Chapter 1 "Globalization"

What is Globalization?

- **Globalization**: The shift toward a more integrated and interdependent world economy.

The Globalization of Markets: The merging of historically distinct and separate national markets into one huge global marketplace.

- Falling barriers to cross-border trade have made it easier to sell internationally.
- A company does not have to be the size of a multinational giant to facilitate, and benefit from , the globalization of markets.
- The most global markets currently are not markets for consumer products – where national differences in tastes and preferences are still important – but markets for industrial goods and materials that serve a universal need.

The Globalization of Production: Sourcing goods and services from locations around the globe to take advantage of national differences in the cost and quality of various factors of production.

- **Factors of Production**: Components of production such as labor, energy, land, and capital.
- By doing this, companies hope to lower their overall cost structure or improve the quality of functionality of their product offering, thereby allowing them to compete more effectively.
- The internet is great facilitator for the globalization of production.

The Emergence of Global Institutions:

- Over the past half century, a number of important global institutions have been created to help manage, regulate, and police the global marketplace.
- **General Agreement on Tariffs and Trade (GATT)**: International treaty that committed signatories to lowering barriers to the free flow of goods across national borders; let to WTO.
- **World Trade Organization (WTO)**: The organization that succeeded the GATT and now acts to police the world trading system.
  - As of 2006, 149 nations that collectively accounted for 97 percent of world trade were WTO members, thereby giving the organization enormous scope and influence.
- **International Monetary Fund (IMF)**: International institution set up to maintain order in the international monetary system.
  - The IMF is seen as the lender of last resort to nation-states whose economies are in turmoil and currencies are losing value against those of other nations.
  - In return for the loan, the IMF requires nation-states to adopt specific economic policies aimed at returning their troubled economies to stability and growth.
- **World Bank**: International organization set up to promote economic development, primarily by offering low-interest loans to cash-strapped governments of poorer nations.
  - Was set up to promote economic development.
- **United Nations (UN)**: An international organization made up of 191 countries charged with keeping international peace, developing cooperation between nations, and promoting human rights.
  - When states become members of the United Nations, they agree to accept the obligations of the UN Charter, an international treaty that established basic principles of international relations.

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<u>Drivers of Globalization</u>:

Declining Trade and Investment Barriers:
- **Foreign Direct Investment (FDI)**: Occurs when a firm invests resources in business activities outside its home country.
- Many barriers to international trade took the form of high tariffs on imports of manufactured goods. The typical aim of such tariffs was to protect domestic industries.

The Role of Technological Change:
- **Microprocessors and Telecommunications**: Perhaps the single most important innovation for globalization. It allowed for the explosive growth of high-power, low-cost computing, and vastly increasing the amount of information that can be processed by individuals and firms.
- **The Internet and World Wide Web**: The web makes it much easier for buyers and sellers to find each other, wherever they may be located and whatever their size.
- **Transportation Technology**: In economic terms, the most important development of transportation technology is the use of commercial jet aircrafts, super-freighters, and the introduction of **containerization**, which simplifies transhipment from one mode of transport to another.

<u>The Changing Demographics of the Global Economy</u>:
- As of the late 1960s, four stylized facts described the demographics of the global economy:
  1. U.S. dominance in the world economy and world trade picture.
  2. U.S. dominance in world foreign direct investment.
  3. Dominance of large U.S. firms on the international business scene.
  4. Roughly half the globe – the centrally planned economies of the communist world – were off-limits to western international businesses.
- These four factors are now changing in the current world economy.

The Changing World Output and World Trade Picture:
- In the early 1960s, the united states accounted for 40.3 percent of the world output.
- By 2005, the U.S. accounted for 20.1 percent of world output.
  - This change was not a steady decline, but rather a relative decline. The decline is not a result of the U.S. producing less, it is a result of other countries (Germany, France, UK, etc.) producing more and growing faster.
- Most forecasts now predict a rapid rise in the share of world output accounted for by developing nations such as China, India, Indonesia, Thailand, South Korea, Mexico, and Brazil.

The Changing Foreign Direct Investment Picture:
- **Stock of Foreign Direct Investment**: The total accumulated value of foreign-owned assets at a given time.
- In the 1960s U.S. firms accounted for 66.3 percent of worldwide FDI.
- Follows the same trend in the previous section.

The Changing Nature of the Multinational Enterprise (MNE):
- **Multinational Enterprise (MNE)**: Any business that has productive activities in two or more countries.
- The two trends in the demographics of the multinational enterprise have been (1) the rise of non-U.S. MNEs and (2) the growth of mini-multinationals.

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The Changing World Order:

- Throughout the late 80s and 90s a series of remarkable democratic revolutions swept the communist world.
- With the continuation of pro-democratic governance, the potential for international business grows enormously.

The Globalization Debate:

Anti-Globalization Protests:

- Reasons for protest include: (1) job losses in industries under attack from foreign competitors, (2) downward pressure on the wage rates of unskilled workers, (3) environmental degradation, and (4) the cultural imperialism of global media and MNEs.
- Large segments of the population in many countries believe that globalization has detrimental effects on living standards and the environment.

Globalization, Jobs, and Income:

- One concern frequently voiced by globalization opponents is that falling barriers to international trade destroy manufacturing jobs in wealthy advanced economies.
- In the last few years, the same fears have been applied to services, which have increasingly been outsourced to nations with lower labor costs.
- Advocators of globalization respond that critics of these trends miss the essential point about free trade – **the benefits outweigh the costs**.
    - They argue that free trade will result in countries specializing in the production of those goods and services that they can produce most efficiently, while importing goods and services that they cannot produce as efficiently.

Globalization, Labor Policies, and the Environment:

- A second concern is that free trade encourages firms from advanced nations to move manufacturing to less developed countries that lack regulations to protect labor and the environment from abuse.
- Supporters of free trade argue that tougher environmental regulations and stricter labor standards go hand in hand with economic progress.
    - In general, as countries get richer, they enact tougher environmental and labor regulations.

Globalization and National Sovereignty:

- Another concern by critics of globalization is that today's increasingly interdependent global economy shifts economic power away from national governments and toward supra-national organizations such as the WTO, the EU, and the UN.
- Many politicians and economists maintain that the power of supra-national organizations such as the WTO is limited to what nation-states collectively agree to grant.

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Globalization and the World's Poor:

- Critics of globalization argue that despite the supposed benefits associated with free trade and investment, over the past century or so the gap between the rich and poor nations of the world has gotten wider.
- Advocators of globalization argue there are several factors that led to the widening gap (outside of globalization).
    1. Many of the world's poorest countries have suffered from totalitarian governments, economic policies that destroyed wealth rather than facilitated its creation.
    2. Endemic corruption
    3. Scant protection for property rights
    4. War
- Promoters of free trade argue that the best way for these countries to improve their lot is to lower their barriers to free trade and investment and to implement economic policies based on free market economics.

