6

The political and economic environment

Contents

Learning objectives

After studying this chapter you should be able to do the following:

- **Discuss how the political/legal environment will affect the attractiveness of a potential foreign market.**
- **Distinguish between political factors in the home country environment and the host country environment.**
- **Explain the steps in a political risk analysis procedure.**
- **Distinguish between tariff barriers and non-tariff barriers.**
- **Describe the major trading blocs.**
- **Explore why the structure of consumption is different from country to country.**
- **Explain how managers can influence local politics.**
- **Define regional economic integration and identify different levels of integration.**
- **Discuss the benefits and drawbacks associated with regional economic integration.**
- **Evaluate consequences of the EMU and the euro on European business.**

6.1 Introduction

This chapter is devoted to macroenvironmental factors that explain the many forces to which a firm is exposed. The marketer has to adapt to a more or less uncontrollable environment within which they plan to operate. In this chapter the environmental factors in the foreign environment are limited to the political/legal forces and the economic forces.

6.2 The political/legal environment

This section will concentrate mainly on political issues. The political/legal environment comprises primarily two dimensions:

1 the home country environment;
2 the host country environment.

Besides these two dimensions there is also a third:

3 The general international environment (see Figure 6.1).

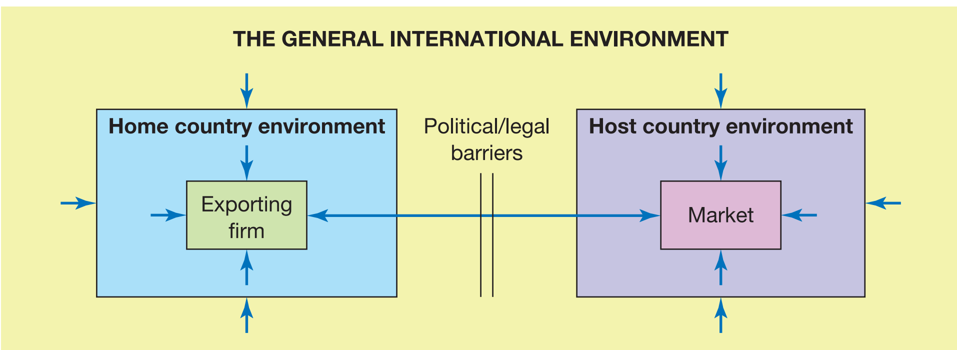
Home country environment

A firm's home country political environment can constrain its international operations as well as its domestic operations. It can limit the countries that the international firm may enter.

The best-known example of the home country political environment affecting international operations was South Africa. Home country political pressure induced some firms to leave the country altogether. After US companies left South Africa the Germans and the Japanese remained as the major foreign presence. German firms did not face the same political pressure at home that US firms had. However, the Japanese government was embarrassed when Japan became South Africa's leading trading partner. As a result some Japanese companies reduced their South African activity.

One challenge facing multinationals is the triple-threat political environment. Even if the home country and the host country do not present problems, they may face threats in third markets. Firms that did not have problems with their home government or the South African government, for example, could be troubled or boycotted about their South African operations in third countries, such as the United States. Today European firms face problems in the United States if they do business in Cuba. Nestlé's problems with its infant formula controversy were most serious, not at home in Switzerland, or in African host countries, but in a third market – the United States.

Figure 6.1 Barriers in the political/legal environment



A third area in which some governments regulate global marketing concerns bribery and corruption. In many countries payments or favours are a way of life, and an 'oiling of the wheels' is expected in return for government services. In the past many companies doing business internationally routinely paid bribes or did favours for foreign officials in order to gain contracts.

Many business managers argue that their home country should not apply its moral principles to other societies and cultures in which bribery and corruption are endemic. If they are to compete globally, these managers argue, they must be free to use the most common methods of competition in the host country. Particularly in industries that face limited or even shrinking markets, such stiff competition forces firms to find any edge possible to obtain a contract.

On the other hand, applying different standards to management and firms, depending on whether they do business abroad or domestically, is difficult to envisage. Also, bribes may open the way for shoddy performance and loose moral standards among managers and employees, and may result in a concentration on how best to bribe rather than on how best to produce and market products.

The global marketer must carefully distinguish between reasonable ways of doing business internationally – including compliance with foreign expectations – and outright bribery and corruption.

Promotional activities (sponsored by governmental organizations)

The programmes adopted by governmental organizations to promote exporting are an increasingly important force in the international environment. Many of the activities involve implementation and sponsorship by government alone, while others are the results of the joint efforts of government and business.

Furthermore, so-called regulatory supportive activities are direct government attempts to make its country's products more competitive in world markets. Also, there are attempts to encourage greater participation in exporting, particularly by smaller companies.

The granting of subsidies is of special interest: export subsidies are to the export industries what tariffs are to domestic industries. In both cases the aim is to ensure the profitability of industries and individual firms that might well succumb if exposed to the full force of competition. For export industries, revenue is supplemented by subsidies, or costs are reduced by subsidies to certain input factors. Subsidies can be given through lower taxes on profits attributable to export sales, refunding of various indirect taxes, etc. Furthermore, a subsidy may take the form of a direct grant, which enables the recipient to compete against companies from other countries that enjoy cost advantages, or may be used for special promotion by recipient companies.

In a broader sense, government export promotion programmes, and programmes for global marketing activities in general, are designed to deal with the following internal barriers (Albaum *et al.*, 2002):

- lack of motivation, as global marketing is viewed as more time consuming, costly and risky, and less profitable, than domestic business;
- lack of adequate information;
- operational/resource-based limitations.

Some of these programmes are quite popular in developing countries, especially if they enjoy the support of the business community.

Financial activities

Through the membership of international financial organizations such as the International Monetary Fund (IMF) and the World Bank the national government can assume its role as an international banker. The granting of subsidies is another financially based promotional activity of national governments.

One of the most vital determinants of the results of a company's export marketing programme is its credit policy. The supplier that can offer better payment terms and financing conditions may make a sale, even though its price may be higher or the quality of its product inferior to that of its competitors.

If the credit terms are extended, the risks of non-payment increase, and many exporters are reluctant to assume the risks. Consequently, it may be necessary to offer exporters the opportunity of transferring some of the risk to governmental organizations through credit insurance. *Export credit insurance* and guarantees cover certain commercial and political risks that might be associated with any given export transaction.

Information services

Many large companies can collect the information they need themselves. Other firms, even if they do not possess the expertise to do their own research, can afford to hire outside research agencies to do the necessary research. However, a large number of companies are not in a position to take either of these approaches. For these firms, generally smaller companies or newcomers to global marketing, their national government is the major source of basic marketing information.

Although the information relevant for international/export marketers varies from country to country, the following kinds are typically available (Albaum *et al.*, 2002, pp. 119–120):

- economic, social and political data on individual countries, including their infrastructure;
- summary and detailed information on aggregate global marketing transactions;
- individual reports on foreign firms;
- specific export opportunities;
- lists of potential overseas buyers, distributors and agents for various products in different countries;
- information on relevant government regulations both at home and abroad;
- sources of various kinds of information not always available from the government: for example, foreign credit information;
- information that will help the company manage its operation: for example, information on export procedures and techniques.

Most types of information are made available to firms through published reports or through the Internet. In addition, government officials often participate in seminars and workshops aimed at helping the international marketer.

Export-facilitating activities

A number of national government activities can stimulate export. These include the following (Albaum *et al.*, 2002, pp. 119–120):

- Trade development offices abroad, either as a separate entity or as part of the normal operations of an embassy or consulate.
- Government-sponsored trade fairs and exhibitions. A trade fair is a convenient marketplace in which buyers and sellers can meet, and in which an exporter can display products.
- Sponsoring trade missions of businesspeople who go abroad for the purpose of making sales and/or establishing agencies and other foreign representation.
- Operating permanent trade centres in foreign market areas, which run trade shows often concentrating on a single industry.

From the national government's point of view, each of these activities represents a different approach to stimulating the growth of exports. From the point of view of an individual company, these activities provide relatively low-cost ways of making direct contact with potential buyers in overseas markets.

Promotion by private organizations

Various non-governmental organizations play a role in the promotion of global marketing. These include the following (Albaum *et al.*, 2002, p. 120):

- industry and trade associations, national, regional and sectoral industry associations, associations of trading houses, mixed associations of manufacturers and traders, and other bodies;
- chambers of commerce: local chambers of commerce, national chambers, national and international associations of chambers, national chambers abroad and binational chambers;
- other organizations concerned with trade promotion: organizations carrying out export research, regional export promotion organizations, world trade centres, geographically oriented trade promotion organizations, export associations and clubs, international business associations, world trade clubs and organizations concerned with commercial arbitration;
- export service organizations, banks, transport companies, freight forwarders, export merchants and trading companies.

The type of assistance available to firms includes information and publications, education and assistance in 'technical' details, and promotion in foreign countries.

State trading

Many of the former communist countries are now allowing some private trading activities, either through joint ventures or as a result of privatization of state-owned enterprises. However, there are still countries with active state trading, such as Cuba and to some extent China.

Private businesses are concerned about state trading for two reasons. First, the establishment of import monopolies means that exporters have to make substantial adjustments in their export marketing programmes. Second, if state traders wish to utilize the monopolistic power they possess, private international marketers will have a difficult time.

