# INTERNATIONA
# BUSINESS

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Second Editio

# INTERNATIONAL BUSINESS

SECOND EDITION

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# Preface

While preparing this book, a revision of our earlier *The Economics of International Business*, we recognized the many environmental and analytical changes that have occurred since 1975. Accordingly, we substantially revised many chapters, consolidated others, and incorporated some entirely new ones. Although more noneconomic topics are treated here than in the earlier version, the book retains its economics flavor. It is our belief that basic economics tools best serve to explicate and describe both the international environment and the operations of firms participating within it.

The book also retains its three-part division. Part I discusses the international economic environment, beginning with a presentation of the theory of comparative advantage in Chapter 2. The question of different bases for trade between countries is examined and placed in the context of the decision maker within the firm. Chapter 3 discusses balance of payments accounting and how the balance of payments should be interpreted for business purposes. Foreign exchange markets are the subject of Chapter 4, particularly stressing certain aspects of interest to managers, for example, forward market hedging. Chapter 5 describes the institutional structure of the international monetary system and discusses methods of financing balance-of-payments disequilibria. Then, the development of international capital markets is reviewed in Chapter 6 along with a thorough analysis of the important Eurocurrency markets. The book's first major section closes with Chapters 7 and 8, providing an overview of the relationship of national economic policies to international trade and finance and reviewing changes in the international economy plus their implications for business. In Part I, Chapters 6 and 8 are completely new, and major updating characterizes other chapters.

Part II examines decision-making activities in firms with international operations, and it includes chapters on selection of methods of entry into international business, decisions on technology, and the financing and organizing of international businesses. Chapters 9 and 10 are companion pieces, providing perspective on the methods and vehicles firms can use to undertake business abroad. These include exportation and importation of goods and services, licensing of patents and trademarks, and the sale of technological and managerial know-how through technical aid and management contracts. Chapter 10 concentrates on direct investment, the *sine qua non* of the multinational corporation, and examines what motivates managements to engage in investment abroad. Chapter 11 deals with the selection of technology by international firms and also examines the influence of host-country policies in this selection. Methods of evaluating foreign projects are the topic of Chapter 12. Here cost–benefit analysis is described from the viewpoints of both corporation managements and host-country governments.

Part II continues with the discussion in Chapter 13 of methods of financing foreign investments and of sources of financial resources in the world economy. Chapter 14, a new chapter, concentrates on problems of managing the financial assets and liabilities of the multinational company, particularly those problems related to foreign exchange exposure. Organizational interdependence and the choice of organization structure in the multinational firm are treated in Chapter 15, making evident the problems of decentralized control. Part II ends with another new chapter, 16, which reviews staffing and management methods in the multinational corporation.

The book's final section, Part III, explores the interface between the firm's international activities and nation-states, especially those conflicts continually arising. In Chapter 17, many of the criticisms of direct foreign investment and emergent issues surrounding the large international firm are aired. Chapter 18 summarizes the book's discussion and also speculates about the future of multinational enterprises.

The book in its earlier form has been used in a variety of academic settings. Some professors have taught courses with such titles as "Introduction to International Business" and found the book to be a more analytical approach to the subject than is available in other textbooks. Other instructors have been involved in courses related to business policy, especially in international business, while still others have used the book successfully in international economics courses emphasizing the multinational enterprise. The earlier edition was used at both undergraduate and graduate levels, generally with supplementation for graduate students, from reading lists following each chapter. Usually, these citations are a little more advanced than the text material and give users an opportunity to broaden their background in the subject area.

We hope this book transmits some of the excitement we have found in the study of international business, for of all the topics normally taught in a business school, none is more dynamic and important than the study of international management. We have attempted to transmit the basic intellectual notions and practical facts in an interesting fashion, hoping to stimulate students to seek further knowledge through more specialized study in other internationally related business courses.

