GLOBAL EDITION

INTERNATIONAL BUSINESS

Environments & Operations

SEVENTEENTH EDITION

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Facets of the Diamond Usually, all four conditions need to be favorable for an industry within a country to attain and maintain global supremacy.

Demand Conditions Both PLC theory and country-similarity theory show that new products (or industries) usually arise from companies' observation of need or demand, which has traditionally been in their home countries, where they start production. This was the case for the Italian ceramic tile industry after World War II: In a postwar housing boom, consumers wanted cool floors (which tile would provide) because of the hot Italian climate.

Factor Conditions Recall natural advantage within the absolute advantage and factor proportions theories. Wood was expensive, and most production factors (skilled labor, capital, technology, and equipment) for producing tile were available within Italy on favorable terms.

Related and Supporting Industries Tile production needed enamels and glazes. Had these not been available nearby, as they were in the case of Italy, costs would have increased too much. Recall, for instance, the importance of transport costs in our discussions of the theory of country size, assumptions of specialization, and factors limiting the PLC theory.

Firm Strategy, Structure, and Rivalry The combination of three features—demand, factor conditions, and related and supporting industries—influenced companies' ability to successfully initiate ceramic tile production in postwar Italy. The ability of the companies to sustain a competitive advantage required favorable circumstances for the fourth feature: *firm strategy, structure,* and *rivalry.*

Barriers to market entry were low in the tile industry (some companies started up with as few as three employees), and hundreds of companies initiated production. Rivalry became intense as companies tried to serve increasingly sophisticated Italian consumers. These circumstances forced breakthroughs in both product and process technologies, which gave the Italian producers advantages over foreign firms and enabled them to gain the largest global share of tile exports.

Domestic existence of all conditions

- does not guarantee an industry will develop,
- is not necessary with globalization.

Limitations of the Diamond of National Advantage Theory The existence of the four favorable national conditions does not guarantee that a flourishing industry will develop. Entrepreneurs may face favorable conditions for many different lines of business. In fact, comparative advantage theory holds that resource limitations may cause a country's firms to avoid competing in some industries despite having an absolute advantage. For instance, Swiss conditions would seem to have favored success if companies in Switzerland had become players in the personal computer industry. However, doing so might have lessened protection of Swiss global positions in such product lines as watches and scientific instruments as companies downsized innovation in those industries by moving their highly skilled people into developing a new industry.

A second limitation concerns the growth of globalization. The industries on which this theory is premised grew when companies' access to competitive capabilities was much more domestically focused. We can see how globalization affects each of the four conditions:

1. Observations of foreign or foreign-plus-domestic demand conditions have spurred much of the recent Asian export growth. In fact, such Japanese companies as Uniden and Fujitech target their sales almost entirely to foreign markets.[31]
2. Companies and countries do not depend entirely on domestic factor conditions. For example, capital and managers are now internationally mobile, and companies may depend on foreign locations for portions of their production.
3. If related and supporting industries are not available locally, materials and components are now more easily brought in from abroad because of transportation advancements and relaxed import restrictions. In fact, many MNEs now assemble products with parts supplied from a variety of countries.
4. Companies react not only to domestic rivals but also to foreign-based rivals at home and abroad. Thus the prior domestic absence of any of the four conditions from the diamond may not inhibit companies and industries from gaining these conditions and becoming globally competitive.

Using the Diamond for Transformation By expanding the diamond of national advantage theory to include changes brought about by globalization, we can see its validity for countries' economic policies. Taiwan diversified its economy from agricultural products to modern high-tech products by satisfying the market entry conditions of the diamond. This transformation could not have occurred had Taiwanese authorities looked only at what was available within their own borders. In Taiwan itself, there was (and still is) insufficient demand for the high-tech products it now produces, such as microchips and medical devices; good transportation, however, makes efficient export possible. Similarly, the country initially lacked some of the factor conditions necessary for producing high-tech products, especially trained personnel. Eventually, though, it altered its educational system so that human resource development fit production needs. It also allowed companies to bring in foreign managers and technicians to fill personnel gaps. Finally, it developed local factors and competition, such as by attracting high-tech companies to ensure a vibrant competitive environment. Thus, understanding and having the necessary conditions to be globally competitive is important, but these conditions are neither static nor purely domestic.

