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# **ASSIGNMENTS -5**

1. How do MNCs come into existence? What steps may an MNC follow in becoming global?

To begin with, MNCs (Multinational Corporation) is a company that operates in its home country, as well as in other countries around the world. It maintains a central office located in one country, which coordinates the management of all other offices such as administrative branches or factories.

It isn’t enough to call a company that exports its products to more than one country a multinational company. They need to maintain an operation in other countries and must make a foreign direct investment there.

From the above definition, we can have a look at some of the characteristics of a Multinational Corporation

Not all businesses can be called a multinational corporation. There are certain features that must be met for them to be named as such. The following are the characteristics of multinational corporations:

**1. Very high assets and turnover:** To become a multinational corporation, the business must be large and must own a huge amount of assets, both physical and financial. The company’s targets are so high that they are also able to make substantial profits.

**2. Network of branches:** Multinational companies keep production and marketing operations in different countries. In each country, the business oversees more than one office that functions through several branches and subsidiaries.

**3. Control:** In relation to the previous point, the management of the offices in other countries is controlled by one head office located in the home country. Therefore, the source of command is found in the home country.

**4. Continued growth:** Multinational corporations keep growing. Even as they operate in other countries, they strive to grow their economic size by constantly upgrading and even doing mergers and acquisitions.

**5. Sophisticated technology:** When a company goes global, they need to make sure that their investment will grow substantially. In order to do achieve substantial growth, they need to make use of capital-intensive technology, especially in their production and marketing.

**6. Right skills:** Multinational companies employ only the best managers who are capable of handling huge funds, using advanced technology, managing workers, and running a huge business entity.

**7. Forceful marketing and advertising:** One of the most effective survival strategies of multinational corporations is spending a huge amount of money on marketing and advertising. It is how they are able to sell every product or brand they make.

**8. Good quality products:** Because they use capital-intensive technology, they are able to produce top-of-the-line products.

Meanwhile from the features explained above, one can derive some reasons for being MNC as briefly stated below:-

* **Access to lower production costs:** It is a very common reason for companies to go global because if they set up production in other countries, especially in developing economies, they spend less on production costs. Though outsourcing is a way of doing this, setting up manufacturing plants in other countries may be even cheaper.
* **Proximity to target international markets:** It is beneficial to set up business in countries where the target market of a company is. It helps reduce transport costs, and it gives multinational corporations easier access to consumer feedback and information, as well as to consumer intelligence.
* **Avoidance of tariffs:** When a company produces or manufactures its products in another country where they sell them, they are exempted from import quotas and tariffs.

Therefore the most obvious reason for a MNC to go global is to seek international markets is to expand sales. Breaking it down, here are five benefits:

* Diversify your markets and customer base.
* Extend the sales life of current products. What’s already established here could be a hot new item elsewhere.
* Reduce dependence on current markets by spreading your risk.
* Counter seasonal fluctuations. If you sell a seasonal product, when it’s summer here, half the world is experiencing winter and vice versa.
* Learn how to compete and grow, and you may want to expand from market to market.

From the definition, features and some of the reasons put forward regarding MNCs, it normally takes a gradual process for a firm to exploit merits of globalization and to reduce the competitive threats by other firms. From this perspective, the gradual process shows a series of movements from low risk low return export based strategy to a higher return production based strategy.

More so the capital needed is low, meaning that risks are low and profits are immediate hence the opportunity to the exporting company to learn about demand conditions and financial system abroad.

In a different scenario, licensing has the merits of smaller investment requirement, faster market entry and lower financial risk meaning a lower revenue stream for the licensor.

As explained by Madura (2008), Comparative advantage theory says that when countries specializes or have expertise knowledge in one field than they don’t waste their resources or energy on research of other field, they share or trade with other countries to share their expertise field. They take advantage of their expertise knowledge and become a head in comparison with others. Labour force is skilled and lower in cost in India and China as compared to western countries. They can be transported or hired for the operations for other companies. Companies such as Intel, IBM, Wipro operate in different countries because to utilize their efficient resources. These companies are operating in India, having their call centers outsource sharing the expertise knowledge in the field of Information Technology as India produces a large amount of IT experts.

As stated by Madura (2008), there are some ways by which firms become multinational enterprises.

• International Trade

• Licensing

• Franchising

• Joint Ventures

• Acquisitions of existing operations

• Establishing new foreign subsidiaries

Conclusively, at last it can be said that, the role of MNC in developing itself and the nations are very important. It in one way helps to build and economy by various advantages. At the same time it can have different repercussions if not properly strategized.

However, not forgetting how MNCs come into existence, history of the multinational is linked with the history of colonialism. Many of the first multinationals were commissioned at the behest of European monarchs in order to conduct expeditions. Many of the colonies not held by Spain or Portugal were under the administration of some of the world's earliest multinationals. One of the first arose in 1660: The East India Company, founded by the British. It was headquartered in London, and took part in international trade and exploration, with trading posts in India. Other examples include the Swedish Africa Company, founded in 1649, and the Hudson's Bay Company, which was incorporated in the 17th century.

