# International Business

By: Kshyam Sagar Mehar

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# Sample Preview of The Chapter

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# INTERNATIONAL BUSINESS

## INTERNATIONAL BUSINESS: ROLE AND PROCESSES

## Introduction: An Overview

1

### INTRODUCTION

The International Business is the trade carried out across the national borders. The origin of international business may be traced back to the ancient times when the Mesopotamian, Greek and, in particular the phoenician merchants, carried out their trading activities in different parts of the world. The sea-borne trade was controlled by the phoenicians, and the network of their foreign business spread in many countries. In modern times, the enormous impact on international business was brought about by the Industrial Revolution at the beginning of the 17th century, facilitating the application of machinery into production process. A series of innovations after the Industrial Revolution caused large scale production of a variety of goods, which required raw materials from abroad in greater quantities. The outcome was the extraction, processing and transportation of raw materials to the parent countries. The growth of international business was tremendous in the post-World War-II period, especially after 1950. Both the world trade and investment grew rapidly. During the decades of the 1950s and 1960s, the FDI was dominated by the United States, but in the subsequent period, the trend moved in favour of the European and Japanese and even some MNEs from the developing countries.

### CHAPTER AT A GLANCE

#### CONCEPT OF INTERNATIONAL BUSINESS

Business between two or more nations is called International Business. Thus, international business is carried on across the national boundaries, the contact lines between people and the multinational enterprises (MNEs) having a distinctive feature attributable to their different social, cultural and economic environments. International business is not confined to the geopolitical boundaries of a country engaged in such trade.

For understanding the concepts relating to international business, a three-pronged approach may be adopted. The first is the transmission of resources from one country to another such as shipment of goods, transfer of funds and movement of people. The second is about with the relation of the MNE with the host societies. The third is about the elements of conflict arising from the national sentiments and nationalistic attitudes guiding both the parent and the host countries. Here the enterprise has to deal with the profitability aspects. The MNE also looks for accommodating the interest of the parent and host nations.

Resource transmission took place on the basis of the mutual benefits of the trading nations. The resource allocation, as per the Comparative Cost Doctrine propounded by Ricardo, benefits the countries involved in trade. The government intervention may cause trade diversion, resulting in inefficient use of resources. International trade provides opportunities to the MNEs for taking advantage of their superior technology, innovativeness and economies of scale.

MNEs confront with diverse business systems prevailing in different societies and choose either conformity or innovation. These enterprises adopt a suitable growth strategy by introducing changes in a gradual manner, acceptable to the host governments, keeping in view the employment and welfare of the people. Conflict may arise because the aim of foreign investors and socio-economic objectives of the host countries may come in conflict.

An MNE conducts its global operations in two ways. It may deal with the individual countries separately according to their politico-economic and social environments, keeping in view the national interests of both the parent and the host countries. In the second approach, to maintain uniformity an MNE considers the entire world as a global market and tries to adopt similar global strategies and goals in the diverse environments of different countries. The success of the global firm lies in achieving a balance between fragmentation and unification.

## NATURE AND IMPORTANCE OF INTERNATIONAL BUSINESS

The international business operations consist of many facets. International trade is one of these aspects. Licensing, Joints ventures and Foreign Direct Investment (FDI) are some other aspects usually follow later, but not necessarily.

FDI and the international trade are integral part of international business. Earlier, FDI was mainly in plantation and mines, but since 1950s, the major type of the FDI was made in the manufacturing sector.

Initially, the developed countries were involved in trade among themselves and they had also investment in one another's firms. The US is the largest investor. However, in the case of the US the reverse investment started in recent years. Now it has been the most important and largest host country to the FDI. Large market potential, abundant raw materials, falling labour costs relative to other countries and the restricted trade policy for some products are the factors responsible for rising FDI into the US. Some MNEs from Europe, Japan and Canada also invested in the US because of certain firm-specific advantages.

