GLOBAL EDITION

INTERNATIONAL BUSINESS

A Managerial Perspective

NINTH EDITION

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Wistron, Inventec, and Hon Hai—none of them household names in the United States—annually export to the United States and to other countries millions of personal computers, many of which are produced under contract for leading PC vendors like Apple, Dell, and Hewlett-Packard. Such an arrangement is typical in this stage of the product life cycle: the production of the good shifts to lower-cost manufacturing sites, but the branding and marketing functions remain in the innovating country.[8]

According to the international product life cycle theory, domestic production begins in stage 1, peaks in stage 2, and slumps in stage 3. Exports by the innovating firm's country also begin in stage 1 and peak in stage 2. By stage 3, however, the innovating firm's country becomes a net importer of the product. Foreign competition begins to emerge toward the end of stage 1, as firms in other industrialized countries recognize the product's market potential. In stage 2, foreign competitors expand their productive capacity, thus servicing an increasing portion of their home markets and perhaps becoming net exporters. As competition intensifies in stage 2, however, the innovating firm and its domestic and foreign rivals seek to lower their production costs by shifting production to low-cost sites in less-developed countries. Eventually, in stage 3, the less-developed countries may become net exporters of the product.

Country Similarity Theory

Country-based theories, such as the theory of comparative advantage, do a good job of explaining interindustry trade among countries. **Interindustry trade** is the exchange of goods produced by one industry in country A for goods produced by a different industry in country B, such as the exchange of French wines for Japanese clock radios. Yet much international trade consists of **intraindustry trade**, that is, trade between two countries of goods produced by the same industry. For example, Japan exports Toyotas to Germany, and Germany exports BMWs to Japan. Such intraindustry trade is not predicted by country-based theories.

Swedish economist Steffan Linder sought to explain the phenomenon of intraindustry trade. Linder hypothesized that international trade in manufactured goods results from similarities of preferences among consumers in countries that are at the same stage of economic development. In his view, firms initially manufacture goods to serve the firms' domestic market. As they explore exporting opportunities, they discover that the most promising foreign markets are in countries where consumer preferences resemble those of their own domestic market. The Japanese market, for example, provides BMW with well-off, prestige- and performance-seeking automobile buyers similar to the ones who purchase its cars in Germany. The German market provides Toyota with quality-conscious and value-oriented customers similar to those found in its home market. As each company targets the other's home market, intraindustry trade arises. Linder's **country similarity theory** suggests that most trade in manufactured goods should be between countries with similar per capita incomes and that intraindustry trade in manufactured goods should be common. This theory is particularly useful in explaining trade in **differentiated goods** such as automobiles, expensive electronics equipment, and personal care products, for which brand names and product reputations play an important role in consumer decision making. (**Undifferentiated goods**, such as coal, petroleum products, and sugar, are those for which brand names and product reputations play a minor role at best in consumer purchase decisions.)

New Trade Theory

The so-called **new trade theory** developed by Elhanen Helpman, Paul Krugman,[9] and Kelvin Lancaster,[10] in the 1970s and 1980s extends Linder's analysis by incorporating the impact of economies of scale on trade in differentiated goods. **Economies of scale** occur if a firm's average costs of producing a good decrease as its output of that good increases. Suppose automobile manufacturing and marketing benefits from economies of scale. If both BMW and Toyota are able to expand their sales beyond their home market, each will benefit from lower average costs and each will improve its competitiveness vis-à-vis smaller firms. In industries in which economies of scale are important, we would expect firms to be particularly aggressive in expanding beyond their domestic markets.

Like Linder's approach, the new trade theory predicts that intraindustry trade will be commonplace. It also suggests MNCs within the same industry, such as Caterpillar and Komatsu, Unilever and Procter & Gamble, and Airbus and Boeing, will continually play cat-and-mouse games with one another on a global basis as they attempt to expand their sales to capture scale

economies. Often they seek to harness some sustainable competitive advantage they enjoy as a means of leveraging their own strengths and neutralizing those of their rivals.

Firms competing in the global marketplace have numerous ways of obtaining a sustainable competitive advantage. The more popular ones are owning intellectual property rights, investing in research and development (R&D), achieving economies of scope, and exploiting the experience curve. We discuss each of these options next.

OWNING INTELLECTUAL PROPERTY RIGHTS A firm that owns an intellectual property right—a trademark, brand name, patent, or copyright—often gains advantages over its competitors. For instance, owning prestigious brand names enables Switzerland's Rolex SA and France's LVMH Moët Hennessy Louis Vuitton to charge premium prices for their upscale products. And Coca-Cola and PepsiCo compete for customers worldwide on the basis of their trademarks and brand names.