Class Notes:

- **Question**: What are the factors behind the growth of globalization since WWII.
    - **Answer**: Increase in telecommunications, Increase in transportation technology (containerization), **Free trade agreements** (Ex. NAFTA), reduction to barriers of FDI, and the rise of international goods (homogenization of tastes and preferences around the wolrd).
- **Modularization**: The internationalization of production. Parts are gathered from different locations but assembled in another.
- **The Present**:
    - Concerns over long trade imbalances (China and USA).
    - Exchange rate instability (current high).
    - US dollar is shaking (it is over-valued).
    - Public debt is the largest it has ever been in history. Japan has the biggest debt.
    - **Multi-Polar-Geo-Politics**: Struggle for global economic dominance.
    - Recession and the rise of protectionism.
    - Failure of Doha.
    - Control over energy and other resources. This issue has dominated global politics over the last twenty years.
    - Environmental economics and politics.
    - Welfare state for some countries.

Chapter 2 "National Differences in Political Economy"

Political Economy: The interdependent combination of a country's political, economic, and legal systems.

Political Systems:
- The system of government in any nation.
- Political systems can be assessed by two dimensions:
  1. The degree to which they emphasize collectivism as opposed to individualism.
  2. The degree to which they are democratic or totalitarian.

Collectivism and Individualism:
- **Collectivism**: Refers to a political system that stresses the primacy of collective goals over individual goals.
  - The needs of society as a whole are generally viewed as being more important than individual freedoms.
  - **Socialism**: The political system that believes in state ownership of a country's means of production, distribution, and exchange so that all can benefit.
    - The idea is to manage state-owned enterprise to benefit society as whole, rather than individual capitalists.
  - **Communists**: Those who believe that socialism can only be realized through violent revolution and totalitarian dictatorship.
  - **Social Democrats**: Those who believed in achieving socialism through democracy.
  - **Privatization**: The sale of state-owned enterprises to private investors.
- **Individualism**: The philosophy that an individual should have freedom in his or her economic and political pursuits.
  - Individualism is built on two central tenets: (1) Emphasis on the importance of guaranteeing individual freedom and self-expression; (2) The welfare of society is best served by letting people pursue their own economic self-interest.
  - In practical terms, individualism translates into an advocacy for democratic political systems and free market economics.

Democracy and Totalitarianism:
- **Democracy**: Refers to a political system in which government is by the people, exercised either directly or through elected representatives.
  - **Representative Democracy**: A democracy in which citizens periodically elect individuals to represent them in government functions.
  - In order for elected representatives to be held accountable for their actions, a number of safeguards are enshrined in constitutional law.
    1. An individual's rights to freedom of expression, opinion, and organization.
    2. Free Media.
    3. Regular elections in which all eligible citizens are allowed to vote.
    4. Universal adult suffrage.
    5. Limited terms for elected representatives.
    6. A fair court system that is independent from the political system.
    7. Non-political state bureaucracy.
    8. A non-political police force and armed service.
    9. Relatively free access to state information.

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- **Totalitarianism**: A form of government in which one person or political party exercises absolute control over all spheres of human life and prohibits opposing political parties.
    - In most totalitarian states, political repression is widespread, free and fair elections are lacking, media is heavily censored, basic civil liberties are denied, and those who question the right of the rulers find themselves imprisoned or worse.
    - Four major forms of totalitarianism:
        1. **Communist Totalitarianism**: A version of collective advocating that socialism can only be achieved through a totalitarian dictatorship.
        2. **Theocratic Totalitarianism**: A political system in which political power is monopolized by a party, group, or individual that governs according to religious principles.
        3. **Tribal Totalitarianism**: A political system in which a party, group, or individual that represents the interest of a particular tribe monopolize political power.
        4. **Right-Wing Totalitarianism**: A political system in which political power is monopolized by a party, group, or individual that generally permits individual economic freedom but restricts individuals political freedom, including free speech, often on the grounds that it would lead to the rise of communism.

<u>**Economic Systems**</u>:

Market Economy: All productive activities are privately owned, as opposed to being owned by the state. Production is determined by the interaction of supply and demand and signaled to producers through the price system.

- When supply exceeds demand, prices fall. When demand exceeds supply, prices rise.
- Monopolies cannot exist in market economies.

Command Economy: An economic system in which government plans the allocation of resources, including determination of what goods and services should be produced and in what quantity.

Mixed Economy: An economic system which certain sectors are left to private ownership and free market mechanisms, while other sectors have significant government ownership and government planning.

<u>**Legal Systems**</u>:

- Rules that regulate behaviour and the process by which the laws of a country are enforced and through which redress of grievance is obtained.

Different Legal Systems:

- **Common Law**: A system of law based on tradition, precedent, and custom, which is flexibly interpreted by judges as it applies to the unique circumstances of each case.
    - Tradition refers to a country's legal history, precedent to cases that have come before the courts in the past, and custom to the ways in which laws are applied in specific situations.
- **Civil Law**: A system of law based on a detailed set of written laws and codes.
- **Theocratic Law**: A system of law based on religious teachings.

Chapter 2 "National Differences in Political Economy"

The Determinants of Economic Development:

Differences in Economic Development:
- **Gross National Income (GNI)**: The yardstick for measuring economic activity of a country, this measures the total annual income of a nation's residents.
- **Purchasing Power Parity (PPP)**: An adjustment in gross domestic product per capita to reflect differences in the cost of living.
- **Human Development Index (HDI)**: Attempt by the UN to assess the impact of a number of factors on the quality of human life in a country.

Geography, Education, an Economic Development:
- By virtue of favorable geography, certain societies were more likely to engage in trade than others and were thus more likely to be open to and develop market-based economic systems, which in turn would promote faster economic growth.
- The general assertion for education is that nations that invest more in education will have higher growth rates because an educated population is a more productive population.

Class Notes:
- Major reason for china's economic growth: (1) The Chinese government controls the population, (2) China embraced women into the work force, (3) and China opened its borders.
- Inequalities to gender is a hindrance to economic development.
- Minimum wage laws lower unemployment. The idea that minimum wage laws increases unemployment is based on the perfect economic system (which does not exist).

Chapter 5 "International Trade Theory"

An Overview of Trade Theory:
- **Free Trade**: The absence of government-imposed barriers, such as quotas or duties, that impede the free flow of goods and services between countries.
- Adam Smith's theory of absolute advantage argued that the invisible hand of the market mechanism, rather than government policy, should determine what a country imports and what it exports.

The Benefits of Trade: Common sense notion of international trade dictates that country's should export products they can produce at low cost, and import products they cannot produce.
- Countries should trade exports that are most efficiently produced in their economy, even though a country can already produce it themselves.

The Pattern of International Trade:
- Climate and natural resource endowments explain why certain countries are able to export certain commodity goods at different times of the year.
- **Product Life Cycle**: Proposed by Raymond Vernon, the PLC theory can be used to explain export patterns for individual products.
- **New Trade Theory**: Proposed by Paul Krugmen, the new trade theory stresses that in some cases countries specialize in the production and export of particular products not because of underlying differences in factor endowments.
- **Theory of National Competitive Advantage**: Proposed by Michael Porter. In addition to factor endowments, Porter points out the importance of country factors such as domestic demand and domestic rivalry in explaining a nation's dominance in the production/export of an industry.

Trade Theory and Government Policy: The arguments for unrestricted free trade is that both imports controls and export incentives (such as subsidies) are self-deafening and result in wasted resources.

Mercantilism: The economic philosophy advocating that countries should simultaneously encourage exports and discourage imports.
- Based on the foundation of receiving gold and silver for exports and giving away gold and silver for imports.
- The mercantilists saw no virtue in large volume trade; rather, they recommended policies to maximize exports and minimize imports.
- **Zero-Sum Game**: A situation in which a gain by one country results in a loss by another. This is the flaw in Mercantilism.