Again, we have received generous assistance from a variety of individuals. Detailed reviews were provided by Professor F. Glenn Boseman, Temple University; Professor L. Jacque, University of Pennsylvania; and Professor Joseph C. Miller, Indiana University. Their efforts were scrutinized carefully and are greatly appreciated. Dr. Janice J. Miller served faithfully and patiently as the author's demanding editorial reviewer. Later, after the manuscript was submitted, Joseph Marcelle, our editor, forced us back to the typewriter with a series of suggestions for improving the exposition and organization of the text. His instincts were unerring. Finally, typing chores were performed diligently and accurately by Mrs. Ellie Magnuson at the University of Texas at Dallas, by Carol Pincus at the University of California at Los Angeles, and by Olivia Dyhouse at the International Finance Corporation in Washington, D.C. All are to be commended for doing truly excellent work on a tight schedule.

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# Contents

# CHAPTER 1

# Introduction to International Business

Almost everyone is affected, directly or indirectly, by the functioning of the international economy. Most people consume imports, while some work for firms that export to other countries. Some actually are engaged in one or another aspect of international business, such as writing bills of lading, banker's acceptances, or forward contracts for foreign exchange; yet few people view such transactions in the perspective of an integrated international economy that connects economic agents in one country with those in other countries. It is the purpose of this book to provide that perspective, not only for those who actually make such decisions, but for others as well.

One need not be engaged directly in international business to appreciate how it affects everyday life: without it, each of us would be worse off. Many Americans would find it disconcerting, if not a downright hardship, to be denied access to fine French wines, Scotch whiskey, English bicycles, German and Japanese automobiles, Italian and Spanish shoes, Brazilian and Colombian coffees, Central American bananas, Philippine plywood, Indian cashew nuts, Swiss watches, Hong Kong textiles, Ceylonese tea, Jamaican bauxite, Venezuelan oil, and a host of other items we obtain only through international trade. It is through our own exports of goods and services, moreover, that we earn the foreign currencies needed to buy the imported goods and services we desire. Few persons see this connection, but it is a basic truth that will be stated and restated in various contexts throughout this book.

International business has been expanding at a rapid rate. Exports of goods and services increased from only 5 percent of U.S. domestic production in 1960 to 8 percent in 1977. An even more rapid increase in the share of production taken by exports occurred in the other advanced industrial countries (from 12 percent to 18 percent). International investment likewise increased rapidly (see Chapter 6). As a result, international business now accounts for over half of the profits of several of the largest New York banks, and U.S. industrial corporations count on international business for an important share of their sales and profits. It is clear that any student of business should have a basic understanding of how the international economy functions and how business decisions may be made within the world economy.

That world is full of diversity. Just as there are no two individuals who are identical, so, too, there are no two countries that are identical. They differ in many ways. Among other features, they differ in size and age composition of population, in language, income levels, extent of urbanization, currencies, climate, resource availabilities, trade and investment regulations, tax laws, and the structure of consumption. Out of this great diversity, opportunities arise for trade and investment by business firms. However, there is also order in this diversity, providing patterns of development, trade, and investment that can be used in the analysis of business decisions.

The following sections of this chapter provide a brief tour of the world economy, stopping to examine the economic characteristics of countries, world trade, and international investment. The chapter concludes with a brief preview of the remainder of the book.

## DISTRIBUTION OF WORLD INCOME

A world traveler would know from first-hand experience that income and wealth are not evenly distributed among the nations of the world. There are a relatively few advanced countries whose citizens are substantially better off than the vast majority of the world population. Table 1–1 shows that the world now contains over 4 billion people. The industrialized countries (which include the United States, Canada, Western European countries, Australia, New Zealand, and Japan) contain only about 15 percent of the world's population but produce (and consume) about 65 percent of its goods and services. Projections of the World Bank indicate that this relative imbalance is not likely to change much by 1990. Per capita incomes in the industrial countries are 40 times the per capita income in the very poor countries of Africa and Asia (including such countries as India, with a population of over 600 million and an average per capita income of $150

