

Chapter 7 – foreign direct investment (FDI):

What is FDI?

- FDI is the acquisition or construction of physical capital by a firm from one (source) country in another (host) country.
- Forms of FDI:
Acquisitions/Multinational Enterprise: a firm that owns business operations in more than one country. (Acquisition of or merger with an existing local firm)
Greenfield Investment: establishing a new operation in a foreign country.

Why FDI?

- To get a greater involvement in another country such as China wants to get greater involvement in Canada in the automobile/cars sector. Starbucks Story.

Exporting: sales of products produced in one country to residents of another country.

- Pros: could export more
- Cons:
 - 1) Transportation cost: when transportation add to production cost, it becomes unprofitable to ship some products over a large distance. This is particular true of products that have a low value – to – weight ratio and can be produced in almost any location.
 - 2) Trade barrier: much FDI is undertaken as a response to actual or threaten trade barrier such as import tariffs or quotas. By placing tariffs on import goods, governments can increase the cost of exporting relative to FDI and licensing.
 - 3) Safety standard
 - 4) Cost of competition

Licensing: occurs when a firm (or licensor) licenses the right to produce its product, use its production processes or use its brand name or trademark to another firm (the licensee). In return for giving the licensee these rights, the licensor collects a royalty fee on every unit the licensee sells.

- Pros:
 - 1). Royalty payment
 - 2). Builds and strengthens the brand image. Increases awareness of the brand.
 - 3). Attracts new customers to the brand name and increase sales.
 - 4). Allows entry to additional or new trade channels. Builds competitive advantages.
 - 5). Protects trademarks by broadening the trade use of marks.
 - 6). Generates revenue beyond the normal revenue and grows market share.
 - 7). Lends credibility to their products through brand association.
- Cons:
 - 1) Licensing may result in a firm giving away valuable technological know – how to a potential foreign competitor – intellectual properties and rights.
 - 2) Licensing does not give a firm the tight control over manufacturing, marketing, and strategy in a foreign country that may be required to maximize its profitability.
 - 3) Licensing arises when the firm’s competitive advantage is based not so much on its products, as on the management, marketing, and manufacturing capabilities that produce those products.
 - 4) Licensing need very professional and practiced contracts.

Greenfield investment: if countries do not want to take the risk of licensing, they

could choose GI. (buy a brand new plant)

- Pros: Country (China) will have a brand new, modern and professional factory.
- Cons: 1) The brand new factory will cost a lot of money.
2) The company may be over budget. There are many uncertainties, so the company will not have a fix budget.
3) Joint Venture – partnership issues.

Acquisition: (Auto) companies have access capacity issue, such as GM:

- Pros: More quick and faster than Greenfield investment, also have the capacity, could produce products (cars) immediately. The company also will take over the sale, marketing or other department. Get instant labor force.
- Cons: Require the liability of the company, and labor cost is also high. Acquisition can be costly.

Why Canada do so well in cars?

Canada: have health/medicine care for people

China: do not care the health problem

US: engine, tire, and health care

- **The pattern of FDI:**

- 1) FDI flows are a reflection of strategic rivalry between firms in the global marketplace.
- 2) Raymond Vernon's product life cycle.
- 3) The eclectic paradigm by John Dunning.

- **Political ideology and FDI:**

- 1) The radical view traces its roots to Marxist political and economic theory.
- 2) The free market view has its roots in classical economics and the international trade theories of Adam Smith and David Ricardo.
- 3) Pragmatic nationalism view is that FDI has both benefits and costs.
- 4) Shifting ideology.

- **Costs and benefits of FDI to the nation-state.**

- 1) Host-country effects: benefits
 - Resource-transfer effects: FDI can make a positive contribution to a host economy by supplying capital, technology, and management resources.
 - Employment effects: another beneficial effect of FDI is that it brings jobs to a host country.
 - Balance of payment effects: the effect of FDI on a country's balance-of-payments accounts is an important policy issue for most host governments.
- 2) Host-country effects: costs
 - The possible adverse effects of FDI on competition within the host nation.
 - Adverse effects on the balance of payments.
 - The perceived loss of national sovereignty and autonomy.
- 3) Home-country effects: benefits
 - The current account of the home country's balance of payments benefits from the inward flow of foreign earnings.
 - Benefits to the home country from outward FDI arise from employment effects.
 - Benefits arise when the home-country MNE learns valuable skills from its exposure to foreign markets that can subsequently be transferred back to the home country.
- 4) Home-country effects: costs: against these benefits must be set the apparent costs of FDI for the home country.