INVESTING IN R&D R&D is a major component of the total cost of high-technology products. For example, Airbus has spent more than $25 billion developing its superjumbo jet, the A380.[11] Firms in the computer, pharmaceutical, and semiconductor industries also spend large amounts on R&D to maintain their competitiveness. Because of such large "entry" costs, other firms often hesitate to compete against established firms. Thus, the firm that acts first often gains a first-mover advantage.

However, knowledge does not have a nationality. Firms that invest up front and secure the first-mover advantage have the opportunity to dominate the world market for goods that are intensive in R&D. Thus, national competitiveness and trade flows may be determined by which firms make the necessary R&D expenditures. Why is the EU a large exporter of commercial aircraft? Because Airbus is one of the few firms willing to spend the large sums of money required to develop new aircraft and because it is headquartered in Europe.

Firms with large domestic markets may have an advantage over their foreign rivals in high-technology markets because these firms often are able to obtain quicker and richer feedback from customers. With this feedback the firms can fine-tune their R&D efforts, enabling the firms to better meet the needs of their domestic customers. This knowledge can then be used to serve foreign customers. For example, U.S. agricultural chemical producers such as Monsanto and Eli Lilly have an advantage over Japanese rivals in developing soybean pesticides because the U.S. market for such pesticides is large whereas the Japanese market is small. Knowledge gained in the U.S. pesticide market can be readily transferred to meet the needs of Japanese farmers.

ACHIEVING ECONOMIES OF SCOPE Economies of scope offer firms another opportunity to obtain a sustainable competitive advantage in international markets. Economies of scope occur when a firm's average costs decrease as the number of different products it sells increases. Firms that are able to achieve economies of scope enjoy low average costs, which give the firms a competitive advantage over their global rivals. Consider the e-retailer Amazon, which has benefited from both economies of scale and scope. It has spent enormous sums developing and maintaining its website and building its customer base. Because many of these costs are fixed, the company's average costs per sale decline as the company expands its sales. In its quest to capture the volume-driven economies of scale, Amazon has been expanding its operations into the international marketplace. Moreover, the marginal cost of adding an additional product line to its website is relatively small. Accordingly, Amazon has expanded from books to compact discs to DVDs to a myriad of other goods to capture such economies of scope.

EXPLOITING THE EXPERIENCE CURVE Another source of firm-specific advantages in international trade is exploitation of the experience curve. For certain types of products, production costs decline as the firm gains more experience in manufacturing the product. Experience curves may be so significant that they govern global competition within an industry. For instance, in semiconductor chip production, unit cost reductions of 25 to 30 percent with each doubling of a firm's cumulative chip production are not uncommon.[12] Any firm attempting to be a low-cost producer of so-called commodity chips—such as DRAM memory chips—can achieve that goal only if it moves further along the experience curve than its rivals do. Both U.S. and Asian chip manufacturers have often priced their new products below current production costs to capture the sales necessary to generate the production experience that will in turn enable the manufacturers to lower future production costs. Because of their technological leadership in manufacturing and their aggressive, price-cutting strategies, Asian semiconductor manufacturers such as Samsung, Taiwan Semiconductor Manufacturing, and SK Hynix dominate the production of low-cost,

standardized semiconductor chips.[13] Similarly, innovative U.S. semiconductor firms such as Intel and Qualcomm use the experience curve to maintain leadership in the production of high-priced, proprietary chips that form the brains of newer microcomputers and smartphones.

Porter's Theory of National Competitive Advantage

Harvard Business School professor Michael Porter's **theory of national competitive advantage** is the newest addition to international trade theory. Porter believes that success in international trade comes from the interaction of four country- and firm-specific elements: factor conditions; demand conditions; related and supporting industries; and firm strategy, structure, and rivalry.

FACTOR CONDITIONS A country's endowment of factors of production affects its ability to compete internationally. Although factor endowments were the centerpiece of the Hecksher-Ohlin theory, Porter goes beyond the basic factors—land, labor, and capital—-considered by the classical trade theorists to include more advanced factors such as the educational level of the workforce and the quality of the country's infrastructure. His work stresses the role of factor creation through training, research, and innovation.