**Table 1–1 Structure of Population, Production, and Exports**

| | Population (millions) | GNP Per Capita (U.S. $) | Percentage Share in World Total | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | Population | | Gross Domestic Product | | Exports | |
| | 1976 | 1976 | 1976 | 1990 | 1976 | 1990 | 1976 | 1990 |
| Industrial countries | 661 | 6,414 | 16.2 | 13.6 | 64.6 | 62.5 | 63.9 | 65.8 |
| Capital surplus oil exporters | 12 | 6,691 | 0.3 | 0.4 | 1.1 | 1.4 | 5.7 | 3.0 |
| Centrally planned economies | 1,276 | 1,061 | 31.3 | 29.2 | 19.0 | 15.9 | 7.8 | 7.0 |
| Developing countries | 2,129 | 538 | 52.2 | 56.8 | 15.3 | 20.2 | 22.6 | 23.2 |
| Low income | 1,193 | 157 | 29.3 | 31.6 | 2.5 | 3.1 | 1.9 | 1.7 |
| Africa | 156 | 158 | 3.9 | 4.4 | 0.3 | 0.3 | 0.4 | 0.4 |
| Asia | 1,037 | 157 | 25.4 | 27.2 | 2.1 | 2.7 | 1.5 | 1.3 |
| Middle income | 936 | 1,022 | 22.9 | 25.2 | 12.8 | 17.1 | 20.6 | 21.5 |
| East Asia/Pacific | 162 | 671 | 4.0 | 4.1 | 1.4 | 2.7 | 4.3 | 6.3 |
| Latin America | 320 | 1,159 | 7.8 | 8.7 | 5.0 | 6.6 | 5.7 | 5.7 |
| Middle East/North Africa | 142 | 989 | 3.5 | 4.0 | 1.8 | 2.2 | 4.4 | 3.7 |
| Sub-Sahara Africa | 190 | 523 | 4.6 | 5.6 | 1.5 | 1.6 | 2.9 | 2.0 |
| Southern Europe | 122 | 1,948 | 3.0 | 2.8 | 3.2 | 4.0 | 3.3 | 3.8 |
| Total | 4,078 | 1,673 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

*Source:* World Bank, *World Development Report 1979* (Washington, D.C.: World Bank, August 1979), Table 12, page 12.

per person per year, and Kenya in Africa with a population of 15 million and a per capita income of $270 per year). The countries of Latin America (such as Brazil and Mexico) are considerably better off than the low-income countries just mentioned, with average annual per capita incomes of over $1,000. The countries of Southern Europe (including Greece and Spain) are at the upper end of the developing-country spectrum and are about to move into the ranks of the advanced industrial countries.

It is difficult to conceive how life could be sustained at the average annual income of the poorest developing countries. If we think what $160 would have bought in the United States in 1976 (the data in Table 1–1 are in 1976 dollars), it is clear that it would not have been possible to live on such a low income. Yet, not only is life sustained in these low-income countries, but, in fact, populations have been expanding at a rapid rate.

This seeming paradox exists because income per person is not a sound indicator either of relative well-being or of the goods and services that individuals are able to command. Relative well-being may differ between countries having the same income per capita because the amount of income required to obtain a given level of consumption differs. For example, in a tropical climate, housing is less costly than in a frigid climate. Simply put, in a colder climate more insulation and more heat are required for human comfort. Also, in countries at low levels of per capita income, services are relatively less costly than in countries at high levels of per capita income. If per capita income of the poor countries is adjusted for this last factor, it is seen in Table 1–2 that the per capita income of India is 7 percent of the per capita income of the United States, rather than only the 2 percent obtained by converting the per capita income of India, expressed in rupees, to dollars at the existing exchange rate. The adjusted incomes of all the countries shown in Table 1–2 are closer to the U.S. income than would be suspected by simply converting their per capita national product to dollars at the exchange rate in effect at the time (1970).

Even with these adjustments, it is still difficult to conceive of living on an income that is only 7 to 10 percent of that obtained by the average person in the United States. The problem is compounded by the fact that the distribution of income is more uneven in many developing countries than is the case in the advanced industrial countries. Table 1–3 shows that in the Philippines, Peru, Turkey, Mexico, and Brazil, the poorest fifth of the population gets less than 5 percent of the national income of the country. Unfortunately, that is also true in the United States, where average incomes are, of course, much higher. Nevertheless, on average, the distribution of income is much more even in the advanced industrial countries, including the United States, than in the poor countries. In the advanced countries, the 20 percent of the population with the highest incomes usually takes less