Host country environment

Managers must continually monitor the government, its policies and its stability to determine the potential for political change that could adversely affect operations of the firm.

Political risks

There is political risk in every nation, but the range of risks varies widely from country to country. In general, political risk is lowest in countries that have a history of stability and consistency. Three major types of political risk can be encountered:

1 *ownership risk*, which exposes property and life;
2 *operating risk*, which refers to interference with the ongoing operations of a firm;
3 *transfer risk*, which is mainly encountered when companies want to transfer capital between countries.

Political risk can be the result of government action, but it can also be outside the control of government. The types of action and their effects can be classified as follows:

- *Import restrictions*. Selective restrictions on the import of raw materials, machines and spare parts are fairly common strategies to force foreign industry to purchase more supplies within the host country and thereby create markets for local industry. Although this is done in an attempt to support the development of domestic industry, the result is often to hamstring and sometimes interrupt the operations of established industries. The problem then becomes critical when there are no adequately developed sources of supply within the country.
- *Local-content laws*. In addition to restricting imports of essential supplies to force local purchase, countries often require a portion of any product sold within the country to have local content: that is, to contain locally made parts. This requirement is often imposed on foreign companies that assemble products from foreign-made components. Local-content requirements are not restricted to developing countries. The European Union (EU) has a 45 per cent local-content requirement for foreign-owned assemblers. This requirement has been important for Far East car producers.
- *Exchange controls*. Exchange controls stem from shortages of foreign exchange held by a country. When a nation faces shortages of foreign exchange, controls may be levied over all movements of capital or, selectively, against the most politically vulnerable companies to conserve the supply of foreign exchange for the most essential uses. A problem for the foreign investor is getting profits and investments into the currency of the home country (transfer risks).
- *Market control*. The government of a country sometimes imposes control to prevent foreign companies from competing in certain markets. Some years ago the US government threatened to boycott foreign firms trading with Cuba. The EU countries have protested against this threat.
- *Price controls*. Essential products that command considerable public interest, such as pharmaceuticals, food, petrol and cars, are often subjected to price controls. Such controls can be used by a government during inflationary periods to control the environmental behaviour of consumers or the cost of living.
- *Tax controls*. Taxes must be classified as a political risk when used as a means of controlling foreign investments. In many cases they are raised without warning and in violation of formal agreements. In underdeveloped countries, where the economy is constantly threatened with a shortage of funds, unreasonable taxation of successful foreign investments appeals to some governments as the most convenient and quickest way of finding operating funds.
- *Labour restrictions*. In many nations labour unions are very strong and have great political influence. Using their strength, unions may be able to persuade the government to pass very restrictive laws that support labour at heavy cost to business. Traditionally labour unions in Latin America have been able to prevent lay-offs and plant shutdowns. Labour unions are gradually becoming strong in western Europe as well. For example, Germany and a number of other European nations require labour representation on boards of directors.
- *Change of government party*. A new government may not honor an agreement that the previous government has made with the company. This is especially an issue in the developing countries, where the governing party changes quite often.
- **Nationalization** *(Expropriation)*. Defined as official seizure of foreign property, this is the ultimate government tool for controlling foreign firms. This most drastic action against foreign firms is fortunately occurring less often as developing countries begin to see foreign direct investment as desirable.

Nationalization
Takeover of foreign companies by the host government.

- *Domestication*. This can be thought of as creeping expropriation and is a process by which controls and restrictions placed on the foreign firm gradually reduce the control of the owners. The firm continues to operate in the country while the host government is able to maintain leverage on the foreign firm through imposing different controls. These controls include: greater decision-making powers accorded to nationals; more products produced locally rather than imported for assembly; gradual transfer of ownership to nationals (demand for local participation in joint ventures); and promotion of a large number of nationals to higher levels of management. Domestication provides the host country with enough control to regulate the activities of the foreign firm carefully. In this way, any truly negative effects of the firm's operations in the country are discovered and prompt corrective action may be taken.

Trade barriers from home country to host country

Free trade between nations permits international specialization. It also enables efficient firms to increase output to levels far greater than would be possible if sales were limited to their own domestic markets, thus permitting significant economies of scale. Competition increases, prices of goods in importing countries fall, while profits increase in the exporting country.

While countries have many reasons for wishing to trade with each other, it is also true to say that all too frequently an importing nation will take steps to inhibit the inward flow of goods and services by effecting **trade barriers**.

Trade barriers
Trade laws (often tariffs) that favour local firms and discriminate against foreign ones.

One of the reasons why international trade is different from domestic trade is that it is carried on between different political units, each one a sovereign nation exercising control over its own trade. Although all nations control their foreign trade, they vary in the degree of control. Each nation or trading bloc invariably establishes trade laws that favour its indigenous companies and discriminate against foreign ones.

There are two main reasons why countries levy tariffs:

1. *To protect domestic producers*. First, tariffs are a way of protecting domestic producers of a product. Because import tariffs raise the effective cost of an imported good, domestically produced goods can appear more attractive to buyers. In this way domestic producers gain a protective barrier against imports. Although producers receiving tariff protection can gain a price advantage, protection can keep them from increasing efficiency in the long run. A protected industry can be destroyed if protection encourages complacency and inefficiency when it is later thrown into the lion's den of international competition.
2. *To generate revenue*. Second, tariffs are a source of government revenue. Using tariffs to generate government revenue is most common among relatively less-developed nations. The main reason is that less-developed nations tend to have less formal domestic economies that presently lack the capability to record domestic transactions accurately. The lack of accurate record keeping makes the collection of sales taxes within the country extremely difficult. Nations solve the problem by simply raising their needed revenue through import and export tariffs. Those nations obtaining a greater portion of their total revenue from taxes on international trade are mainly the poorer nations.

Trade distortion practices can be grouped into two basic categories: tariff and non-tariff barriers.

Tariffs
A tool that is used by governments to protect local companies from outside competition. The most common forms are: quotas, ad valorem and discriminatory.

Tariff barriers

Tariffs are direct taxes and charges imposed on imports. They are generally simple, straightforward and easy for the country to administer. While they are a barrier to trade they are a visible and known quantity and so can be accounted for by companies when developing their marketing strategies.

Tariffs are used by poorer nations as the easiest means of collecting revenue and protecting certain home industries. They are a useful tool for politicians to show indigenous manufacturers that they are actively trying to protect their home markets.

The most common forms of tariffs are as follows:

- *Specific*. Charges are imposed on particular products, by either weight or volume, and usually stated in the local currency.
- *Ad valorem*. The charge is a straight percentage of the value of the goods (the import price).
- *Discriminatory*. In this case the tariff is charged against goods coming from a particular country, either where there is a trade imbalance or for political purposes.

Non-tariff barriers

In the past 40 years the world has seen a gradual reduction in tariff barriers in most developed nations. However, in parallel to this, non-tariff barriers have substantially increased. Non-tariff barriers are much more elusive and can be more easily disguised. However, in some ways the effect can be more devastating because they are an unknown quantity and are much less predictable.

Among non-tariff barriers the most important (not mentioned earlier) are as follows.

Quotas

A restriction on the amount (measured in units or weight) of a good that can enter or leave a country during a certain period of time is called a *quota*. After tariffs, a quota is the second most common type of trade barrier. Governments typically administer their quota systems by granting quota licences to the companies or governments of other nations (in the case of import quotas), and domestic producers (in the case of export quotas). Governments normally grant such licences on a year-by-year basis.

There are two reasons why a government imposes *import quotas*:

1. It may wish to protect its domestic producers by placing a limit on the amount of goods allowed to enter the country. This helps domestic producers maintain their market shares and prices because competitive forces are restrained. In this case, domestic producers win because of the protection of their markets. Consumers lose because of higher prices and less selection due to lower competition. Other losers include domestic producers whose own production requires the import to be slapped with a quota. Companies relying on the importation of so-called 'intermediate' goods will find the final cost of their own products increases.
2. It may impose import quotas to force the companies of other nations to compete against one another for the limited amount of imports allowed. Thus those wishing to get a piece of the action will likely lower the price that they are asking for their goods. In this case, consumers win from the resulting lower prices. Domestic producers of competing goods win if external producers do not undercut their prices, but lose if they do.

Likewise, there are at least two reasons why a country imposes *export quotas* on its domestic producers:

1. It may wish to maintain adequate supplies of a product in the home market. This motive is most common among countries exporting natural resources that are essential to domestic business or the long-term survival of a nation.

2 It may restrict exports to restrict supply on world markets, thereby increasing the international price of the good. This is the motive behind the formation and activities of the Organization of Petroleum Exporting Countries (OPEC). This group of nations from the Middle East and Latin America attempts to restrict the world's supply of crude oil to earn greater profits.

A unique version of the export quota is called a *voluntary export restraint* (VER) – a quota that a nation imposes on its exports usually at the request of another nation. Countries normally self-impose a voluntary export restraint in response to the threat of an import quota or total ban on the product by an importing nation. The classic example of the use of a voluntary export restraint is the automobile industry in the 1980s. Japanese carmakers were making significant market share gains in the US market. The closing of US carmakers' production facilities in the United States was creating a volatile anti-Japan sentiment among the population and the US Congress. Fearing punitive legislation in Congress if Japan did not limit its auto exports to the United States, the Japanese government and its carmakers self-imposed a voluntary export restraint on cars headed for the United States.