1. Compare licensing agreement with establishment of a subsidiary.

License provides the legal authority to engage in certain acts. Some licenses are required for the protection of the public. For example, a physician is licensed to assure professional competence and the owner of a bar and restaurant is licensed to prove moral fitness. Some licenses are designed to raise government revenue (e.g., automobile licenses) or to grant some other party permission to make use of land (e.g., land easement). In business, a license is the granting of permission to use a property right in a limited capacity, while still allowing the licensor to retain ownership. For example, under a licensing agreement a U.S. clothing manufacturer may allow a foreign producer to use its designs and specifications to make clothes.

For a license to exist, there must be a contract between two or more parties giving an explanation as to what property rights the licensor is agreeing to give up to the licensee. This agreement or contract is known as the licensing agreement. These agreements have been in existence since the first copyrights and patents were issued in the late 1700s.

The licensing agreement is a complex legal document that begins by identifying parties to the agreement, as well as the dates of the agreement. It specifies the subject matter to be licensed, including patents and trade secrets. Also specified are the provisions or rights of the license, such as whether it grants exclusive rights or is subject to other agreements. Any limitations, such as territorial and quantity restrictions, are also specified. A final section can specify duration, termination, and related provisions of the agreement.

As the majority or sole stockholder in the subsidiary, the parent corporation has a great deal of clout. Like any majority stockholder, it can vote to appoint or remove the subsidiary's board members and make major decisions about how the subsidiary operates. Still, the subsidiary is a corporation in its own right. That puts a brake on the parent corporation's influence and gives the subsidiary independence as well as responsibilities:

* The subsidiary's directors are responsible for managing the company.
* The directors must make decisions based on the best interests of the subsidiary, not the parent.
* The directors are subject to the same corporate laws and regulations as any board of directors.
* Subsidiary directors don't report to the parent board, except in the same way they'd report to a stockholder.

However, the parent company has the authority to replace the directors if it doesn't like their management decisions. Legally this is a better option than overruling or dictating to them.

A subsidiary company is a company owned and controlled by another company. The owning company is called a parent company or sometimes a holding company.

A subsidiary's parent company may be the sole owner or one of several owners. If a parent company or holding company owns 100% of another company, that company is called a "wholly owned subsidiary."

1. What risks does an international finance manager face?

Global financial management is the financial system of operations that determines the health and performance of the world economy. Even a small business owner needs to be conversant with global finance, especially if you do business internationally. Your marketing and investment strategies hinge on an understanding of the economics of the different regions where you have an interest.

* **Diverse Economic Environment**: Operating in a globalized environment means being answerable to different countries with different political environments and cultural norms, as well as trade procedures and tax conditions to comply with. In addition, the credit conditions may be totally different from what they are domestically. Anticipate day-to-day financial management challenges when operating internationally and devise ways to maintain healthy equilibrium within this economic framework to ensure your business's continued growth and survival.
* **Risk Management Challenges**: Risk management is a major challenge of global financial management. For example, if you're buying supplies or selling products overseas, your business may face the risk of high prices caused by inflation in emerging economies. Although vulnerability to financial crises in many emerging markets has been reduced significantly due to stronger balance sheets, better fiscal policies and more flexible exchange rate regimes, other factors still pose risks. Potential threats to energy supplies, imbalances in the world economy and other fiscal sustainability issues call for prudent financial planning and management of those risks that most affect your particular business.
* Political risk transpires when a country's government unexpectedly changes its policies, which now negatively affect the foreign company. These policy changes can include such things as trade barriers, which serve to limit or prevent international trade. Some governments will request additional funds or tariffs in exchange for the right to export items into their country. Tariffs and quotas are used to protect domestic producers from foreign competition. This also can have a huge effect on the profits of an organization because it either cuts revenues from the result of a tax on exports or restricts the amount of revenues that can be earned.
* The fast changes and challenges that took place in the economic environment in the last years broadened the role of financial managers. If their basic responsibilities were linked mainly to financial reporting, financial planning, capital budgeting, capital structure, nowadays a stronger strategic dimension defines the role of financial managers. In addition, an important role is given to the financial manager in communicating professionally not only to the investors but also to the board

1. Describe the different kinds of international financial flows.

International financial flows play a central role in the international monetary system, not just because they represent the necessary counterpart to trade flows. In good times, they channel savings to the countries and regions of the world where they are most productive. In crisis times, they have the potential to disrupt the domestic financial systems of the most vulnerable countries and therefore constitute a key factor affecting global financial stability. International financial flows also represent one of the corner stones of the contemporary “dilemmas” and “trilemmas” that link monetary policy, exchange rates and the capital account. Together with trade flows, international capital flows act as a powerful channel through which domestic shocks are transmitted across borders. Finally, the composition of international capital flows underlines the concept of “global liquidity”, which plays a central role in the international monetary system.

International investment or capital flows fall into four principal categories: commercial loans, official flows, foreign direct investment (FDI), and foreign portfolio investment (FPI).

