MBA

(DISTANCE MODE)

DBA 1702

INTERNATIONAL BUSINESS MANAGEMENT

III SEMESTER
COURSE MATERIAL

Centre for Distance Education
Anna University Chennai
Chennai – 600 025

Author

Dr.M.Selvam
Professor & Head
Department of International Business & Commerce
Alagappa University
Karaikudi - 630 004

Reviewer

Dr.G.Rajendran
Assistant Professor
Department of Management Studies
Anna Uniersity Chennai
Chennai - 600 025

Prof. Dr. D. VISWANATHAN
B.E (Mech.),M.E. (Prod).,Ph.D. (Mech-Met.),
F.I.E., I.I.M., I.S.N.T., I.I.P.E., I.S.T.E.,
Vice-Chancellor

PROGRESS THROUGH KNOWLEDGE
ANNA UNIVERSITY
CHENNAI 600 025 INDIA

Phone : +91-44-22351445
: +91-44-22353445
Fax : +91-44-22350397
e-mail : vc@annauniv.edu

April, 2008

FOREWORD

Let me at the outset express my hearty congratulations to all the students on the eve of themselves being promoted to higher semester.

Anna University Chennai, one of the world's leading Technological Universities has launched the distance mode of education with the prime objective of providing education to the deserving aspirants, who have been deprived of enhancing their professional competencies.

Response to distance education programme of Anna University Chennai is very encouraging from all stake holders – industries, individuals, professional bodies and others. This is evident from the number of applicants who belong to diverse clusters that include Information Technology, Manufacturing, Marketing, Medical, Administrative Services, Engineering and Consultancy etc.

In this background, the course materials have been prepared by experts, focusing on the theoretical and conceptual underpinning of the concerned subject matters along with practical exposure to the extent needed.

The Indian industries witness brand new challenges in terms of frequent new entrants from both within and outside the nation, technology upgradation at a faster rate, shorter product life cycle, increase in the customer expectations and the like.

This scenario demands our professionals to be empowered with world class managerial and technical inputs, so that they can render their best in the profession of their choice. The course materials prepared shall provide a strong platform to enable professionals to meet the challenges effectively.

Further keeping in mind the constraints of time and other resources of the enrolled students, the course materials prepared are intended to serve as ready reckoner to meet the academic requirements in a rewarding manner.

This endeavour of Anna University Chennai is to make abundant availability of value embedded human capital to the nation at large and there by enable India to be globally strengthened on multiple facets.

I wish the students all the very best.

(D. VISWANATHAN)

ACKNOWLEDGEMENT

The author has drawn inputs from several sources for the preparation of this course material, to meet the requirements of the syllabus. The author gratefully acknowledges the following sources:

- John D Daniels and Lee H Radebaugh, 'International Business', Pearson Education Asia, New Delhi, 2000.
- Richard M Hodgetts and Fred Luthans, 'International Management' Tata McGraw Hill, New Delhi, 2003.
- Francis Cherunilam, 'International Business', Wheeler Publications.
- Anant K Sundaram and I Stuwart Black, 'International Business Environment', Prentice Hall of India, New Delhi, 2001.
- Sak Onkvisit and John J Shaw, International Marketing, Pearson Education Asia, New Delhi, 2004.
- Tom Peters and Waterman, In Search of Excellence.
- Alvin Toffler, The Third Wave
- Ricky Griffin, Management
- Wikipedia Web Sites and Web sources of WTO, UNCTAD, etc.
- Wikipedia and other Websites
- Wikipedia Web Sites and Web sources of WTO, WBG, ICC, International Alert (an NGO)
- Web Source: www.conflictrecovery.org/methodscr.htm

Inspite of at most care taken to prepare the list of references any omission in the list is only accidental and not purposeful.

Dr.M.Selvam
Author

DBA 1702 INTERNATIONAL BUSINESS MANAGEMENT

UNIT I – INTRODUCTION

Definition –Trade and investment flow –Economic theories –Forms of international business –Trade policy – Export promotion –Export Procedures and documents –FOREX management –Exchange rate determination – Exchange risk –Managing exchange rate.