Consumers in the country that imposes an export quota benefit from greater supply and the resulting lower prices if domestic producers do not curtail production. Producers in an importing country benefit because the goods of producers from the exporting country are restrained, which may allow them to increase prices. Export quotas hurt consumers in the importing nation because of reduced selection and perhaps higher prices. However, export quotas might allow these same consumers to retain their jobs if imports were threatening to put domestic producers out of business. Again, detailed economic studies are needed to determine the winners and losers in any particular export quota case.

Embargoes

A complete ban on trade (imports and exports) in one or more products with a particular country is called an *embargo*. An embargo may be placed on one or a few goods or completely ban trade in all goods. It is the most restrictive non-tariff trade barrier available and is typically applied to accomplish political goals. Embargoes can be decreed by individual nations or by supranational organizations such as the United Nations. Because they can be very difficult to enforce, embargoes are used less today than in the past. One example of a total ban on trade with another country has been the United States' embargo on trade with Cuba.

Administrative delays

Regulatory controls or bureaucratic rules designed to impair the rapid flow of imports into a country are called *administrative delays*. This non-tariff barrier includes a wide range of government actions such as requiring international air carriers to land at inconvenient airports; requiring product inspections that damage the product itself; purposely understaffing customs offices to cause unusual time delays; and requiring special licences that take a long time to obtain. The objective of such administrative delays for a country is to discriminate against imported products – in a word, it is protectionism.

Although Japan has removed some of its trade barriers many subtle obstacles to imports remain. Products ranging from cold pills and vitamins to farm products and building materials find it hard to penetrate the Japanese market.

Local-content requirements

Laws stipulating that a specified amount of a good or service be supplied by producers in the domestic market are called local-content requirements. These requirements can state that a certain portion of the end product consist of domestically produced goods, or that a certain portion of the final cost of a product have domestic sources.

The purpose of local-content requirements is to force companies from other nations to employ local resources in their production processes – particularly labour. Similar to other restraints on imports, such requirements help protect domestic producers from the price advantage of companies based in other, low-wage countries. Today companies can circumvent local-content requirements by locating production facilities inside the nation stipulating such restrictions.

Historical development of barriers

Non-tariff barriers become much more prevalent in times of recession. The United States and Europe have witnessed the mobilisation of quite strong political lobby groups as indigenous industries, which have come under threat, lobby their governments to take measures to protect them from international competition. The last major era of protectionism was in the 1930s. During that decade, under the impact of the most disastrous trade depression in history, most countries of the world adopted high tariffs.

After the Second World War there was a reaction against the high tariff policy of the 1930s and significant efforts were made to move the world back to free trade. World organizations (such as GATT and its successor, WTO) have been developed to foster international trade and provide a trade climate in which such barriers can be reduced.

The general international environment

In addition to the politics and laws of both the home and the host countries, the marketer must consider the overall international political and legal environment. Relations between countries can have a profound impact on firms trying to do business internationally.

The international political environment involves political relationships between two or more countries. This is in contrast to our previous concern for what happens only within a given foreign country. The international firm almost inevitably becomes somewhat involved with the host country's international relations, no matter how neutral it may try to be. It does so because its operations in a country are frequently related to operations in other countries, either on the supply or the demand side or both. East–West relations are a good example of a situation in the international political environment that is continually evolving.

The effect of politics on global marketing is determined by both the bilateral political relations between home and host countries and the multilateral agreements governing the relations among groups of countries. One aspect of a country's international relations is its relationship with the firm's home country.

A second critical element affecting the political environment is the host country's relations with other nations. If a country is a member of a regional group, such as the European Union or ASEAN, this influences the firm's evaluation of the country. If a nation has particular friends or enemies among other nations, the firm must modify its international logistics to comply with how that market is supplied and to whom it can sell.

Another clue to a nation's international behaviour is its membership of international organizations. Membership of the IMF or the World Bank may aid a country's financial situation, but it also puts constraints on the country's behaviour. Many other international agreements impose rules on their members. These agreements may affect, for example, patents, communication, transportation and other items of interest to the international marketer. As a rule, the more international organizations a country belongs to, the more regulations it accepts, and the more dependable is its behaviour.

The political risk analysis procedure

We now outline in general terms a procedure for analysing political risk and avoiding the common error of over- or underestimating such risk at the firm level. The goal of this procedure is to help firms make informed decisions based on the ratio of the return to risk, so that firms can enter or stay in a country when the ratio is favourable and avoid or leave a country when the ratio for them is poor. This procedure involves three major steps (Figure 6.2).

Step 1: Assessing issues of relevance to the firm

Clearly, the relevant issues and the magnitude of their importance will vary by firm even within a given country. For one firm the repatriation of profits (and therefore policies and changes that affect that issue) could be the most important. For another firm in the same country repatriation of profits may be less of a concern, but product quality (and therefore policies and changes that affect labour, material or technology) may be of the highest concern.

Step 2: Assessing potential political events

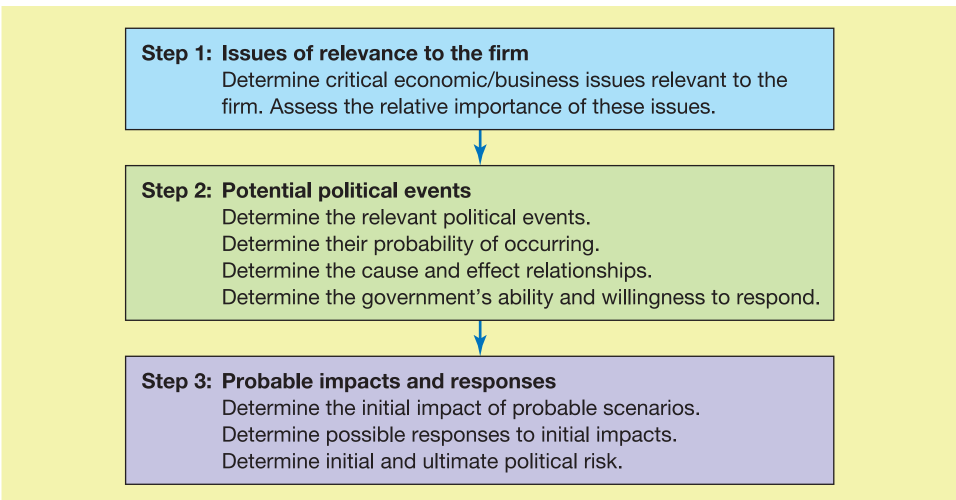
In general, political instability is more likely during greater periods of economic depression. However, the more the event is controllable and the more government is able and willing to exercise control, the lower the probability that the event will have a direct impact on foreign firms.

It is important to estimate not only the probability of a single political event occurring or the confidence with which that prediction is made, but also the sequence of related events. For example, suppose it was highly likely that Russian president Vladimir Putin was going to be replaced by a new president. Would this have any effect on policies on the repatriation of profits, the regulations of exports and other related issues?

Step 3: Addressing political risks through relationship building

Step 3 is really where 'political risk' for the particular firm is assessed. Because political instability in a country does not equal political risk for a firm, the same scenario of

Figure 6.2 Three-step process of political risk analysis



politically destabilizing events could have very different associated risks for different firms in the same industry or for those in different industries. Generally political risk are addressed through the building of relationships with the various stakeholders of the company (Erevelles *et al.*, 2005):

- the government
- customers
- employees
- the local community.

1 Building relationships with government

Managers must be able to deal with the political risks, rules and regulations that apply in each national business environment. Moreover, laws in many nations are susceptible to frequent change, with new laws continually being enacted and existing ones modified. To influence local politics in their favour, managers can propose changes that positively affect their local activities:

- *Lobbying*. Influencing local politics always involves dealing with local lawmakers and politicians, either directly or through lobbyists. Lobbying is the policy of hiring people to represent a company's views on political matters. Lobbyists meet with local public officials and try to influence their position on issues relevant to the company. They describe the benefits that a company brings to the local economy, natural environment, infrastructure and workforce. Their ultimate goal is getting favourable legislation passed and unfavourable legislation rejected.
- *Corruption/bribery*. Though illegal in most countries bribes are common for gaining political influence and building relationships to political decision-makers. This issue is further discussed in section 19.6: Transnational bribery in cross-cultural negotiations.

2 Building relationships with customers

Local customers support companies that have provided them with desirable products and services. For example, in the case of expropriation the firm that has excelled in relationship building with its customers will have considerable support from them, as they will fear losing the benefits that the firm provides.

3 Building relationships with employees

Local employees can be very protective of a company, even in times of instability, especially if they perceive that their jobs could be affected by government interference. Therefore, well-treated employees will usually be interested in the company's survival, because they perceive it to be key to their own survival.

4 Building relationships with the local community

The local community may be concerned that the foreign company will extract materials and labour and make a profit, but fail to give back something to the local environment and the local people. Therefore the company needs to be a good 'local citizen' and reinvest in the local community.

Management of the international terrorist threat

After the 9/11 attack companies realized that terrorism (bombings, armed attacks, kidnapping, vandalism and hijacking) will increasingly influence the evaluation and selection of markets, particularly those located abroad. Developing nations tend to be most vulnerable to economic and consumption downturns following terrorist events.