DEMAND CONDITIONS The existence of a large, sophisticated domestic consumer base often stimulates the development and distribution of innovative products as firms struggle for dominance in their domestic markets. In meeting their domestic customers' needs, however, firms continually develop and fine-tune products that also can be marketed internationally. Thus, pioneering firms can stay ahead of their international competitors as well. For example, Japanese consumer electronics producers benefit internationally because of the willingness of Japan's large, well-off middle class to buy the latest electronic creations of Sony, Toshiba, and Matsushita. After being fine-tuned in the domestic market, new models of Japanese digital cameras, big-screen TVs, and Blu-ray players are sold to eager European and North American consumers. A similar phenomenon is occurring in the telecommunications market, where the rapid adoption of the Internet, tablets, and smartphones by North American consumers and companies has created a fertile climate for companies such as Twitter, Facebook, eBay, and Amazon to develop and tailor new products to meet the needs of this market domestically and internationally.

RELATED AND SUPPORTING INDUSTRIES The emergence of an industry often stimulates the development of local suppliers eager to meet that industry's production, marketing, and distribution needs. An industry located close to its suppliers will enjoy better communication and the exchange

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The Netherlands' rich farmland and favorable climate makes it the world's largest producer of tulip and daffodil bulbs—an estimated 9 billion per year. Dutch producers in turn benefit from sophisticated supporting industries and trade associations, such as the Dutch Flower Council, the Association of Dutch Flower Growers Research Groups, and the FloraHolland flower auctions, which facilitate the competitiveness of Dutch flower growers.

of cost-saving ideas and inventions with those suppliers. Competition among these input suppliers leads to lower prices, higher-quality products, and technological innovations in the input market, in turn reinforcing the industry's competitive advantage in world markets. For example, Hollywood's dominance of the world film industry is based in part on the local availability of specialist input suppliers, such as casting directors, stunt coordinators, costume and set designers, demolition experts, animators, special-effects firms, and animal wranglers.

FIRM STRATEGY, STRUCTURE, AND RIVALRY The domestic environment in which firms compete shapes their ability to compete in international markets. To survive, firms facing vigorous competition domestically must continuously strive to reduce costs, boost product quality, raise productivity, and develop innovative products. Firms that have been tested in this way often develop the skills needed to succeed internationally. Further, many of the investments they have made to succeed in the domestic market (for example, in R&D, quality control, brand image, and employee training) are transferable to international markets at low cost. Such firms have an edge as they expand abroad. Thus, according to Porter's theory, the international success of Japanese automakers and consumer electronics manufacturers and of Hollywood film studios is aided by intense domestic competition in these firms' home countries.

Porter holds that national policies may also affect firms' international strategies and opportunities in more subtle ways. Consider the German automobile market. German labor costs are high, so German automakers find it difficult to compete internationally on the basis of price. As most auto enthusiasts know, however, there are no speed limits on many stretches of Germany's famed autobahns. So German automakers such as Daimler-Benz, Porsche, and BMW have chosen to compete on the basis of quality and high performance by engineering chassis, engines, brakes, and suspensions that can withstand the stresses of high-speed driving. Consequently, these firms dominate the world market for high-performance automobiles.

Porter's theory is a hybrid: It blends the traditional country-based theories that emphasize factor endowments with the firm-based theories that focus on the actions of individual firms. Countries (or their governments) play a critical role in creating an environment that can aid or harm the ability of firms to compete internationally, but firms are the actors that actually participate in international trade. Some firms succeed internationally; others do not. Porsche, Daimler-Benz, and BMW successfully grasped the opportunity presented by Germany's decision to allow unlimited speeds on its highways and captured the high-performance niche of the worldwide automobile industry. Conversely, Opel chose to focus on the broader middle segment of the German automobile market, ultimately limiting its international options.

In summary, no single theory of international trade explains all trade flows among countries. The classical country-based theories are useful in explaining interindustry trade of homogeneous, undifferentiated products, such as agricultural goods, raw materials, and processed goods like steel and aluminum. The firm-based theories are more helpful in understanding intraindustry trade of heterogeneous, differentiated goods, such as Samsung smartphones and Caterpillar bulldozers, many of which are sold on the basis of their brand names and reputations. Further, in many ways, Porter's theory synthesizes the features of the existing country-based and firm-based theories. It also explains another important phenomenon of international competition, the regional clustering of firms within an industry, which is discussed in "Venturing Abroad." Figure 6.5 summarizes the major theories of international trade.

