

Introduction to International Business

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Preview Summary

Dear E&BE-student,

Welcome at the Rijksuniversiteit Groningen! You are now reading the summary for Introduction to International Business E&BE. SlimStuderen.nl and Capita Selecta summarized all the mandatory literature and articles you need to know for your exam, so that you may study in the best possible way. We would like to wish you good luck in advance with studying!

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A. Globalizing business

International business is a business that engages in cross border economic activities. Also, it is the action of doing business abroad. A **Multinational Enterprise (MNE)** is a firm that engages in Foreign Direct Investment (FDI). **FDI** can be determined as investment in controlling and managing value-added activities in other countries.

Global Business is just business around the world. It includes both, international business activities as well as domestic business activities. **Emerging Economies** are economies that only recently established institutional frameworks that facilitate international trade and investment, typically with low or middle level income and above average economic growth.

There are some measurements of global business. **Gross Domestic Product (GDP)**, which is the sum of value added by resident firms, households, and governments operating in an economy. **Purchasing Power Parity (PPP)** is a conversion that determines the equivalent amount of goods and services different currencies can purchase. This conversion is usually used to capture the differences in cost of living in different countries.

Gross National Product (GNP) equals gross domestic product plus income from non-resident sources abroad. **Gross National Income (GNI)** is GDP plus income from non-resident sources abroad. GNI is the term used by the World Bank and other international organizations to supersede the term GNP.

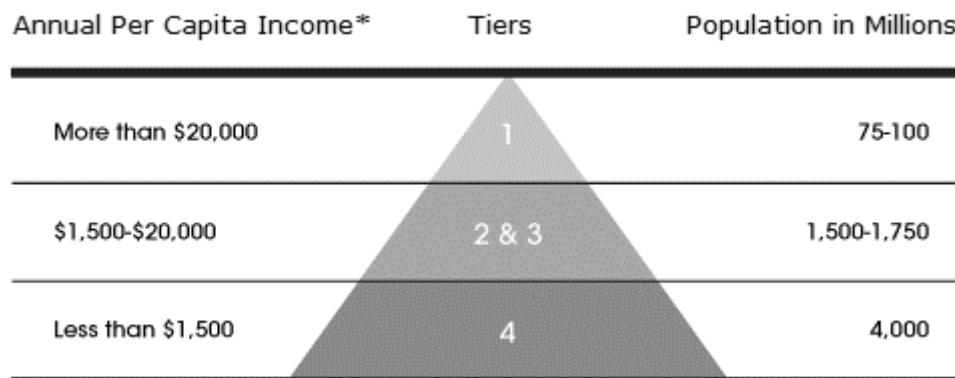


Figure 1: Global economic pyramid (source: SlimStuderen.nl).

The top consists of people who live in the developed economies such as North America, Western Europe and Japan. The base of the pyramid includes emerging economies.

Why study Global Business?

- To enhance one's employability and advance your career in the global economy;
- Better preparation for possible expatriate assignments abroad;
- Stronger competence in interacting with foreign suppliers, partners and competitors and in working for foreign-owned employers in one's own country.

