


FIFTH EDITION

MANAGER IN THE INTER- NATIONAL ECONOMY



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RAYMOND VERNON
LOUIS T. WELLS, JR.

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MANAGER

IN

THE INTERNATIONAL

ECONOMY

RAYMOND VERNON

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Preface

This is the fifth edition of a book that is intended to introduce the reader to a manager's perspective in the fields of international payments, international trade, and international investment.

The international economic environment, as the reader hardly needs to be told, has changed profoundly over the past ten years. Old institutions have been swept away; old assumptions have been altered. We were determined to try to capture some of the dimensions of that shift in the present edition.

Another factor of importance has shaped this edition. In the past decade or two, scholars at Harvard and other institutions have done exhaustive studies of the operations of the multinational enterprise, or multinational corporation, or transnational enterprise. In that period of intensive study, a stream of materials and concepts has emerged that illuminates the strategies, structures, practices, and effects of such enterprises. This edition tries to capture these concepts in textbook form.

Although we have borrowed frequently from the concepts of economic theory, this book is different in both purpose and content from a standard textbook in international economics. Such texts must discharge an obligation that this book has not assumed; here we must face some issues that standard texts can quite properly disregard.

Any discipline such as economics is concerned with the development of a system of mutually consistent and interrelated principles that, in the aggregate, "explain" a field. A textbook in a given discipline has the task of presenting the principles that make up the discipline. However, many of the propositions that are indispensable to fill out the rational structure of the discipline have no obvious relevance for understanding the international environment or for analyzing the problems encountered in it. Accordingly, we have chosen the

uninhibited course of presenting principles and concepts from the economic discipline (and other disciplines, for that matter) when we thought the ideas useful, while disregarding the contributions of the disciplines when we thought them irrelevant in this context. For instance, our use of trade theory and monetary theory in the explanation of international economic behavior is balanced quite differently from the presentation in standard textbooks.

Of course, many of the problems in the international economy can derive little help from the familiar precepts of the disciplines. As a rule, the problems encountered in the international economy are shrouded in uncertainty and risk, and the disciplines are still in their infancy in the development of propositions in which uncertainty and risk are involved. At other times, as in the case of problems involving foreign exchange risk, the coupling of propositions from various disciplines, such as economics and political science, is required in ways that may not be satisfying to either. Accordingly, we have not hesitated to stray beyond the solid structure of the disciplines whenever we thought that something systematic might usefully be said bearing on the problems of enterprises in the international economy.

Most textbooks come very close to being stolen intellectual goods. Proper acknowledgments for the contributions that go into the making of a textbook, therefore, present a real problem for any author. The situation could hardly be otherwise. The job of a textbook is largely to present the current state of the art. Few scholars individually can do much more than add a few insights, a few clarifications, to a body of ideas already formulated by the culture that spawned them. Inevitably, that is the character of this book.

A word on authorship. This edition, as the names on the cover attest, is the work of two authors. The general strategy and content of the present edition represented a joint effort of the authors. Wells was principally responsible for Chapters 3, 5, 6, 7, and 12, while Vernon was principally responsible for the rest. Ya-Shung Huang performed admirably as research assistant in the development of this edition. Andree Brown and Valerie Grasso, exploiting word processors to their limits, helped us meet difficult deadlines.

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Strategies of the firm in international business

This book is for the reader who expects to be involved, one way or the other, in the conduct of international business. If the reader is like most of those who have used this book in the past, he or she will already know something about the concepts and tools of finance, marketing, production, and organization, and something about the interaction between the strategy of the firm and the characteristics of its environment. But the odds are that the reader will feel most at home with these ideas as applied in a single national economy, not in a world made up of many economies.

The object of this book is to add the international dimension: to present the institutions, forces, and problems that are involved when business managers try to operate in many economies at once, and to sort out the threats and promises that develop when they try to link their operations across national boundaries. Because the viewpoint is that of the manager, it begins with the firm itself as it looks outward at the international economy.

Of course, the transactions that take place across the borders of any country affect every part of that country's economy, not just the transacting firms. The pervasive impact of changes in the international oil market over the past decade illustrates the point well enough. But some kinds of enterprises are much more caught up than others in the dangers and opportunities that arise from developments that lie outside the home economy.