UNIT II – INTERNATIONAL BUSINESS ENVIRONMENT

Globalization of business – Economic, political and cultural environment of India –Regional trade blocks – Inter-religion trade among regional groups.

UNIT III – GLOBAL STRATEGIC MANAGEMENT

Structural design of MNEs –Approaches to control – The role of information systems-Performance measurement – Mechanics of measurement –Various performance indicators – Evaluation and evaluation systems.

UNIT IV–CONFLICT IN INTERNATIONAL BUSINESS AND NEGOTIATIONS

Factors causing conflict – Conflict resolution actions – The role of negotiations in international business – The role of international agencies in conflict resolution.

REFERENCES

1. John.D.Daniels and Lee H.Radebaugh,'International Business', Pearson Education Asia, New Delhi, 2000.
2. Richard M.Hodgetts and Fred Luthans, International Management', Tata McGraw Hill, New Delhi, 2003
3. Charles W.L.Hills,'International Business', Tata McGraw Hill, New Delhi, 2005
4. Francis Cherunilam, International Business, wheeler publication.
5. Anand k sundaram and I.Stewart Black,' The international Business Environment', Prentice Hall of India, New Delhi, 2001.
6. Michael R.Czinkota, Ikka A.Ronkainen and Michael M.moffett, 'International Business', Thompson, Asia, Bangalore, 2003.
7. Don Ball and Wendell McCulloch,'International Business', Irwin McGraw hill, NewYork, 1999.
8. Roger Benett,'International Business', Pitman publishing, New Delhi, 2000.
9. Vyuptakeshgaram, 'International Business', Pearson Education, New Delhi, 2006.

CONTENTS

UNIT I
INTRODUCTION TO
INTERNATIONAL BUSINESS

UNIT II
INTERNATIONAL BUSINESS ENVIRONMENTSTRUCTURE OF THE UNIT

UNIT III
GLOBAL STRATEGIC MANAGEMENT

UNIT IV
CONFLICT IN INTERNATIONAL BUSINESS AND NEGOTIATIONS

NOTES

UNIT I

INTRODUCTION TO INTERNATIONAL BUSINESS

1.1 INTRODUCTION

Political boundaries of nations, states or regions are no longer the fetters for business in the global economic paradigm. There is a paradigm shift in the way businesses are done now. A product is seldom completely produced in one country nor consumed in the same country. On the other hand, its design, fabrication, assembling, stamping, etc are done in different countries and then marketed world over. Thus production and consumption are globally spread for most products. That is the international aspect of business we are concerned with. Available data suggest that Multinational Companies (MNCs) or Multinational Enterprises (MNEs) are vastly responsible for the growth of cross-border or international production and marketing.

Economics, trade and finance know no national borders. By their nature these are not confinable through man-made fetters for long time. Economics, trade and finance are truly international, multinational, global and transnational. We see the continents of the world and some nations are divided by waters. But, beneath the depths of even the deepest Pacific Ocean, land mass unifies continents and nations. So, geographical divisions based on political aspects are man-made. But the nature unifies. And this applies to global economy, of which global trade and global finance are integral parts.

Pundit Jawaharlal Nehru observed that, 'History today has ceased to be the history of this country or that. It has become the history of mankind – because we are all tied up together in a common fate'. What applies to history is applicable to economy and business as well. Today's economy has in fact ceased to be economy of this or that nation, but has become global economy. Similarly business activities have to be conceived, designed and executed with a global perspective. There is that much of integration. Thus business has simply become international or global business. International or global business has become a large and growing chunk of total world business. Global events and competition affect almost all business firms – large and small, because most firms sell outputs to and secure supplies from rest of the world.