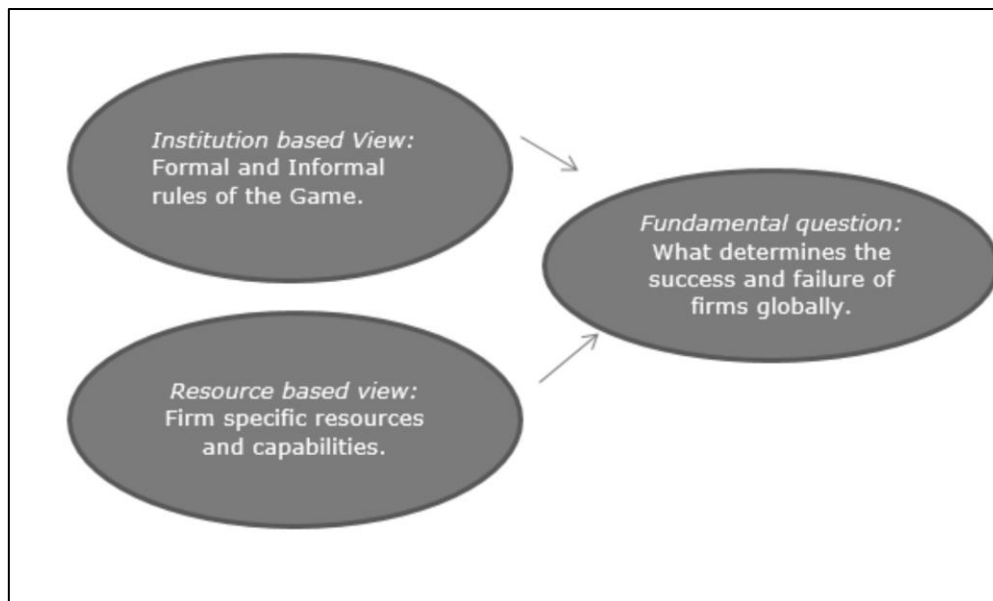


Figure 2: Unified framework for global business (source: SlimStuderen.nl).

Institution based view

Institution based view consists of formal and informal rules of the game. In this view success and failure of a firm is determined by the enabling and constraining by constitutions. Institution is another word for the rules of the game. Doing business around the globe requires intimate knowledge about both formal rules (such as laws, regulations) and informal rules (such as values, ethics, norms, culture). This view suggests that institutions shed a great deal of light on what drives firm.

Resource based view

The **resource based view** includes firm-specific resources and capabilities. In view of this, success and failure of a firm is determined by their environments. This view focuses on a firm's internal resources and capabilities.

There seem to be firms that have valuable and unique firm-specific resources and capabilities that are not shared by their competitors in the same environments. It is always challenging to do business abroad because they have to overcome the liability of foreignness. The firms must for example, adapt to different regulations, culture and language. This view focuses on how winning firms acquire and develop such unique and enviable resources and capabilities and how competitor firms imitate and then innovate in an effort to outcompete the winning firms.

Fundamental Question

The above two view points toward the most fundamental question of "What determines the success and failure of firms around the globe?".

What is globalization

Globalization is the close integration of countries and people of the world.

Three views of globalization:

- A **new force** sweeping through the world in recent times. They suggest it is a new phenomenon beginning in the late 20th century, driven by recent technology innovation and a western ideology focused on exploiting and dominating the world through MNEs. There are also anti-globalization advocates who argue that globalization needs to be slowed down or stopped because of environmental stress, social injustice and sweatshop labor;
- A **long-run historical evolution** since the dawn of human history. Here they argue that globalization is just part and parcel of human history. Even for example, in Roman times the Roman emperor imported silk from China. In a nutshell, globalization is nothing new and will probably always exist.
- A **pendulum** that swings from one extreme to another from time to time. It suggests that globalization has been caused by the reduction of transportation and communication costs. Also, breaking down of artificial barriers to the flows of goods, services, capital, knowledge and people across the borders have led to a closer integration among countries. Globalization is neither recent nor one directional. It is a process that is similar to the swing of a pendulum.

Symptoms of Global Economic Crisis

- The bursting of a real estate bubble;
- The liquidity and solvency problems of major banks;
- The refusal by consumers and companies to spend on consumption and investment;
- Plummeting global output, trade, and investment;
- Skyrocketing unemployment;
- Rapid contagion around the world due to the closely interconnected nature of the global economy.

Semi-globalization is the perspective that suggests that barriers to market integration at borders are high, but not high enough to completely insulate countries from each other. **Risk management** can be described as the identification and assessment of risks and the preparation to minimize the impact of high-risk, unfortunate events. **Scenario planning** is a technique to prepare and plan for multiple scenarios (either high or low risk).

Debate

Globalization has its pros and cons. Many of the elite in a country have failed to take into sufficient account the social, political, and environmental costs associated to globalization. Also, the economic power and political institutions are largely controlled by the elite in almost every country.

The opponents of globalization often feel powerless so, they end up resorting to unconventional tactics such as protests to show their point. The nongovernmental organizations (NGOs) are often involved in anti-globalization. Many business students are in favor of globalization. They tend to focus more on the gains and much less concerned with the disadvantages.

B. Understanding formal institutions: politics, laws and economics

Institutions are the formal and informal rules of the game. The institution-based view is a perspective in international business that suggests that firm performance is, at least in part, determined by the institutional frameworks governing firm.

Table 1: Dimensions of institutions.

Degree of Formality	Examples	Supportive Pillars
Formal Institution	<ul style="list-style-type: none"> • Laws; • Regulations; • Rules. 	Regulatory (coercive)
Informal Institution	<ul style="list-style-type: none"> • Norms; • Cultures; • Ethics. 	Normative and Cognitive

Formal institutions are institutions represented by laws, regulations and rules. However, **informal institutions** are institutions represented by norms, culture and ethics.