After a decade of rapid growth, the international financial system is now plagued with extreme volatility and crisis. International financial flows have exploded during the 1990s as countries, particularly in the developing world, have bowed to the conventional wisdom that they should remove barriers to these flows. As a result, three major trends have emerged:

1. **Dominance of private capital**: As recently as 1990, financial flows into developing countries from public institutions (e.g., the World Bank) were larger than those from private sources (e.g., Citicorp); today private capital dwarfs the value of public lending. In 1994 and 1995, roughly three-quarters of the resource flows into the developing world were from the private sector; by 1996, private flows were over 85 percent of the total.
2. **Short-term portfolio flows**: Foreign direct investment remains the largest source of private financial flows, but short-term portfolio flows have grown at the fastest pace. Between 1990 and 1996, the movement of portfolio equity flows into the South surged from $3.2 billion to $45.7 billion as a number of debtor countries followed U.S., World Bank, and IMF advice (often in order to satisfy loan requirements) to open their stock markets to foreign investors and deregulate their financial markets. Even some countries not under IMF or World Bank programs bowed to pressure from inside and outside to liberalize their financial systems or be left behind in a dynamic global economy.
3. **Highly concentrated investment**: Despite the surge in private flows, the entire developing world is not awash in foreign capital. In fact, three-fourths of private investment goes to just 10 countries, often called the “emerging markets” because of their profitable trade and investment opportunities and prospects for economic growth. Meanwhile, the rest of the developing world has experienced not only reduced aid flows but also the inability to attract private capital in the form of loans for investment. Supporters of a deregulated global economy have heralded the capital influx as the developing world’s ticket to prosperity and a sign of sound economic management in the recipient countries. Critics have argued that the flood of capital into countries like Mexico, while fueling economic growth for a period of time, has done little to improve the lives of the majority of people. Moreover, they have argued that the flood of unregulated capital inflows has made countries vulnerable to economic instability caused by rapid capital flight.
4. Comment on the structure of balance of payments. What are the basic principles governing recording of the flows?

The Balance of Payments or BoP is a statement or record of all monetary and economic transactions made between a country and the rest of the world within a defined period (every quarter or year).

In a perfect scenario, the Balance of Payments (BoP) should be zero. That is, the money coming in and the money going out should balance out. But that doesn’t happen in most cases. A country’s BoP statement correctly indicates whether the country has a surplus or a deficit of funds. A BoP surplus indicates that a country’s exports are more than its imports. A BoP deficit, on the other hand, indicates that a country’s imports are more than exports. Both scenarios have short-term and long-term effects on the country’s economy.

Not all capital flows are alike, and there is evidence that the motivation for capital flows and their impact vary by the type of investment. Capital flows can be grouped into three broad categories: foreign direct investment, portfolio investment, and bank and other investment

**Foreign Direct Investment:** Foreign direct investment occurs when an investor, in many cases a firm rather than an individual, gains some control over the functioning of an enterprise in another country. This typically takes place through a direct purchase of a business enterprise or when the purchaser acquires more than 10 percent of the shares of the target asset.

**Portfolio Investment:** Portfolio investment occurs when investors purchase non-controlling interests in foreign companies or buy foreign corporate or government bonds, short-term securities, or notes. This type of investment accounted for almost half of world capital inflows in 2002.

**Bank Investment:** Bank investment is the third major type of capital flow. Bank-related international investment includes deposit holdings by foreigners and loans to foreign individuals, businesses, and governments. These investments, grouped with a few other miscellaneous types of investments, accounted for over one quarter of total international capital inflows in 2002. For emerging markets, the importance of these bank-related and other investment flows has declined dramatically in the past decade.

In BoP, there exist some components such as—current account, capital account, and financial account. As mentioned earlier, the BoP should be zero. The current account must balance with the combined capital and financial accounts.

**Current Account:** The current account monitors the flow of funds from goods and services trade (import and export) between countries. Now this includes money received or spent on manufactured goods and raw materials. It also includes revenue from tourism, transportation receipts, revenue from specialized services (medicine, law, engineering), and royalties from patents and copyrights. In addition, the current account includes revenue from stocks.

**Capital Account:** The capital account monitors the flow of international capital transactions. These transactions include the purchase or disposal of non-financial assets (for example, land) and non-produced assets. The capital account also includes money received from debt-forgiveness and gift taxes. In addition, the capital account records the flow of the financial assets by migrants leaving or entering a country and the transfer, sale, or purchase of fixed assets.

**Financial Account:** The financial account monitors the flow of funds pertaining to investments in businesses, real estate, and stocks. It also includes government-owned assets such as gold and Special Drawing Rights (SDRs) held with the International Monetary Fund (IMF). In addition, it includes foreign investments and assets held abroad by nationals. Similarly, the financial account includes a record of the assets owned by foreign nationals.

1. How can the trade deficit be reduced or eliminated? Give your arguments based on the elasticity approach,

Before we look at how trade deficit can be reduce using the elasticity approach, let us first define what a trade deficit is.

A trade deficit is an economic measure of international trade in which a country's imports exceed its exports. A trade deficit represents an outflow of domestic currency to foreign markets. It is also referred to as a negative balance of trade (BOT).

Trade Deficit = Total Value of Imports – Total Value of Exports

And in the US, the [Bureau of Economic Analysis](https://www.thebalance.com/bureau-of-economic-analysis-3305976) measures defines the trade deficit as goods and services produced in a [foreign country](https://www.thebalance.com/imports-definition-examples-effect-on-economy-3305851) and bought by U.S. residents. It includes all goods shipped to the U.S., even if they're produced by an American-owned company. If a product goes through U.S. Customs and is intended to be sold in America, it is considered an import.

Looking at the US trade deficit policy, the US runs a trade deficit, not because of bad trade deals, but because its citizens spend more than they earn and finance the difference with foreign credit. In 2016, the households, firms, and government in the US earned $18.6 trillion but spent $19.1 trillion on goods and services, resulting in a disparity of $500 billion.