Terrorism's major impact on business originates from the indirect effects that occur in national and global economies, including (Czinkota and Knight, 2005a):

- short and long-term declines in customer demand due to the fear and panic that ensue in the wake of terrorist acts;
- unpredictable shifts or interruptions in the supply chain of needed inputs and resources for the global production of products and services;
- government policies and laws enacted to deal with terrorism, thereby altering the business environment and introducing new friction to the flow of business;
- macroeconomic effects, such as falling stock market values.
- deteriorating relations among countries due to the impact of terrorism, such as greater scrutiny of visa applications or governmental discord over policy issues.

These indirect effects are critical because they raise the level of uncertainty in the business environment. Uncertainty implies a lack of information about future events, so that decision making, appropriate actions and associated outcomes become unpredictable. Perhaps the greatest threat from terrorism is the resultant psychological response leading to substantial declines in demand and other shifts in people's behaviour.

The terrorist risk is difficult to assess in an integrated global economy where supply chains are complex and producers rely on suppliers and suppliers' suppliers at locations across the globe. The more a firm relies on international sources of supply, the greater the vulnerability of inventory stocks. The more that suppliers are seen as vulnerable, the less likely buyers will be to purchase goods from those suppliers.

Terrorism, even at distant locations, can induce shortages or delays of input goods that disrupt critical company operations. Distribution and logistics are particularly vulnerable because governments impose regulations and restrictions that affect the timing and efficiency of such activities, particularly from international sources. Following 9/11, for example, tighter security at US customs checkpoints prompted long shipping delays, which forced Ford Motor Co. to temporarily close five of its US auto plants.

What can be done about global terrorism?

Managers must consider the possibility of terrorism in overall strategic and portfolio planning. *Scenario planning* (see section 5.7) can be instrumental in encouraging preparedness and a rapid response to changing conditions. Strategy and practice are best determined through market research and assessment of the basic nature of each location, industry characteristics and the level of risk that management is willing to tolerate. This includes scanning to anticipate the likely consequences – primarily indirect effects – of future terrorist events. Regularly scanning and forecasting emerging business conditions is critical, especially for firms that rely heavily on foreign-sourced raw materials and other input goods. Preparing for terrorism involves expenditure that may prove unnecessary in the long run. Cost–benefit analysis, therefore, is useful for determining the optimal balance between the cost of preparing for terrorism and the consequences of terrorism.

Reconsidering the customer – and the market portfolio

Customers who are exposed to terrorism may no longer be able to fulfil a contract or buy new merchandise. In consequence, companies will increasingly begin to develop trade portfolios, which allocate effort globally on both the supply side and the demand side.

The threat level of terrorism should be used as a segmentation variable when evaluating new markets, particularly those located in risky areas. Highly vulnerable markets should be avoided or assigned risk premiums. Terrorism should be considered when designing and developing supply chains and distribution channels. Risk premiums should be considered when developing foreign-based production or marketing facilities at relatively hazardous locations. Terrorism should influence planning the location of foreign subsidiaries, proposed target markets, and especially international distribution channels and supply-chain management. For example, following recent terrorist events, toy manufacturing giant *Hasbro* invested considerable sums in planning and implementation to ensure the integrity of its extensive global supply chain.

Flexibility in sourcing from different suppliers

The threat of terrorism means that firms should source from a more extensive range of suppliers located in a wider range of locations, or from safer sources of supply. It is important to keep flexibility by having the ability to source from various suppliers or switching production to different regions in case of unanticipated disruptive events.

Purchasing managers should consider maintaining larger safety stocks of essential vulnerable input goods or develop multiple supply sources as a security against terrorism's effects. Manufacturers should regularly re-evaluate transportation and shipping arrangements. In the long run, they could even consider producing more essential inputs themselves, as opposed to buying them from suppliers. For example, Compaq (now part of Hewlett-Packard) established secondary suppliers for all of its critical computer input components. The firm also owned assembly operations in various locations worldwide. Management could quickly shift production from one locale to another in the event of a crisis. Such flexibility minimized the possibility that Compaq's operations would be interrupted in the event of a terrorist attack (Czinkota and Knight, 2005b).

Collaboration and information sharing with local partners

Increased collaboration with local partners can help mitigate the harm of terrorism. For example, Hewlett-Packard now relies on linkages with backup US-based suppliers of inkjet printers in addition to a Singapore firm that handles most of the firm's stable production. Risk sharing is possible in instances of major terrorist interruption of corporate activities. In particular, firms with long-standing customer–supplier relationships should cooperate to reduce exposure to interruptions in normal value-chain activities.

Information sharing with local partners aims to ensure that trading partners share information and coordinate forecasts to avoid unnecessary inventory fluctuations. For example, following 9/11, Toyota Motor Corp. worked with its top suppliers to develop security plans that now offer alternative arrangements in the event of supply interruptions. This represents a major shift in company strategy from just-in-time to 'just-in-case' planning (Czinkota and Knight, 2005b).

Companies that operate their own marketing subsidiaries abroad are better positioned to deal with the aftermath of terrorism, thanks to better access to local information and control over marketing resources. Alliances and joint ventures offer increased means for intelligence gathering through partnerships with local based companies, providing greater access to information that can be leveraged to deal more effectively with crises. Emergent harm may be mitigated by the firm's relationships with other businesses and governments, as well as by sharing various risks with local partners.

The risk of terrorism can never be entirely eliminated, but with appropriate strategic and operational thinking, the effects of terrorism can be anticipated and planned for. While new procedures intended to minimize terrorism's harm may prove costly, they must be weighed against the substantial savings afforded by being prepared at the corporate level for both the direct and indirect effects of terrorism. In the long run, manufacturers should increasingly incorporate product value chains that facilitate rapid switching to alternative parts and components in the event of supply shocks to critical input goods.

Companies are not helpless in a volatile world. But as a first step, there needs to be an acknowledgement that terrorism is a global business problem. All too often, local subsidiaries transfer terrorism-related issues to headquarters (Czinkota and Knight, 2005a).

6.3 The economic environment

Market size and growth are influenced by many forces, but the total buying power in the country and the availability or non-availability of electricity, telephone systems, modern roads and other types of infrastructure will influence the direction of that spending.

Economic development results from one of three types of economic activity:

1. *Primary*. These activities are concerned with agriculture and extractive processes (e.g. coal, iron ore, gold, fishing).
2. *Secondary*. These are manufacturing activities. There are several evolutions. Typically countries will start manufacturing through processing the output of primary products.
3. *Tertiary*. These activities are based upon *services* – for example, tourism, insurance and health care. As the average family income in a country rises the percentage of income spent on food declines, the percentage spent on housing and household activities remains constant, and the percentage spent on service activities (e.g. education, transport and leisure) will increase.

How exchange rates influence business activities

Times of crisis are not the only occasions during which companies are affected by exchange rates. In fact movement in a currency's exchange rate affects the activities of both domestic and international companies. Let us now examine how exchange rate changes affect the business decisions of companies, and why stable and predictable rates are desirable.

Exchange rates affect demand for a company's products in the global marketplace. When a country's currency is *weak* (valued low relative to other currencies), the price of its exports on world markets declines and the price of imports increases. Lower prices make the country's exports more appealing on world markets. They also give companies the opportunity to take market share away from companies whose products are highly priced in comparison.

Furthermore, a company selling in a country with a *strong* currency (one that is valued high relative to other currencies) while paying workers in a country with a weak currency improves its profits.

The international lowering of the value of a currency by the nation's government is called devaluation. The reverse, the intentional raising of its value by the nation's government, is called revaluation. These concepts are not to be confused with the terms *weak* and *strong* currencies, although their effects are similar.

Devaluation lowers the price of a country's exports on world markets and increases the price of imports because the country's currency is now worth less on world markets.

Thus a government might devalue its currency to give its domestic companies an edge over competition from other countries. It might also devalue to boost exports so that a trade deficit can be eliminated. However, such a policy is not wise because devaluation reduces consumers' buying power. It also allows inefficiencies to persist in domestic companies because there is now less pressure to be concerned with production costs. In such a case, increasing inflation may be the result. *Revaluation* has the opposite effect: it increases the price of exports and reduces the price of imports.

As we have seen, unfavourable movements in exchange rates can be costly for both domestic and international companies. Therefore, managers prefer that exchange rates be *stable*. Stable exchange rates improve the accuracy of financial planning, including cash flow forecasts. Although methods do exist for insuring against potentially adverse exchange rate movements, most of these are too expensive for small and medium-sized businesses. Moreover, as the unpredictability of exchange rates increases, so too does the cost of insuring against the accompanying risk.

Law of one price

An exchange rate tells us how much of one currency we must pay to receive a certain amount of another. But it does not tell us whether a specific product will actually cost us more or less in a particular country (as measured in our own currency). When we travel to another country we discover that our own currency buys more or less than it does at home. In other words, we quickly learn that exchange rates do not guarantee or stabilize the buying power of our currency. Thus we can lose purchasing power in some countries while gaining it in others.

The law of one price stipulates that an identical product must have an identical price in all countries when price is expressed in a common-denominator currency. For this principle to apply products must be identical in quality and content in all countries, and must be entirely produced within each particular country.