Three pillars of institutions:

- **Regulatory:** the coercive (using force or threats) power of governments;
- **Normative:** the mechanism through which norms (values, beliefs) influence individual and firm behavior;
- **Cognitive:** the internalized, taken-for-granted values and beliefs that guide individual and firm behavior.

What do institutions do

The key role of institutions is to reduce uncertainty. They constrain the range of acceptable actions. This uncertainty can lead to transaction costs. An important source of transaction costs is opportunism. Without a stable institutional framework, the transaction costs are so high that certain transaction would simply not take place. We have to take in consideration that institutions always move.

Opportunism is the act of seeking self-interest with guile. **Transaction costs** are the costs associated with economic transactions or, more broadly, the costs of doing business.

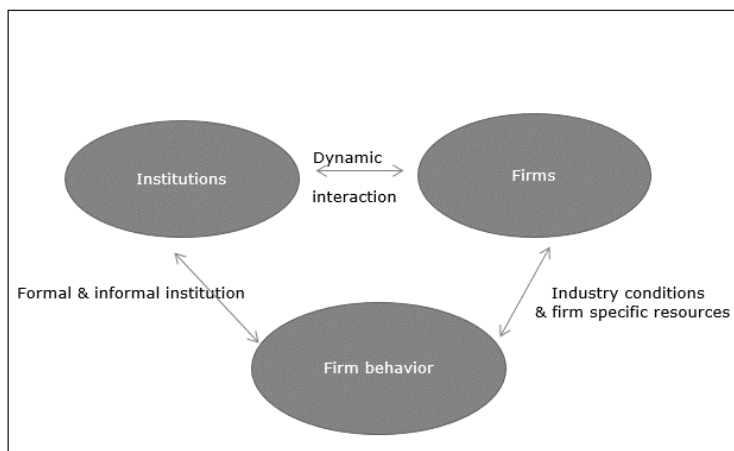


Figure 3: Institutions, firms, and firm behavior (source: SlimStuderen.nl).

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Two core propositions of institution based

Managers and firms pursue their interests and make choices rationally within the formal and informal constraints in a given institutional framework. This means that the managers aiming to enter a new country need to do their homework by having a thorough understanding of the formal institutions affecting their business. Rules are very different in democratic market economy than in totalitarian command market.

Although formal and informal institutions combine to govern firm behavior, in situations where formal constraints are unclear or fail, informal constraints will play a larger role in reducing uncertainty and providing constancy to managers and firms. For example, if a country has a strong favor for rational exchanges (such as China) then it is not a good idea to insist on formalizing the contract right away.

Political System

Political system is a system of the rules of the game on how a country is governed politically. In this political system we have two primary systems:

- **Democracy:** a political system in which citizens elect representatives to govern the country on their behalf. A fundamental aspect of democracy that is relevant to global business is the individual's right to freedom of expression and organization;
- **Totalitarianism (dictatorship):** a political system in which one person or party exercises absolute political control over the population. This is the opposite of democracy. There are four different systems to distinguish in the world:
 - **Communist totalitarianism:** centers on a communist party. For example, Central and Eastern Europe and Soviet Union till the 80s. Nowadays China, Cuba, North Korea and, Vietnam are still practicing this communism;
 - **Right-wing totalitarianism:** is characterized by its intense hatred of communism. One party, typically backed by the military, restricts political freedom because its members believe that such freedom would lead to communism. Most of these countries have recently become democracies (South Africa, South Korea). Still there are Latin America countries, Taiwan and Philippines, who practice this;
 - **Theocratic totalitarianism:** refers to the monopolization of political power in the hand of one religious party or group. Iran, Saudi Arabia and, Afghanistan;
 - **Tribal totalitarianism:** refers to one tribe or ethnic group (which may or may not be the majority of the population) monopolizing political power and oppressing other tribes or groups. For example, Rwanda.

Political Risk is the risk associated with political changes that may negatively impact domestic and foreign firms. In general, democracy is better for business than totalitarianism. In these countries you have more riots, protest, wars and chaos. For a firm the political risk is much higher in totalitarianism than in democracy.

Legal System

The rules of the game on how a country's laws are enacted and enforced. By specifying the do's and don'ts a legal system reduces the transaction costs by minimizing uncertainty and combating opportunism.