FIGURE 6.5
Theories of International Trade

Country-Based Theories

Country is unit of analysis
Emerged prior to World War II
Developed by economists
Explain interindustry trade
Include:
- Mercantilism
- Absolute advantage
- Comparative advantage
- Relative factor endowments (Heckscher-Ohlin)

Firm-Based Theories

Firm is unit of analysis
Emerged after World War II
Developed by business school professors
Explain intraindustry trade
Include:
- Country similarity theory
- Product life cycle
- New trade theory
- National competitive advantage

VENTURING ABROAD

BIRDS OF A FEATHER FLOCK TOGETHER

Although important for the development of trade theory, Porter's theory of national competitive advantage also explains the existence of another phenomenon of international business activity, the regional **clustering** of firms within an industry resulting from agglomeration economies. **Agglomeration economies** occur when a firm's costs of production decline as the number of firms in that industry increase within a given area. Such growth attracts additional input suppliers to the areas, which then increases price competition and innovation among those suppliers. As their customer base increases, suppliers can specialize, developing unique abilities that benefit the cluster as a whole. Clusters also promote innovation and entrepreneurship. Competition is intense, and firms must continually improve their products and productivity to survive. Entrepreneurs can tap into sophisticated local knowledge networks. Moreover, local bankers and financiers understand the ins-and-outs of the local industry and thus are better able to recognize good ideas when entrepreneurs request loans or capital. Firms within the cluster thus enjoy significant advantages when competing with a firm from outside the cluster. Map 6.1 depicts some key industrial clusters in Western Europe.

Consider three California industries, filmed entertainment, centered in Los Angeles; premium wines, centered in Napa and Sonoma counties; and Internet software services, centered in the Silicon Valley. Each industry no doubt started and benefited from supportive factor endowments and demand conditions. But as area firms began to prosper, other firms within the same industry were attracted to the region seeking to replicate the pioneering firms' success. The expanding number of customers then induced supplier firms to relocate as well. Over time, the cluster becomes so strong that firms not in the cluster are at a significant disadvantage. Film studios requiring the best directors, cinematographers, screenwriters, casting agents, and such are likely to find them in Hollywood. Suppliers of specialized services like pyrotechnics, animal wrangling, special effects, and set design are readily available as well. Similarly, firms seeking the latest vineyard management techniques or viniculture science are likely to find them in Napa or Sonoma counties or at the nearby University of California at Davis. Firms specializing in making or supplying wine-making and grape-harvesting equipment, barrels, corks, bottles, and label design have proliferated there as well, benefiting and strengthening the area's vineyards. Or consider the move of Facebook from Cambridge, Massachusetts, to the Silicon Valley as portrayed in the movie *The Social Network*. There are plenty of smart people in Cambridge. However, Facebook founder Mark Zuckerberg realized that Facebook needed to access the specialized resources and talent that the Silicon Valley could best provide if it were to dominate the social networking market.

Porter argues that clusters play an important role in promoting international competitiveness. Such competition is being transformed from a firm-versus-firm basis to a cluster-versus-cluster basis. In wine, for example, we often think of competition as being between a French vineyard such as Chateau Lafite Rothschild or a California grower like Chateau Montelena. From a cluster perspective, however, the nature of competition changes: California's Sonoma and Napa Valley vintners compete against vintners from France's Burgundy and Champagne provinces and from growers in Australia's Barossa Valley. In Porter's view, a wise government institutes policies that allow the cluster to flourish, perhaps by funding research at local universities or providing infrastructure improvements that benefit the cluster as a whole.

Sources: Based on Harvard Business School, "Global Wine War 2009: New World versus Old," Case number 9-910-405 (2009); Harvard Business School, "Finland and Nokia: Creating the World's Most Competitive Economy," Case number 9-702-427 (2008); Michael Porter, "Clusters and the New Economics of Competition," *Harvard Business Review*, November–December 1998, pp. 77–90; Michael Porter, "The Competitive Advantage of Nations," *Harvard Business Review*, March–April 1990, pp. 73–93.

In Practice

- The firm-based trade theories highlight the importance of multinational corporations in international trade and international investment flows.
- Regional clustering of firms within an industry can be an important source of competitive advantage to firms and to countries.

For further consideration: What percentage of your budget do you spend on undifferentiated goods? On differentiated goods?