Big Mac Index/Big MacCurrencies

The usefulness of the law of one price is that it helps us determine whether a currency is overvalued or undervalued. Each year *The Economist* magazine publishes what it calls its 'Big MacCurrencies' exchange-rate index (see Table 6.1).

The index is based on the theory of purchasing-power parity (PPP), the notion that a dollar should buy the same amount in all countries. The theory naturally relies on certain assumptions, such as negligible transportation costs, that goods and services must be 'tradable', and that a good in one country does not differ substantially from the same good in another country. Thus, in the long run, the exchange rate between two currencies should move towards the rate that equalizes the prices of an identical basket of goods and services in each country. In this case the 'basket' is a McDonald's Big Mac, which is produced in about 120 countries. The Big Mac PPP is the exchange rate that would mean hamburgers cost the same in the United States as abroad. Comparing actual exchange rates with PPP indicates whether a currency is under- or overvalued.

This index uses the law of one price to determine the exchange rate that should exist between the US dollar and other major currencies. It employs the McDonald's Big Mac as its single product to test the law of one price. Why the Big Mac? Because each Big Mac is fairly identical in quality and content across national markets and almost entirely produced within the nation in which it is sold. The underlying assumption is that the price of a Big Mac in any world currency should, after being converted to dollars, equal the price of a Big Mac in the United States. A country's currency would be overvalued if the Big Mac price (converted to dollars) is higher than the US price.

Table 6.1 The hamburger standard (based on 25 March 2006 Big Mac prices)

Country	Big Mac price		Implied PPP of the $ (local price divided by price in US)	Actual Exchange Rate 1 USD =	Over(+) / Under(–) valuation against the dollar, %
	in local currency	in US dollars			
United States	$3.10	3.10	–	1.00	–
Argentina	Peso7.00	2.27	2.26	3.08	–27
Australia	A$3.25	2.49	1.05	1.30	–19
Brazil	Real6.40	2.94	2.06	2.17	–5
Britain	£1.94	3.68	1.60*	1.90*	+19
Canada	C$3.52	3.13	1.14	1.12	+2
China	Yuan10.50	1.31	3.39	7.98	–58
Euro area	€2.94	3.77	0.95	0.77	+22
Hong Kong	HK$12.00	1.54	3.87	7.77	–50
Hungary	Forint 560	2.65	181.00	210.74	–14
Indonesia	Rupiah14,600	1.60	4.71	9,090.91	–48
Japan	¥250	2.17	80.6	115.18	–30
Malaysia	M$5.50	1.49	1.77	3.67	–52
Mexico	Peso29.0	2.66	9.35	10.87	–14
New Zealand	NZ$4.45	2.81	1.44	1.58	–9
Poland	Zloty6.50	2.15	2.10	3.02	–30
Russia	Rouble48.00	1.79	15.5	26.72	–42
Singapore	S$3.60	2.29	1.16	1.57	–26
South Africa	Rand13.95	2.06	4.50	6.76	–33
South Korea	Won2,500	2.57	806	970.40	–17
Sweden	Skr33.0	4.60	10.6	7.16	+48
Switzerland	SFr6.30	5.12	2.03	1.22	+65
Taiwan	NT$75.00	2.29	24.2	32.65	–26
Thailand	Baht60.0	1.59	19.4	37.52	–48

* Dollars per pound.

Source: *The Economist*, 25 March 2006 © The Economist Newspaper Limited, London (25.04.06).

Conversely, a country's currency would be undervalued if the converted Big Mac price was lower than the US price.

Such large discrepancies between a currency's exchange rate on currency markets and the rate predicted by the Big Mac Index are not surprising, for several reasons. For one thing, the selling price of food is affected by subsidies for agricultural products in most countries. Also, the Big Mac is not a 'traded' product in the sense that one can buy Big Macs in low-priced countries and sell them in high-priced countries. Prices can also be affected because Big Macs are subject to different marketing strategies in different countries. Finally, countries impose different levels of sales tax on restaurant meals.

The drawbacks of the Big Mac Index reflect the fact that applying the law of one price to a single product is too simplistic a method for estimation of exchange rates. Nonetheless, a recent study finds that currency values in eight out of 12 industrial countries do tend to change in the direction suggested by the Big Mac Index. And for six out of seven currencies that change more than 10 per cent the Big Mac Index was as good a predictor as more sophisticated methods.

Table 6.1 also uses the concept of purchasing-power parity (PPP), which economists use when adjusting national income data (GNP, etc.) to improve comparability. PPPs are the rates of currency conversion that equalize the purchasing power of different currencies by eliminating the differences in price levels between countries. In their simplest form PPPs are simply price relatives that show the ratio of the prices in national currencies of the same good or service in different countries.

The easiest way to see how a PPP is calculated is to consider Table 6.1 for a product that is identical in several countries. For example, a Big Mac costs Peso7.00 in Argentina. If we divide 7.00 with the price in the United States, \$3.10, the result will be the PPP of the dollar = 2.26 (the 'theoretical' exchange rate of the Peso). Then if we divide 2.26 with the actual exchange rate, 3.08, we find that the Argentina Peso is undervalued by $1 - (2.26/3.08) \times 100 = 27$ per cent.

However, the easiest way to calculate the over- or under-valuation of the local currency against the US\$ is to divide the local Big Mac price (in US\$) with the US Big Mac Price. So, for example, the Indonesian Rupiah is undervalued with $1 - (1.60/3.10) \times 100 = 48$ per cent.

PPPs are not only calculated for individual products; they are calculated for a 'basket' of products, and PPP is meaningful only when applied to such a 'basket'.

Classification by income

GNP
Gross national product is the value of all goods and services produced by the domestic economy over a one-year period, including income generated by the country's international activities.

GNP per capita
Total GNP divided by its population.

Countries can be classified in a variety of ways. Most classifications are based on national income (GDP or GNP per capita) and the degree of industrialization. The broadcast measure of economic development is **gross national product (GNP)** – the value of all goods and services produced by a country during a one-year period. This figure includes income generated both by domestic production and by the country's international activities. *Gross domestic product* (GDP) is the value of all goods and services produced by the domestic economy over a one-year period. In other words, when we add to GDP the income generated from exports, imports and the international operations of a nation's companies, we get GNP. A country's **GNP per capita** is simply its GNP divided by its population. GDP per capita is calculated similarly.

Both GNP per capita and GDP per capita measure a nation's income per person. In this regard GNI (Gross National Income) can be regarded as the same as GNP.

Less developed countries (LDCs)

This group includes underdeveloped countries and developing countries. The main features are a low GDP per capita (less than \$3,000), limited amount of manufacturing activity and a very poor and fragmented infrastructure. Typical infrastructure weaknesses are in transport, communications, education and health care. In addition, the public sector is often slow moving and bureaucratic.

It is common to find that LDCs are heavily reliant on one product and often on one trading partner. The typical pattern for single-product dependence is the reliance on one agricultural crop or on mining. Colombia (coffee) and Cuba (sugar) are examples of extreme dependence upon agriculture. The risks posed to the LDC by changing patterns of supply and demand are great. Falling commodity prices can result in large decreases in earnings for the whole country. The resultant economic and political adjustments may affect exporters to that country through possible changes in tariff and non-tariff barriers.

A wide range of economic circumstances influences the development of the LDCs in the world. Without real prospects for rapid economic development private sources of capital are reluctant to invest in such countries. This is particularly the case for long-term infrastructure projects. As a result, important capital spending projects rely heavily on world aid programmes.

The quality of distribution channels varies considerably between countries. There are often great differences between the small-scale, undercapitalized distribution intermediaries in LDCs and the distributors in more advanced countries. Retailers, for example, are more likely to be market traders. The incidence of large-scale self-service outlets will be comparatively low.

Newly industrialised countries (NICs)

NICs are countries with an emerging industrial base: one that is capable of exporting. Examples of NICs are the 'tigers' of south-east Asia: Hong Kong, Singapore, South Korea and Taiwan. Brazil and Mexico are examples of NICs in South America. In NICs, although the infrastructure shows considerable development, high growth in the economy results in difficulties with producing what is demanded by domestic and foreign customers.

Advanced industrialized countries

These countries have considerable GDP per capita, a wide industrial base, considerable development in the services sector and substantial investment in the infrastructure of the country.

This attempt to classify the economies of the world into neat divisions is not completely successful. For example, some of the advanced industrialized countries (e.g. the United States and France) have important agricultural sectors.