Absolute Advantage: When one county is more efficient than any other country in producing a particularly product.
- According to Smith, countries should specialize in the production of goods for which they have an absolute advantage and then trade these for goods produced by other countries.
- A country should never produce goods at home that it can buy at a lower cost from other countries.
- **Production Possibility Frontier (PFF)**: The various output possibilities a country can produce from its resources pool.

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Comparative Advantage:

- David Ricardo took Adam Smith's theory one step further by exploring what might happen when one country has an absolute advantage in the production of all goods.
- **The Gain from Trade**: The theory of comparative advantage suggests that trade is a positive-sum game in which all countries that participate realize economic goals.

Qualifications and Assumptions: The conclusion that free trade is universally beneficial is a rather bold one to draw from such a simple model.

1. We have assumed a simple world in which there are only two countries and two goods. In the real world. there are many countries and many goods.
2. We have assumed away transportations costs between countries.
3. We have assumed away differences in the prices of resources in different countries. We have said nothing about exchange rates.
4. We have assumed that resources can move freely from the production of one good to another within a country. In reality, this is not always the case.
5. We have assumed constant returns to scale; that is, that specialization by a country has no effect on the amount of resources required to produce on ton of that product. The amount of resources required to produce a good might decrease or increase as a nation specializes in production of that good.
6. We have assumed that each country has a fixed stock of resources and that free trade does not change the efficiency with which a country uses its resources. This static assumption makes no allowances for the dynamic changes in a country's stock of resources and in the efficiency with which the country uses its resources that might result from free trade.
7. We have assumed away the effects of trade on income distribution within a country.

Extensions of the Ricardian Model:

- **Immobile Resources**: Resources do not always shift quite so easily from producing one good to another. The process creates friction and human suffering too.
- **Dynamic Effects and Economic Growth**: Opening an economy to trade is likely to generate dynamic gain of two sorts.
  1. Free trade might increase a country's stock of resources as increased supplies of labor and capital from abroad become available for use within the country.
  2. Free trade might also increase the efficiency with which a country uses its resources. This could arise from a number of factors:
     - Economies of large-scale production might become available as trade expands the size of the total market available to domestic farms.
     - Better technology can increase labor productivity or the productivity of the land.
     - Opening an economy to foreign competition might stimulate domestic producers to look for ways to increase their efficiency.
- **The Samuelson Critique**: Looks at what happens when a rich country enters into a free trade agreement with a poor country that rapidly improves its productivity after the introduction of a free trade regime.
- The critique suggests that in such cases, that lower prices that the rich country's consumers pay for goods imported from the poor country following the introduction of a free trade regime may not be enough to produce a net gain for the rich country if the dynamic effect of free trade is to lower real wage rates in the rich country.

Chapter 5 "International Trade Theory"

- **Evidence for the Link between Trade and Growth**: Countries that adopt a more open stance toward international trade enjoy higher growth rates than those that close their economies to trade.
    - Adopt an open economy and embrace free trade, and your nation will be rewarded with higher economic growth rates. This will in turn raise income levels and living standards.

Heckscher-Ohlin Theory:

- Comparative advantage arises from differences in national factor endowments.
- **Factor Endowments**: The extent to which a country is endowed with such resources as land, labour, and capital.
    - Nations have different factor endowments, and those differences explain differences in factor costs; specifically, the more abundant a factor, the lower its cost.
- **Heckscher-Ohlin Theory**: Predicts that countries will export those goods that make intensive use of factors that are locally abundant, while importing goods that make intensive use of factors that are locally scarce.
- **The Leontief Paradox**: An exception to the Heckscher-Ohlin Theory.

New Trade Theory:

- **Economies of Scale**: Unit cost reductions associate with a large scale of output. Economies of scale are a major sources of cost reductions in many industries.
- New trade theory makes two important points:
    1. Through its impact on economies of scale, trade can increase the variety of goods available to consumers and decrease the average costs of those goods.
    2. Those industries in which the output required to attain economies of scale represents a significant proportion of total world demand, the global market may be able to support only a small number of enterprises.

Increasing Product Variety and Reducing Costs:

- If a national market is small, there may not be enough demand to enable producers to realize economies of scale for certain products.
- Accordingly, those products may not be produced, thereby limiting the variety of products available to consumers.
- When nations trade with each other, individual national markets are combined into a large world market. As the size of the market expands as a result of trade, individual firms may be better able to attain economies of scale.

Economies of Scale, First-Mover Advantages, and the Pattern of Trade:

- **First-Mover Advantage**: The economic and strategic advantages that accrue to early entrants into an industry.
    - The ability to capture economies of scale ahead of later entrants, and thus benefit from a lower cost structure, is an important first-mover advantage.
- New Trade theory argues that for those products for which economies of scale are significant and represent a substantial proportion of world demand, the first movers in an industry can gain a scale-based cost advantage that later entrants find almost impossible to match.

Chapter 5 "International Trade Theory"

Implications of New Trade Theory: The theory suggests that nations may benefit from trade even when they do not differ in resource endowments or technology.

- Trade allows a nation to specialize in the production of certain products, attaining economies of scale and lowering costs of producing those products, while buying products that it does not produce form other nations, which leads to a variety of products becoming available.
- The theory also suggests that a country may predominate in the export of a good simply because it was lucky enough to have one or more firms among the first to produce that good.
- The most contentious implication of the new trade theory is the argument that it generates for government intervention and strategic trade policy.

National Competitive Advantage – Porter's Diamond:

- The essential task of Porter's work was to explain why a nation achieves international success in a particular industry.
- Porter theorizes that four broad attributes of a nation shape the environment in which local firms compete, and these attributes promote or impede the creation of competitive advantage.
- These four factors are:
    1. **Factor Endowments**: A nation's position in factors of production such as skilled labor or the infrastructure necessary to compete in a given industry.
        - **Basic Factors**: Natural resources, climate, location, and demographics. **First Advantage**.
        - **Advanced Factors**: Communication infrastructure, sophisticated and skilled labor, research facilities, and technological knowledge. **More Important to Success**.
    2. **Demand Conditions**: The nature of home demand for the industry's product or service.
        - Gain competitive advantage if domestic consumers are sophisticated and demanding. Such customers pressure local firms to meet high standards.
    3. **Relating and Supporting Industries**: The presence or absence of supplier industries and related industries that are internationally competitive.
        - The benefit of investments in advanced factors of production by related and supporting industries can spill over into an industry, thereby helping it achieve a strong competitive advantage.
        - One consequence of this process is that successful industries within a country tend to be grouped into clusters of related industries.
    4. **Firm Strategy, Structure, and Rivalry**: The conditions governing how companies are created, organized, and managed and the nature of domestic rivalry.
        - Different nations are characterized by different management ideologies, that either help them or do not help them build a national competitive advantage.
        - There is a strong association between vigorous domestic rivalry and the creation and persistence of competitive advantage in an industry.
- There are two additional variables that can influence the national diamond in important ways: chance and government.
    - Chance events such as major innovations can reshape industry structure and provide the opportunity for one nation's firms to supplant another's.
    - Governments, by its choice in policies, can detract from or improve national advantage.

Chapter 6 "The Political Economy of International Trade"

Instruments of Trade Policy:

Tariffs: A tax levied by governments on imports or exports.