NOTES

International business is a term used to collectively describe the operations of firms with interests in several countries. Simply, it is business beyond national or continental borders by firms. You hear very often terms such as International competition, Multinational corporation, Transnational deals, Globalization, Multi-domestic business models, Worldwide sales, dynamics of Global Market place and so on daily. All these capture one or other issues concerning international business. You know international business is the most competitive with mounting uncertainties. Success in international business requires more business acumen than managing a domestic firm. Of course opportunities abound in the borderless world. So also the threats wield an intimidating future. Firms must be able to reap the opportunities while ably negotiating with the attending threats. Firms must not only deal with general business functions and values, but also understand and work from a global perspective that adds multiple variables such as divergent geo-political dynamics, multi-cultural nuances, volatile-financial conditions, different time zones, and vast spatial-distance issues to the international business management equation. Deftness and foresightedness are much needed for doing business across the globe.

Doing business internationally or globally needs certain decisions taken in strategic manner. On the basis of the syllabus of this course, these decision areas are put into 4 classes conforming to the 4 paragraphs of the syllabus.

First and foremost, decision as to **forms of International Business** is needed. While many alternative forms are available, the choice of best is not that easy and this is not a one-time decision as form of organization has to change as business environment/scale/ emphasis changes. Structural designs of multinational enterprises, approaches to steer and steward them, the design and use of information systems, contours of performance and their measurement, etc constitute the strategic, tactical and operational issues of international business firms.

Second decision relating to **responding to globalization and the environmental changes** is needed. Causes, issues and concerns of globalization of world economies and the trend, terms and patterns of international trade and investment have to be studied as the premises for right decision. Besides, there need to be study and evaluation of Trade Policies / Procedures, Investment Policies / Procedures and Competition Policies / Procedures of nation states, trade blocks and other aggregates by international business firms to incorporate changes in the models of business followed by them. Also, study and evaluation of Economic, Ecological, Natural, Climatic, Educational, Political, Infrastructural, Technological, Legal, Security, Social and Cultural Environment of nation states, or blocks of nations in some form of economic integration such as trade blocks/ common market/ customs union/ monetary union/ common currency are needed to continually adapt to changing needs. Trade and Investment between inter-region and intra-regional members also need evaluation for proper business initiatives by international firms in the competitive world.

NOTES

Third decision relates to **foreign exchange management and global finance**. Adhering to the system of exchange rate and forex reserve management by nation states or their aggregates, responses by firms doing business globally as foreign exchange rates change, options on deft handling of exchange exposures and risk, etc make a valuable chunk of operations of international business firms. These involve complicated decisions requiring best brains committed to sound decision making. Issues and implications of size and types of investment across the globe have to be deeply studied by international business firms. Participating in the international financial market, committing to direct investment in equity and portfolio investment opportunities globally, managing the resulting risk etc are important decision areas.

Fourth decision relates to **conflict resolution**. Conflicts result within and outside. Managing cross cultural conflicts within the firm and transforming the firm into a global firm is a formidable task. Conflicts within co-partners of the firm such as supply chain participants and alliance partners and co-investors need amicable decisions with win-win orientation. Conflicts with the external forces / stakeholders / competitor firms/ governments of other countries/ other trade blocks, etc need different handling. Resolution of the same through negotiations and within the frameworks of prevailing international / regional agencies is an important aspect of international business.

This course deals with the above and related topics. Hope this prelude to this course has given you an eye-opener to its contents or the subject matter.

For the World Economic Forum annual meeting, up to 2500 politicians, business leaders and heads of international organizations began arriving in the Swiss city of Davos on Tuesday 22nd January 2008 to discuss global economic issues. India is represented by leading industrial figures and decision-makers led by the Industry Minister Sri Kamal Nath and Finance Minister Sri P. Chidambaram. A total of 27 heads of state or government and 113 cabinet ministers including US Secretary of State Condoleezza Rice, Japanese Prime Minister Yasuo Fakuda and China's vice-premier Zeng Peiyan are to attend. Bill Gates of Microsoft, Sir Howard Stringer, head of Sony Corporation, and E Neville Isdell, head of Coca Cola are among the business leaders scheduled to participate. The high profile meeting, shows the economy is becoming globalized