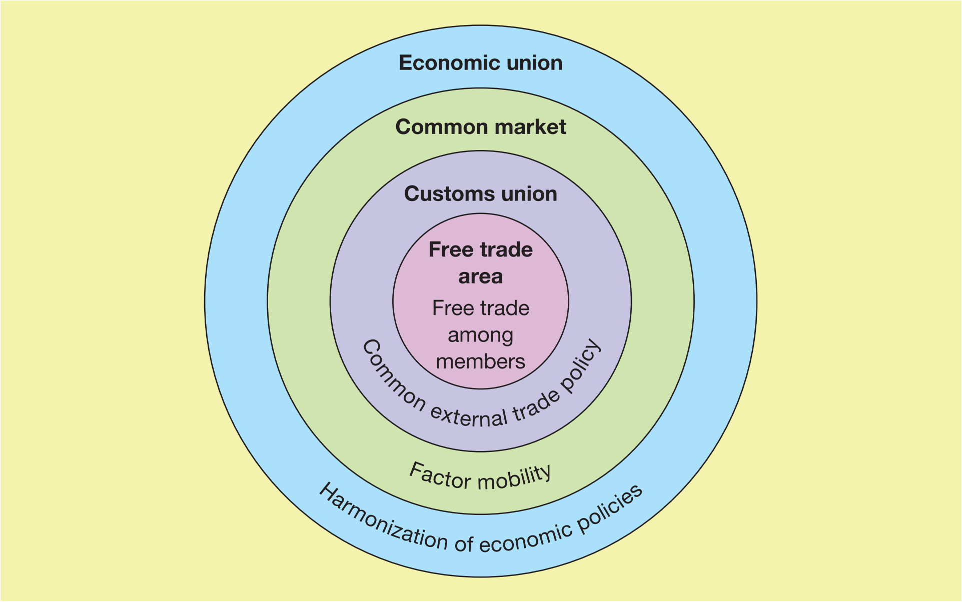
Regional economic integration

Economic integration has been one of the main economic developments affecting world markets since the Second World War. Countries have wanted to engage in economic cooperation to use their respective resources more effectively and to provide large markets for member-country producers.

Some integration efforts have had quite ambitious goals, such as political integration; some have failed as a result of perceptions of unequal benefits from the arrangement or a parting of the ways politically. Figure 6.3, a summary of the major forms of economic cooperation in regional markets, shows the varying degrees of formality with which integration can take place. These economic integration efforts are dividing the world into trading blocs.

The levels of economic integration will now be described.

Figure 6.3 Forms of economic integration in regional markets



Source: *Global Marketing*, 1st edition by Czinkota/Ronkainen. 1996. Reprinted with permission of South-Western, a division of Thomson Learning: www.thomsonrights.com. Fax 800 730–2215.

Free trade area

The free trade area is the least restrictive and loosest form of economic integration among nations. In a free trade area all barriers to trade among member countries are removed. Each member country maintains its own trade barriers vis-à-vis non-members.

The European Free Trade Area (EFTA) was formed in 1960 with an agreement by eight European countries. Since that time EFTA has lost much of its original significance due to its members joining the European Union. All EFTA countries have cooperated with the European Union through bilateral free trade agreements, and since 1994 through the European Economic Area (EEA) arrangement that allows for free movement of people, products, services and capital within the combined area of the European Union and EFTA. Of the EFTA countries, Iceland and Liechtenstein have decided not to apply for membership of the European Union and Norway turned down membership after a referendum in 1994. Switzerland has also decided to stay out of the European Union.

After three failed tries during the last century the United States and Canada signed a free trade agreement that went into effect in 1989. North American free trade expanded in 1994 with the inclusion of Mexico in the North American Free Trade Agreement (NAFTA).

Customs union

The customs union is one step further along the spectrum of economic integration. As in the free trade area, goods and services are freely traded among members. In addition, however, the customs union establishes a common trade policy with respect to non-members. Typically this takes the form of a common external tariff, whereby imports from non-members are subject to the same tariff when sold to any member country. The Benelux countries formed a customs union in 1921 that later became part of wider European economic integration.

Common market

The common market has the same features as a customs union. In addition, factors of production (labour, capital and technology) are mobile among members. Restrictions on immigration and cross-border investment are abolished. When factors of production are mobile capital, labour and technology may be employed in their most productive uses.

The removal of barriers to the free movement of goods, services, capital and people in Europe was ratified by the passing of the Single European Act in 1987 with the target date of 31 December 1992 to complete the internal market. In December 1991 the EEC agreed in Maastricht that the so-called 1992 process would be a step towards cooperation beyond the economic dimension. While many of the directives aimed at opening borders and markets were completed on schedule some sectors, such as cars, will take longer to open up.

Economic union

The creation of true economic union requires integration of economic policies in addition to the free movement of goods, services and factors of production across borders. Under an economic union members harmonize monetary policies, taxation and government spending. In addition, a common currency is used by members and this could involve a system of fixed exchange rates. The ratification of the Maastricht Treaty in late 1993 resulted in the European Union being effective from 1 January 1994. Clearly the formation of a full economic union requires the surrender of a large measure of national sovereignty to a supranational body. Such a union is only a short step away from political unification, but many countries in the European Union (especially in the northern part of Europe) are sceptical about this development because they fear a loss of national identity.

Enlargement of EU

The EU can already look back on a history of successful enlargements. The Treaties of Paris (1951), establishing the European Coal and Steel Community (ECSC), and Rome (1957), establishing the European Economic Community (EEC) and EURATOM, were signed by six founding members: Belgium, France, Germany, Italy, Luxembourg and the Netherlands. The EU then underwent four successive enlargements: 1973, Denmark, Ireland and the United Kingdom; 1981, Greece; 1986, Portugal and Spain; 1995, Austria, Finland and Sweden.

After growing from six to 15 members, the European Union is now preparing for its biggest enlargement ever in terms of scope and diversity. Thirteen countries have applied to become new members and ten of these – Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovack Republic, and Slovenia – joined on 1 May 2004. Bulgaria and Romania joined on 1 January 2007, while Turkey is not currently negotiating its membership. However, Turkey wants to be a member of the EU and the issue will be taken up again in the future.

The current 27 member states of the European Union as on 1 January 2007 are: Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Spain, Slovakia, Slovenia, Sweden and the United Kingdom.

New countries wanting to join the EU, need to fulfil the economic and political conditions known as the 'Copenhagen criteria', according to which a prospective member must (http://europa.eu.int/comm/enlargement): be a stable democracy, respecting human rights, the rule of law, and the protection of minorties; have a functioning market economy; and adopt the common rules, standards and policies that make up the body of EU law.

6.4 The European Economic and Monetary Union and the euro

The Maastricht Treaty resulted in the European Economic and Monetary Union (EMU), which also included the new common European currency, the euro. Although the EMU is currently limited to 12 of the 25 member states, it nevertheless involves the extension of the 'law of one price' across a market comprising 300 million consumers, representing one-fifth of the world economy, which should promote increased trade and stimulate greater competition. Consequently the development of this 'new' Europe has an importance beyond the relatively small group of nations currently involved in its creation. The former eastern European nations, eager to gain full EU membership, for political and economic reasons, will be required to accept full participation in EMU. Unaided, this could conceivably preoccupy their economies for decades (Whyman, 2002).

The consequences of European economic integration will not be restricted to so-called 'European' business. Most obviously the developments associated with the EMU will have a direct impact upon all foreign subsidiaries located within the new euro market. These companies will be forced to adapt their accounting, personnel and financial processes to accommodate the new currency.

The EMU will also affect the international competitiveness of European companies. Reductions in transaction costs, exchange rate risk, intensified domestic competition and the possibilities of gleaning additional economies of scale should all facilitate reductions in the cost structures of European firms, with inevitable consequences upon their external competitors. However, this may be negated by the impact of demands for wage equalization and restrictions imposed by regulations.

With so many important issues in the EMU there is no single economic consensus concerning the likely development of the European economy.

Supporters of EMU claim that the greater nominal exchange rate stability, lower transaction costs (by the introduction of the euro) and price transparency (across European borders) resulting in reduction of information costs will increase the international competitiveness of European business, raising consumer welfare together with the demand for cheaper products. The establishment of an independent European Central Bank (ECB) is anticipated to ensure a low level of inflation, reduce real interest rates and thereby stimulate investment, output and employment.

Opponents of the EMU claim the following:

- The loss of national economic policy tools will have a destabilizing impact.
- The lack of 'real' convergence of participating economies is likely to increase the problem of asymmetric shocks.
- The ECB's attempts at stabilization by the use of a single instrument, a common interest rate, are likely to prove insufficient because the common monetary policy affects EU members differently due to differences in factors, including the concentration of owner-occupation and variable interest borrowing.

Benefits of regional integration

Nations engage in specialization and trade because of the gains in output and consumption, and higher standards of living for all should result from higher levels of trade between nations.

Trade creation

As we have seen, economic integration removes barriers to trade and/or investment for nations belonging to a trading bloc. The increase in the level of trade between nations that results from regional economic integration is called trade creation. One result of trade creation is that consumers and industrial buyers in member nations are faced with a wider selection of goods and services.

Another result of trade creation is that buyers can acquire goods and services at less cost following the lowering of trade barriers such as tariffs. Furthermore, lower costs tend to lead to higher demand for goods because people have more money left over after a purchase to buy other products.

Greater consensus

The World Trade Organization (WTO) works to lower barriers on a global scale. Efforts at regional economic integration differ in that they comprise smaller groups of nations – ranging anywhere from several countries to as many as 30 or more nations. The benefit of trying to eliminate trade barriers in smaller groups of countries is that it can be easier to gain consensus from fewer members as opposed to, say, the 133 countries that comprise the WTO.

Political cooperation

There can also be political benefits from efforts at regional integration. A group of nations can have significantly greater political weight in the world than the nations have individually. Thus nations can have more say when negotiating with other countries. Moreover, integration involving political cooperation can reduce the potential for military conflict between member nations.

