs) and their network of affiliates, subcontractors and partners. Yet another viewpoint analyses the different dimensions of internationalisation ascribing the internationalisation of corporate strategies, in particular, their commitment to competition as well as the internationalisation of consumer and financial markets, the diminished role of national governments in designing the rules for international governance, and so on as a set of characteristics describing the different dimensions of the process.

Superior Performance from Indian Subsidiaries

In the past, it was the Indian subsidiaries of the MNEs who had to depend on their parent companies for financial support. Though, many of the Indian subsidiaries still do that, a new phenomenon is also gaining ground. Many of the Indian subsidiaries of major MNEs like ABB, LG, Samsung, Nestle, and Siemens, to name a few, are all beating their parent companies on the performance scale, and India is fast emerging as the growth engine for MNEs. Some of these Indian subsidiaries are even clocking double-digit growth even when their parent companies are recording losses.

Though the vast Indian market of billion plus population holds great opportunity for the consumer goods companies, this phenomenon is not restricted to that sector only. Indian subsidiaries for the MNEs in non consumer goods sectors such as engineering and pharmaceuticals are also showing the same phenomenon. Global sales for Siemens (Siemens AG) has decreased by 3.4 per cent in 2002 (total sale in 2003 was only \$83,784 million) while the Indian subsidiary of Siemens showed an increase in net sales by 13.8 per cent.

Changing Global Dynamics

With rapid globalisation, intensive competition and poor economic conditions prevailing in most economies, MNE's are always searching for ways to reduce costs to improve bottom line. As a result, we have seen a rise in outsourcing to India. Along with this - India's advantage of availability of low cost skilled labour, gained importance. On the flip side, with the opening up of the Indian economy, new opportunities arrived, which these companies have grabbed successfully.

International Business

At the same time, opening up of the Indian economy and moderately high growth rate have attracted new competitors. With increased competition, companies have to reassess their existing investments and business portfolio. Those businesses, where returns on investments were not high and were not contributing significantly to their overall profit, were sold or hived off. The restructuring has left the Indian subsidiaries in a better position to move ahead of competition.

Manufacturing Efficiencies

Production of goods and managing supply chain efficiently has also helped Indian subsidiaries of the MNEs to contribute more to their bottom line. Low manpower cost in manufacturing has helped the Indian subsidiaries very much. Siemens India benefited by shedding its excess workforce and reorganising its workforce has been able to reduce its costs. At the factory level, the company reorganised its workforce on the basis of employees ability to handle functions across one or more divisions. As a result, Siemens was able to maintain the same efficiency in terms of output level with 50 per cent fewer employees.

Hyundai India has the best-integrated manufacturing plant amongst the Indian subsidiaries of the MNEs. The efficiency of Hyundai India's operation at its Chennai plant has made the top management of its parent company in South Korea to send 2,000 managers and workers from its plant to Seoul to study Indian subsidiary's operations. Siemens has also reduced -its number of vendors from 20,000 to 2,000 with plans of further reducing them. Earlier the sheer number of vendors complicated the process of checking, ensuring quality, and delivery time. It has since then started grading its suppliers on several- parameters.

LG has followed kaizen in its Indian manufacturing plants, with the ultimate aim to achieve Six Sigma Quality. LG has also passed on the same work ethics to its suppliers.

Hyundai is planning to make Hyundai India as the global sourcing base for Santro. Siemens India is now also becoming increasingly significant contributor to Siemens AG. The outsourcing from Siemens India now contributes 21 per cent of its consolidated revenues. Cummins India now exports to China and Mexico.

Customer-Driven

While MNEs like Kellogg's failed to understand the Indian consumers, relentless focus towards the Indian consumers has enabled these companies to increase their sales, which has a positive impact on their revenues and profits. Localisation of products and knowing what the Indian consumers want worked well for the consumer goods companies. Samsung has learned this aspect quickly and that it is very important for them to live to the expectations of the Indian consumers to stay on in Indian market.

Samsung has washing machines with unique 'sari guard' and a memory restart feature that is ideally suited for India where there are frequent power cuts. LG has also launched TV s with Hindi and regional language menus.

Both Samsung and LG have launched TV sets with more than 800 watts 'of sound, compared to the normal 200 watts. This is a result of findings by both the companies that Indians like more volume on their TV sets because families often watch in noisy environment. With the end-consumers in mind, LG now offers products with unique technology. Its Plasma range air conditioners with their unique Gold Fin technology offer air-filtering benefit. For the lower-end market, where the consumers are price conscious, LG has launched low-priced TV such as Cine plus.

Nestle India launched a low priced (Rs 2) liquid chocolate, called Choc stick to cater to the price conscious customers. Hyundai Accent has a powerful engine and sleek interiors at an attractive price range. In Siemens' case, the company has introduced several programmes to seek, generate and monitor customer feedback, and improve response time. It even redesigned indirect sales channels.

One such customer related programme is the Key Account Management (KAM) concept. Earlier, a customer was being approached by people from two or more divisions of the company. In the KAM concept, one key executive is responsible for getting business from all divisions of that customer. The company also initiated a mystery caller competition, under which top Siemens executives acting as customers would call up executives of various centres at different times, even during lunch hours. These initiatives have resulted in an increase in the number of repeat orders, which resulted, in generating more revenues and profits.