THE THEORY AND MAJOR EFFECTS OF FACTOR MOBILITY

6-5 Summarize the reasons for and major effects of international factor movements

We have already noted that major trade theories assume that production resources are not mobile between countries. However, land and natural resources are really the only truly immobile factors of production. Increasingly, labor, capital, and technology are becoming more mobile internationally. **Factor mobility theory** focuses on why production factors move, the effects of that movement on transforming countries' factor endowments, and the impact of international factor mobility on trade.

POINT

Should Nations Use Strategic Trade Policies?

A **strategic trade policy**, or **industrial policy**, is one in which a government identifies target industries to develop to be internationally competitive.

YES If you're a country that wants to compete in today's globalized business environment (and you have to), you must develop and maintain some industries that will be internationally competitive. Those industries must grow and earn sufficient revenues to keep your domestic economy growing at least as well as other countries are performing.

A government's role is rarely neutral. The government may claim that its economic policies don't affect the performance of specific domestic industries on the world stage, but a lot of those policies are bound to have precisely that effect. Who will argue that U.S. efforts to "improve agricultural productivity" and "enhance defense capabilities" have nothing to do with the fact that the United States does a healthy business in the export of farm and aerospace products?

Moreover, just about every government policy designed to help one industry will have a negative effect on another. European airlines complain (with some

COUNTERPOINT

Should Nations Use Strategic Trade Policies?

NO Of course, countries should try to become most competitive in the industries that promise the best returns and have the most potential for going global. Obviously, they're the ones most likely to add value to the national economy. However, strategic trade policy is not the best way to achieve this goal.

I'll make a concession: Under limited circumstances a targeting program will work, particularly for small countries such as Taiwan. Because Taiwan's GDP amounts to just a little more than the value of Walmart's annual sales, parties involved can manageably work together to reach mutually beneficial agreements with minimal frustration. But in a large economy? Impossible.

However, it's debatable just how much Taiwan's economic success is due to strategic trade policy and how much goes back to conditions that existed before the government began involving itself in foreign trade. During the era of Japanese occupation, Taiwan's infrastructure, literacy, and school attendance improved markedly so that its environment for becoming internationally competitive was well established. Further, when justification) that European government support for high-speed rail traffic deprives them of the revenue they need to compete with U.S. overseas carriers, which don't have much to worry about from railroad passenger traffic at home. In other words, national policymakers everywhere face trade-offs. So if every government policy will help one party while hurting another, why shouldn't a country's practices call for taking special care of the industries that will likely give it its best competitive advantage?

Executing such a plan can be pretty simple. First, target a growth industry and figure out what factors make it potentially competitive. Next, identify your country's likely competitive advantages (and make sure you know why you have them). Finally, develop a little synergy between the strong points you've uncovered during both processes: Target the resources needed to support the industries that fit best with your country's advantages.

A strategic trade policy is particularly effective if you're a developing country. Why? Because you've probably already decided that (1) you need to integrate yourself into the global economy and (2) you need to figure out the best way to excel in the international game. If other countries support high-potential start-ups and you don't, your new industries will be disadvantaged.[32] But you need to remember that simply opening up your borders to foreign competition doesn't necessarily mean that domestic producers will have an easier time competing either abroad or at home.

When you do this, foreign competitors may have considerable advantages over homegrown companies you're trying to foster. They've had a head start that's allowed them to develop not only certain efficiencies but cozy relations with everybody in the international distribution channel. Moreover, no matter how promising your targeted industries may be, or how carefully you've tried to match up your industries with your competitive advantages, as a developing country your businesses probably lack the technology and marketing skills they'll need to compete. So, why not help them?[33]

This brings us back to why strategic trade policy is your optimal choice. Your government must protect your local industries—say, by helping them get the skills and technology they'll need. You could also focus your efforts on attracting foreign investment by companies that have the marketing and technical skills you need; that's one good way to bring in the kind of production you need. It also wouldn't hurt to extend incentives within the industries you're counting on.