And before we look at the ways of reducing trade deficit, let’s have a recap on the causes of trade deficit

* A trade deficit occurs when a country does not produce everything it needs and borrows from foreign states to pay for the imports. That's called the current account deficit.
* A trade deficit also occurs when companies manufacture in other countries. Raw materials for manufacturing that are shipped overseas to factories count as exports. The finished manufactured goods are counted as imports when they're shipped back to the country. The imports are subtracted from the country's gross domestic product even though the earnings may benefit the company's stock price, and the taxes may increase the country's revenue stream.

Since the deficit is about production and consumption, the tools that will be most effective in reducing it are those that impact how much US citizens, businesses, and governments save.

Three ways to reduce the trade deficit are:

1. **Consume less and save more.** If US households or the government reduce consumption (businesses save more than they spend), imports will drop and less borrowing from abroad will be needed to pay for consumption. This means that consumption taxes—like those that nearly all other countries in the world have—could help reduce the deficit, by discouraging consumption, increasing saving, and reducing the government deficit. In contrast, an unfunded tax cut, such as the one proposed by the administration, will expand the deficit because the government will be consuming more relative to its earnings.
2. **Depreciate the exchange rate.** Trade deficit reversals are typically driven by significant real exchange rate depreciation. A weaker dollar makes imports more expensive and exports cheaper and improves the trade balance. Given the dollar is the world's reserve currency, and still regarded as the safest for investors, it tends to run stronger than other currencies. But when foreign governments actively push the dollar up to maintain their surpluses, the United States could counteract intervention by selling dollars and buying foreign currencies.
3. **Tax capital inflows.** One of the reasons that the United States runs a trade deficit is because borrowing from abroad is cheap and easy. If it were more expensive, US citizens and the government would borrow less. A tax on (non–foreign direct investment) capital inflows that rises with the size of the inflow could reduce excessive borrowing for consumption and help close the government imbalance. While some worry that capital controls could distort asset prices and reduce investment, they could also curb excessive speculative investment, such as happened before the financial crisis.
4. Why are MNCs driving investments in South Asian Countries like Thailand, Malaysia and Indonesia?

MNCs driving investments in South Asian Countries like Thailand, Malaysia and Indonesia over the past four decades, foreign direct investment (FDI) has played a pivotal role in the rapid growth and structural transformation of Malaysia through export-oriented industrialization.

There is also a clear evidence that outflow of FDI from Malaysia has consistently surpassed inflow of FDI, a pattern not seen in the other major Southeast Asian countries. Hence there is no evidence that FDI in Malaysia is crowed out by an increasing flow of FDI into China.

MNCs are driving investments in South Asian because of the Strong markets make region the world's main driver of FDI growth. And the economic integration of Southeast Asia—which would turn a region with a population of estimate of 600 million and a nominal GDP of approximately $6.2 trillion into one of the world’s biggest and most dynamic emerging markets—has been an aspiration of forward-thinking regional leaders for nearly three decades.

In another scenario, the digital technologies already heavily influence the purchasing decisions of South East Asians Countries. Hence Southeast Asia remains an immensely diverse region economically. It includes highly developed economies such as Singapore, middle-income economies such as Malaysia and Thailand, rapidly developing economies such as Indonesia and the Philippines, and frontier markets such as Vietnam and Myanmar. The percentage of middle-class and affluent consumers (MACs), which is the key consuming class, likewise varies widely.

MNCs Countries also choose to pay relatively high wages for several possible reasons. For example, Dunning’s (1988, 1993) popular theory of the multinational corporation stresses the importance of ownership advantages as a determinant of a firm’s competitiveness in foreign markets. At the most basic level, ownership advantages influence a firm’s ability to overcome numerous cost disadvantages relative to local firms in host markets and become an MNC.

Financial institutions in Asia Pacific are now core service providers that complement finance with a focus on customers’ needs and services. The changes in the banking industry are due as much to its transformed approach to governance and its regional business approach as they are to internationalization.

Most innovative Asian Trailblazers in the banking industry have significantly expanded their customer bases in Asia Pacific by reaching the underserved and younger generations, coupling international expansion with technology, using new distribution channels and establishing strategic partnerships with retailers and telecommunication companies. Banks’ regional approach to their customer bases required them to take a Pan-Asian view to the design and deployment of products and services.

1. Why are China and India emerging as attractive centers of FDI in recent years?

Although the growing economic stature of China and India is widely recognized, the factors underlying their success are still not well understood. The advantage of a large low-wage workforce is apparent to everyone, but that can never be the foundation of an economic superpower. True economic leadership comes only with the ability to produce high-quality high-technology goods and services and to create innovative new products and technologies. To appreciate the long-term potential of China and India, we need to take a comprehensive look at their innovative capacity.

Innovation in China and India should be understood to include not just knowledge that is new to the world, but also knowledge that is new to these countries. It is important to consider this second dimension of innovation because it helps to understand why these economies are growing so fast and how rapidly they are likely to grow in the future.