Drawbacks of regional integration

Although trade tends to benefit countries, it can also have substantial negative effects. Let us now examine the more important of these.

Trade diversion

The flip side of trade creation is trade diversion – the diversion of trade away from nations not belonging to a trading bloc towards member nations. Trade diversion can occur after formation of a trading bloc because of the lower tariffs charged between member nations. It can actually result in reduced trade with a more efficient non-member producer and increased trade with a less efficient producer within the trading bloc. In this sense economic integration can unintentionally reward a less efficient producer within the trading bloc. Unless there is other internal competition for the producer's good or service buyers will be paying more after trade diversion due to the inefficient production methods of the producer.

Shifts in employment

Perhaps the most controversial aspect of regional economic integration is how people's jobs are affected. Industries requiring mostly unskilled labour, for example, will tend to shift production to low-wage nations within a trading bloc.

Thus trade agreements do cause dislocations in labour markets – some jobs are lost while others are gained.

It is highly likely that countries protecting low-wage domestic industries from competition will see these jobs move to the country where wages are lower once trade and investment barriers are removed. But this is also an opportunity for workers to upgrade their skills and gain more advanced job training. This can help nations increase their competitiveness because a better educated and more skilled workforce attracts higher paying jobs than does a less skilled workforce. However, an opportunity for a nation to improve some abstract 'factors of production' is little consolation to people finding themselves suddenly without work.

Loss of national sovereignty

Successive levels of integration require that nations surrender more of their national sovereignty. A certain amount of sovereignty has to be surrendered to the trading bloc.

Major trading blocs

Table 6.2 shows the major trading blocs together with their population, GNI (gross national income) and GNI per capita. GNI (= GNP) is the current income indicator used by the World Bank. Previously the World Bank used **gross domestic product** (GDP) which is the total value of all goods and services produced by capital and workers in a country. GNI is GDP plus net income from assets abroad (e.g. subsidiaries). This means that GNI is the total value of all goods and services produced by a country's residents or corporations, regardless of their location (World Bank, 2005).

Gross domestic product
Plus/minus net income from assets (e.g. subsidiaries abroad) is GNI (= GNP).

Table 6.2 Major trading blocs as of 1 January 2007 (figures are from 2005 – World Bank)

Organization	Type	Members	Population (million)	GNI ($bn)	GNI per capita ($)
European Union	Political and economic union	Belgium	10.5	373.8	35,700
		Luxembourg	0.5	30.0	65,630
		Denmark	5.4	256.8	47,390
		France	60.7	2,177.7	34,810
		Germany	82.5	2,852.3	34,580
		Ireland	4.2	166.6	40,150
		Italy	57.5	1,724.9	30,010
		UK	60.2	2,263.7	37,600
		Netherlands	16.3	598.0	36,620
		Greece	11.1	218.1	19,670
		Portugal	10.6	170.7	16,170
		Spain	43.4	1,100.1	25,360
		Sweden	9.0	370.5	41,060
		Austria	8.2	303.6	36,980
		Finland	5.2	196.5	37,460
		Bulgaria	7.7	26.7	3,450
		Cyprus	0.8	13.6	16,510
		Czech Republic	10.2	109.2	10,710
		Estonia	1.3	12.2	9,100
		Latvia	2.3	15.5	6,760
		Lithuania	3.4	24.0	7,050
		Hungary	10.1	101.2	10,030
		Malta	0.4	5.5	13,590
		Poland	38.1	271.4	7,110
		Romania	21.6	82.9	3,830
		Slovakia	5.4	42.8	7,950
		Slovenia	2.0	34.7	17,350
		Total	488.6	13,543.0	27,718
Association of South East Asian Nations (ASEAN)	Limited trade and cooperation agreement	Indonesia	220.6	282.2	1,280
		Brunei	n.a.	n.a.	n.a.
		Vietnam	83.0	51.7	620
		Malaysia	25.3	125.8	4,960
		Singapore	4.4	119.6	27,490
		Philippines	83.1	108.3	1,300
		Thailand	64.2	176.9	2,750
		Laos	5.9	2.6	440
		Myanmar	n.a.	n.a.	n.a.
		Cambodia	14.1	5.3	380
		Total	500.6	872.4	1,743
Asia Pacific Economic Cooperation (APEC, excl. ASEAN, USA and Canada)	Formal institution	China	1,304.5	2,263.8	1,740
		Japan	128.0	4,988.6	38,980
		South Korea	48.3	764.7	15,830
		Taiwan*	23.0	337.1	14,630
		Australia	20.3	654.6	32,220
		New Zealand	4.1	106.7	25,960
		Total	1,528.2	9,115.5	5,965
North American Free Trade Area (NAFTA)	Free trade area	US	296.5	12,969.6	43,740
		Canada	32.3	1,051.9	32,600
		Mexico	103.1	753.4	7,310
		Total	431.9	14,774.9	34,209

* Estimated from different sources as Taiwan is not in the World Bank Statistics.

Source: Adapted from *World Bank* (2006).

The size and economic importance of the EU, USA and Japan stand out. The affluence of Luxembourg and Denmark – both small countries – is marked by high values of GNI per capita.

Besides the major trading blocs mentioned in Table 6.2 the most important global market will be the 'triad'.

The triad of Europe, North America and Japan

The global economic size of these three, Europe, the United States and Japan, is disproportionate to their actual number or physical size. Ohmae (1985) cites Japan and the United States alone as accounting for 30 per cent of the free world total, and that with the addition of the United Kingdom, Germany, France and Italy this increases to 45 per cent. Aside from economic wealth these countries share other similarities: mature, stagnant economies; ageing populations; dynamic technological developments and constantly escalating costs of research and development and production facilities. This is all part of the new reality as Ohmae sees it.

This triad creates a market of 600 million with marked demographic similarities and levels of purchasing power as a result of the following:

- growth of capital intensive manufacturing;
- accelerated tempo of new technology;
- concentrated pattern of consumption.

A reaction to any of those forces above is protectionism. Ohmae shows that industries critical to wealth generation in the 1980s were all concentrated in Japan, the United States and Europe, constituting more than 80 per cent of global production and consumption. The implication of the triad is that these 600 million consumers share the same desire for the same goods: Gucci bags, Sony Walkmans, McDonald's hamburgers, etc. While there is an international youth market for denims, CDs and tapes, tastes are not the same, nor is purchasing power equal. Psychographic segmentation based on values and attitudes that may also be shared across national boundaries is what is important.

The answer to market entry in each of the triad regions comes through consortia and joint ventures that pose a new challenge for the corporation, as Ohmae points out, of learning how to communicate institutionally with the very different corporate cultures and languages of other companies.

Per capita income

The statistic most frequently used to describe a country economically is its per capita income. This figure is used as a shorthand expression for a country's level of economic development as well as its degree of modernisation and progress in health, education and welfare. Partial justification for using this figure in evaluating a foreign economy lies in the fact that it is commonly available and widely accepted. A more pertinent justification is that it is, in fact, a good indicator of the size or quality of a market.

The per capita income figures vary widely among the countries of the world. The World Bank finds over half the world's population living in countries with an average per capita income of only $330.

However, some criticism can also be made of per capita income figures:

- *Uneven income distribution*. Per capita figures are less meaningful if there is great unevenness of income distribution in the country. This has already been discussed. Per capita income figures are averages and are meaningful if most people in the country are near the average. Frequently, however, this is not the case. Among world nations the Scandinavian countries have a relatively equal distribution of income among people. Even here, however, marketers are very attentive to differences in income levels when studying potential for their product if the product is at all income sensitive. Many countries have a relatively uneven distribution of income. An extreme example is Brazil, where the lowest 20 per cent of the population receive less than 3 per cent of the national income, whereas the highest 20 per cent receive 63 per cent of that income. This may directly impact the size of the market, especially number of potential customers for certain products.

- *Purchasing power is not reflected*. Per capita income comparisons are expressed in a common currency – usually US dollars – through an exchange rate conversion. The impact of speculation can pull a currency away from its 'true' value.
- *Lack of comparability*. A large part of a European's budget, for example, goes on food, clothing and shelter. In many less developed nations these items may be largely self-provided and are therefore not reflected in national income totals.

Structure of consumption

While it is important to measure the volume of consumption among various cultures, nations and societies, the characteristics of that consumption reveal its structure. Consumption in most advanced countries is characterized by a higher proportion of expenditure devoted to capital goods than in poor countries, where substantially more is spent on consumer goods.

The structural differences with regard to expenditure among nations can be explained by a theory propounded by the German statistician Engel. The law of consumption (Engel's law) states that poorer families and societies spend a greater proportion of their income on food than well-to-do people. Housing, in particular, receives a much smaller share of income in underdeveloped countries than in the advanced nations.

The structure of consumption can also vary among developed countries. While the average person in England eats 13 pounds of cereal a year, per capita consumption in France is just 1 pound, and in Japan less than one-quarter of a pound. Americans eat about 10 pounds of cereal each per year (Jain, 1996, p. 193).

6.5 Summary

In this chapter we have concentrated on analysing the political/legal and the economic environment as it affects the firm in international markets. Most companies are unable to influence the environment of their markets directly, but their opportunities for successful business conduct largely depend on the structure and content of that environment. A marketer serving international markets or planning to do so, therefore, has to assess carefully the political and legal environments of the markets served or under consideration to draw the appropriate managerial consequences.