Want some evidence that strategic trade policy is effective in helping developing nations go global? Look at South Korea, which not only managed to attract companies with experience in consumer-electronics production but eventually emerged as a global competitor by building on imported technologies and targeting technical education to become both a competitive and technical leader.[34] By the same token, we have ample evidence that laissez-faire often doesn't work in developing countries. In sub-Saharan

it instituted its import substitution policies, these policies were not really targeting industries to be internationally competitive.

An alternative is for a country to focus on conditions affecting its attractiveness as a competitive location in general instead of targeting specific industries. In other words, a government can alter conditions affecting, say, factor proportions, efficiency, and innovation by upgrading production factors—cultivating human skills, moving to new levels of infrastructure, encouraging consumers to demand higher-quality products, and promoting an overall competitive environment—for any industry interested in doing business within its borders.

Let's turn to your comments about sub-Saharan Africa. I'll even make another concession: Inefficiency from political bureaucracy is indeed a way of life in much of the area, and there's no reason to expect that it will go away any time soon.[38] But what if we looked at things from another perspective? Rather than trying to focus on a specific industry in, say, the global high-tech universe, wouldn't all these bureaucratic agencies and ministries find it more constructive to review (and enforce) their own laws; take steps to stabilize their populations; rectify their most glaring economic, social, and gender inequities; and support entrepreneurial activity in the informal sectors of their economies? Wouldn't they find it more positive to foster an environment of trust—one in which, say, the government helps cut transaction costs so local firms will be willing to work with other companies, domestic and foreign, to acquire a little of the knowledge and a few of the resources they need to compete?[39] Again, instead of picking and haggling over special industries, wouldn't they be better advised to improve the investment environment in which, after all, everybody will ultimately have to operate anyway?

At this point, I might as well take the offensive in this debate. Strategic trade policies typically result in no more than small payoffs—primarily because most governments find difficulty in identifying and targeting the right industries.[40] What if a country targets an industry in which global demand never quite lives up to expectations? That's what happened to the United Kingdom and France when they got together to underwrite supersonic passenger planes. Or what if the domestic companies in a targeted industry simply fall short of being competitive? That's what happened when Thailand decided to support the steel business.[41] And even in your example of China, previous industrial policies targeting semiconductors and automobiles have not produced competitive industries.[42]

What if too many nations target the same global industries, thereby committing themselves to excessive competition and inadequate returns?[43] What if two countries compete to support the same industry, as happened when both Brazil and Canada decided

Africa, for example, government institutions are so deeply rooted that it's almost impossible for anyone—either individuals or multinationals—to make a move without getting entangled in the bureaucratic undergrowth.[35] One reason for China's economic success is its industrial and trade policy. Its 2015 policy, "Made in China 2025," specified 10 sectors that are the focus of planning, which includes targets for domestic and global market share.[36]

Moreover, because no single political institution in developing countries has much in the way of resources, all are better off focusing their collective efforts on specific industries that have some potential for international competitiveness; otherwise, what you have is a bunch of under-resourced agencies and ministries aiming at markets scattered all over the economic landscape.[37]

to produce regional jets in the same hemisphere?[44] Finally, what if a country successfully targets an industry only to find unexpected conditions? Should it stay the course by reacting to various pressures, such as the pressure to support employment in a distressed industry?[45]

Finally, even if a government can identify a future growth industry in which a domestic firm is likely to succeed—a very big if—it doesn't follow that a company deserves public assistance. History recommends that nations permit their entrepreneurs to do what they do best: take risks that don't jeopardize whole sectors of the economy. The upshot will probably be the same as always: Some will fail, but the successful ones will survive and thrive competitively.

Currently, one of the biggest changes underway concerns relative population numbers. Presently, 46 percent of the world's population lives in countries, mainly developed ones, where the fertility rates are below the population replacement rate.[46] These countries are also encountering a higher portion of people at a postretirement age along with a higher portion who are entering the workforce at a later age because of extended education. This leaves a smaller percentage of residents in their workforces. Further, the aging of the population is expected to require more workers in order to care for illnesses.[47] Concomitantly, many countries, primarily the developing ones, are experiencing rapid population growth. Nine countries are expected to account for half of the world's population increase, with India and Nigeria leading the pack. India is projected to overtake China as the world's most populous country around 2027, and the population of sub-Saharan Africa is expected to double by 2050.[48] High population growth means there are more young people looking for employment, and jobs in these countries are typically difficult to find.