China and India emerging as attractive centers of FDI due to several factors as explained below:

1. **Capital Availability:** In the early 2000s, China overtook the United States as the world's largest recipient of foreign capital. FDI is comprised of capital that an outside investor is willing to place (and risk) within a local region. Conditions in the global capital markets and general economic environment play a role in determining the flow of FDI into China.
2. **Competitiveness:** China's attractiveness as a destination for investment capital rests on its development of infrastructure, resource availability (physical and labor), productivity and workforce skills, and the development of the business value chain. The level of maturation of these elements can make China more attractive for FDI relative to other nations, such as India, that compete and vie for the same investment capital. A growing and developing economy requires infrastructure and resources in order to facilitate the sale of goods and services. Lower transaction costs, due to the maturation of these elements, enables investors to earn returns on their investments as their enterprises are able to generate profits
3. **Regulatory Environment:** When a national government enacts and enforces rules and policies aimed at favoring state entities at the expense of privately held firms, such an environment can be detrimental to initiatives that aim to attract FDI. As such, the regulatory environment can either encourage or impede foreign direct investment in China. Excessive regulations tend to hinder entrepreneurial and commercial activities, as managers and employees must spend more time and money to comply with rules and regulations.
4. **Stability:** Political and economic stability can facilitate an influx of FDI. Stability represents predictability and the opportunity for enterprises to gain better foresight into the future. Alternatively, constant social unrest, rioting, rebellions and social turmoil are settings not conducive to business. Economic instability can also contribute to hyperinflation, which can render the currency virtually obsolete. To encourage FDI, citizens/workers as well as businesses should have a reasonable basis for respecting Chinese law and order. Violence, criminal activity, blackmail, kidnappings, and counterfeit currency and products have all been problems in China that serve to undermine the efficacy of conducting trade activities. The justice system should also have effective mechanisms for reducing, or altogether eliminating, rogue and corrupt elements of law enforcement agencies.
5. **Openness to Regional and International Trade:** Market openness serves several important roles in attracting FDI. Of critical importance is a business' ability to sell its products and services to both local and foreign markets. If Chinese-based enterprises have limited or no access to foreign customers, particularly the United States, Western Europe, Japan, and others, then the local market may not be enough to warrant a significant investment in money and energy. Trade barriers such as tariffs are typically viewed as disincentives by other nations. An American product that is subject to high tariffs in China will be less in demand in the Chinese market due to the artificially inflated price.
6. What forces stimulate FDI in a country?

The growth of international production is mainly driven by economic and technological forces. It is also driven by the ongoing liberalization of Foreign Direct Investments (FDI) and trade policies. Foreign Direct Investments (FDI) refers to an international investment made by a resident entity in one economy (Direct Investor) with the objective of establishing a lasting interest in an enterprise.

Globalization offers exceptional opportunities for developing countries to achieve a rapid economic growth through trade and investment. FDI is considered as a major incentive to economic growth in developing countries, as it contributes to host country economic growth, by enhancing the country’s capital stock, introducing complementary inputs, inducing technology transfer and skill acquisition, or increasing competition among local industries. But only a few countries have been successful in attracting significant FDI inflows to their country owing to so many reasons.

FDI bring forth much needed resources to developing countries such as capital, technology, managerial skills, entrepreneurial skills, brands and access to new markets etc. These are essential for a developing country to industrialize, develop and create jobs attacking the poverty situation in their countries. As such most developing countries recognize the potential value of FDI and have liberalized their investment regimes and engaged in investment promotion.

FDI decisions depend on a variety of characteristics of the host economy as explained below:-

* **Size of the Market:** There can be seen a well well-known relationship between FDI and the size of the market and as well as with some of its characteristics (e.g. average income levels and growth rates). When the GDP of a country is relatively small, it is an indicator of low level of national income. As such investors prefer to invest in countries where there is a high growth potential and where there is a large market for their products and services.
* **Openness:** Even though the investors pay attention on the size and the growth of the market as important, all the other domestic market factors are predictably much less relevant in export oriented foreign firms. Wide spread insight is that open economies encourage more foreign investment. One indicator of openness is the relative size of the export sector.
* **Labour costs and productivity:** Labour cost is a significant factor for foreign investors specially when making their investments in labour intensive industries and for export oriented subsidiaries. (For an example opening up garment factories, export processing firms where larger number of employees is required) Low wage rates heavily stimulate investors to make their investment decisions in a particular country.
* **Political Risk:** High returns in the extractive industries seem to compensate for political instability. In general, as long as the foreign company is confident of being able to operate profitably without undue risk to its capital and personnel, it will continue to invest. Large companies overcome some of the political risks by investing in their own infrastructure maintenance and their own security forces. But these companies are restrained by small local markets and exchange rate risks since they tend to sell exclusively on the international market. If a country is vulnerable to a higher degree of riots, labour disputes, and corruption and if it possesses greater criminal level, those will be the determinants that restrain foreign investments.
* **Infrastructure Facilities:** Infrastructure covers many dimensions ranging from roads, ports, railways and telecommunication systems required to institutional development (e.g. Legal services, accounting etc.) The extent of transport facilities and the proximity to major ports has a significant positive effect on the location of FDI within the country. Poor infrastructure can be seen both as an obstacle and as well as an opportunity for foreign investment.
* **Incentives and operating conditions:** Removal of boundaries and provision of a healthy environment for businesses that consists of better operating conditions, lower tax rates or tax holidays are generally believed to have a positive impact on stimulating FDI. Further incentives such as the granting of equal treatment to foreign investors in relation to local counterparts and the opening up of new markets (e.g. air transport, retailing, banking) have been reported as important factors of encouraging FDI flows to a particular country.
* **Privatization:** Through privatization it has attracted some foreign investment inflows in recent years. But when moving on to most of the developing, low income countries progress is still low due to divestments of state assets. This has become political issue that demotivate investors. For an example employee resistance and their aggressive actions over privatization or other moves which threaten their existing jobs and worker rights may act as a deterring factor of FDI.