1. **Specific Tariffs**: Levied as a fixed charge for each unit of good imported.
2. **Ad Valorem Tariff**: Levied as a proportion of the value of the imported good.

- In most cases, tariffs are placed on imports to protect domestic producers from foreign competition by raising the price of imported goods.
- Tariffs also produce revenue for the government.
- **Who Gains? Who Suffers?** The **government gains**, because the tariff increases government revenues. **Domestic producers gain**, because the tariff affords them some protection against foreign competitors. **Consumers lose** because they must pay more for certain imports.
- **Economic Conclusions**:
    1. Tariffs are unambiguously pro-producer and anti-consumer.
    2. Import tariffs reduce the overall efficiency of the world economy. This is because it encourages domestic producers to produce goods that, in theory, could be produced more efficiently elsewhere.
- **Export Tariffs**: Much less common. The objectives of such tariffs are: (1) raise revenue for the government, and (2) reduce exports from a sector, often for political reasons.

Subsidies: Government financial assistance to a domestic producer. Grants, low-interest loans, tax breaks, and government equity participation are all forms of subsidies.

- By lowering production costs, subsidies help domestic producers in two ways: (1) competing against foreign imports, and (2) gaining export markets.
- Agriculture tends to by one of the largest beneficiaries of subsidies in most countries.
- Subsidies tend to protect the inefficient and promote excess production.
    1. Allow inefficient farmers to stay in business.
    2. Encourage countries to overproduce heavily subsidized agricultural products.
    3. Encourage countries to produce products that could be produced abroad more efficiently.
    4. Reduce international trade in agriculture products.

Import Quotas and Voluntary Export Restraints:

- **Import Quotas**: A direct restriction on the quantity of some good that can be imported into a country. The restriction is usually enforced by issuing import licenses to a group of firms.
- **Tariff Rate Quota**: The process of applying a lower tariff rate to imports within the import quota than those over the quota.
- **Voluntary Export Restraint (VER)**: A quota on trade imposed by the exporting country, typically at the request of the importing country's government.
- Same economic conclusions as tariffs and subsidies.
- **Quota Rent**: The extra profit producers make when supply is artificially limited by an import quota.

Local Content Requirement: A requirement that some specific fraction of a good can be produced domestically.

- Used in developing countries to try to protect local jobs and industry from foreign competition.

Chapter 6 "The Political Economy of International Trade"

Administrative Trade Policies: Rules adopted by governments that can be used to restrict imports or boost exports.

Antidumping Policies: Rules designed to punish foreign firms that engage in dumping and thus protect domestic producers from unfair foreign competition.

- **Dumping**: Selling goods in a foreign market for less than their cost of production or below their fair market value. **Countervailing Duties**: Anti-dumping duties.

<u>The Case for Government Intervention</u>:

Political Arguments for Intervention:

- **Protecting Jobs and Industries**: The most common political argument for government intervention.
- **National Security**: Countries sometimes argue that it is necessary to protect certain industries because they are important for national security. Defense-related industries such as aerospace, advanced electronics, etc. get this kind of treatment.
- **Retaliation**: Some argue that governments should use the threat to intervene in trade policy as a bargaining tool to help open foreign markets and force trading to "play by the rules."
    - If it works, such a politically motivated rationale for government intervention may liberalize trade and bring with it resulting economic gains.
- **Protecting Consumers**: Many governments have long had regulations to protect consumers from unsafe products.
- **Furthering Foreign Policy Objectives**: Governments sometimes use trade policy to support their foreign policy objectives. Ex: A government may grant preferential trade terms to another country that it wants to build a strong relationship with.
    - **Helms-Burton Act**: Passed in 1996, this law allows Americans to sue foreign firms that use Cuban property confiscated from them during Cuba's 1959 revolution.
    - **D'Amato Act**: Passed in 1996, this law allows Americans to sue foreign firms that use property in Libya or Iran confiscated from Americans.
- **Protecting Human Rights**: Governments sometimes use trade policy to try to improve the human rights policies of trading partners. Ex: American granting Most Favored Nation (MFN) to China.

Economic Arguments for Intervention:

- **The Infant Industry Argument**: Proposed by Alexander Hamilton in 1792, this argument for government intervention stats that developing countries have a comparative advantage in manufacturing. Many economist remain critical of this argument for two reasons:
    1. Protection of manufacturing from foreign firms does no good unless the protection helps make the industry efficient.
    2. The argument relies on the assumption that firms are unable to make efficient long-term investments by borrowing money from the domestic or international capital markets.
- **Strategic Trade Policy**: Government policy aimed at either helping the country's domestic firms retain first-mover gains or helping domestic firms find entry into a market; applied when the world market will probably support only a few firms an certain countries may predominate in the export of certain products simply because they had first-mover firms.

Chapter 6 "The Political Economy of International Trade"

Revised Case for Free Trade:

- **Retaliation and Trade War**: Strategic trade policy aimed at establishing domestic firms in a dominant position in a global industry boosts national income at the expense of other countries.
- **Domestic Policies**: Governments do not always act in the national interest when they intervene in the economy; politically important interest groups often influence them.

Food Security: Japan and South Korean food security policies are the most severe in the world.

Raising Revenue:

Chapter 7 "Foreign Direct Investment"

Introduction:

- **Foreign Direct Investment (FDI)**: Occurs when a firm invests directly in facilities to produce or market a product in a foreign country.
    - **Multinational Enterprise (MNEs)**: A firm that undertakes FDI.
    - **Gross Fixed Capital Formation**: The summary of the total amount of capital invested in factories, stores, offices, and the like.
- Two main forms:
    1. **Greenfield Investment**: Establishing a new operation in a foreign country.
    2. Acquiring or merging with an existing firm in the foreign country.

FDI in the World Economy:

- **Flow of FDI**: the amount of FDI undertaken over a given time period (normally a year).
- **Stock of FDI**: The total accumulated value of foreign-owned assets at a given time.

Trends in FDI: FDI has grown more rapidly than world trade and world output for several reasons.

1. Firms fear protectionist pressures, despite the decline in trade barriers over the last 30 years.
    - Firms see FDI as a way of circumventing future trade barriers.
2. Recent increases in FDI are being fueled by the political and economic changes that have been occurring in the world's developing nations.
    - The shift toward democracy and free market economies are fueling FDI.
3. Globalization of the world economy. Firms see the whole world as their market.
4. Creation of a more FDI-friendly global environment (trade agreements and treaties).

China and FDI: In late 1978, China's leadership decided to move the economy away from a centrally planned socialist system to one that was more market driven. The result has been three decades of sustained how economic growth rates and a exponential increase in FDI inflows.

1. With a population of 1 billion people, China represents the largest market in the world.
    - Import tariffs have made it difficult to serve this market via exports, so FDI was required if a company wanted to tap into the country's huge potential.
2. In order to attract more FDI, the Chinese government has committed itself to invest more than $800 billion in infrastructure projects over 10 years.
    - By doing so, they will be giving firms more incentives to invest in China.

- **Problems**: China, although developing, is still a poor nation. Most people cannot afford western consumer goods.
    - Poor infrastructure and a highly regulated environment, both of which make conducting business problematic.

The Source of FDI: Since WWII, the U.S. has been the largest source country for FDI. Other important sources include U.K., France, Germany, the Netherlands, and Japan.