1.2. LEARNING OBJECTIVES

- To define international business.
- To present the growth and growth causes & concerns of international business and the patterns of internationalization

NOTES

- To elucidate the concept and causes of world merchandize and services trade and world investment flow
- To analyze the trend in world merchandize and services trade and world investment flow
- To explain and evaluate different theorie
- To give the influence of WTO and Regional agreements on trade / investment policy*
- To provide an account of export promotion measures in terms of 5 Fs, namely, Finance, Facilities, Fiscal incentives, Favours and Felicitations*
- To explain the export documents for export by ship, land & post and the import documents*
- To present legal and operational procedures for exports from India*
- To know the basic concepts of foreign exchange (forex, in short) and the nature and types of forex market
- To provide an idea of the types of foreign exchange rates, the determinants of exchange rate between two currencies and the models & theories of exchange rate determination
- To discuss the computation of exchange rate, especially the forward rates.
- To present the concept and types of forex risk, the internal and external hedging strategies for transaction and operating risks, including the 'derivatives'.

(Note – Those items with the '*' mark are dealt with the Indian context)

1.3. INTERNATIONAL BUSINESS

[DEFINITION, GROWTH, CAUSES & PATTERNS]

You must be aware of that international business today is so universal and diverse that anyone, including yourself, can give it a more or less clear definition. In our lives we constantly come across goods and services of transnational companies (TNCs), which have got into different spheres of our lives. Even a child knows such leaders of business as McDonalds, Microsoft, Sony, Adidas, Nokia, Samsung, Toyota, etc. How many automobile names or mobile handset names can you recall? I can do a dozen of the automobiles and half-a-dozen of mobile handset names. All of them are products of so called multinational companies. All these companies are in international or global business, that is, business across nations / continents as against confining to just one nation. Now let us quote some definitions.

NOTES

1.3.1 Definitions On The Basis Of Actions And Actors

There are two ways of looking at the term 'international business'. **One is the 'action' and the other is the 'actor'.** As an 'action', 'international business' refers to the types, process, scale, governance and other aspects of carrying out international business. As referring to actor, the term 'international business' refers to 'the entity carrying out the international business'.

John D Daniels and Lee H Radebaugh in their book, 'International Business', define international business as, 'all commercial transactions- private and governmental- between two or more countries. Private companies undertake such transactions for profit; governments may or may not do the same in their transactions. These transactions include sales, investments and transportation'.

The **Internet Public Library (IPL)** defines International Business as, 'doing business in international markets, and business information specific to various countries or geographic regions of the world'. A great part of international business is international trade which is defined as, 'The business of buying and selling commodities / services / investments beyond national borders'.

According to **Harcourt Brace & Company, Orlando, Florida,** 'International business consists of transactions that are devised and carried out across national borders to satisfy the objectives of individuals and organizations'.

These definitions see the term 'international business' as an 'action'. The next one looks at the term as referring to the 'actor'.

According to **International Business Journal,** 'International business is a commercial enterprise that performs economical activity beyond the bounds of its location, has branches in two or more foreign countries and makes use of economic, cultural, political, legal and other differences between countries'.

1.3.2 Growth In International Business Through Mncs

World Investment Report 1997 put thaat there were 45000 MNCs with 280,000 affiliates in 1996. **In 2001, the World Investment Report** put that there were 63000 MNCs with 822,000 affiliates. 12% of these affiliates were in the developed countries.

NOTES

China hosts about 44% affiliates, compared to India's pittance of 0.16%. In India of the 10 top 500 companies by market value, about 75 were MNCs present in India include the Lever, the ITC, the Castro, the Colgate-Palmolive, the Nestle, the Siemens, the Ponds, the ABB, the Ingersoll Rand, the Philips, the MICO, the Glaxo, the Reckitt and Colman, the Procter & Gamble, the Smithkline-Beecham, etc. Thus MNCs have been growing in stature and spread all over.

