Inroduction to Special Topics in Business Economics

BUSINESS IN THE INTERNATIONAL ENVIRONMENT AND THE GLOBAL ECONOMY

PhD Candidate: Eirini Stergiou

e.stergiou@upnet.gr

School of Business Administration

Department of Economics

University of Patras, Greece

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Structure

1. Globalization and multinational business
   - Globalization: Setting the Scene
   - What is a Multinational Corporation?
   - Trends in Multinational Investments
   - Outsourcing
   - Why do businesses go multinational?
   - MNC investment for the host state
2. International Trade
   - Trading Patterns
   - Advantages of Trade
   - Barriers to Imports
3. The Global Economy
   - Business in Emerging Markets
   - Common Currency Areas and European Monetary Union
   - Fiscal Policy

As Legrain suggests, **globalization** is *"shorthand for now our lives are becoming increasingly intertwined with those of distant people and places around the world - economically, politically and culturally."*
What makes globalization an issue today is **the speed** at which interdependence is growing.
A global economy enables a business to locate the different dimensions of its value chain wherever it might get the best deal to **lower costs** or **improve quality** or both. It encourages relocation and the framing of business strategy within a global context.
$\Rightarrow$ **Drivers** of globalization:

1. Market drivers
2. Cost drivers
3. Government drivers
4. Competitive drivers

Are you a supporter?

Multinational Corporations: Businesses that own and control foreign subsidiaries in more than one country.

$\Rightarrow$**Diversity** among MNCs:

- Size
- Nature of business
- Overseas business relative to total business
- Production locations
- Ownership patterns
- Organizational structure

Many modern multinationals are organizations that combine the advantages of size (i.e. economies of scale) with the responsiveness and market knowledge of smaller firms

- Constant adjustment in the economic environment
- Flexibility
- Simultaneously global and local

SUCCESS!!!

Global foreign direct investment (FDI) inflows in 2011 reached $1.52 trillion with 51% of flows towards developing and transition economies.

Outsourcing: Contracting out of a part of the business' operations to another organization
It includes accounting activities, IT, human resources activities such as payroll, training, recruitment. It does not mean that the operation goes abroad, as it can be referred to other organizations within the domestic country.

1. *Cut costs:* A vertically integrated multinational may be able to locate each part of the production process in the country where the relevant factor prices are lowest
2. *Tap into new markets*: New opportunities by expanding production overseas

They can expand with 3 ways:

1. Creating a new production facility from scratch (i.e. Nissan in North England)
2. Merging with or taking over existing foreign producers (i.e. ASDA - Wal-mart)
3. Engaging in an international strategic alliance (i.e Finland's Nokia- Japan's Sanyo)

Horizontally integrated multinational: It produces the same product in many different countries

Vertically integrated multinational: It undertakes the various stages of production for a given product in different countries

Advantages:

- Employment
- Import substitution: The replacement of imports by domestically produced goods or services
- export promotion
- Technology transfer: Where a host state benefits from the new technology that an MNC brings in investment
- Taxation of MNCs

Disadvantages:

- Uncertainty of MNCs
- Control (e.g. difficulties on pollution controls)
- Transfer pricing (Reduce its profits in countries with high taxation)
- The environment (natural resources)

Trade: Proportion of country's income

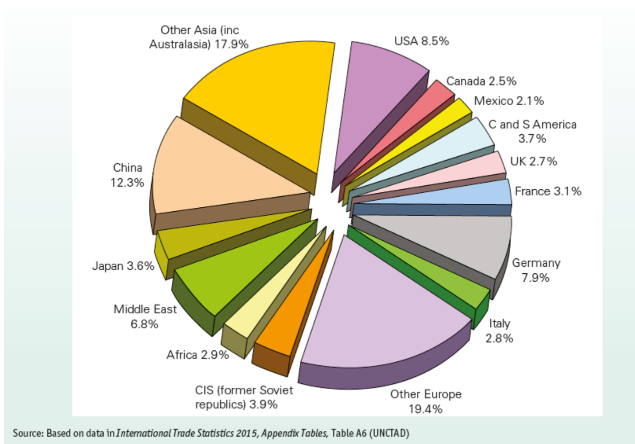

Figure 1: Share of world merchandise exports, by value (2014)