Form of FDI – M&A vs. Greenfield Investments: Why do firms prefer M&A's over Greenfield investments?

1. M&As are quicker to execute.
2. Foreign firms are acquired because they have valuable strategic assets.
3. The acquiring firms believe they can increased the efficiency of the acquired unit by transferring capital, technology, or management skills.

Chapter 7 "Foreign Direct Investment"

The Shift to Services: The shift to services is being driven by four factors.

1. The shift reflects the move in many developed economies away from manufacturing to services.
2. Many services cannot be traded internationally.
3. Many countries have liberalized their regimes governing FDI in services.
4. The rise of internet-based global telecommunications networks has allowed some service enterprises to relocate some of their value-creation activities to different nations to take advantage of favourable factor costs. (Ex. Call centers in India).

Theories of FDI:

Why FDI? Why do firms conduct FDI when they can export or license?

- **Exporting**: Sale of products produced in one country to residents of another country.
- **Licensing**: Occurs when a firm (the licensor) grants a foreign entity (the licensee) the right to produce its product, use its production processes, o use its brand name o trademark in return for a royalty fee on every unit sold.

Limitations of Exporting: The viability of an exporting strategy is often constrained by transportation costs and trade barriers.

- When transportation costs get added to production costs, it becomes unprofitable to ship some products over a large distance.
  - This is especially true for low-value-to-weight products that can be produced anywhere.
- Some firms undertake FDI as a response to actual or threatened trade barriers.
  - By placing tariffs on imported goods, governments increase the cost of exporting.
  - By limiting exports through quotas, governments increase the attractiveness of FDI.

Limitations of Licensing:

- **Internalization Theory**: The argument that firms prefer FDI over licensing in order to retain control over know-how, manufacturing, marketing, and strategy or because some firm capabilities are not amenable to licensing.
- Three major drawbacks of licensing:
  1. Licensing may result in a firm giving away its valuable technological know-how to a potential foreign competitor.
  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. When the firm's competitive advantage is not based the product, but on the management, marketing, and manufacturing capabilities that make the product, licensing is limited because such capabilities are often not amenable in licensing.
- When one or more of the following conditions hold, FDI is more profitable than licensing:
  1. When the firm has valuable know-how that cannot be protected by a licensing contract.
  2. When the firm needs tight control over a foreign entity to maximize its market share.
  3. When a firm's skills and know-how are not amenable to licensing.

Chapter 7 "Foreign Direct Investment"

Advantages of FDI:

- **Strategic Behavior**: FDI flows are a reflection of strategic rivalry between firms in the global marketplace. Firms will imitate the operations and behaviours of competing firms in order to ensure they don't achieve a competitive advantage.
  - **Oligopoly**: An industry composed of a limited number of large firms.
  - **Multipoint Competition**: When two or more enterprises encounter each other in different regional markets, national markets, or industries.
- **Product Life Cycle**: Firms undertake FDI at particular stages in the life cycle of a product they have pioneered.
  - They subsequently shift production to developing countries when product standardization and market saturations give rise to price competition.
- **Location-Specific Advantages**: Advantages that arise from utilizing resource endowments or assets that are tied to a particular foreign locations and that a firm finds valuable to combine with its own unique assets, such as technological, marketing, or management capabilities.

<u>**Political Ideology and FDI**</u>:

1. **The Radical View**: Traces its roots to Marxist political and economic theory. Radical writers argue that the MNEs are an instrument of imperialist domination.
   - By this rational, radicals view FDI hinders the development of poor nations and keeps them dependant on advanced capitalist nations for investments, jobs, and technology.
   - A decline in the radical view is a result of three reasons: (1) collapse of communism in eastern europe; (2) generally abysmal economic performance of "radical" countries; and (3) strong economic performance from "free market" countries.
2. **The Free Market View**: Traces its roots to Adam Smith and David Ricardo. The free market view argues that international production should be distributed among countries according the theory of comparative advantage.
   - Countries should specialize in the production of those goods and services it can produce most efficiently.
3. **Pragmatic Nationalism**: The political view that FDI has both benefits and costs.
   - FDI can benefit a host country by bringing capital, skills, technology, and jobs, but those benefits come at a cost. Countries that pursue a pragmatic stance adopt policies designed to maximize national benefits.
   - Another aspect of pragmatic nationalism is the tendency to aggressively court FDI by offering subsidies and tax breaks to foreign MNEs.

<u>**Benefits and Costs of FDI**</u>:

Host-Country Benefits:

1. **Resource Transfer**: FDI supplies the host country with capital, technology, and management resources that would otherwise be unavailable and thus boost the country's economy.
2. **Employee**: FDI brings jobs to the host country that would otherwise not be created there.
3. **Balance-of-Payments**: FDI helps countries maintain a positive **current balance-of-payments** account by: (1) being a substitute for imports; and (2) the MNE uses a foreign subsidiary to export goods and services to other countries.
4. **Competition and Economic Growth**: FDI increases the level of competition in the host-country, which, according to economic theory, drives efficiency.

Chapter 7 "Foreign Direct Investment"

Host Country Costs:

1. **Adverse Effects of Competition**: In general, while FDI in the form of greenfield investments should increase competition, it is less clear that this is the case when the FDI takes the form of an acquisition of an established enterprise in the host nation.
    - Acquisitions and Mergers do not result in a net increase in the number of competitors.
2. **Adverse Effects on the Balance-of-Payments**:
    - Set against the initial capital inflow that comes with FDI must be the subsequent outflow of earnings from the foreign subsidiary to its parent company. These appear as capital outflows on the host-country's balance-of-payments account.
    - When an MNE imports a substantial number of its inputs from abroad there is a debit on the current account of the host country's balance-of-payments account.
3. **National Sovereignty and Autonomy**: Host governments worry that FDI is accompanied by some loss of economic independence.

<u>Government Policies on FDI</u>:

Home Country Policies:

- **Encouraging Outflows**:
    1. Government-backed insurance programs to cover major types of foreign investment risk.
    2. Special funds/banks that make government loans to firms wishing to invest in developing countries (EDC).
    3. Many countries eliminated double taxation of foreign income.
    4. Many home countries have exerted their political influence to persuade host countries to relax their restrictions on inbound FDI.
- **Restricting Outflows**:
    1. Concern over balance-of-payments account.
    2. Changed tax regulations to encourage firms to invest domestically.
    3. Trade sanctions due to political reasons.

Host Country Policies:

- **Encouraging Inflows**: Incentives are motivated by a desire to gain from the resource-transfer and employment effects of FDI.
    - Tax concessions, low-interest loans, and grants or subsidies.
- **Restricting Inflows**:
    1. Foreign firms are often excluded from certain sectors on the grounds of national security or competition.
    2. Ownership restraints seem to be based on a belief that local owners can help to maximize the resource-transfer and employment benefits of FDI.

International Institutions and the Liberalization of FDI:

- The WTO embraces the promotions of international trade in services.
- **Organization for Economic Cooperation and Development (OECD)**: initiated talks in 1995 between its members to draft a **multilateral agreement on investment (MAI)** that would make it illegal for signatory states to discriminate against foreign investors.
    - MAI failed because the USA refused to sign.
- **G20**: Group of finance ministers and central bank governors from 20 major economies.

