**Chapter 1**

**Current Multinational Challenges and the Global Economy**

Questions

**1-1. Globalization and the MNE**. The term *globalization* has become very widely used in recent years. How would you define it?

Narayana Murthy’s quote is a good place to start any discussion of globalization:

“*I define globalization as producing where it is most cost-effective, selling where it is most profitable, and sourcing capital where it is cheapest, without worrying about national boundaries.*”

Narayana Murthy, President and CEO, Infosys

**1-2. Assets, Institutions and Linkages**. Which assets play the most critical role in linking the major institutions which make up the global financial marketplace?

The debt securities issued by governments. These low risk or risk-free assets form the foundation for the creation, trading, and pricing of other financial assets like bank loans, corporate bonds, and equities (stock). In recent years a number of additional securities have been created from the existing securities—derivatives, whose value is based on market value changes in the underlying securities. The health and security of the global financial system rely on the quality of these assets.

**1-3. Eurocurrencies and LIBOR**. Why have eurocurrencies and LIBOR remained the centerpiece of the global financial marketplace for so long?

Eurocurrencies and LIBOR (and there are LIBOR rates for all eurocurrencies) reflect the “purest” of market driven currencies and instrument rates. They are largely unregulated, and therefore reflect freely traded assets whose value is set by the daily global marketplace.

**1-4. Theory of Comparative Advantage**. Define and explain the theory of comparative advantage.

The *theory of comparative advantage* provides a basis for explaining and justifying international trade in a model world assumed to enjoy free trade, perfect competition, no uncertainty, costless information, and no government interference. The theory contains the following features:

• Exporters in Country A sell goods or services to unrelated importers in Country B.

• Firms in Country A specialize in making products that can be produced relatively efficiently, given Country A’s endowment of factors of production: that is, land, labor, capital, and technology. Firms in Country B do likewise, given the factors of production found in Country B. In this way the total combined output of A and B is maximized.

• Because the factors of production cannot be moved freely from Country A to Country B, the benefits of specialization are realized through international trade.

• The way the benefits of the extra production are shared depends on the terms of trade, the ratio at which quantities of the physical goods are traded. Each country’s share is determined by supply and demand in perfectly competitive markets in the two countries. Neither Country A nor Country B is worse off than before trade, and typically both are better off, albeit perhaps unequally.

**1-5. Limitations of Comparative Advantage**. The key to understanding most theories is what they say and what they don’t. What are four or five key limitations to the theory of comparative advantage?

Although international trade might have approached the comparative advantage model during the nineteenth century, it certainly does not today, for the following reasons:

• Countries do not appear to specialize only in those products that could be most efficiently produced by that country’s particular factors of production. Instead, governments interfere with comparative advantage for a variety of economic and political reasons, such as to achieve full employment, economic development, national self-sufficiency in defense-related industries, and protection of an agricultural sector’s way of life. Government interference takes the form of tariffs, quotas, and other non-tariff restrictions.

• At least two of the factors of production, capital and technology, now flow directly and easily between countries, rather than only indirectly through traded goods and services. This direct flow occurs between related subsidiaries and affiliates of multinational firms, as well as between unrelated firms via loans, and license and management contracts. Even labor flows between countries, such as immigrants into the United States (legal and illegal), immigrants within the European Union and other unions.

• Modern factors of production are more numerous than in this simple model. Factors considered in the location of production facilities worldwide include local and managerial skills, a dependable legal structure for settling contract disputes, research and development competence, educational levels of available workers, energy resources, consumer demand for brand name goods, mineral and raw material availability, access to capital, tax differentials, supporting infrastructure (roads, ports, and communication facilities), and possibly others.

• Although the terms of trade are ultimately determined by supply and demand, the process by which the terms are set is different from that visualized in traditional trade theory. The terms are determined partly by administered pricing in oligopolistic markets.

• Comparative advantage shifts over time as less developed countries become more developed and realize their latent opportunities. For example, over the past 150 years, comparative advantage in producing cotton textiles has shifted from the United Kingdom to the United States, then to Japan, to Hong Kong, to Taiwan, and to China.

• The classical model of comparative advantage did not really address certain other issues, such as the effect of uncertainty and information costs, the role of differentiated products in imperfectly competitive markets, and economies of scale.

Nevertheless, although the world is a long way from the classical trade model, the general principle of comparative advantage is still valid. The closer the world gets to true international specialization, the more world production and consumption can be increased, provided the problem of equitable distribution of the benefits can be solved to the satisfaction of consumers, producers, and political leaders. Complete specialization, however, remains an unrealistic limiting case, just as perfect competition is a limiting case in microeconomic theory.

**1-6. Trident’s Globalization.** After reading this chapter’s description of Trident’s globalization process, how would you explain the distinctions between *international, multinational,* and *global* companies?

The difference in definitions for these three terms is subjective, with different writers using different terms at different times. No single definition can be considered definitive, although as a general matter the following probably reflect general usage.