1. What is internationalization theory of FDI? Discuss strengths and weaknesses of the theory?

In business, internalization is a transaction conducted within a corporation rather than in the open market. Internalization also occurs in the investment world, when a brokerage firm fills a buy order for shares from its own inventory of shares instead of executing the trade using outside inventory.

Internalization theory explains the existence and functioning of the multinational enterprise. It contributes to understanding the boundaries of the MNE, its interface with the external environment and its internal organizational design. Much work in the international strategic-management sphere has unfortunately not taken on board internalization-theory thinking and lacks the insights provided by this comparative institutional approach.

In a different perceptive, internalization theory of multinational firms proposes that direct international investment occurs when a firm has information-related intangible assets with public good properties.

In short we can say that Internalization theory is a branch of economics that is used to analyses international business behavior.

These foreign direct investment strengths and weakness provide a foundation for the decision-making process. Every key point must be carefully considered before completing a transaction. That way, the best possible outcome can be achieved for everyone involved in the investment. The strengths and weakness of the theory are discussed as under:-

1. **Strengths:**

* **It provides local economic benefits in multiple locations.** The companies or individuals that participate in FDI can stimulate community economic growth on the local level for their headquarters or home. Profits are often reinvested into workers or increasing organizational opportunities, which can create new jobs, which then creates new FDI opportunities. The investments do the same for the home market of the foreign organization as well.
* **It makes international trade easier to complete.** Many countries have import tariffs that must be paid for goods and services. Import/Export businesses can struggle to keep products at affordable prices for customers because of these taxes. Through FDI, it becomes possible to limit or eliminate these tariffs since a minimum stake in a foreign organization occurs. That gives the local business more control over the market while maintaining price competition.
* **Foreign income can increase.** Many foreign markets have employees working at wages that would be considered poverty wages in the United States. A majority of the world earns less than $4 per hour. Some international markets offer less than $1 per hour. With FDI, foreign income levels can increase. Worker wages increase. That creates new resources that can help communities to begin growing.
* **It improves human resources.** Businesses are successful because humans have expertise. In the under-developed and developing world, human skills are limited to basic labor, agricultural work, and other entry-level skills. Foreign direct investment creates educational opportunities so that people can improve their personal skill base. With better skills, higher wages can be earned. Greater productivity levels are achieved. The company benefits, as does the individual, and that trickles down to each community.
* **It allows your money to work harder for you.** To encourage FDI, many governments have placed tax incentives on this type of investment. That makes more money available to work for a foreign company without disrupting the investing agency’s budget dramatically. These incentives make it easier to accomplish goals because the money involved can be directed toward resources instead of government coffers. At the same time, the gap between cost and revenue is reduced, providing more opportunities to find profit streams.
* **It provides a foreign company with needed experience.** Investors bring more than money to an FDI relationship. They can also bring their personal experiences within a specific industry. For the foreign company, such an investment can create an immediate surge in productivity. Investments can also provide better facilities for the foreign organization, better equipment assets, and improved vendor access if contact access from the investor is permitted in the relationship.
* **It creates new opportunities for workers.** Workers who are employed by the investing company can travel overseas and experience new cultures and ideas. That can make them more productive at home. Foreign workers have better access to the best practices that have been developed, which helps them to create new opportunities as well. This process helps both parties grow faster than if they were on their own.

### Weakness of Foreign Direct Investment

* + **It stops domestic investments from happening.** A 10% minimum investment into a foreign company is money that isn’t going into domestic companies. Although money comes back into local communities with FDI, a local investment’s value is almost another $1 for every dollar spent. That means a $10,000 domestic investment could be worth $20,000 or more in the future.
  + **It isn’t without risk.** Political instability around the world means that the business environment can change at a moment’s notice. Although companies and individuals choose foreign organizations that have little risk, there can never be a complete elimination of risk from the transaction. In some countries, the political risk factors could be so high that a foreign direct investment doesn’t make sense.
  + **It can be more expensive.** In the United States, the dollar is one of the strongest currencies in the world. For an investment into the developing world, the value of the currency can be stretched further than it would be domestically. That isn’t always the case, however, because the euro and the pound trade higher than the dollar. Investing into one of those markets through FDI would actually have higher costs for the individual or business compared to a domestic investment.
  + **It can affect currency exchange rates.** A developing country with a struggling currency may see a surge of popularity after a foreign direct investment. People and companies see an investment as a sign of stability, creating additional interest in the market being examined. That higher level of interest can lead to a better monetary value for the foreign nation, which may destabilize exchange rates.
  + **It can lead to exploitation.** Exploitation of FDI can happen on a number of levels. A foreign government might choose to seize the investment. Assets or proprietary information might be seized for political purposes. The foreign company might take the investment and squander it. Even if there is a well-constructed contract governing the terms and conditions of the investment, some foreign companies may decide to take the money and run. That can leave an investor with few, if any, options to recover their funds.

In conclusions, the theory of internalization does provide an explanation of certain types of FDI activities by MNEs. In particular, there are three areas where internalization appears to provide an explanation of FDI as a specific form of international involvement by the MNE: these entail vertical integration, transfer pricing and quality control.