Chapter 8 "Regional Economic Integration"

Introduction:

- **Regional Economic Integration**: Agreements among countries in a geographic region to reduce and ultimately remove tariff and non-tariff barriers to free flow of goods, services, and factors of production between each other.
- **Examples**: NAFTA (Canada, US, and Mexico); EU (European Union); MERCOSUR (Uraguay); SAFTA (South America); APEC (Pacific nations).
- The move toward REI can potentially benefit consumers but not firms.

Levels of Economic Integration:

1. **Free Trade**: No tariffs, quotas, subsidies, or admin. impediments are allowed between member states. Can impost protection regulations for inward flow.
2. **Customs Market**: Eliminates trade barriers between members and common ext. trade policy.
3. **Common Market**: No barriers to trade between members, common external trade policy. Allowed free flow of factors of production. **This is tough to create and maintain**.
4. **Economic Union**: Free flow of products and factors of productions, common currency, common monetary and fiscal policy, and tax harmonization.
    - EU would not be considered a economic union because they have different taxes.
5. **Political Economy**: All states and provinces combined into a single nation united by democracy.

The Case for Regional Integration:

The Economic Case for Integration:

- International trade theory states that countries should produce/export those products that they can produce most efficiently.
- Stimulates economic growth through FDI benefits (transfer of technological, marketing, and managerial know-how to host nations).

The Political Case for Integration: Making linked and interdependent economies creates incentive for political cooperation. This could prevent future violent conflicts.

Obstacles to Integration:

1. Some countries may lose in regional free trade agreements. For example, there could be a loss of jobs and capital outflow for one country when production moves abroad.
2. Concerns over national sovereignty. Countries lose control after engaging in agreements.

The Case Against Regional Integration: A regional free trade agreement will benefit the world only if the amount of trade it creates exceeds the amount it diverts.

- **Trade Creation**: Trade created within a free trade area due to the replacement of high-cost domestic producers by low-cost external producers.
- **Trade Diversion**: Trade diverted within a free trade area when lower-cost external suppliers are replaced by higher-cost external suppliers.

Chapter 8 "Regional Economic Integration"

Regional Economic Integration in Europe:

Evolution of the European Union: The EU is the regional economic union of most European countries, formed as a result of (1) the two world wars and (2) the European nations desire to hold their own in the world's political and economic stage.

- **Treaty of Rome**: Signed in 1957; established the European community, a forerunner to the EU and created the common European market.

Political Structure of the European Union:

1. **European Commission**: Responsible for proposing, implementing, and monitoring compliance with EU legislation, run by a group of commissioners appointed by each member country.
2. **Council of the European Union**: The ultimate decision-making body of the EU, it passes legislation from the commission into law and is comprised of one representative from each member state's government.
3. **European Parliament**: Made up of 732 members directly elected by member states' populations, it serves as a consultative body to debate and propose amendments to the legislation forwarded from the council.
4. **The Course of Justice**: Comprised of one judge from each member state, this is the supreme appeals court for EU law.

The Single European Act: Adopted by members of the European Community in 1987, this act committed member countries to establish a single market by the end of 1992.

- Created in response to the failed operations of the European Community.
- **Objectives of the Act**: Purpose was to have one market in place by December 31, 1992.
    - Remove all frontier controls between EC countries, mutual recognition, lift barriers, remove restrictions on foreign exchange, etc.
- **Impact**: 15 years after the formation of a single market, the reality still falls short of the ideal. This is due to established legal, cultural, and language difference between nations.

The Establishment of the Euro:

- **Maastricht Treaty**: a 1991 treaty committing members of the EC to adopt a common currency by 1999; the euro.
- **Benefits of the Euro**:
    1. Businesses and individuals will realize significant savings from having to handle once currency.
    2. The adoption of a common currency will make it easier to compare prices across Europe [increased competition/lower prices].
    3. Faced with lower, European producers will be forced to look for ways to reduce their production costs to maintain their profit margins.
    4. Strong boost to the development of a highly liquid pan-European capital market. This will lead to a lower cost of capital and increase efficiency in FDI.
    5. Increase the range of investment opportunities for individuals and institutions.
- **Costs of the Euro**: National authorities have lost control over monetary policies.

Chapter 8 "Regional Economic Integration"

Regional Economic Integration in the Americas:

NAFTA: North American Free Trade Agreement formed among Canada, USA, and Mexico on Jan 1, 1989.

- **Case for**: Helps Mexico with positive FDI effects.
- **Case against**: Job losses in USA and Canada, and Mexico fears loss of national sovereignty.
- **Experience**: Mexico is in a financial crisis; Canada and US exports went down.
- **Enlargement**: Case is being made to include Chile.

The Andean Community of Nations:

- **Andean Pact**: Based on the EU model and begun in 1969, this agreement unites Bolivia, Chile, Ecuador, Colombia, and Peru in free trade, but it has been unsuccessful at achieving its stated goals; renamed the Andean Community in 1997.
- By the mid-1980s, the Andean pact had all but collapsed and had failed to achieve its objectives.
- In the late 1980s, the tide began to turn when the governments of Latin America began to adopt free market economic policies.

Chapter 9 "The Foreign Exchange Market"

Introduction:
- **Foreign Exchange Market**: A market for converting the currency of one country into that of another country.
- **Exchange Rate**: The rate at which one currency is converted into another.

The Functions of the Foreign Exchange Market:
- **Foreign Exchange Risk**: The risk that changes in exchange rates will hurt the profitability of a business deal.

Currency Conversion: Four main uses of foreign exchange markets
1. The payments a company receives for its exports, income it receives from foreign investments, etc. may be in foreign currencies.
2. When a company pays a foreign company for its products or services in its country's currency.
3. International businesses use foreign exchange markets when they have spare cash that they wish to invest for short terms in money markets.
4. **Currency Speculation**: Moving funds from one currency to another over the short-term in hopes of profiting from shifts in exchange rates.

Insuring against Foreign Exchange Risk:
- **Hedging**: The process of insuring one's business against foreign exchange risk by using forward exchanges or currency swaps.
- **Spot Exchange Rates**: The rate at which a foreign exchange dealer converts currency on any particular day.
    - The Value of a currency is determined by the interaction between the demand and supply of that currency relative to the demand and supply of other currencies.
- **Forward Exchange**: When two parties agree to exchange currency and execute a deal at some specific date in the future.
    - **Forward Exchange Rates**: The exchange rate governing forward exchange transactions, calculated at the time of the exchange but based on future expectations.
    - When a firm enters into a forward exchange contract, it is taking out insurance against the possibility that future exchange rate movements will make a transaction unprofitable by the time that transaction has been executed.
- **Currency Swaps**: The simultaneous purchase and sale of a given amount of foreign exchange for two different value dates.

Economic Theories of Exchange Rate Determination: At the most basic level, exchange rates are determined by the demand and supply of one currency relative to the demand and supply of another.

Prices and Exchange Rates:
1. **The Law of One Price**: The principle that in competitive markets free of transportation costs and barriers to trade, identical products sold in different countries must sell of the same price when their price is expressed in the same currency.