Strategic Wonders

Formulating successful strategies and executing them efficiently played an important role behind these companies' profitability; be it in the entry level, manufacturing, marketing, branding and pricing. Some of these companies have also found huge success by entering the vast rural market.

Even though Hyundai entered the Indian market only in 1996, it was able to lead in all the three auto segments, namely B-segment, C-segment and D-segment, in which it competes. Hyundai's choice of the deluxe small car to enter the Indian auto market instead of a sedan was its brilliant strategic move. Hyundai had correctly read the gap in the Indian market in that segment. That success helped Hyundai to establish its brand among the Indian consumers and has allowed Hyundai's parent company to introduce more new cars in other segments in India.

Marketers of these companies have adopted different strategies for launching products. LG's strategy of promoting its premium models like Flatron helps the brand create an image of a high technology company. The company has positioned its products keeping in mind the health conscious attitude of Indians. Samsung's 'Digital All' campaign has worked in positioning Samsung as a company, which produces high technology products in the minds of the consumers. Hyundai has used the image of Shahrukh Khan in advertising its Santro, which was an instant hit among the Indian consumers.

(Source: Pune University, 2007. *International business Management* [Online] Available at: <<http://www.deepakpore.com/international-business-management-question-papers-pune-university>>. [Accessed 17 October 2011].)

Questions

1. Parent Corporation is looking at Indian subsidiary for improving their quality of corporate governance and enhancing profitability. Theory says the reverse will happen, i.e. spill over effect from the parent to the subsidiary. This is also considered as the greatest honour ever received for Indian corporates in the professional arena.
 - i. What are the factors that may result in higher profitability?
 - ii. What can be the impact of customer driven business practices in: Indian environment?
2. What are the measures that can be taken by the MNEs to improve their local image in India?
3. There is a growing concern about the opening up of retail sector in India. What is the significance of retail MNEs in national economy by looking at the experience of Korean MNEs in India?

Case Study III

International Marketing

General Motors

Seven months after taking over as President of General Motors Asia Pacific Frederick Henderson came for a visit to India and announced that his dream was to turn the world's biggest car manufacturer into the biggest car marketer in India.

GM. India is a very small player in India right now. It has a plant to produce 25,000 cars, but last fiscal sold only 8,473 cars. It seems to be stuck in the slow lane in India. In what will be a first in the Indian automotive industry, GM. Plans to use its 21-year-old global alliance with Suzuki, and a more recent one with Fiat to move into gear. What helps is that GM. owns 20% stake in both the companies. Combined in India, their purchasing will soar over Rs.6, 1 00 Cr a year, the dealership and service network will jump to 360, and make it an alliance with the widest range of passenger cars.

Apparently, the idea is to create an Indian version of the Global Alliance that the three already have. They can now develop new products, sale each other's cars in various market source components together and even enter into joint ventures. In India the alliance will form on the companies sharing each other's products, buying components together in order to cut both components and sourcing costs, working on the engines and transmissions together, and entering into cross branding agreements.

The Indian Automobile Industry is in for a big change. Under the new scheme of things, three players out of 12 players would, for all practical purposes, play the game as one. The Alliance could bring to India the World's largest car maker's vast portfolio of brands. And the volumes of Maruti will give the alliance the leeway with vendors to source components cheap and expand markets through Maruti's wide network.

Fiat can help Maruti with its quest for Diesel engines, for cars. GM. and Fiat auto plan to invest \$ 100 million at Fiat's Ranjangaon facility in order to produce new models and power trains. The equally owned joint venture, details of which are being worked out could also become a global source of power trains for small and mid-sized cars.

There is little reason to doubt the partnership rolling in India. The Asia-Pacific region is after all, the fastest growing car market.

Ravi Khanna, country President and M.D. Delphi Automotive Systems (INDIA), "Globally, the auto industry is now more agile as a result of consolidation. In India, circumstances may be peculiar or unique. But the pattern can be seen quite clearly.

(Source: MBA SEM III, *Business Policy and Strategic Management* [Online] Available at: <<http://www.docstoc.com/docs/10432294/301-BPSM>>. [Accessed 17 October 2011].)

Questions

1. Analyse the case from the Globalisation point of view.
2. What opportunities do you see for Indian companies in this alliance?
3. How do you think other MNC's in this market will/should react to this development?

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Self Assessment Answers

Chapter I

1. a
2. b
3. a
4. b
5. a
6. c
7. b
8. a
9. a
10. a

Chapter II

1. c
2. a
3. b
4. b
5. b
6. d
7. a
8. a
9. a
10. d

Chapter III

1. a
2. c
3. d
4. a
5. a
6. a
7. a
8. b
9. d
10. c

Chapter IV

1. a
2. a
3. d
4. c
5. d
6. a
7. b
8. a
9. a
10. a

Chapter V

1. a
2. a
3. b
4. c
5. a
6. b
7. a
8. a
9. a
10. a

Chapter VI

1. b
2. c
3. a
4. a
5. b
6. a
7. b
8. b
9. c
10. b

Chapter VII

1. b
2. b
3. c
4. d
5. a
6. a
7. c
8. a
9. a
10. c

Chapter VIII

1. c
2. c
3. b
4. c
5. c
6. a
7. d
8. a
9. a
10. a