- **Civil law:** a legal tradition that uses comprehensive statutes and codes as a primary means to form legal judgments. The civil law is derived from the Roman law and strengthened by Napoleon's France. It's the oldest most influential and most distributed law in the world. Over 80 countries practice civil law, such as Germany, Russia, The Netherlands, China, etc.;
- **Common law:** a legal tradition that is shaped by precedents and traditions from previous judicial decisions. The common law is English in origin, so has spread to all English-speaking countries so included former colonies. It is a law that has more flexibility because judges have to resolve specific disputes based on their interpretation of the law and this may give new meaning of the law, which will turn shape. For example, UK, US, Hong Kong, Kenya, India, South Africa, etc.;
- **Theocratic law:** a legal system based on religious teaching. The theocratic law is based on Jewish and Islamic laws. However, Jewish law is not formally embraced so only the Islamic law is formally practiced by some governments. An example is that male and female should be separated so there is a male bank and a female bank. For example, Iran, Saudi Arabia and United Arab Emirates. Overall, legal systems are a crucial component of the institutional framework because they form the first, regulator pillar that supports institutions.

Property rights

Property rights are the legal rights to use an economic property (resource) and to derive income and benefits out of it. Examples of property include homes, offices and factories. The property rights are different among countries and this has to do with the fact of how the property rights are protected. Formal institutions play a very large role in this protection of property. When a legal system is stable and predictable, tangible property also makes other, less tangible economic activities possible.

Intellectual property is the intangible property that is the result of intellectual activity. **Intellectual property rights (IPR)** are rights associated with the ownership of intellectual property (such as books, websites, and videos). There are different types of intellectual property rights:

- **Patents:** legal rights awarded by government authorities to inventors of new technological ideas, who are given exclusive (monopoly) rights to derive income from such inventions through activities such as manufacturing, licensing, or selling;
- **Copyrights:** exclusive legal rights of authors and publishers to publish and disseminate their work. The global business book is for example, protected by copyright laws;
- **Trademarks:** exclusive legal rights of firms to use specific names, brands, and designs to differentiate their products from others.

IPR are usually protected country-by-country basis. The WTO has found a solution for this issue when a country has agreed on the Agreement on Trade-Related Aspects of IPR (TRIPS). The country has agreed to adopt the Paris Convention for the Protection of Industrial Property this is the "gold standard" for a higher level of IPR protection. Once countries join TRIPS, firms often forced to pay more attention to innovation.

If the IPR protection is weak than these violators make a rational decision by investing in skills and knowledge in this business. It seems that thousands of individuals and firms voluntarily choose to be involved in this business worldwide. So we can conclude that a stronger IPR protecting will lead to a reduce counterfeiters' incentive.

Economic System

An economic system is the rules of the game on how a country is governed economically. There are three kinds of markets:

- **Market economy:** an economy that is characterized by the 'invisible hand' of market forces. In a market economy the government takes a hands-off approach known as laissez-faire approach (introduced by Adam Smith). In this economy all factors of production should thus be privately owned except providing roads and defense because the private sector cannot perform that;
- **Command economy:** an economy in which all factors of production are government- or state-owned and controlled, and all supply, demand and pricing are planned by the government. During the communism days the former Soviet Union and China approached such an ideal;
- **Mixed economy:** an economy that has elements of both a market economy and command economy. In practice we say that a country has a market economy if it organizes its economy mostly by market forces and that still has certain elements of a command market. Also, free market economy are not totally free, it comes down to matter of degree of freedom.

Debate and Extension

Drivers of economic Development: Culture, Geography, or Institutions

The differences among countries economic development are striking. There are three explanations that have been debated.

The first one is the culture side that argues that rich countries tend to have a smarter and harder working population driven by a stronger motivation for economic success. However, it is difficult to imagine that for example an average Norwegian is 700 times smarter and harder working than an average Burundian.

The geographical school suggests that rich countries tend to be well endowed with natural resources. However, Democratic Republic Congo possesses also rich natural resources and rich countries like Japan and Denmark are very poor in natural resources.

In addition, some countries are believed to be cursed by their poor geographic locations such as nearby the equator are land-locked. Again, this doesn't hold for all countries, such as Switzerland (landlocked country) and Singapore (nearby equator). Geography is important but not destiny.