Chapter 9 "The Foreign Exchange Market"

2. **Purchasing Power Parity**: If the law of once price were to hold true, then countries would have the same purchasing power.
    - **Efficient Market**: A market in which prices reflect all available information and trade is not restricted.
    - **Relatively Efficient Markets**: A market in which few impediments to international trade and investment exist. If this were to be the case, the price of a basket of goods would be roughly equivalent in each country.
    - **Formula**: $E_{\$/¥} = P_{\$}/P_{¥}$
3. **Money Supply and Price Inflation**: Theoretically, 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 lower.
    - The growth rate of a country's money supply determines its likely future inflation rate.
    - **Price Inflation**: When the increase in the supply of money increases the demand of goods, which in turn increases the price of those goods.
    - **When the growth in a country's money supply is faster than the growth of its output, price inflation is fueled**.

Empirical Tests of PPP Theory: Although PPP theory seems to yield relatively accurate predictions in the long run, it does not appear to be a strong predictor of short run movements in exchange rates covering time spans of five years or less.

- The theory is less useful for predicting exchange rate movements between the currencies of advanced industrialized nations that have relatively small differentials in inflation rates.
- **This could be a result of**: (1) PPP theory does not account for transportation cost and barriers to trade; (2) Government intervention; (3) MNE power over national markets.

Interest Rates and Exchange Rates:

- **Fisher Effect**: The theory that nominal interest rates (i) in each country equal the required real rate of interest (r) and expected rate of inflation (I) over the time period for which the funds are to be lent. **Therefore**: i = r + I
- **International Fisher Effect**: The theory that for any two countries, the spot exchange rate should change in an equal amount but in the opposite direction to the difference in the normal interest rates between countries.

Investor Psychology and Bandwagon Effects: Various psychological factors play an important role in determining the expectations of market traders as to likely future exchange rates.

- **Bandwagon Effect**: When traders move like a herd, all in the same direction and at the same time, in response to each other's perceived actions.

<u>**Why Did the Korean Won Collapse?**</u>

- SK's largest firms initiated large investing projects that needed loans 4 times the size of the investments.
- All transactions were done in US dollars and not the SK Won.
- With the knowledge that Korean firms would be unable to pay back their loans, foreign firms pulled out of Korean markets.

Chapter 9 "The Foreign Exchange Market"

Exchange Rate Forecasting: Should businesses invest in forecasting services?

The Efficient Market School: Forward exchange rates represent market participants' collective predictions of likely spot exchange rates at specified future dates.

- If the foreign exchange market is efficient, forward exchange rates should be unbiased predictors of future spot rates.
- Should not invest in forecasting services.

The Inefficient Market School: Some economists believe the foreign exchange market is inefficient.

- **Inefficient Market**: A market in which prices do not reflect all available information.
- If this is the case, then it may be worthwhile for international businesses to invest in forecasting services.

Approaches to Forecasting: if markets are inefficient.

1. **Fundamental Analysis**: Draws on economic theory to construct econometric models for predicting exchange rate movements.
    - Variables include money supply growth rate, inflation rates, and interest rates.
    - Running a deficit on a balance-of-payments current account (importing more than exporting) creates pressures that may result in depreciation of the country's currency.
2. **Technical Analysis**: Uses price and volume data to determine past trends, which are expected to continue into the future.

Currency Convertibility:

- **Freely Convertible Currency**: When a country's government allows both residents and non-residents to convert its currency into foreign currency.
- **Externally Convertible Currency**: When a country's government allows only non-residents to convert the currency into foreign currency.
- **Non-convertible Currency**: When a country's government allows neither residents not non-residents to convert its currency into a foreign currency.
- **Capital Flight**: When residents and non-residents rush to convert their holdings of a domestic currency into a foreign currency, usually taking place when domestic currency is depreciating rapidly or a country is facing dim economic prospects.
- **Countertrade**: The trade of goods and services produced in one country for the goods and services of another country.

Chapter 10 "The International Monetary System"

Introduction:

- **International Monetary System**: The institutional arrangements countries adopt that governs exchange rates.
- **Floating Exchange Rate**: A system under which the exchange rate for converting one currency into another is continuously adjusted depending on the law of supply and demand.
- **Pegged Exchange Rate**: A system under which the value of a country's currency is fixed relative to a reference currency, and then the exchange rate between that currency and other currencies is determined by the reference currency exchange rate.
- **Dirty Float**: A system under which a country's currency is nominally allowed to float freely against other currencies, but in which the government will intervene if it believes the currency has devalued too far from its value.
- **Fixed Exchange Rate**: A system under which the exchange rate for converting one currency into another is set at a constant rate.

The Gold Standard:

Mechanics of the Gold Standard: By 1880, the world's major trading nations adopted the gold standard.

- **Gold Standard**: The practice of pegging currencies to gold and guaranteeing convertibility.
- **Gold Par Value**: The amount of currency needed to purchase one ounce of gold.

Strength of the Gold Standard: The great strength claimed by the gold standard was that it contained a powerful mechanism for achieving balance-of-trade equilibrium by all countries.

- **Balance-of-Trade Equilibrium**: Reached when the income a country's residents earned from exports equals the money they pay for imports.

The Period between the Wars (1918 – 1939): The gold standard worked reasonably well from the 1870s until the start of World War I in 1914, when it was abandoned.

- Several governments financed military expenditures by printing money. This resulted in inflation, and by the war's end in 1918, price levels were higher everywhere.
- Because of the war (and inflation), countries devalued their currencies at will and no one could be certain how much gold a currency could buy.

The Bretton Woods System: In 1944, at the height of WWII, representatives from 44 countries met at Bretton Woods, New Hampshire, to design a new international monetary system.

- The result of which was the establishment of two multinational institutions: the International Monetary Fund (IMF) and the World Bank.
- Also, all currencies were set to be fixed at the value of gold, but not to be converted in gold.

The Role of the IMF:

- **Discipline**: A fixed exchange rate regime imposes discipline in two ways:
  1. Puts a stop to competitive devaluations and brings stability to the world trade environment.
  2. Imposes monetary discipline on countries, thereby curtailing price inflation.
- **Flexibility**: The fixed exchange rate regime still needed to be flexible to avoid repeating the chaos caused by the gold standard.
  1. **IMF Lending Facilities**: The IMF would lend foreign currencies to members to help them over short period of balance-of-payments deficits.

2. **Adjustable Parities**: The system allowed for devaluation in a country's currency by more than 10 percent if the IMF agreed that the country's balance-of-payments were in *fundamental disequilibrium*.
    - **Fundamental Disequilibrium**: Countries that suffered permanent adverse shifts in the demand for their products.

The Role of the World Bank: The bank's mission was to development and began lending money to "Third World" nations. The bank lends money under two schemes.

1. **IBRD Scheme**: Money is raised through bond sales in the international capital marker. The bank then offers low-interest loans to risky customers whose credit rating are often poor such as the governments of underdeveloped nations.
2. **International Development Association (IDA) Scheme**: Resources to fund the IDA, an arm of the bank created in 1960, are raised through subscription from wealthy members. IDA loans go only to the poorest nations. Borrowers have 50 years to repay at an interest rate of 1 percent a year.

The Collapse of the Fixed Exchange Rate System: System collapsed in 1973

- The collapse can be traced back to the inflation caused by the US printing money in order to fund the Vietnam war and its welfare programs.
- The system could only work if the key currency, the US dollar, remained its low inflation rate and did not run a balance-of-payments deficit.

The Floating Exchange Rate Regime: Formalized in 1976.