THE MULTINATIONAL ENTERPRISES

What they are. The "multinational enterprises" of the world (or multinational corporations or transnational enterprises) are especially exposed in this respect. In the course of the past few decades most of the large enter-

prises of the world, whether engaged in manufacturing, mining, banking, or services, have come to fall in this category. Such enterprises are characteristically made up of a parent firm located in one country and a cluster of affiliated firms located in a number of other countries. Enterprises of this sort commonly operate in such a way that the affiliated firms, although in different countries, nevertheless share the following characteristics:

1. They are linked by ties of common ownership.
2. They draw on a common pool of resources, such as money and credit, information and systems, and trade names and patents.
3. They respond to some common strategy.

About one-half of the industrial output of the non-communist world today is produced by firms that have developed a multinational structure. These enterprises have some special problems that arise from their being multinational. But they also face the problems and opportunities of any importer or exporter, or any lender or borrower who deals across national boundaries. Accordingly, from the viewpoint of the manager who is interested in the international economy, our focus on the multinational enterprise does not narrow the book's approach.

Although multinational enterprises have come to account for a large part of the non-communist world's total output, they still consist of a very distinctive group of firms. By and large, international business is the game of big enterprises. Practically all the four or five hundred biggest enterprises in the world have substantial business interests in the form of operating units located outside their own country. Ford Motor Company, for instance, has 39 percent of its employees outside the United States; N. V. Philips of the Netherlands, 79 percent of its employees outside the home country; Imperial Chemical Industries, 43 percent outside Britain; and Matsushita Electric, 37 percent outside Japan. In the past few years, the largest firms of Brazil, Mexico, and other industrializing countries have begun to take on signs of a similar trend.

Firms that have developed a multinational structure not only tend to be large; they also tend to be engaged in certain kinds of business activities. The manufacturing industries as a group account for more of these enterprises than any other category. According to almost any measure—including capital invested, number of employees, or number of firms involved—multinational enterprises in manufacturing exceed those in oil, banking, mining, or agriculture.

Within the manufacturing sector, the multinational enterprise is especially strong in certain kinds of industries. In practically all countries, multinational enterprises have a dominant position in motor vehicles, chemical products, petroleum refining, drugs, electronic products, and food products. Some firms from developing countries such as Brazil and India, however, have sometimes managed to create multinational networks in less complex industries, for instance, textiles and food preparations.

Why they exist. Why have so many enterprises developed a multinational network in the past few decades? Managing a multinational network obviously entails special difficulties and generates special costs. Managers must set up costly systems of command and control, must expose their enterprises to the hazards of investing in foreign currencies, and must risk the possibility of being discriminated against as foreign investors. Yet the fact that multinational enterprises have managed to expand so rapidly suggests that managers see some advantages in developing a multinational structure. Academics and managers are fairly well agreed on the nature of the advantages that managers are looking for. In very brief form, those advantages are commonly described as follows:

1. **Creating an internal market.** The various affiliates of the multinational enterprise create an internal market in which the enterprise can exploit some of its most valuable capabilities—notably, specialized management skills, unique marketing skills, technology, patents, and trademarks—with results that are more favorable than would come from licensing or selling these capabilities.

2. **Achieving the advantages of scale.** Although size is not always an advantage for the firm, size does prove to be an advantage for some firms in some circumstances.

3. **Reducing risk.** Managers often develop a multinational structure either (a) to achieve diversification of sources or markets or (b) to reduce a threat that is perceived to have been created by a rival's establishment of an affiliate in a new location.

4. **Developing a global perspective.** The enterprise that has an efficient means of collecting and interpreting information from all parts of the globe often has an advantage over rivals. The firm sometimes improves that capability by developing a multinational structure.

MULTINATIONALS AS INTERNAL MARKETS

Any firm with special managerial skills, technology, patents, or trademarks that wishes to exploit these capabilities in foreign markets theoretically has the option of (a) incorporating its capabilities in a product or service for export to those foreign markets, (b) selling or licensing those capabilities to an independent firm so that it can produce and sell the product or service in such foreign markets, or (c) setting up a foreign subsidiary to produce in the foreign market. The relative virtues of those various courses of action differ from one case to the next, responding to some fairly systematic factors.