Chapter 8 – Regional Economic Integration:

Describe and comment on the various levels of integration between countries.

L: levels of integration; D:description C:comments

(From the simplest level to the most complex level.)

- 1) Level One:
L: Free trade area, example NAFTA
D: free trade on goods and services between countries
C: free trade also means fair
- 2) Level Two:
L: Custom Union, for example Guba
D: free trade area + common trade policies
C: know extremely rare
- 3) Level Three:
L: common market
D: customs union + free flow factors of production
C: know extremely rare
- 4) Level Four:
L: economic union
D: common market + common currency
C: Europe is very unique, European Union is an economic union, European Union may move toward a similar federal structure.
- 5) Level Five:
L: Political union
D: Political Union + a central/national government (dictator) e.g. Chinese, India, Italy
C: prefer the expanded definition of free trade, auto industries, EFTA, united states, and europe

Chapter 9– the Foreign Exchange Market

Economic theories of exchange rate determination: exchanges rates are determined by the demand and supply of one currency relative to the demand and supply of another.

- 1) Prices and exchange rates:
 - The law of one price: states that in competitive markets free of transportation costs and barriers to trade, identical products sold in different countries must sell for the same price when their price is expressed in term of the same currency.
 - Purchasing power parity: states that given relatively efficient markets which markets in which few impediments to international trade exist-the price of a “basket of goods” should be roughly equivalent in the each country.
 - Money supply and price inflation: a country in which price inflation is running wild should expect to see its currency depreciate against that of countries in which inflation rates are lowers. Inflation is a monetary phenomenon.
- 2) Interest rates and exchange rates: interest rates reflect expectations about likely future inflation rates which mean if inflation rates are high, interest rates will also be high.
- 3) Investor phycology and bandwagon effects: empirical evidence suggests that neither PPP theory nor the International Fisher Effect are particularly good at explaining short-term movements in exchanges rates.

Chapter 10 – the Global Monetary System

What are the advantages and disadvantages of the different kind of exchange rates?

- 1) Flexible/ floating exchange rate: it is market determines exchange rate, and it is truly floating exchange rate

Advantages:

- Automatic balance of payments adjustment – any balance of payments disequilibrium will tend to be rectified by a change in the exchange rate.
- Flexibility
- Lower foreign exchange reserves
- Freeing internal policy
- Absence of crises
- It is also a signal of economic health. When the dollar is falling, it is a warning to the country.
- When appears difficulties, it will correct/solve the difficulties.

Disadvantages:

- Lots of volatility and lots of movement – uncertainty.
- Difficulties in investment since it is difficult to decide where and how much to invest in the business. The business value is not clear.
- Speculation.
- Lack of discipline in economic management.
- Inflation.

- 2) Fixed exchange rate: countries mutually agree to a fixed exchange rate.

Advantages:

- Make business easier.
- Reduced risk in international trade.
- Introduces discipline in economic management – monetary policy adjusts money supply, interest rate and so on.
- Fixed rates should eliminate destabilizing speculation.

Disadvantages:

- No automatic balance of payments adjustment.
- Fixed rate is that countries mutually agree to a fixed exchange rate. Countries will not treat it seriously, so fixed exchange rate is impossible.
- Large holdings of foreign exchange reserves required.
- Loss of freedom in the internal policy.
- Fixed rates are inherently unstable.

- 3) Dirty float: most common exchange rate in the world.

Advantages:

- Most common exchange rate in the world.
- Response to the weakness of flexible/floating exchange rate: too volatility. Dirty float allows government to control and regulate the volatility of exchange rate.
- Also can call other central bank for help.
- Also cannot go far out of the line, still is controlled and regulated by the policy like monetary policy.

Disadvantages:

- Dollars was undervalued for many years.
- Required very high economic development.

- 4) Pegged exchange rate: very rare, only two countries have pegged exchange rate which are

China and Hong Kong. Pegged exchange rate means countries have a fixed exchange rate until they want to change it to another.

Advantages:

- Pegged exchange rate is almost like fixed exchange rate, so it could maintain the value of Hong Kong dollar or Chinese Yuan.
- There are lots of disciplines on the Hong Kong government, so they could control the surplus/deficit, and they could also accumulate lots of reverses. Hong Kong is the largest reverse in the world.