In 2006, the MNCs numbered at least some 78,000 parent companies with at least 780,000 foreign affiliates according to **United Nations Conference on Trade and Development's** (UNCTAD) report. Of these, about 58,000 parent TNCs were based in developed countries and about 20,000 in developing and transition economies (18,500 in developing countries and 1,650 in transition economies). The number of TNCs from developing and transition economies has increased more than those from developed countries over the past 15 years: 4,000 in the former and 31,000 in the latter in 1992. Regarding foreign affiliates, in 2006 there were 260,000 located in developed countries, 407,000 in developing countries, and 111,000 in the transition economies. China continues to host the largest number of foreign affiliates, accounting for one third of all foreign affiliates of TNCs worldwide. Given its small share in global inward stock (only 2% in 2006), this implies that many foreign affiliates in China are very small, or are joint ventures with domestic enterprises. UNCTADs Transnational Index shows that in 2004 (the latest year for which the index was compiled), the importance of international production rose in most host economies (developed and developing as well as transition), reflecting the rise of FDI flows that year. The transnationalization of the largest TNCs worldwide has also increased.

1.3.3 Why Firms Go International?

Several factors underlie the growth of international business. These could be put as: Facilitators, Drivers, Attractions and Compulsions. Table 1.1 lists them. Explanation follows later.

TABLE 1.1 Facilitators, Drivers, Attractions & Compulsions of International Business

FACILITATORS	DRIVERS	ATTRACTIONS	COMPULSIONS
i Factor mobility ii Economic reforms iii. Opening up of command economics iv. Bretton Woods system / WTO regime v. Communicatio n & Transportation tech.	i Innate growth impetus or urge of the MNCs ii Constant search for growth through foreign markets iii Management culture of MNCs	i Access to raw materials ii Sales Growth iii Low cost possibilities iv Enhanced profitability	i Limitations of domestic market ii Need for risk minimization by diversification.

NOTES

1.3.3.1 Facilitators Of International Business

The facilitators include, increasing factor mobility, economic reforms, opening up of command economics, the Bretton Woods system / WTO regime and developments in communication and transportation technology spheres.

First, **factor mobility** is the most important of all factors that has contributed to growth of international business. During the time of the great economists like Adam Smith, David Ricardo and their great folk, cross-border movement of goods only on the principle of comparative cost advantage was envisaged. Cross-border movement of factors of production was not envisaged. Now capital, technology, brands, labour management and intellectual property just move from anywhere to anywhere. Perhaps international understanding and economic corporation have paved the way for world-wide flow of factors of production. Technical collaborations, overseas job market expansion and overseas management consultancy are all on the increase. MNCs play a vital role in this factor mobility contributing to the growth. As a result of factor mobility, instead of goods being traded across national borders, production plants are set up in the identified market themselves by the MNCs resulting in growing international business. .

Second, the **economic reforms** undertaken in the most of the developing and under developed economics are another cause for the growth of international business. Governments of most of these countries having become vexed with regressed performance of their public sector and their bureaucracy and consequent waste of precious resources resulting poor GDP growth fuelling poverty and unemployment, in order to take their economies on the growth path have started embarking on programme of economic reforms. Globalization, as a part of such reforms process, has opened their economies to international players on an equal footing with domestic operators. For example, ever since the reforms process has been introduced in India many MNCs have started opening up their ‘units’ in the country. Ford Motors, Hyundai Motors, Pepsi, Coca-Cola, Microsoft, IBM, Cogentrix etc have set their foot in India.

Existing multinationals have enhanced their stake in the country and some are putting up 100% subsidiaries. For example Unilever has put up Unilever India Pvt. Ltd., to produce a chemical used to make soap, P&G has put up P&G Home Products Pvt. Ltd. To market detergents, Gillette has put up Wilkinson India Pvt. Ltd. To channelize investments into other companies, ABB has put up ABB Housing Company to pump investments into new ventures, Rhone Poulene has put up Rhone Poulene (India) to introduce pharmaceutical products in Key therapeutic areas, Hewlett Packard has put up Hewlett Packard (India) to develop and export software, Unisys has put up Unisys(India) Ltd to develop and export software, Cadbury Schweppers has put up CS Beverages India Pvt. Ltd to market a range of soft drinks, Danone has put up Danone India Ltd to enter into brand licensing

NOTES

agreements, Warner Lambert has put up Warner Lambert Ltd to bring in a range in pharma and health care products and GEC has put up GEC of India Ltd to oversee the group's expanding Indian operations. 100% ownership will enable the parent to retain proprietary control over technologies and products. Besides backward integration to gain economics and shed diseconomies of scale is possible.