*International* simply means that the company has some form of business interest in more than one country. That international business interest may be no more than exporting and importing, or it may include having branches or incorporated subsidiaries in other countries. International trade is usually the first step in becoming “international,” but the term also encompasses foreign subsidiaries created for the single purpose of marketing, distribution, or financing. The term *international* is also used to encompass what are defined as *multinational* and *global* below.

*Multinational* is usually taken to mean a company that has operating subsidiaries and performs a full set of its major operations in a number of countries; i.e., in “many nations.” “Operations” in this context include both manufacturing and selling, as well as other corporate functions, and a *multinational* company is often presumed to operate in a greater number of countries than is an international company. A *multinational* company is presumed to operate with each foreign unit “standing on its own”—although that term does not preclude specialization by country and/or supplying parts from one country operation to another.

*Global* is a newer term which essentially means about the same as “multinational;” i.e., operating around the globe. *Global* has tended to replace other terms because of its use by demonstrators at the international meetings (“global forums?”) of the International Monetary Fund and World Bank that took place in Seattle in 1999, and Rome in 2001. Terrorist attacks on the World Trade Center and the Pentagon in 2001 led politicians to refer to the need to eliminate “global terrorism.”

**1-7. Trident, the MNE.** At what point in the globalization process did Trident become a multinational enterprise (MNE)?

Trident became a multinational enterprise (MNE) when it began to establish foreign sales and service subsidiaries, followed by the creation of manufacturing operations abroad, or by licensing foreign firms to produce and service Trident’s products. This multinational phase usually follows the international phase, which involved the import and/or export of goods and/or services.

**1-8. Trident’s Advantages.** What are the main advantages that Trident gains by developing a multinational presence?

Entry into new markets, not currently served by the firm, which in turn allow the firm to grow and possibly to acquire economies of scale.

Acquisition of raw materials, which are not available elsewhere.

Achievement of greater efficiency by producing in countries where one or more of the factors of production are underpriced relative to other locations.

Acquisition of knowledge and expertise, which are centered primarily in the foreign location.

Location of the firms’ foreign operations in countries deemed politically safe.

**1-9. Trident’s Phases.** What are the main phases that Trident passed through as it evolved into a truly global firm? What are the advantages and disadvantages of each?

**a.** *International trade.* Two advantages are: finding out if the firms’ products are desired in the foreign country. and learning about the foreign market. One disadvantage is lack of control over the final sale. Another disadvantage is service to the final customer (many exports are to distributors or other types of firms that in turn resell to the final customer) and the possibility that costs and thus final customer sales prices will be greater than those of competitors that manufacture locally.

**b.** *Foreign sales and service offices*. The greatest advantage is that the firm has a physical presence in the country, allowing it great control over sales and service, as well as allowing it to learn more about the local market. The disadvantage is that the final local sales prices, based on home country plus transportation costs, may be greater than those of competitors that manufacture locally.

**c.** *Licensing a foreign firm to manufacture and sell*. The advantages are that product costs are based on local costs, and that the local licensed firm has the knowledge and expertise to operate efficiently in the foreign country. The major disadvantages are that the firm might lose control of valuable proprietary technology, and that the goals of the foreign partner might differ from those of the home country firm. Two common problems in the latter category are whether the foreign firm (that is manufacturing the product under license) is a shareholder wealth or corporate wealth maximizer, which in turn often leads to disagreements about reinvesting earnings to achieve greater future growth versus making larger current dividends for owners and payments to other stakeholders.

**d.** *Part ownership of a foreign, incorporated, subsidiary; i.e., a joint venture*. The advantages and disadvantages are similar to those for licensing: Product costs are based on local costs and that the local joint owner presumably has the knowledge and expertise to operate efficiently in the foreign country. The major disadvantages are that the firm might lose control of valuable proprietary technology to its joint venture partner, and that the goals of the foreign owners might differ from those of the home country firm.

**e.** *Direct ownership of a foreign, incorporated, subsidiary*. If fully owned, the advantage is that the foreign operations may be fully integrated into the global activities of the parent firm, with products resold to other units in the global corporate family without questions as to fair transfer prices, or too great specialization. (*Example*: the Ford transmission factory in Spain is of little use as a self-standing operation; it depends on its integration into Ford’s European operations.) The disadvantage is that the firm may come to be identified as a “foreign exploiter” because politicians find it advantageous to attack foreign-owned businesses.

**1-10. Financial Globalization**. How do the motivations of individuals, both inside and outside the organization or business, define the limits of financial globalization?

If influential insiders in corporations and sovereign states continue to pursue the increase in firm value, there will be a definite and continuing growth in financial globalization. But, if these same influential insiders pursue their own personal agendas, which may increase their personal power, influence, or wealth, then capital will not flow into these sovereign states and corporations. The result is the growth of financial inefficiency and the segmentation of globalization outcomes, creating winners and losers.

The three fundamental elements—*financial theory*, *global business*, *management beliefs and actions—*combine to present either the problem or the solution to the growing debate over the benefits of globalization to countries and cultures worldwide.