Even with increases in productivity, countries experiencing low population growth will need more immigrants to help provide for their nonemployed populations, and countries with high population growth are in a position to supply them. Japan is an example of a country with a low birth rate and an aging population that has reformed its immigration policies to permit more foreign workers in its economy.[49] After a longstanding taboo on immigration, the Japanese government introduced a visa program for foreign workers, particularly for the restaurant, agriculture, and nursing sectors. Most come from developing countries in Asia, such as Vietnam and the Philippines.

Population changes are important in understanding and predicting changes in export production and import market locations. At the same time, mobility of people, capital, and technology affects trade and relative competitive positions.

WHY PRODUCTION FACTORS MOVE

People and capital move internationally to

- gain more income,
- flee adverse political situations.

People Movement of people across borders has become physically easier over time. Of course, some people travel to other countries as tourists, students, and retirees; however, this does not affect factor endowments because these travelers do not work in the destination countries. But as movement has become physically easier, migration has become bureaucratically more difficult.[50] To live and work abroad, people must get immigration papers and work permits, which most countries provide sparingly. Migrants must also incur high relocation costs, and they may have to learn another language and adjust to a different culture away from their customary support groups. Despite such barriers, people do endure hardships and risks to move to other countries, and there are now 270 million people who live outside the country where they are born. The largest populations outside their homelands are Indians, Mexicans, Russians, and Chinese, each with more than 10 million people.[51]

Migration was the major engine of globalization during the late nineteenth and early twentieth centuries, and at present it is important again. A person who lives outside their native country is known as an **expatriate**. About 3.5 percent of the world's population has migrated to another country. Because movement of people is spread unevenly, expatriate populations are much greater in some countries than in others (e.g., 29.6 percent of the population in Australia and less than 1 percent in Mexico). The foreign-born population in the United States is 13.6 percent.[52]

Of the people who go abroad to work, some move permanently, some temporarily. On the one hand, some people immigrate to another country, become citizens, and plan to reside there for the rest of their lives. On the other hand, some enter a country on temporary work permits, usually for short periods. For instance, most workers in the United Arab Emirates are there on temporary work permits.[53] In addition, MNEs may assign employees to work abroad for periods ranging from a few days to several years (usually to a place where they also transfer capital). In many cases, workers leave their families behind in the hopes of returning home after saving enough money while working in the foreign country. Some move legally, others illegally (undocumented)—that is to say they lack government permission to enter or work.

Motives About 90 percent of the people who move to another country do so largely for economic reasons, such as Indonesian laborers working in Malaysia. Migrants who move to higher-income countries earn three to six times more than they did at home. This is good for economic growth, and by one estimate global output would double if everyone who wanted to migrate could do so.[54]

About 10 percent of migrants move for political reasons—for example, because of persecution or war dangers, in which case they are known as **refugees**—and usually become part of the labor pool where they live. It is not surprising that most refugees emanate from war-torn countries—recently many from Syria, Afghanistan, South Sudan, The Democratic Republic of the Congo—and mainly go to nearby countries. Recently, the largest recipients have been Turkey, Pakistan, and Iran.[55] In addition, there are about 10 million people who have no citizenship, most of whom are seeking some country to give them rights as citizens.[56]

Sometimes it is difficult to distinguish between economic and political motives for international mobility because poor economic conditions often parallel poor political conditions. In recent years, hundreds of thousands of Syrians fled the civil war in their country; however, the fact that many have returned after not finding work may indicate that their motive was economic.

Capital Capital also moves across borders. When we think of factor endowments, capital is the physical plant and equipment, such as the factory buildings, offices, machinery, and computers that are used to produce goods and services. Equipment and some other physical capital can move across borders through exports and imports. Buildings may "move" across borders through trade in building materials. Either way, the relocation of physical capital is associated with international lending and borrowing or else it would simply be trade. Typically, the capital movement is in fact viewed from the monetary (lending and borrowing) aspect, and from this perspective capital is a very mobile production factor.