Some MNEs from developing countries such as Brazil, Argentina, Mexico, India, Hong Kong, Taiwan and South Korea also started giving tough competition to the firms from the US, Japan and German. The MNEs from the developing countries took advantage of their adaptive attitudes, lower cost of production and lower profits and remittances and willingness to enter into joint ventures and partnerships.

The US has the largest share in international trade followed by Germany, Japan and France. However, the share of other developed and developing countries, mainly oil-producing nations in the Middle East, are increasing and that of the US is declining.

There are some countries like Singapore, Hong Kong and Taiwan which have exports and imports greater than their GNP. These countries export most of their production and import export-related products. These countries are mainly offshore assembly platforms or trade entrepots.

Global business deals with *(i)* quantum, composition and direction of trade flows and FDI; and *(ii)* the impact of trade and foreign investment on the importing and exporting companies and world economies at large. Without international business, the countries could have depended on themselves producing all the goods of their needs by using their factor endowments at sub-optimal level. The merchandise trade and the trade in services have made it possible for the proper allocation of resources as per the cost advantages. Licencing, joint ventures and FDI came into being because of the imperfections and trade barriers in world market. Thus to understand the international trade and FDI and their effect on the world economic growth and welfare, the study of international business is required.

## GROWTH OF INTERNATIONAL BUSINESS AND FDI

In the ancient times the Mesopotamian, Greek, and particularly the Phoenician merchants conducted trade in different parts of the world. The Phoenicians were involved in seaborne trade and used to procure goods from Egypt, Babylonia and Assyria and sell them across the Mediterranean. They were doing business even up to Cape Verde and the Azores Islands in the Atlantic. For trade, they were travelling through the straits of Gibralter.

During that period, the Phoenicians were buying India's spices and textiles and selling them to Egypt, Turkey, Greece and Rome. They were using the West Coast of India for the trade. They were taking the goods through sea routes in Southern Arabia and transported them to the Mediterranean ports for shipping to other trading places.

The Roman traders were actively involved in global business. Trade in Rome was facilitated by development of the banking system. The banks, owned by private entrepreneurs, accepted deposits for providing loans and credits to the traders.

The Roman merchants were operating as far as the Atlantic Coasts of Africa and Europe and reached Germany up to the Baltic Sea. Some were travelling up to Turkestan to buy Chinese goods.

During the 13th and 14th centuries after the fall of the Roman Empire, the Arab crusaders spread their network in South-East Asian countries, present day Malayasia, Indonesia, Brunei and Southern Philippines. The Arabs purchased goods from India by setting up trading ports in Sind and dominated the trade on the Indian West Coast. Later on the Arabs looked for new avenues for trade. New business centres in Italy like Genoa and Venice emerged. The Europeans, after losing their control of the sea routes to India through Red Sea and the Straits of Harmuz, had to circumnavigate Africa to get the Indian spices and textiles, which were in great demand in Europe. In 1498, the Renaissance in Europe led to voyages and the discovery of America by Columbus and the arrival of Vasco de Gama at Calicut.

The development of credit institutions and the introduction of methods of payments eased the hurdle in the growth of international business. The trade instruments like the bills of exchange and drafts facilitated the rapid rise in trade transactions, as there was no need for actual gold or silver to be delivered to settle the unfavourable balance of trade. The payment to the exporter was assured by the bill of exchange on a specified date. The banking houses, based in the Eastern Mediterranean region in the 14th century, became important financial centres. Holland by the 16th century developed into a global financial centre and the Dutch banks financed the business all over Europe.

After considerable expansion, lots of money were required for international business and the individual investors were unable finance it. To pool capital together for carrying out large transactions, the mechanism of joint stock company developed. Investors were issued shares. The investors could earn dividends and could sell their shares to the company depending upon their market value.

The international business came under the impact of the Industrial Revolution. The production of manufacturing goods took place in the UK and other European countries and these goods become cheaper with the onset of the Industrial Revolution. The excess production was exported and food-stuffs and raw materials were imported.