1. Gold standard provided domestic price stability and automatic adjustment in balance of payments and in exchange rate. Discuss.

To begin with; we need to understand what Gold standard is all about. A gold standard is a monetary system in which the standard economic unit of account is based on a fixed quantity of gold. Three types can be distinguished: specie, bullion, and exchange.

In the gold specie standard the monetary unit is associated with the value of circulating gold coins, or the monetary unit has the value of a certain circulating gold coin, but other coins may be made of less valuable metal.

The gold bullion standard is a system in which gold coins do not circulate, but the authorities agree to sell gold bullion on demand at a fixed price in exchange for the circulating currency.

Under flexible (or floating) exchange rates, the disequilibrium in the balance of payments is automatically solved by the forces of demand and supply for foreign exchange. An exchange rate is the price of a currency which is determined, like any other commodity, by demand and supply.

We can further have a look at the basic features of the gold standard as stated below:

* + - The monetary unit is defined in terms of certain weight and fineness of gold.
    - All gold coins are held as standard coins and considered unlimited legal tender.
    - All other types of money (paper money or token money) are freely convertible into gold or equivalent of gold.
    - There is unlimited coinage of gold at no cost.
    - There is free and unlimited melting of gold.
    - Import and export of gold is freely allowed.
    - The monetary authority is under permanent obligation to buy and sell gold at the fixed price without limit.

From the above features of Gold Standards, let have a brief discussion on the Functions of Gold Standard:

The Gold standard performs two important functions:

**1. To Regulate the Volume of Currency:** Internally, gold standard forms the basis of the currency and acts as a regulator of the volume of currency in the country. This function is called the domestic aspect of the gold standard since it is concerned with stabilising the internal value of the currency. Under gold standard, currency notes are exchangeable on demand for gold of equivalent value.

Thus, note issue is fully backed by gold reserves and the growth of fiduciary note issue (without gold backing) is checked. Moreover, since the amount of cash in the country is limited by the gold reserve held by the central bank and there must be a cash basis for credit creation, the capacity of the banks to create credit is also limited by the gold reserve. Thus under gold standard, total currency of the country is regulated by its gold reserves.

**2. To Maintain the Stability of Exchange Rate:** Externally, gold standard aims at regulating and stabilising the exchange rate between the gold standard countries. This function is called the international aspect of the gold standard because it is concerned with stabilising the external value of the currency. Under gold standard, every member country fixes the value of its currency in terms of certain weight of gold given purity.

Moreover, there is an undertaking given by each country’s monetary authority to purchase or sell gold in unlimited quantity at the officially fixed price. Under these conditions, a stable relation exists between the money units of different gold standard countries and free movement of gold helps in maintaining the stability of exchange rates.

Thus, under gold standard, a gold reserve is maintained for two purposes:

**(a) As backing for note issue; and**

**(b) To cover a deficit in the balance of payments and thus to maintain the stability of exchange rate.**

While distinguishing between the two aspects or functions of gold standard, Crowther writes- “The cardinal point in the Domestic Gold Standard is clearly the proportion of volume enforced by the law between the gold reserves and the currency. The essence of the International Gold Standard is the convertibility of the currency into gold- that is the fixed proportion of value between a unit of gold and a unit of currency.”

The analysis of gold standard is based on the following assumptions:

1. There are two countries Britain and U.S.

2. Both are on flexible exchange rate system.

3. BOP disequilibrium is automatically adjusted by changes in exchange rates.

4. Prices are flexible in both the countries.

5. There is free trade between the two countries.

1. Mention the features of the fixed parity system of exchange rate. What were the causes behind its collapse?

A fixed exchange rate is a regime applied by a government or central bank ties the country's currency official exchange rate to another country's currency or the price of gold. The purpose of a fixed exchange rate system is to keep a currency's value within a narrow band.

Though fixed rates provide greater certainty for exporters and importers, the causes behind its collapse were due to the following reasons:-

* The need for a fixed exchange rate regime is challenged by the emergence of sophisticated derivatives and financial tools in recent years, which allow firms to hedge exchange rate fluctuations
* The announced exchange rate may not coincide with the market equilibrium exchange rate, thus leading to excess demand or excess supply
* The central bank needs to hold stocks of both foreign and domestic currencies at all times in order to adjust and maintain exchange rates and absorb the excess demand or supply
* Fixed exchange rate does not allow for automatic correction of imbalances in the nation's balance of payments since the currency cannot appreciate/depreciate as dictated by the market
* It fails to identify the degree of comparative advantage or disadvantage of the nation and may lead to inefficient allocation of resources throughout the world
* There exists the possibility of policy delays and mistakes in achieving external balance
* The cost of government intervention is imposed upon the foreign exchange market
* Does not work well in countries with dissimilar economies and thus dissimilar economic shocks

However the collapse of the system of fixed exchange rates was one of the most accurately and generally predicted of major economic events.

1. Do you agree that fixed exchange rate is better than floating rates? Explain.

A floating exchange rate is one in which the market sets the price for the currency. A fixed exchange rate is one where the rate is fixed (obviously), usually by the government that controls the currency.

The benefit of a floating-rate currency is that it can act as a “shock absorber” to adjust imbalances. So for example if a country is importing a lot more than it is exporting, the currency is likely to depreciate (weaken). This will make imports more expensive and exports more competitive. The country should in theory import less and export more, and its trade should come back into balance.