**Table 1–2 Comparisons of Per Capita Gross Domestic Product: 1970**

| *Indices* | *Kenya* | *India* | *Colombia* | *Hungary* | *Italy* | *U.K.* | *Japan* | *Germany* | *France* | *U.S.* |
|---|---|---|---|---|---|---|---|---|---|---|
| Per capita product converted to dollars at exchange rates (U.S. $ = 100) | 3.00 | 2.04 | 6.85 | 21.6 | 35.4 | 44.6 | 41.7 | 64.2 | 60.4 | 100.0 |
| Per capita product valued at international prices (U.S. $ = 100) | 5.72 | 7.12 | 15.9 | 40.3 | 45.8 | 60.3 | 61.5 | 74.7 | 75.0 | 100.0 |

*Source:* Irving Kravis, et al., *A System of International Comparisons of Gross Product and Purchasing Power* (Baltimore: Johns Hopkins, 1975), Table 1, page 8.

**Table 1–3 Percentage Shares of Household Income, by Percentile Groups of Households**

| *Country* | *Year* | *Lowest 20%* | *2nd 20%* | *3rd 20%* | *4th 20%* | *Highest 20%* | *Highest 10%* |
|---|---|---|---|---|---|---|---|
| India | 1964–65 | 6.7 | 10.5 | 14.3 | 19.6 | 48.9 | 35.2 |
| Sri Lanka | 1969–70 | 7.5 | 11.7 | 15.7 | 21.7 | 43.4 | 28.2 |
| Philippines | 1970–71 | 3.7 | 8.2 | 13.2 | 21.0 | 53.9 | N.A. |
| Korea | 1976 | 5.7 | 11.2 | 15.4 | 22.4 | 45.3 | 27.5 |
| Peru | 1972 | 1.9 | 5.1 | 11.0 | 21.0 | 61.0 | 42.9 |
| Turkey | 1973 | 3.4 | 8.0 | 12.5 | 19.5 | 56.5 | 40.7 |
| Mexico | 1977 | 2.9 | 7.4 | 13.2 | 22.0 | 54.4 | 36.7 |
| Taiwan | 1971 | 8.7 | 13.2 | 16.6 | 22.3 | 39.2 | 24.7 |
| Brazil | 1972 | 2.0 | 5.0 | 9.4 | 17.0 | 66.6 | 50.6 |
| Yugoslavia | 1973 | 6.5 | 11.9 | 17.6 | 24.0 | 40.0 | 22.5 |
| United Kingdom | 1973 | 6.3 | 12.6 | 18.4 | 23.9 | 38.8 | 23.5 |
| Germany | 1973 | 6.5 | 10.3 | 15.0 | 22.0 | 46.2 | 30.3 |
| United States | 1972 | 4.5 | 10.7 | 17.3 | 24.7 | 42.8 | 26.6 |
| Sweden | 1972 | 6.6 | 13.1 | 18.5 | 24.8 | 37.0 | 21.3 |

*Source:* World Bank, *World Development Report 1979* (Washington, D.C.: World Bank, August 1979), Annex Table 24.

than 45 percent of total income, whereas in many poor countries, the highest-income segment of the population often takes 55 percent of total income.

There are some exceptions to this general pattern, however: Korea, Taiwan, and Yugoslavia, among market-oriented developing countries, have combined rapid economic growth with a distribution of income that is as even as that of the more advanced countries. They have done so by pursuing a development strategy that started with a redistribution of assets: both Korea and Taiwan carried out major redistribution of land in the early 1950s, and Yugoslavia, of course, underwent a socialist revolution before adopting a system of market socialism. The three countries followed redistribution of assets with a major effort to increase education, particularly universal primary education. By doing so, they have achieved high levels of adult literacy and have produced a relatively well-educated labor force. Korea and Taiwan then pursued a development strategy that emphasized expansion of labor-intensive industries, thus creating widespread employment opportunities. High levels of employment led to relatively high incomes in even the lowest-income segments of the population.