Third, **opening up of command economies** is another factor behind, recent growth in international business. China, Russia, etc are no longer command economies. Socialism and communism have given big welcome to capitalism in their very place of origin and growth. The communist countries have opened up their economies to competition. Since 1985, Russia introduced **'perestroika'** or restructuring measures, though the collapse of political structure there in the late 1980s to early 1990s had hampered the transition to market economy resulting in economic disruption. Western and multilateral aid to Russia to support budget and currency stabilization is being extended. During 1992 and 1993 a total of $ 2.3 bn aid flowed into Russia. Privatization is being acceleratingly followed in Russia. As of March 1994, more than 60% of industrial workforce was employed in privatized enterprises and more than 12000 enterprises were privatized by June 1994. Similar exercises are being introduced in the erstwhile USSR states called as CIS nations. A logical extension of this privatization programme is the entry of MNCs into these lands. Since the dawn of the third millennium, Russia and the CIS nations are smartly rebuilding their economies. China is sporting excellently in opening up its economy, as is borne out by foreign investment statistics. The Chinese reforms process has been introduced in top-down orderly fashion since 1980. Between 1980 and 2007 annual rise in industrial output was over 10%. Foreign investment rose significantly. And many MNCs have put up their plants in China. Some have hastened to have their plants there, as they did not want to lag behind potential competitors. China has been getting foreign direct investment to the tune of $ over 70 billion annually in the recent years.

Fourth, **the Bretton Woods organizations and WTO –** the World Bank and International Monetary Fund and their subsidiaries like the International Development Association, International Finance Corporation, Multilateral Investment Guarantee Agency and other multilateral bodies especially the World Trade Organization (WTO) generally insist on member countries to open their economies. This paves the way for growth of international business vastly through the MNCs.

Fifth, **developments in communication and transportation technology spheres** facilitated the growth of international business is ably. Seamless communication, real-time communication, containerization, third-party logistics, life cycle logistics, supply-chain management, etc enabled internationalization of businesses.

NOTES

1.3.3.2 Drivers Of International Business

The drivers of international business include the innate growth impetus or urge of the MNCs, constant search for growth through foreign markets, the management culture of MNCs, etc.

First, MNCs generally have the **innate growth impetus** with them that engines the spread international business. They always look upon growth opportunities anywhere in the globe and try to seize them. Strategic alliance, joint ventures, wholly owned subsidiaries, mergers on acquisition, franchising, etc are the diverse strategies they adopt to expand their operation globally. The motives for such expansion are: (i) securing supplies of minerals, energy and scarce raw materials (e.g. all oil, mineral and metal companies), (ii) increasing sales volume and value so as to raise market share and with that enhancing earnings, (iii) leveraging their technological advances or brand superiority leading to global demand met through overseas investment and (iv) availability of cheaper factors overseas and using the same by geographically spreading their operations. MNCs have technology and competitive edge. With these they easily establish brand image. Global spread is very simple for them unless nation-states are vociferously against the entry of MNCs. Liberalization and reforms process adopted in the third world nations have opened out vast growth opportunities for MNCs. However the essential element is the urge of MNCs to seek out, undertake and integrate manufacturing, marketing, R&D and finance opportunities on a global scale rather than on domestic level.