- **The Jamaica Agreement**: (1) Floating rates were declared as acceptable; (2) Gold was abandoned as a reserve asset; (3) Total annual IMF quotas were increased to $41 billion and les developed nations were given greater access to IMF funds.
- **Exchange Rates Since 1973**: Increase volatility in the international monetary system/market.
    - **Managed Float System**: System under which some currencies are allowed to float freely, but the majority are either managed by government intervention or pegged to another currency.

Fixed Versus Floating Exchange Rates:

The Case for Floating Exchange Rates:

- **Monetary Policy Autonomy**: Advocates argue that removal of the obligation to maintain exchange rate parity would restore monetary control to a government. This goes both ways in that it can both help and hurt an economy.
- **Trade Balance Adjustments**: Critics of the fixed system argue that the adjustment mechanism works much more smoothly under a floating exchange rate regime.

The Case for Fixed Exchange Rates:

- **Monetary Discipline**: Advocates of this system argue that governments succumb to political pressure and expand the monetary supply too rapidly in floating exchange rate systems.
- **Speculation**: Can cause fluctuations in exchange rates in a floating system.
- **Uncertainty**: The uncertainty makes business planning difficult in a floating system.
- **Trade Balance Adjustments**: Advocates of this system argue that trade deficits should be determined by the savings and investments in a country, not by the value of its currency.

Chapter 10 "The International Monetary System"

Exchange Rate Regimes in Practice:

Pegged Exchange Rates: Evidence shows that adopting a pegged exchange rate regime moderates inflationary pressures in a country (LOWER EXCHANGE RATES).

Currency Boards: A country's currency authority that holds reserves of foreign currency equal at the fixed exchange rate to at least 100 percent of the domestic currency issued in order to keep inflation down.

Crisis Management by the IMF:

- **Currency Crisis**: When a speculative attack on the exchange value of a currency results in a sharp depreciation of the currency or forces authoritties to expend large volumes of international currency reserves and sharply increase interest rates to defend the prevailing exchange rate.
- **Banking Crisis**: When individuals and companies lose confidence in the banking system and withdraw their deposits in what is called a *run on bank*.
- **Foreign Debt Crisis**: A situation in which a country cannot service its foreign debt obligations, whether private-sector or government debt.

Chapter 15 "Global Manufacturing and Materials Management"

Strategy, Production, and Logistics:

- **Logistics**: The procurement and transmission of material through the supply chain, from suppliers to customers.
- **Strategic Objectives**:
  1. **Lower Costs**: Dispersing production activities to various locations around the globe where each activity can be performed most efficiently can lower costs.
     - Efficient supply chain management (SCM) reduces the amount of inventory in the system and increases inventory turnover, which means less investment.
  2. **Increase Product Quality**: In this context, quality refers to reliability.

Total Management Quality: Philosophy of management that focuses on improving the quality of a company's products or services.

- Developed by a number of American consultants such as W. Edward Deming and Joseph Juran.
- **Deming** identified a number of steps that should be part of any TQM program.
  - Mistakes, defects, and poor-quality materials are not acceptable.
  - Quality of supervision should be improved.
  - Work standards should not only be about quotas, but also about quality.
  - Management has the responsibility to keep employees trained.
  - Achieving better quality requires commitment from everyone in the company.
- **Six Sigma**: The modern successor to TQM; a statistically based management philosophy that aims to reduce defects, boost productivity, eliminate waste, and cut costs throughout a company.
- **ISO 9000**: Certification process that requires certain quality standards to be met.
- **Other Objectives**:
  1. Production and logistics functions must be able to accommodate demands for local responsiveness.
  2. Production and logistics must be able to respond quickly to shifts in customer demand.

Where to Produce:

Country Factors: Other things being equal, a firm should locate its various manufacturing activities where the economic, political, and cultural conditions are conducive to the performance of those activities.

- Formal and informal trade barriers obviously influence location decisions.
- Another factor is expected future movements in the country's exchange rate.

Technological Factors:

- **Fixed Costs**: In some cases, the fixed costs of setting up a production plant are really high. In this situation, it would make sense to serve the world market from one location.
- **Minimum Efficient Scale**: The level of output at which most plant-level scale economies are exhausted. (Economies of Scale plays no affect). High MES = centralize production to one place
- **Flexible Manufacturing and Mass Customization**:
  1. **Flexible Manufacturing**: Technology designed to reduce setup time, improve job scheduling, and improve quality control.
  2. **Mass Customization**: The ability of companies to use flexible manufacturing technology to achieve product customization at low cost.

Chapter 15 "Global Manufacturing and Materials Management"

Product Factors:
- **Value-to-Weight Ratio**: This ratio influences transportation decisions. Many electronic components and pharmaceuticals have high value-to-weight ratios because they are expensive and weigh very little. A high ratio = multiple production locations.
- **Universal Needs**: Needs are not the same all over the world. If the product does not meet universal needs, it should be kept to where it does.

Locating Production Facilities: Two basic strategies.
1. Concentrating them in a centralized location and serving the world market from there.
    - **Makes Sense When**: (1) High variance in country factors and low trade barriers; (2) exchange rates are stable; (3) High fixed costs and high MES; (4) High value-to-weight ratio and it meets universal needs.
2. Decentralizing them in various regional or national locations that are close to major markets.
    - **Makes Sense When**: Opposite of above.

The Strategic Role of Foreign Factories: Their strategic role typically is to produce labor-intensive products at as low a cost as possible.
- Strategic role of foreign firms arises because they upgrade their own capabilities.
    1. Corporate pressure to improve a factory's cost structure or customize a product to the demands of consumers in a particular nation leads to development of additional capabilities at that factory.
    2. The increasing abundance of advanced factors of production in the nation in which the factory is located.
- **Global Learning**: The idea that valuable knowledge resides not only in a firm's domestic operations but in its foreign subsidiaries as well.

Outsourcing Production – Make-or-Buy Decision: The decision as to whether a firm should make or outsource the making of component parts.

Advantages of Make:
- **Lowering Costs**: If the firm is more efficient at producing the component than any other firm, they should continue to produce it in-house.
- **Facilitating Specialized Investment**: An asset whose value is contingent upon a particular persisting relationship. When substantial investment in specialized assets are required to manufacture a component, the firm will prefer to make the component internally.
- **Protecting Proprietary Product Technology**: Firms do not want to get the technology that makes their product superior.
- **Improving Scheduling**: Planning, coordination, and scheduling of adjacent processes much easier and, in some cases, easier.

The Advantages of Buy:
- **Strategic Flexibility**: The firm can maintain its flexibility by switching orders between suppliers as circumstances dictate. The aim is to get the best deal.
- **Lower Costs**: In-house production requires a lot of coordination and supervision and there is a smaller incentive to reduce cost.

Chapter 15 "Global Manufacturing and Materials Management"

Trade-Offs: The benefits of making all or part of a product in-house seem to be greatest when (1) highly specialized assets are involved; (2) vertical integration is necessary for protecting proprietary technical knowledge; (3) and the firm is most efficient.

- If these conditions are not met, it is better to buy the product or the components.

Strategic Alliances with Suppliers: Firms try to reap the benefits of vertical integration by creating strategic alliances with suppliers.

- Leads to just-in-time inventory (JIT), computer-aided design (CAD), and computer-aided manufacturing (CAM). These systems rely on close links between firms and their suppliers.