Exploiting a technological lead. To observe some of the factors that determine which course is to be preferred, consider the firm whose special capability is embodied in a technological lead. There is a strong likelihood that such a firm will have various contacts with foreign markets outside the home

base. In some cases, as in the aeronautical industry, the contact with foreign markets will take the form of exports; for instance, Boeing, Aerospatiale, and McDonnell Douglas depend on exports to a much greater degree than most manufacturing firms. In the chemical, drug, scientific instruments, transportation equipment, and machinery industries exports also are comparatively heavy. To facilitate their exports, firms commonly appoint agents or develop sales subsidiaries in the foreign markets.

The linkage between technological leadership and foreign markets can be seen not only for firms based in the United States but also for those based in Europe and Japan. And behind the linkage lies an obvious set of causes.

Since the beginning of modern industry over one hundred years ago, a good deal of the research and development undertaken by industrial firms has typically resulted in new products. The emphasis on new products has been especially typical of the research and development efforts of firms in the United States, whose expenditures on research and development are responsible for almost half of the industrial research and development expenditures in the non-communist world. Some of these products, such as drip-dry shirts, simply perform a familiar job for the consumer better than the existing product. Others, such as computer-controlled machine tools, help the producer perform his tasks more efficiently. But many, such as penicillin and commercial aircraft, were not in serious competition with any existing products at the time of their introduction and could be regarded as satisfying wants that were never previously addressed.

The location of a firm will strongly influence the firm's propensity to innovate and the direction in which it is likely to innovate. In order for substantial industrial innovations to take place in a country, a body of trained engineers and interested business managers must exist. But that is not quite enough. Business managers and engineers need an incentive to innovate: the hope of gain or the fear of loss must be strong enough to justify the effort. In some national environments, where the position of individual firms is rendered fairly secure by agreements with potential competitors or by government controls, the motivation to innovate may be quite low; in other environments it will be higher.

Where the capacity and incentive to innovate are strong enough, innovators are likely to concentrate on those products that seem most wanted in the national environment, in which the innovators operate. To be sure, all countries welcome new products or processes that will reduce their production costs. But in a country where, say, skilled labor is exceedingly scarce and dear while capital is abundant and cheap, business managers and engineers are likely to concentrate on labor-saving devices. In countries where labor is the abundant resource and raw materials are scarce, the innovations that capture the interest of business managers and engineers tend to be material saving. Moreover, countries with high per capita incomes offer opportunities for the sale of new products or services that have not been seen before, whereas countries

with low per capita incomes offer unique opportunities for the adaptation of existing products to lower-priced versions.

There are other variables that influence the propensity for industrial innovation in any economy and the direction those efforts take. Countries in which the military buy large quantities of hardware from their producers generate one kind of market; and countries in which the government buys large quantities of medicines, quite another. In big countries, the presence of a large internal market induces innovations that are associated with economies of scale; in small countries, that kind of innovation may be less likely. And so on.

Once a firm establishes a technological lead in some product, it will be faced with the question of how best to exploit the lead. Sometimes, as in the case of the Boeing 757 or the Airbus A-310, exploitation in foreign markets can be achieved well enough through exports. A buyer of a Boeing 757 who is located in Melbourne does not think of the aircraft as less available or less attractive simply because it is designed and produced in Seattle. Besides, at the early stage of any product's development, managers are not acutely concerned with questions of production cost. For various reasons, their attention at that stage is on other factors:

1. The lines separating the development stage, the pilot-plant stage, and the first commercial production stage for a new product are often not clean-cut. In these early stages, the manager is likely to be most concerned with maintaining effective communication among the key development engineers, production specialists, controllers, sales people, and prospective first users of the product. If the product proves successful, the manager is likely to produce the first units of the new product at the site where the development occurred. More than any other factor, this explains the U.S. automobile industry's early location in Detroit and the chemical industry's early location in New Jersey.