Similarly, if a country has a high inflation rate, the currency is likely to depreciate, which will keep its exports competitive.

The problem is that sometimes the market sets a rate for a currency that the government doesn’t like. Many emerging market (EM) countries for example want to have a cheap currency so that they can promote exports over imports. This is one way to spur development in their country. They might therefore try to fix the rate of the currency at a cheaper level than what the market would set.

On the other hand, some countries (like Venezuela) try to fix their currency at an overvalued level, whether out of national pride or in order to enable the country to import essential goods. They then need to have a system of rationing the availability of foreign exchange, since obviously everyone will want to get their hands on it (imagine if you could buy a euro for $0.25.) This gives the government great power to reward & enrich its friends by enabling them to buy foreign exchange at the official (cheap) price. It’s why when I visited Ghana in 1982; they were importing sugar cubes from France even though they could grow their own sugar! The supermarket owners had access to foreign exchange, but the farmers didn’t. So the supermarket owners could get the money to import sugar cubes, but the farmers couldn’t get the foreign exchange to buy parts to repair their tractors.

Furthermore, with a floating currency sometimes foreign investors will pile into financial assets in a country (like Brazil). That will push up the value of the currency and make it difficult to carry on businesses, as imports become cheap relative to domestically produced goods. Then businesses will shut down. When foreigners then take their money out of the country, the value of the currency collapses. Now the country neither has its own manufacturing base nor can it afford imports. Trouble!

Hong Kong’s currency is pegged to the dollar. That means its interest rates are determined by the Fed, even though its economic conditions are more determined by the health of China’s economy. This can make for some seriously out-of-synch monetary policy, which can cause a big bubble in real estate.

So there are advantages and disadvantages to both systems. After the Asia Crisis in 1997, Malaysia pegged its currency. The IMF and other bodies roundly criticized it for this distortion, backing away from free-market principles, etc., but in fact Malaysia recovered faster than many other countries in the region.

You can look at the current problems of the Eurozone as problems of a fixed exchange rate system. In fact, the whole Greek debt crisis etc. was a currency crises masquerading as a bond market crisis. If Greece had its own currency, the crisis never would have occurred, or at least not in the form it did. The drachma would have fallen and that would have resolved much of the problems.

Many countries now operate what’s called a “dirty float.” That is, their currency floats within limits set by the government. That seems to be an effective half-way house between the two.

1. **What do you mean by SDRs? How do they help improve international liquidity?**

Before we proceed, we need to understand what these SDRs and International liquidity are.

An SDR stands for Special Drawings Rights (SDR) and it simply refers to a low cost way of adding to members' international reserves, allowing members to reduce their reliance on more expensive domestic or external debt for building reserves.

In other words, SDRs are supplementary foreign-exchange reserve assets defined and maintained by the International Monetary Fund (IMF). The SDR is the unit of account for the IMF, and is not a currency. SDRs instead represent a claim to currency held by IMF member countries for which they may be exchanged.

Meanwhile International liquidity is defined as the aggregate stock of internally acceptable assets held by the central bank to settle a deficit in a country’s balance of payments. In other words, international liquidity provides a measure of a country’s ability to finance its deficit in balance of payments without resorting to adjustment measures. Shortage of liquidity hampers the expansion of global trade and its surplus leads to global inflationary pressures.

International liquidity is generally used as a synonym for international reserves. Such reserves include a country’s official gold stock holdings, its convertible foreign currencies, SDRs, and its net reserve position in the IMF.

This definition implies international availability of liquidity and the possibility of obtaining credit from financial institutions operating in international financial markets. Thus, in the broader sense, international liquidity includes private as well as official holdings of international liquidity assets.

The following points highlight some of the measures to improve the problem of international liquidity.

* **Measure#1. Gold Tranche policy**: This policy came in force in, 1952 with the help of IMF under which the people can draw the funds at their own account to the extent of the gold tranche position with the Fund. This is called Unconditional Liquidity. At the same, there is another Credit-Tranche which is called as Conditional Liquidity. For the type of loan, the member will have to fulfill certain conditions imposed by the Fund.
* **Measure#2. Raising the official price of Gold**: This proposal was presented by Charles De Gaulle. He suggested that raising official price of gold is necessary to solve the problem of international liquidity. The volume of liquidity would increase with the raising official price of gold.
* **Measure# 3. Standby Credit Scheme:** The fund has organized a standby agreement in order to promote drawing facilities in 1952. Under this scheme, the members are permitted to draw the limit; they need foreign exchange from the fund within a specified period without further application of the fund.
* **Measure#4. Special oil facility**: There was another scheme named special oil facility presented by IMF in 1974 to finance loans to the non-oil developing countries to meet their deficit of oil imports from the OPEC countries from 3 years to 7 years. This facility proved to be helpful for the improvement of non-oil developing countries but unfortunately it came to an end in 1976 against the protest from developing countries.
* **Measure#5. Subsidy Account:** The IMF established a subsidy account to assist the most seriously affected members to meet the cost of using resources made available through the oil facility.
* **Measure#6.** Compensatory Financing of Export Fluctuations scheme: This scheme was devised by IMF in 1963, under this scheme IMF offers borrowing facilities to its member countries to meet their deficits in the balance of payment arising from the fluctuations in exports earnings beyond their control.

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