Other poor countries, including India and Sri Lanka, also have achieved relatively even income distribution; nevertheless, low average incomes and uneven distribution of that income have combined to condemn a large portion of the population of the world to a life of absolute poverty. The World Bank has estimated that 40 percent of the population of the developing world, or 800 million people, live in a state of absolute poverty: "a condition of life so characterized by malnutrition, illiteracy, disease, squalid surroundings, high infant mortality and low life expectancy as to be beneath any reasonable definition of human decency."[1]

Even under a relatively optimistic scenario of growth in the gross domestic product of developing countries of 5.5 percent per year, it is projected that 600 million people will still live in absolute poverty in the developing countries in the year 2000. This is a scenario that can be altered only by more rapid growth and by a massive effort to bring the benefits of growth to the poorest of the poor.

This is not impossible, for there has been a measure of success in the development effort in the second half of the 1960s and the 1970s that previously had not been thought possible. Middle-income developing countries such as Brazil, Turkey, and Korea realized growth in their domestic production of almost 7 percent per year between 1965 and 1974. While balance-of-payments difficulties have restrained growth of these countries after 1974, they still are achieving 5 percent annual increases in production. The low-income countries, meanwhile, did not match the high growth rates of middle-income countries, and fell further behind. Recently, however, their growth has accelerated, particularly with improved performance in India.

The economic growth of nations has been associated with far-reaching changes in their social and economic structure that, when viewed as a whole, have tended to follow some broad patterns. As pointed out by the World Bank, "The central feature is the increase in the share of industry in total output, and the decline in the share of primary production (agriculture and mining) as countries develop. The poor countries of Asia and Africa are in the early part of the transformation, followed by the middle income nations of Latin America, East Asia, and the Mediterranean region, while in the industrialized countries, where income per capita is highest, the rising share of services in the economy is accommodated by stabilization and eventual decline in the share of industry."[2] This pattern arises because of the accumulation of capital and skills and changes in the composition of

[1]Robert S. McNamara in the Foreword to the World Bank, *World Development Report 1978* (Washington, D.C.: World Bank, 1978).

[2]World Bank, *World Development Report 1979* (Washington, D.C.: World Bank, 1979), page 44.

demand. For example, food consumption falls from 40 percent of aggregate demand in an economy at $150 per capita to less than 20 percent of the total at $3,000 per capita, and this decline helps explain the falling share of primary production. The evolving composition of production is reflected in the sectoral employment of the labor force—as the share of labor employed in agriculture falls—with a lag. The complete transformation of the agricultural sector to modern commercial agriculture takes a very long time, and only now is being completed in Western Europe.

The pattern of transforming poor agricultural societies into modern industrial economies will vary with the size and resource endowment of the country. The process will be slower in small countries and in those that have abundant natural resources. Resource-rich countries may achieve growth by exploiting their resources and are under less pressure to pursue a rapid industrial transformation.

There are also many patterns in the commodities a country is likely to export and import, as well as in the countries with which it is most likely to trade. A country's international trade is largely a reflection of its industrial structure and, in turn, its level of development. Countries at low levels of development tend to be heavily dependent for their export trade on primary commodities and intermediate goods. Their imports, on the other hand, are heavily oriented toward finished manufactured goods. Countries that are industrially advanced tend to export advanced manufactured goods and sophisticated services such as financing, insurance, and transportation. Their imports tend to be heavily oriented toward fuels, minerals, raw materials, and a diversity of manufactured goods.

There are also patterns in the growth and development of institutions to be found in various countries, although organization of financial, goods, and labor markets is also a function of cultural variables and even historical accident. It does tend to be true, however, that institutions, their functions, and their diversity are closely related to level of economic development, composition of output, level of urbanization, and size of market. The many-layered structure of financial institutions found in the United States is the exception rather than the rule. Much the same can be said of the available marketing institutions and distribution channels. For example, the chain-store system so common in the United States is a recent development in Europe. In developing countries, one seldom if ever finds this form of marketing and distribution. In the field of finance, the United States has many different types of specialized institutions. For instance, many savings institutions receive deposits (or premiums in the case of life insurance) that can be invested in long-term commitments. Thus, the United States has developed a highly diversified market for equity issues, bonds, mutual fund shares, and the like. This is not so much the case in Europe, and, in