2. Even if managers could take their choice of locations, they would have great difficulty in determining the least-cost points of production and distribution. Products that are in their infancy often come in a variety of experimental shapes, sizes, and materials; witness the consumer electronics market of the 1980s. Moreover, they cater to markets whose ultimate size and geographical bounds cannot be determined.

3. Besides, at these early stages, the character of the demand and of the competition is such that the pressure on the manager to minimize production and distribution costs is not likely to be great. In new products such as videotapes and laser-aiming devices, the number of competing producers is small, at least at first. Besides, the earliest customers as a rule are not very sensitive to small variations in price; at that stage, in economic jargon, the product is not very price elastic.

In time, however, the manager is forced to worry about costs again. The reasons for the increased worry are various:

1. As the product matures, it begins to assume characteristics that permit easier comparison from one producer to the next. Automobiles, for instance, took some time before they eventually settled down to a four-wheel vehicle with a steering wheel and a gasoline engine.

2. As the product matures, the original producer's special knowledge and special skills, whatever they may be, are shared with others at home and abroad. The threat of price competition becomes more tangible.

3. As the demand for the product grows, the later users are generally found placing much more weight on questions of price than the first users. In economic terms, the price elasticity of demand of the later users is higher than for the original users. Moreover, differences in price between brands—cross-elasticities—generally matter more with these later users.

4. As total demand grows and as the volume of sales in some foreign markets increases, the possibility of producing from foreign plant locations grows. In these later stages, a formal analysis to determine least-cost production points is more likely to suggest the establishment of foreign production sites than it would in the earlier stages. The timing, of course, depends partly on the importance of (a) scale economies in production and (b) transportation costs for the plant's inbound and outbound freight.

5. As the product matures, importing countries may begin to ask if there are ways of encouraging local production to take the place of imports. Import restrictions sometimes develop at this stage. Some are overt restrictions, such as tariffs and import-licensing requirements. Others are more subtle restrictions, stemming out of "buy-at-home" policies on the part of government agencies or regulations that require some minimum domestic content as in assembled automobiles.

If exports are no longer possible or desirable, the firm still must decide between licensing the production of its product to an independent firm located in the foreign market or exploiting its innovational lead through a foreign subsidiary of its own. In terms of the internalization hypothesis summarized earlier, this is the point at which the firm must determine if an efficient market exists in which it can sell or license its technology, patents, and trade names at a favorable price. Such a license may provide for a flow of unpatented technical information to the licensee; it may grant patent rights to the licensee covering specified countries; it may authorize the licensee to use the licensor's trade name in given markets; and it may make provision to supply some exotic line of machinery or industrial supplies. In return, the licensee will be obliged to make various payments to the licensor, typically on the order of 3 or 4 percent of its gross sales. The licensee may also be obliged to take on various commitments to the licensor, such as confining its sales to certain markets or buying its intermediate products from the licensor.

But the market for such licenses may prove quite imperfect. Perhaps the most important reason applies to the sale of any hitherto undisclosed technology: The buyer cannot tell if the technology being offered is worth the price

until after the purchase has been completed and the technology has been applied; accordingly, the buyer has a poor basis for proposing a price. That basic problem is exacerbated by the fact that it is often very difficult to communicate subtle and complex technologies successfully from one firm to the next, especially if the recipient is an independent firm operating in another culture; accordingly, heavy costs may be involved in effectively transmitting the necessary information. It is also difficult as a rule for licensors to be sure that licensees are maintaining adequate quality control in their production, a particularly worrisome point for the licensor when the licensee is using the licensor's trade name. Finally, the licensor may find it difficult and expensive to police other provisions of the licensing agreement, such as the licensee's adherence to the territorial limitations set out in the agreement.

To be sure, this method of formulating the issue is only the beginning of the analysis. The possibility has to be explored of separating some aspects of the stages of manufacturing from others, perhaps in order to place only the later stages in the foreign market. The possibility that the import duty may be raised, thereby raising the foreign delivered cost, must also be considered. As that contingency is introduced, appropriate account must also be taken of the possibility that the increase in price may lower internal demand or encourage new sources of competition within the foreign market or both. But these complicating aspects of the problem can usually be analyzed in a systematic way.