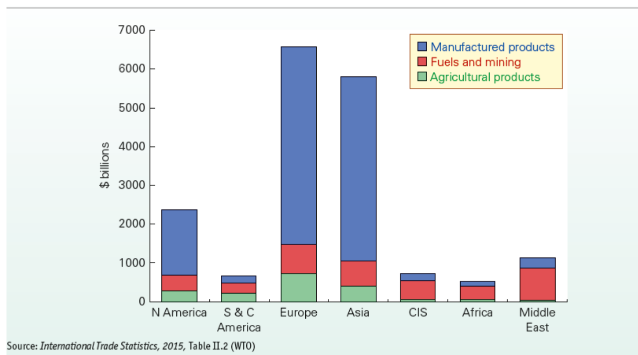

Figure 2: Value of merchandise exports by region: $ billions, 2014

Countries **differ** in population density, labor skills, climate, raw materials, capital equipment e.t.c. This means that the **relative costs** of producing goods will vary from country to country.

When a country can produce a good with fewer resources than another, it is said to have an **absolute advantage** in that good.(i.e. France-wine, UK-gin). With the trade of those two goods, both will gain.
Comparative advantage: A country has a comparative advantage over another in the production of a good if it can produce it at a lower opportunity cost (i.e. if it has to forgo less of other goods in order to produce it)
Law of comparative advantage: Trade can benefit all countries if they specialize in the goods in which they have a comparative advantage.

- Customs duties (or "tariffs"- tax) on imports
- Restrictions on the amount of certain goods that can be imported ("quotas")
- Subsidies on domestic products to give them a price advantage over imports
- Administrative regulations designed to exclude imports, such as customs delays or excessive paperwork
- Governments favoring domestic producers when purchasing equipment (e.g. defense equipment)

An **emerging market economy** is one where the per capita income of the population is in the middle to low range compared to the rest of the global economies. The United Nations puts the number of emerging economies at 120 out of 150 it recognizes.

- Examples: Brazil, Russia, India and China (resource endowment and huge human resources)
- *It is not just the size of the country that matters, but the internal economic structures that are important.*
- Engaging more and more characteristics of market economies and openness to trade and outside investment.
- Economies with price mechanism, institutions and political stability

- Why are Emerging Markets so Important?
- Problems Facing Business in Emerging Markets

- **Opportunity**.In the developed economies there is a limited growth rate
- Billions of new potential customers
- Rapid future revenue

Problems:

- Understanding the market they are getting into
- Replication models do not work because of religious, political, cultural differences
- Assumptions about the market and consumers are wrong
- Variation on wages

Business Strategies

1. **Hit and Run Strategies:** Firms sell products to those that can afford them, take the profits and then leave the market.
   Advantage: Short-term profit
   Disadvantage: Long -term profit and business relationships are sacrificed
2. **Enclave Strategies**: Firms exploit natural resources. They set up operations which do not depend on local supply networks and local businesses.
3. **Learn to Earn:** The short-term profits will be slim, but building longer-term relationships and understanding the emerging market will lead to higher consistent profits.

A common **currency area** is a geographical area throughout which a single currency circulates as the channel of exchange.

A **monetary union** is a group of countries that have adopted permanently and irrevocably fixed exchange rates among their various currencies.

There are currently 17 countries that have joined the EMU(European Economic and Monetary Union) from 1992.

In 1999 the euro officially came into existence when 12 countries adopted it.

Benefits of a Single Currency

Elimination of Transaction Costs: As the trade becomes easier between members, there is a reduction in the transaction costs. Converting currencies are no longer necessary.
Reduction in Price Discrimination: There is a reduction in price discrimination when a common currency exists. Consumers can compare easily prices and buy goods from regions tat are cheaper.
Reduction in Foreign Exchange Rate Variability: Exchange rates were fluctuated substantially on a day-to-day basis. Nowadays, firms do not need to worry about the receipts from their exports

There is nothing in the adoption of a common currency that implies that members of the currency union should not still retain independence in fiscal policy.
The asymmetric demand shocks should be confronted differently by each country.However, a set of common fiscal rules, known as the Stability and Growth Pact (SGP):

- Members should aim to achieve balanced budgets
- Members with a budget deficit of more than 4% of GDP will be subject to fines that may reach as high as 0.5% of GDP unless the country experiences exceptional circumstances (such as natural disaster) or a very sharp recession in which GDP declines by 2% or more in a single year