The global business was further influenced by the Second Industrial Revolution in 1880 which caused large scale production of a variety of goods which needed more raw materials from other countries. The European countries started exporting manufactured goods and the less developed countries exported food and raw materials. The import of capital by some countries provided them a scope to develop their own industries and they became a part of the industrial world.

**Emergence of Multinational Corporation**: In the 14th century, multinational companies in the Italian trade centres of Genoa and Venice operated across the border throughout the Eastern Mediterranean area. In the UK, companies were well-known for their foreign business during the reign of Queen Elizabeth I. These firms had monopoly powers in world markets, but they were surpassed by new forms of enterprises created by the Industrial Revolution. There was a need for direct investment abroad to produce sufficient raw materials to meet the requirements of the manufacturing plants at home.

Following this, multinational firms started making direct foreign investment for extraction, processing and transportation of raw materials. Some individuals were the forerunners in the setting up of MNEs. Friedrick Bayer, a German, in 1865 bought some shares in New York just after two years of establishing a chemical plant in Germany. In 1876, he set up dyestuff factories in Russia, in 1882 in France and, in 1908 in Belgium. According to 1990 Fortune Survey, this German firm Bayer was in 39th among 500 world's largest firms in terms of their sales.

In 1866, Alfred Nobel, a Swedish industrialist, set up a plant at Hamberg, Germany. In 1887, the Singer company set up a plant at Glassgow, Scotland. In India, with the establishment of the East India Company at the beginning of 17th century may be assumed to have started the commencement of the multinational corporate business. In 1788, Thomas Perry was the first free merchant in Madras followed by Jessop's predecessors, Breen & Co, in Calcutta now Kolkata.

The international business activities got new dimensions after such trends in the FDI provided new dimensions. Royalties, license fees and management fees were paid by MNEs in return for the use of patents, trade marks and technological know-how.

Multinational companies from the US started their operations in 1850, when the United Fruit Company set up its plants in Honduras and Nicaragua. The US firms also developed in their early stages due to the need for new sources of raw materials. The US foreign investment took place mainly in oil and mining. After the First World War, the US first came on the global scene on a massive scale and industries. The firms from the US invested in automotives, chemicals, petroleum and machine tools. In 1920s, the US automotive industry began dominating the world markets.

**International Business in the Post-World War-II Period:** The international business after suffering a setback following the severe recession in 1930s in the world economy saw a tremendous growth in the post-World War-II period, especially after 1950. Changes in the global economic arrangements like the proliferation of the bilateral investment treaties specifically meant for the promotion and protection of the FM, favourable political and economic environments of the host countries, prospects of profits and the developments of new forms of investments led to faster growth of the international trade and investment. The MNEs also played a leading role in the international trade in services after the production of merchandised goods. The contribution of the trade in services in 1989 was $ 1000 billion out of the total world trade amounting to $ 3100 billion.

Since the mid-1970s, the new investment arrangements in the form of non-equity involvement in licensing agreements, management contracts, turnkey contracts, franchising, international subcontracting and equity sharing in joint ventures have seen rapid growth. The Newly Industrialized Countries (NICs) signed such contracts. After attaining export capability, they began exporting technology abroad, both in the form of joint ventures and the FDI. Many oil-producing countries have joint venture arrangements for downstream processing, refining and distribution of related petroleum products. Japan is the major partner in the petrochemical joint ventures in the ASEAN countries.

In 1950s and 1960s, the US continued to be the major investor in foreign countries. The book value of the US FDI rose from $ 11.8 billion in 1950 to $ 78.1 billion in 1970. Canada and Western Europe received more than 50 per cent of the total US FDI in 1970. The influx of American investment in Western Europe was mainly meant to take advantage of the emerging prosperity of the Common Market countries and to protect its export markets from their tariff barriers. In West Europe, the markets for Eurodollars and Eurobonds also developed promoting US investments there. The MNEs in the US continued to expand by using these markets when the US Government imposed restrictions on the American FDI.