Second, there are MNCs who always have a **constant eye on foreign markets** resulting in expanding international business. IBM, Volkswagen, Unilever, Coco-Cola, N.V.Philips, Singer, Sony, Toyota, Microsoft, General Motors, Exxon, etc come in this category. Originally American firms bought plant and equipment in the Western Europe. This happened till 1960s. Later Western Europe firms opened shops in the USA. By 1980s, Japanese acquired firms in the Europe and America. Now there is camping of MNCs in the Emerging World Markets like India, China, Mexico, Thailand, etc. Perceived/ actual restrictions on imports led to MNCs opening up factories in the foreign lands. India and China are a great attraction as market for most MNCs at present. There is a classic difference between US and Japanese MNCs in market capturing. US MNCs look at the up-end of the market, while Japanese MNCs look at the unattended low-end. Low-end market has lot of growth potential and this gives scale economies. With accumulated resource, wide market and proven process technology, Japanese MNCs are a threat to the US MNCs.

Very recently **Indian companies** are on a shopping spree acquiring overseas entities. Tata Steel, the renowned Indian private sector steel firm, acquired Corus, the Europe's second largest steel producer with revenues in 2005 of GBP 9.2 billion, and crude steel production of 18.2 million tons primarily in U.K. and Netherlands. Corus has

NOTES

41,100 employees in over 40 countries and sales offices and service centres worldwide. Combining international expertise with local customer service, the Corus brand represents quality and strength. The Acquisition of Corus by Tata Steel is consistent with Tata Steel's stated objective of growth and globalization. Growth at Tata Steel has been focused towards new, higher end-markets and a more sophisticated customer base. Mittal Steel of India acquired Arcelor of Austria. ArcelorMittal is the world's number one steel company, with 320,000 employees in more than 60 countries. ArcelorMittal brings together the world's number one and number two steel companies, Arcelor and Mittal Steel.

Third, growth of international business is very much influenced by the **management culture of mncs.** MNCs generally adapt to local conditions and the relationship between parent and subsidiaries is that of "coordinated federation". Decisions on investment financing and market are localized. But Japanese MNCs do centralize decisions. The East-West difference is thus found. But the underlying similarity is the bias for action. Corporate strategic planning is an essential package of MNCs management practice whereby the MNCs scan and plan for enhanced integration and coordination of their global activities. And subsidiary level strategic plan is directed at localizing the global strategy according to the peculiarities of the local conditions. Microsoft Corporation allows its European subsidiaries to develop local strategies to meet local market needs. This type of autonomous adoption to fast changing local business environment has been the main reason for the spatial spread of MNCs. The autonomy enjoyed by subsidiaries is not to turn into dysfunctional anarchy, for the ehavior of individual managers is well shaped through shared vision of, identification with and binding commitment to the global strategy of the MNCs. Hence the growth of MNCs.

1.3.3.3 Attractions Of International Business

The attractions of international business include access to raw materials, sales growth, low cost possibilities and enhanced profitability.

First, initially most MNCs were spreading their wings globally just to **tap raw materials** available elsewhere for supporting production at the patent plant. British, Dutch and French East India companies are classic examples of MNCs of the raw-material seeking type. Now instead of tapping raw materials, the MNCs set up plants where factor markets are favourable. Their search for growth is never inward-seeking but always outward-oriented. That is their culture and this led to growth in international business.

Second, the attraction of international business is increased **sales growth.** Top-line growth is indispensable for all round performance improvements. Global markets provide the opportunity for the same. Geographical market growth leverages on existing brand and technology. The growth is therefore cheaper and hence helps in containing the middle-lines (read as costs) and strengthening the bottom-line (that is, profits).

NOTES

Third, MNCs are driven by **cost-minimization possibilities**. They set up plants at places where low-cost production possibilities are great. Hong Kong, Taiwan, China, India, Mexico and Ireland, are preferred by MNCs for setting up electronic industrial units for there is cost efficiency. China, being a cheap-labour country, MNCs have started flooding into China. IBM and Ford, outsource production of parts to low-wage countries such as Mexico and by establishing assembly plants and R&D centres in Europe and Japan.