Disadvantages:

- It doesn't have a monetary policy, and it is determined by the external forces.
- Couldn't hold the pegged, so maybe give up.
- It requires a very good sense that the value should be at the right level – should be higher, but very low. U.S. and other countries may complain about this.
- The real reason to have a pegged exchange rate is to get the exchange rate the country (Hong Kong, Chinese) want, in order to control the deficit and surplus. If the pegged exchange rate is high, can force it down easily. Vice versa.
- Very hard to control the pegged exchange rate in a long run, except in a small country – Hong Kong, since other countries will complain about this.

Chapter 15 – Global Manufacturing and Materials Management

Question 1: 3318 IB Consultants have been asked by a Canadian firm to provide a brief report on how it should select a foreign country "to produce its new biodegradable (生物降解) toilets.

An essential decision facing an international firm is where to locate its manufacturing activities to achieve the goals of minimizing costs and improving product quality.

- 1) Country factors: Political economy, culture, and relative factor costs differ from country to country. When other things being equal, a firm should locate its various manufacturing activities where the economic, political, and cultural conditions, including relative factor costs, are conducive to the performance of those activities. Also important in some industries is the presence of global concentrations of activities at certain locations. Formal and informal trade barriers obviously influence location decisions. Another country factor is expected future movements in its exchange rate.
- 2) Technological factors: the technological we are concerned is manufacturing technology – the technology that performs specific manufacturing activities. Fixed cost – firm should choose a country with relatively low level of fixed costs, and allow the firm to better accommodate demands for local responsiveness. Minimum efficient scale – when the minimum efficient scale of production is relatively low, it may be economical to manufacture a product at several locations. Flexible manufacturing and mass customization – the best way to achieve high efficiency, and hence low unit costs, is through the mass production of a standardized output.
- 3) Product factors: two product features affect location decisions. The first feature is the product's value – to – weight ratio because of its influence on transportation costs. The second feature is whether the product serves universal needs, needs that are the same all over the world.
- 4) Locating manufacturing facilities: two basic strategies for locating manufacturing facilities: concentrating them in a centralized location and serving the world market from there, or decentralizing them in various regional or national locations that are close to major market.

Concentrated manufacturing makes most sense when: differences between countries in factor costs, political economy, and culture have a substantial impact on the costs of manufacturing in various countries; trade barriers are low; externalities arising from the concentration of like enterprise favor certain locations; import exchange rates are expected to remain relatively stable; the production technology has high fixed costs, a high minimum efficient scale, or a flexible manufacturing technology exists; the product's value – to – weight ratio is high; and the product serves universal needs.

Decentralization of manufacturing is appropriate when: differences between countries in factor costs, political economy, and culture do not have a substantial impact on the costs of manufacturing in various countries; trade barriers are high; location externalities are not important; volatility in important exchange rates is expected; the production technology has low fixed costs, low minimum efficient scale, and flexible manufacturing technology is not available; the product's value – to – weight ratio is low; and the product does not serve universal needs (that is, significant differences in consumer tastes and preferences exist between nations).

Question 2: 3318 IB Consultants have been asked by a Chinese auto firm to advise it on how to decide between making or buying a special battery it will need for the cars to be made in its Canadian factories.

Sourcing decisions: whether a firm should make or buy component parts.

Make:

Advantages: lower costs – if a firm is more efficient at that production activity than any other enterprise, the company should make; facilitate specialized investments – when a firm must invest in specialized assets to supply another, mutual dependency is created, so company should make; protect proprietary product technology – if the proprietary product technology enables a firm to produce a product containing superior features, it can give the company a competitive advantage; and improve scheduling – the weakest argument for vertical integration is that production cost savings result from it because it makes planning, coordination, and scheduling of adjacent processes easier, and this is particularly important in firms with just – in – time inventory systems.

Buy:

Advantages: strategic flexibility – the firm can maintain its flexibility, switching orders between suppliers as circumstances dictate by buying component parts from independent suppliers, this is particularly important internationally, where changes in exchange rates and trade barriers can alter the attractiveness of supply sources; lower costs – outsourcing may lower the firm's cost structure; offset – other countries may help the firm capture more orders from that country,

Trade – offs:

Trade – offs are involved in make – or – buy decisions. The benefits of manufacturing components in – house seem to be greatest when highly specialized assets are involved, when vertical integration is necessary for protecting proprietary technology, or when the firm is simply more efficient than external suppliers at performing a particular activity. When these conditions are not present, the risk of strategic inflexibility and organizational problems suggest it may be better to contract out component part manufacturing to independent suppliers. Since issues of strategic flexibility and organizational control loom even larger for international business than purely domestic ones, an international business should be particularly wary of vertical integration into component part manufacture. In addition, some outsourcing in the form of offsets may help a firm gain larger orders in the future.