In any event, the maturing of technologically advanced products tends to press enterprises toward the establishment of overseas production units, whether through licensees or through subsidiaries. Where that choice exists, the subsidiary commonly proves to be the more attractive alternative for many firms.

Exploiting a strong trade name. The fact that firms cannot always sell or license their assets for use in foreign markets is also illustrated by the problems of exploiting a strong trade name. In the modern world of easy international movement and communication, trade names can sometimes gain strength in a foreign market without much conscious effort on the part of the firm that owns the name. Casual unplanned exports sometimes establish a position for a foreign brand. Military installations on foreign soil sometimes perform the same role. International tourists, movies, and television can also be the carriers.

As a rule, the strength of the foreign trade name is associated with the fact or the illusion of superior performance. Fact or illusion, the expectation of superior performance is often strengthened and fortified by copious promotional expenditures, as is commonly the case for name-branded pharmaceuticals and food preparations.

Sometimes, too, the strength of a brand name is associated not with superior performance but with predictable performance. When that is the case, the existence of a strong trade name may rest on some technological capabili-

ty. For instance, delivering a packaged food product such as chocolates or biscuits in a reasonably standardized condition on a reasonably reliable basis can be a technically exacting job that has been mastered by only a limited number of firms.

In any event, whether based on substance or illusion, some trade names command a premium in foreign markets. In some products, such as packaged foods, soft drinks, and drugs, where trade names play a critical role, enterprises have often discovered that they could not adequately exploit their advantage by way of exports and have commonly established plants in their foreign markets. Yet, once established in such markets, these producers have generally had to confront national competitors who were operating on roughly the same cost basis. Indeed, the foreigners have sometimes been handicapped by added costs, such as the costs of communication and control associated with the maintenance of a multinational organization. In such cases, the special strength of the trade name has usually been indispensable for the foreign firm to maintain a competitive position.

Nevertheless, although foreign trade names have been known to endure for long periods of time in such markets, their ability to command a price premium in a given type of product against the competing offers of national producers often erodes in time. As long as the product itself remains unchanged, the national producers learn either to match the performance of the foreign product or to overcome the illusion of a difference that was never there. When that happens, multinational enterprises find themselves obliged to share their foreign markets with national producers. In most instances, foreign-owned firms continue to sell their product, albeit to a smaller share of the market; in some cases, they find themselves obliged to abandon the market altogether to their national competitors.

Figure 1-1 presents an idealized version of typical competitive developments in markets that are originally dominated by a foreign-owned multinational enterprise. In the earliest stage, the multinational enterprise relies on its trade name or its technology or both to introduce a new product. But its monopoly is usually short-lived, as its presence in the market is joined by rival multinationals. At some point later, the technology becomes sufficiently diffused and the product becomes sufficiently standardized to permit national firms to produce and market the product in competition with the leaders.

MULTINATIONALS AND THE ADVANTAGES OF SCALE

In sheer quantity terms, most of the output of multinational enterprises is in products whose sale depends on costs and prices rather than on a strong technological lead or a strong trade name. In oil, copper, aluminum, heavy chemicals, and many other standardized products, *differences in technology and differences in trade names play only a secondary role in marketing.*