Political environment

The international marketer's political environment is complex because of the interaction among domestic, foreign and international politics. When investing in a foreign country firms have to be sensitive to that country's political concerns. The firm should prepare a monitoring system that allows it systematically to evaluate the political risks – such as expropriation, nationalization and restrictions against exports and/or imports. Through skilful adaptation and control political risks can be reduced or neutralized.

Tariffs have traditionally been used as barriers to international trade. International trade liberalization during the last decade of the twentieth century led to a significant reduction of tariff barriers. Therefore governments have been increasingly using non-tariff barriers to protect those of their countries' industries that they think are unable to sustain free international competition. A government may also support or deter international business through its investment policy, that is, the general rules governing legislation concerning domestic as well as foreign participation in the equity or ownership of businesses and other organizations of the country.

There are various trade barriers that can inhibit global marketing. Although nations have used the WTO to lessen many of the restrictions several of these barriers will undoubtedly remain.

The political risk perspective of a nation can be studied using factors such as:

- a change in government policy;
- the stability of the government;
- the quality of the host government's economic management;
- the host country's attitude towards foreign investment;
- the host country's relationship with the rest of the world;
- the host country's relationship with the parent company's home government;
- the attitude towards the assignment of foreign personnel;
- the closeness between the government and people;
- the fairness and honesty of administrative procedures.

The importance of these factors varies from country to country and from firm to firm. Nevertheless, it is desirable to consider them all to ensure a complete knowledge of the political outlook for doing business in a particular country.

International terrorism is an increasing problem for companies, but with appropriate strategic and operational thinking, the effects of terrorism can be anticipated and planned for. While new procedures intended to minimize terrorism's harm may prove costly, they must be weighed against the substantial savings afforded by corporate preparedness for both the direct and indirect effects of terrorism. In the long run, manufacturers should increasingly incorporate product value chains that facilitate rapid switching to alternative parts and components in the event of supply shocks to critical input goods.

Economic environment

The economic environment is a major determinant of market potential and opportunity. Significant variations in national markets originate in economic differences. Population characteristics, of course, represent one major dimension. The income and wealth of the nation's people are also extremely important because these key figures determine people's purchasing power. Countries and markets may be at different stages of economic development, each stage having different characteristics.

The Maastricht Treaty resulted in the European Economic and Monetary Union (EMU), which also included the new common European currency, the euro. Although the EMU is currently limited to 12 of the 15 member states it nevertheless involves the extension of the 'law of one price' across a market comprising 300 million consumers, representing one-fifth of the world economy, which should promote increased trade and stimulate greater competition. Consequently the development of this 'new' Europe has an importance beyond the relatively small group of nations currently involved in its creation.

Formal methods for gauging economic development in other nations include: (a) national production, such measures as gross national product and gross domestic product; (b) purchasing-power parity, or the relative ability of two countries' currencies to buy the same 'basket' of goods in those two countries. This index is used to correct comparisons that are made.

CASE STUDY 6.1

The World Bank and the IMF: What on earth is globalization about? Massive protests during a meeting in Prague

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The Internet may be spearheading a global communications revolution; fashion designers may embrace 'ethnic' hues and styles; McDonald's may spread its restaurants across the globe. Globalization is a reality that, for better or worse, touches our lives in ways most of us never stop to think about. Many would certainly say it was a good thing. Increased international trade has made us wealthier and allowed us to lead more diverse lifestyles.

However, the WTO Summit in Hong Kong, in December 2005, was followed by large demonstrations outside the conference centre. The WTO is the global promoter and enforcer of the ideology that 'free trade' is the best way to foster economic growth and, hence, development. But the protesters said that it is actually worsening the life of many poor people in developing countries.

For globalization

For consumers and avowed capitalists globalization is largely a good thing. The fall of protectionist barriers has stimulated free movement of capital and paved the way for companies to set up several bases around the world. The rise of the Internet and recent advances in telecommunications have spurred on the already surging train. Vigorous trade has made for more choice in the high street, greater spending, rising living standards and a growth in international travel. Supporters of globalization say it has promoted information exchange, led to a greater understanding of other cultures and allowed democracy to triumph in most countries.

Anti-globalization

As the street protests indicate there is a growing opposition to the forces of globalization. The anti-globalization movement developed in the late twentieth century to combat the globalization of corporate economic activity and the free trade with developing nations that might result from such activity.

Critics say the West's gain has been at the expense of developing countries. Demonstrators say rich countries should forgive debts of the poorest nations. Generally speaking, protesters believe that these global institutions and agreements (WTO, World Bank/IMF, G8) undermine local decision-making methods. Many governments and free trade institutions are seen as acting for the good of transnational (or multinational) corporations (e.g. Microsoft, Unilever).

Rock star Bono of U2, who has attended several of these meetings to press for debt relief said that people's concerns needed to be heard and addressed. He urged ministers to go further to provide debt relief and has lately achieved some results in this area.

The already meagre share of the global income of the poorest people in the world has dropped from 2.3 per cent to 1.4 per cent in the past decade. But even in the developed world not everyone has been a winner. The freedoms granted by globalization are leading to increased insecurity in the workplace. Manual workers in particular are under threat as companies shift their production lines overseas to low-wage economies.

Developing countries are demanding that the EU and the United States cut back their agricultural subsidy programmes and provide market access for products like Central American sugar or Brazilian orange juice. But with agribusiness being focal in several EU-countries and in the United States, and with thousand of agricultural jobs being at stake in these areas, it is unlikely the US- or the

EU-administration will negotiate seriously on these issues in the near future.

At the heart of the demonstrators' concerns is the fact that huge transnational companies are becoming more powerful and influential than democratically elected governments, putting shareholder interests above those of communities and even customers. Ecological campaigners say corporations are disregarding the environment in the stampede for worldwide mega-profits. Human rights groups say corporate power is restricting individual freedom. Even business people behind small firms have sympathy for the movement, afraid as they are that global economies of scale will put them out of work.

The mere fact that the debate can take place simultaneously across countries and continents, however, may well show that the celebrated global village is already here.

Source: adapted from BBC News, 26 September 2003, news.bbc.co.uk/1/hi/business/2283666.stm.

Questions

1 What were the key arguments of the anti-globalization groups?
2 How could these protests affect the operations of multinational companies?
3 How could the WTO do a better marketing job in communicating its views to the global audience?

CASE STUDY 6.2

Sauer-Danfoss: Which political/economic factor would affect a manufacturer of hydraulic components?

Sauer-Danfoss (**www.sauer-danfoss.com**) is a comprehensive subsupplier of mobile hydraulic solutions as either components or integrated systems to manufacturers of mobile equipment in agriculture, construction, material handling and road building, as well as specialty vehicles in forestry and on-highway. With more than 7,000 employees and 24 factories in North America, Europe and East Asia, Sauer-Danfoss is among the largest manufacturers and suppliers of mobile hydraulics in the world today. Sauer-Danfoss has its principal business centres in Ames, Iowa (US), Neumünster (Germany) and Nordborg (Denmark).

Questions

1 Which political and economic factors in the global environment would have the biggest effect on the future global sales of Sauer-Danfoss hydraulic components/systems to:
   (a) manufacturers of construction and mining equipment (e.g. Caterpillar)?
   (b) manufacturers of agricultural machinery (e.g. John Deere)?
2 What are the biggest problems in forecasting future demand for a subsupplier such as Sauer-Danfoss?

VIDEO CASE STUDY 6.3

download from www.pearsoned.co.uk/hollensen

Debate on globalization

Globalization seems inevitable, but it is not without controversy. The debate on globalization will continue as people try to make sure that the benefits of global trade outweigh the costs for all countries, not just a select few. Despite the pervasive influence of globalization, it is hard to pin down one definition that will suit everybody. For our purposes, globalization refers to an interdependent world economy – in which people in one part of the world interact with people in another part as buyers, sellers or intermediaries.

Questions

1 In your opinion, is globalization inevitable? Are the overall benefits of globalization positive? What are the gains and losses from globalization?

2 What external influences does a company encounter when determining how and where to conduct business globally?

3 How do the stages that a company goes through evolve as its operations become more globalized?

For further exercises and cases, see this book's website at www.pearsoned.co.uk/hollensen

Questions for discussion

1 Identify different types of barrier to the free movement of goods and services.

2 Explain the importance of a common European currency to firms selling goods to the European market.

3 How useful is GNP when undertaking a comparative analysis of world markets? What other approaches would you recommend?

4 Discuss the limitations of per capita income in evaluating market potential.

5 Distinguish between: (a) free trade area, (b) customs union, (c) common market, (d) economic and monetary union and (e) political union.

6 Why is the international marketer interested in the age distribution of the population in a market?

7 Describe the ways in which foreign exchange fluctuations affect: (a) trade, (b) investments, (c) tourism.

8 Why is political stability so important for international marketers? Find some recent examples from the press to underline your points.

9 How can the change of major political goals in a country have an impact on the potential for success of an international marketer?

10 A country's natural environment influences its attractiveness to an international marketer of industrial products. Discuss.

11 Explain why a country's balance of trade may be of interest to an international marketer.

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