An Overview of International Investment

6.4. Describe and categorize the different forms of international investment.

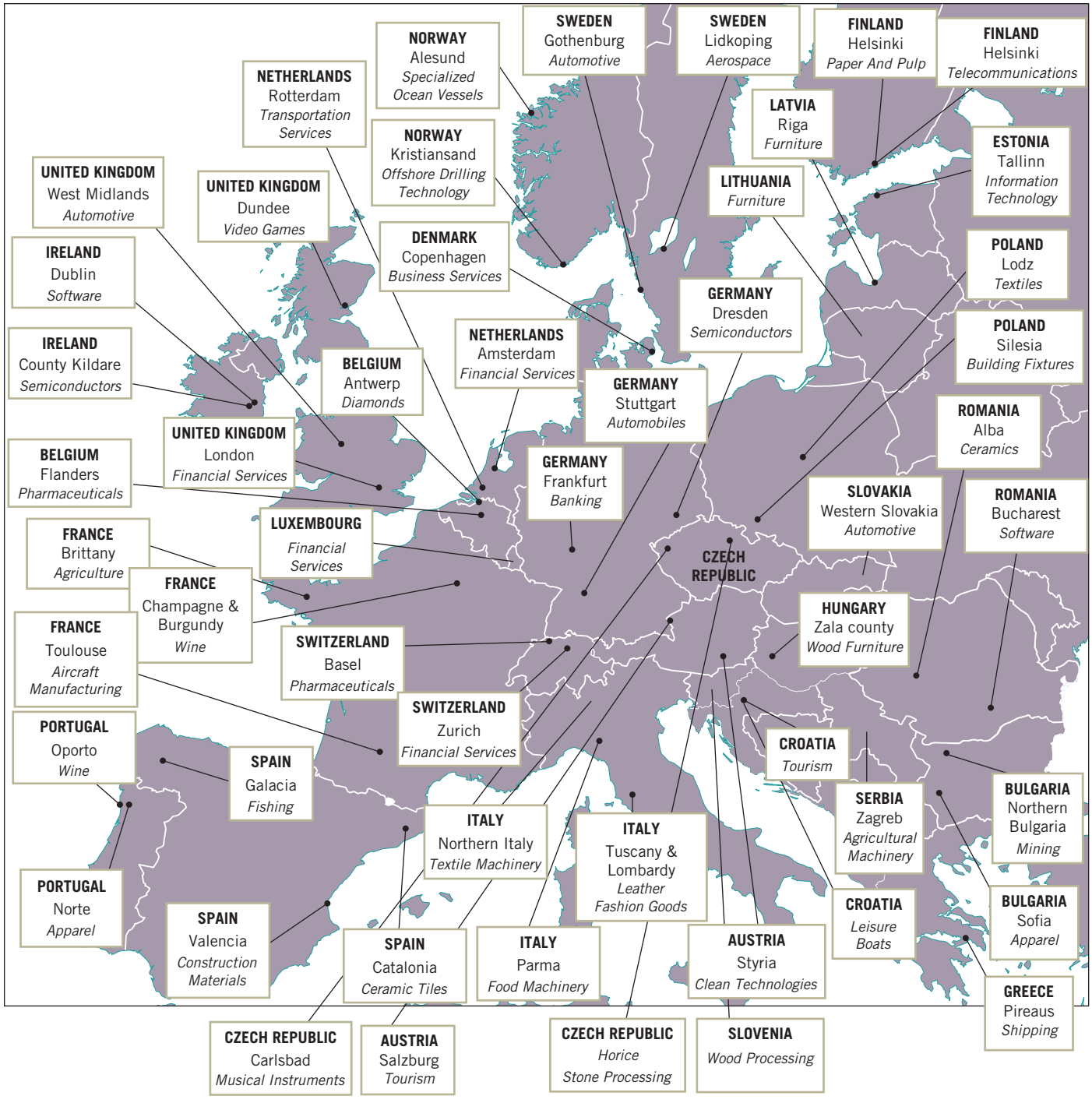
Trade is the most obvious but not the only form of international business. Another major form is international investment, whereby residents of one country supply capital to a second country.

Types of International Investments

International investment, as discussed in Chapter 1, is divided into two categories: foreign portfolio investment (FPI) and foreign direct investment (FDI). The distinction between the two rests on the question of control: Does the investor seek an active management role in the firm or merely a return from a passive investment?

MAP 6.1

Key Industrial Clusters in Western Europe



Foreign portfolio investments (FPI) represent passive holdings of securities such as foreign stocks, bonds, or other financial assets, none of which entails active management or control of the securities' issuer by the investor. Modern finance theory suggests that FPI will be motivated by attempts to seek an attractive rate of return as well as the risk reduction that can come from geographically diversifying one's investment portfolio. Sophisticated money managers in New York, London, Frankfurt, Tokyo, and other financial centers are well aware of the advantages of international diversification. In 2017, for example, U.S. citizens purchased $587 billion worth of foreign securities, bringing their total holdings of such securities to $12.5 trillion. Foreign official