Institutional scholars argue that the institutions are the basic determinants of the performance of an economy. Institutions provide the incentive structure of a society, formal political, legal and economic systems to have a significant impact on economic development by affecting the incentives and the costs of doing business. In short, rich countries are rich because they have developed better market-supporting institutional frameworks. Several points can be made:

- This helps firms and individuals to grow and specialize in order to capture the gains of trade (economically advantageous);
- Lack of this force then individuals have to trade on an informal basis with a small neighboring group and forces firm to remain small. Instead of, gains from larger division of labor by trading on a large scale with distant partners;
- This helps to encourage individuals to specialize and firms to grow in size to capture the gains from complicated long-distant trade;
- This helps to protect property rights and provide more innovation, entrepreneurship so more economic growth. In conclusion, it is still not 100% clear that democracy leads to strong economic development.

Table 2: Private vs. State Ownership.

	Private ownership	State ownership
Objective of the firm	Maximize profits for private owners who are capitalists (and maximize shareholder value for shareholders if the firm is publicly listed).	Optimal balance for a "fair" deal for all stakeholders. Maximizing profits is not the sole objective of the firm. Protecting jobs and minimizing social unrest are legitimate goals.
Establishment of the firm	Entry is determined by entrepreneurs, owners, and investors.	Entry is determined by government officials and bureaucrats.
Financing of the firm	Financing is from private sources (and public shareholders if the firm is traded publicly).	Financing is from state sources (such as direct subsidiaries or banks owned or controlled by governments).
Liquidation of the firm	Exit is forced by competition. A firm has to declare bankruptcy or be acquired if it becomes finally insolvent.	Exit is determined by government officials and bureaucrats. Firms deemed "too big to fail" may be supported by taxpayer dollars indefinitely.
Appointment and dismissal of management	Managers appointments are made by owners and investors largely based on merit.	Managers appointments are made by government officials and bureaucrats who may also use noneconomic criteria.
Composition of management	Managers' compensation is determined by competitive market forces. Managers tend to be paid more under private ownership.	Managers' compensation is determined politically with some consideration given to a sense of fairness and legitimacy in the eyes of the public. Managers tend to be paid less under state ownership.

C. Glossary

Civil law	The legal tradition that uses comprehensive statutes and codes as a primary means to form legal judgments.
Common law	A legal tradition that is shaped by precedents and traditions from previous judicial decisions.
Democracy	The political system in which citizens elect representatives to govern the country on their behalf.
Emerging economies	Economies that only recently established institutional frameworks that facilitate international trade and investment, typically with low or middle level income and above average economic growth.
Foreign direct investment (FDI)	Investment in controlling and managing value-added activities in other countries.
Formal institution	Institutions represented by laws, regulations and rules.
Global business	Business around the world.
Globalization	The close integration of countries and peoples of the world.
Gross domestic product (GDP)	The sum of value added by resident firms, households, and governments operating in an economy.
Gross national income (GNI)	GDP plus income from non-resident sources abroad.
Gross national product (GNP)	Gross domestic product plus income from non-resident sources abroad.
Informal institution	Institutions represented by norms, culture and ethics.
Institution based view	In this view success and failure of a firm is determined by the enabling and constraining by constitutions.
Intellectual property	Intangible property that is the result of intellectual activity.

International business	A business that engages in cross border economic activities.
Multinational enterprise (MNE)	A firm that engages in Foreign Direct Investment (FDI).
Opportunism	The act of seeking self-interest with guile.
Political risk	Risk associated with political changes that may negatively impact on domestic and foreign firms.
Property rights	The legal rights to use an economic property (resource) and to derive income and benefits out of it.
Purchasing power parity (PPP)	A conversion that determines the equivalent amount of goods and services different currencies can purchase.
Resource based view	A leading perspective in global business that posits that firm performance is fundamentally driven by differences in firm-specific resources and capabilities.
Risk management	The identification and assessment of risks and the preparation to minimize the impact of high-risk, unfortunate events.
Scenario planning	A technique to prepare and plan for multiple scenarios (either high or low risk).
Semi-globalisation	A perspective that suggests that barriers to market integration at borders are high, but not high enough to completely insulate countries from each other.
Theocratic law	A legal system based on religious teaching.
Totalitarianism (dictatorship)	A political system in which one person or party exercises absolute political control over the population.
Transaction costs	Costs associated with economic transactions or, more broadly, the costs of doing business.

Epilogue

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