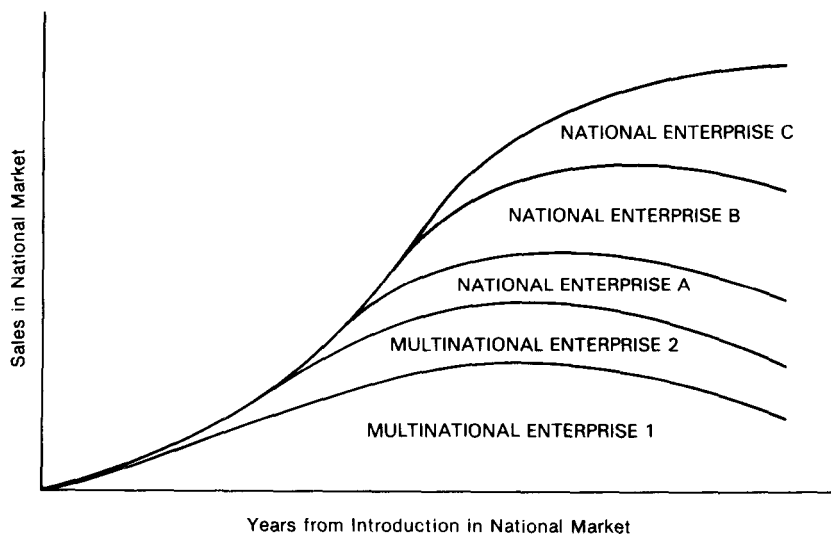


FIGURE 1-1 Schema of changing industry structure in a national market

The strategic need. The strength of the leaders in these industries lies primarily in the fact that large firms are often in a position to be more efficient than small ones. A new challenger, as a rule, has to find some way of assembling the funds, physical assets, and organization that are capable of producing, distributing, and controlling on a very large scale; otherwise, the newcomer usually runs the risk of being a high-cost competitor. If the capital markets of the world were highly efficient, they might be expected to provide a newcomer firm with the needed capital for purchasing its productive assets, acquiring a management team, and financing a running-in period for the organization. But the market for large-scale capital and management teams is notoriously imperfect. In many industries, therefore, leaders can feel reasonably secure that new rivals will not be appearing overnight.

Shut-out pricing. An established enterprise labors under one disadvantage when compared with a newcomer: it has lost some degree of flexibility in both technology and location. But its strength lies in the fact that its marginal costs are low, so that it has a certain measure of price flexibility for a portion of its output. In oligopolistic markets, therefore, a standard reaction on the part of the established leaders to the appearance of a newcomer is the obvious one—drastically, albeit temporarily, reducing the going price. This is a reaction of especial importance in the kind of industry that is dominated by multinational enterprises.

Picture a well-defined market in which the leaders of an industry have settled down into an acceptable equilibrium. Each leader has a *stable share* of the market and no great uncertainties about the price. Now a newcomer ap-

appears in the market. The newcomer may have adequate resources, financial and technical, to make a serious bid for a share of the market. This possibility is based on the fact that the newcomer is already well established in other related lines or in the same line in other markets. Since entry into the market is not easy, profit rates are likely to be fairly high. The newcomer who is able to overcome the entry barriers may therefore be in a position to cut the price in a bid for a share of the market. Confronting the newcomer, the leaders may respond in various ways, but two possibilities are obvious:

1. The leaders may disregard the newcomer's bid and permit it to capture some share of the market, relying on the expectation that the newcomer's goal in share-of-market terms is limited and that equilibrium will reassert itself once the goal has been achieved. In this case, the cost to the leaders of the newcomer's appearance is the quantity of sales lost multiplied by profit per unit.

2. An alternative strategy for the leaders is to reduce the price to a shut-out price, thereby retaining the previous volume of sales but accepting for the necessary period a lower profit margin on those sales. In that case, the cost to the leaders is the quantity of shut-out sales multiplied by the decline in profit per unit. Such a strategy, it is apparent, is particularly attractive to the leaders if the newcomer has made its challenge in only a limited number of national markets, thus allowing the leaders to continue to operate at their old profit margin in other countries.

MULTINATIONALS AND RISK REDUCTION

Multinational enterprises, however, usually see the advantages of size and geographical spread in more general terms. One such general advantage on which they place considerable emphasis has already been mentioned—that of diversification.

Multiple markets and multiple sources. An enterprise that serves several different markets is less vulnerable to the random variation of demand that affects any national market and less vulnerable to the interventions of national governments. If the market is shrinking for any reason in one nation, it may possibly be increasing in another. An act of nationalization in one market can be offset by an expansion elsewhere.

Moreover, when an enterprise has established sources of supply in several different countries, that fact enhances its ability to respond effectively to an increase in the global demand for one of its products. The decision whether to fill such a demand by exporting from a plant that is already established or by creating a new production unit is, of course, a familiar one.

Figure 1-2 indicates the key factors that are involved when only one production facility is in existence. Obviously the diagram incorporates various arbitrary assumptions, such as the assumption that the marginal cost of produc-