As an example, consider BMW's factory in the United States. BMW, the German MNE that produces luxury automobiles and motorcycles, built a plant in South Carolina to produce automobiles for the U.S. market as well as for exporting from the U.S. The amount BMW spent on the investment is a movement of capital from Germany to the U.S. We see the additional physical capital – in the form of the plant and equipment – in the U.S., but this would not have been possible without borrowing financial capital from Germany. The plant adds to the productive capacity of the U.S., but the owners of the plant are German so this is a foreign direct investment. The U.S. has in fact relied extensively on foreign direct investment in the U.S. for several decades.

Relocation of capital by MNEs is only one type of capital movement. There are also portfolio investments, which involve buying and selling corporate stocks and bonds across borders. At the point of initial offering, a corporation selling stocks or bonds to foreigners (whether individuals, investment funds, or other companies) directly enables the movement of financial capital from foreign countries to increase physical capital investment at home.

(Subsequent sales and purchases of these stocks and bonds represent changes in ownership, but do not affect the physical investment.) The banking sector also plays an important role in cross-border lending and borrowing, as when U.S. banks take deposits from foreigners and subsequently lend domestically. These forms of capital movement focus on the financial flows, but in all cases they enable additional investment in production resources that would not be possible with the prevailing level of domestic savings. From the financial perspective, investors can transfer capital by wire instantaneously at a low cost, so these forms of capital are more mobile than direct investment because there are active markets for buying foreign holdings and selling them when investors want to transfer the capital back home.

CONCEPT CHECK

Chapter 3 defines political risk as the threat that decisions or events in a country will reduce the profitability of an investment.

Motives As with the movement of people, capital moves to another country primarily for economic reasons, such as when an investor expects a higher rate of return abroad than at home. In our example of BMW, the rate of return on the investment in South Carolina must have been higher than the rate of return in Germany in order to justify the deployment of capital abroad. Taxation of the returns may play a role as well; an otherwise low pre-tax rate of return will be more appealing when taxes are lower, since corporations care about after-tax rates of return. Capital movement may also occur because of political considerations. Capital may move out of a country to avoid high political risk and will move into a country with low political risk, often referred to as a **safe haven** for investment.

EFFECTS OF FACTOR MOVEMENTS

Factor movements alter factor endowments.

Neither international capital nor population mobility is a new occurrence. For example, had it not been for historical mass immigration, Australia, Canada, and the United States would have greatly reduced populations today. Further, many immigrants brought human capital with them, thus adding to the base of skills that enabled those countries to be newly competitive in an array of products they might otherwise have imported. Finally, these same countries received foreign capital to develop infrastructure and natural resources, which further altered their competitive structures and international trade.

What Happens When People Move? We have already indicated that migration is good for growth, and as a result there currently may not be enough of it. However, immigration is controversial in many countries, and some people think there is already too much.

The United States is an example of a country whose recent immigration is largely concentrated at the high and low ends of human skills. Over a third of all people with doctoral degrees in the United States are foreign-born. Immigrants with entrepreneurial skills have been important in American business; 43 percent of the 500 largest U.S. companies are reported to be founded or co-founded by immigrants or their children.[57] At the other end, much recent U.S. immigration has been made up of low-skilled workers. At both extremes, the United States has had shortages of native-born workers, which has been partially alleviated through immigration.

Inward migration has been controversial in the United States and many other countries because of perceptions that it puts downward pressure on domestic workers' wages and that some immigrants may be taking jobs from local citizens. There is scant evidence on this, however, and most economists think the impact is quite small. This is partly because immigration stimulates demand, and this allows native citizens to move into better jobs.[58] Nevertheless, there are additional controversies because countries receiving migrants incur costs by providing social services and acculturating people to a new language and society. There is also a backlash against immigration for fear that some immigrants, particularly illegal (undocumented) immigrants, are a source of crime or terrorist activity.

Another controversial issue is the effect of outward migration on countries. On the one hand, countries lose potentially productive resources when educated people leave—a situation known as a **brain drain**. On the other hand, many of these people are now sending remittances back, which often amount to more than they would have earned if they worked at home. Remittances are now more than 10 percent of GDP in 28 countries, and are more than 30 percent in Haiti, Tajikistan, and Tonga.[59]

There is also evidence that the outward movement and remittances of people leads to an increase in start-up companies and capital in their home countries. Further, the emigrants