The US had not made larger investment in the LDCs because America put greater accent on investment in manufacturing. The US investment in Latin America increased only from $ 1.8 billion in 1950 to $ 4.6 billion in 1970. However, its investment in Asia during the same period grew from $ 100 million to $ 150 million. The total US direct investment in manufacturing grew from $ 6.4 billion to $32.3 billion during the period. The US firms thus changed their geographic as well as investment foci, resulting in very marginal or no development of LDCs.

The developed countries in 1970s made relatively larger investments in the developing economies. The US investment in 1975 in the developing countries was about 47 per cent of its total foreign investment and in case of Japan it was about 60 per cent. This trend however was reversed in the 1980s and the developing countries again received relatively small amount of FDI. The foreign investment by the US and Japan in 1986 to the developing countries was about 27 per cent and 33 per cent respectively.

In the 1970s, the optimism about the growth potential of the developing countries led to increase in FDI in the these countries. In 1980s, that optimism did not continue. The declining confidence in their credit worthiness due to the debt crisis in those countries, recession and macro economic instability, reduction in the attractiveness of large resource based projects, particularly petroleum owing to the nationalization drive in the Middle East and the relative improvement in the profitability in the industrialized world itself were the other reasons for decline in foreign investment in 1980s.

During 1970s and 1980s, there was a fall in the dominance of the US MNEs and the rise in the competitive strength of the European and Japanese firms, and of some MNEs from the developing countries. There was also a reverse trend. The MNEs from Europe and Japan also started investing large amounts of FDI in America. They also offered competition to American firms in the overseas markets. A greater foreign investment happened in the manufacturing and service industries, showing a movement away from resource-based projects.

In relation to FDI, two lessons can be learned. One, the quantity of FDI depends on the economic success of a country. Those countries which have liberalized their economic policies received relatively larger amount of investments. Second, infrastructural development is an essential prerequisite for attracting FDI. The prospects of the FDI in the LDCs thus depend upon the economic policies pursued by those countries with regard to the foreign investment and predictable political stability, and also the protection these countries can provide to the trade marks.

## DIMENSIONS OF INTERNATIONAL BUSINESS

The international business has various dimensions. It is not just the crossing of borders and buying and selling goods or products. The MNEs face numerous problems in the overseas markets. Different countries adopt different business laws, tax systems and have different political, economic and cultural environments. The MNEs have to taken all these into account while making strategy to achieve efficiency in the functional areas, such as production, finance, marketing and human resource management.

In the international business management, the MNEs confront with two types of theoretical issues. First, it is the study of trade and the FDI theories. Second is the financial matters and the factors which affect them such as fluctuation in foreign exchange rates, changes in political and economic conditions and inflation. A company has to consider all these while evaluating the fruitfulness of the foreign investment.

To achieve objectives, the MNEs have to adopt an adjusting attitude towards the policies and programmes of the host nations. The MNEs should maintain good ties with the host governments and convince them that their goal is not merely the make profit but directed at raising the level of growth and employment.

International accounting, pricing, management and marketing have a direct bearing on the operations of an MNE. A multinational firm has to understand all these to make the necessary changes in its operation and production techniques for lowering cost, raising productivity and improving the quality of its products.

## CENTRAL ACTORS IN INTERNATIONAL BUSINESS

In international business, MNEs are the central actors. Also known as Multinational Corporation (MNC), International Corporation (IC) and Transnational Corporation (TC), the MNEs carry out the business across the borders of a country. MNCs, in the words of the UN Centre for Transnational Enterprises, are "enterprises which own or control production or service facilities outside the country in which they are based." MNEs are defined by Feyerweather as "multicultural, multinational, global spanning systems". Rodriguez and Carter describe