Fourth, international business expansion leads to **enhanced profitability**. MNCs are generally highly profitable. Profit booking facilitates growth diversification, modernization and R&D competitiveness. Actually MNCs book profits by being flexible, adaptable and quick in action. In today's head-on competition, the most important factor for growth is speed. Ability to design, develop and distribute products/services in short-span of time holds the key to success. This is what **Bill Gates** would call as **Business @ Speed of Thought**. The managerial culture of MNCs facilitates quick action and growth flows thereby.

1.3.3.4 Compulsions For International Business

The compelling reasons for firms going global business are limitations of domestic market and need for risk minimization by diversification.

First, the **limitations of domestic market** are a major compelling factor for business to go global. However big the domestic market, it is but a fraction of world market. There is a limit for growth. Further, when your competitor is out-sourcing growth, you cannot get confined to domestic market. Tasting the foreign market is a test of your strengths as well.

Second, businesses have long back realized the need for **risk-minimizing.** Threats from oligopolistic competitors are always there. Further country-risk is always there. Meeting both the risks is facilitated by geographical spread. By being close to market, better orientation is easily facilitated. Global geographical spread is risk-minimizing strategy. And there is growth. Japanese competition affects the American Auto Industry. So, American Auto firms go out to the third world in search of strategic alliance partnership.

1.3.4 Patterns Of Internationalization

The patterns of internationalization are of different shades. The same is depicted in table 1.2 in terms of Impetus for internationalization, Number of foreign countries landed in, Responsibility for foreign operations, Mode of foreign operation, Operational Similarity between F & D (foreign & domestic) and Basic Business Strategy.

NOTES

TABLE 1.2 Patterns of Internationalization

Factors of Difference	100% Domestic	Low level of Internationalization	Medium level of Internationalization	High level of Internationalization
Impetus for internationalization	None	Passive response to proposals	Active response to proposals	Active search for opportunities
No. of foreign countries landed in	None	1 or 2	3 to 10 (Several)	> 10 (Many)
Responsibility for foreign operations	None	Vested with overseas partners	Shared with overseas partners	Fully self-handled by the firm
Mode of foreign operation	None	Limited to export and import	Foreign production and marketing	Foreign operations cover financing too
Operational Similarity of F&D	Not applicable	Quite Similar	Moderately Similar	Much dissimilar
Basic Business Strategies	Localized	Ethno-centric	Ethno-centric or Regio-centric	Poly-centric or Geo-centric

Source: Based on 'International Business' by John D Daniels and Lee H Radebaugh.

QUESTIONS TO CONTEMPLATE AND DELIBERATE

Q.1.3.a. What is international business? How the same is defined?

Q.1.3.b What is the present state of growth in international business, especially theMNCs?

Q.1.3.c. Can you present the causes for international business growth in terms of drivers, facilitators, attractions and compulsions?

Q.1.3.d. What are the patterns of internationalization of business firms?

1.4 TRADE AND INVESTMENT FLOWS

Trade and investment flows across the hemispheres or among the countries have been very common of late. Global trade in goods and services are on the rise. Investment flows across the nations are further higher.

1.4.1 Concepts Of Trade And Investment Flows

Trade flow refers to flow of goods and services across the globe through commercial transactions. In short, imports and exports are the routes of trade flow and constitute. In fact trade flow results in international trade. Trade flow across the globe has been present throughout much of history, though its economic, social, and political importance has been on the rise in recent times. Industrialization, advanced transportation, globalization, multinational corporations and outsourcing are all having a major impact on trade flow. Increasing trade flow is basic to globalization. Trade flow is a major source of economic revenue for any nation that is considered a world power. Without trade flow, nations would be limited to the goods found / produced within their own borders. A world without such exchanges is called a world of autarchy. It cannot be the best at all. Trade flow facilitates **specialized production, but universal consumption**.

NOTES

Investment flow is the flow of capital across the globe. In a way it is export and import of capital or finance. Capital rich countries / firms export capital in favour of capital needing countries / firms. Direct and Portfolio investments flows, Equity and Debt capital flows, Multilateral and Bilateral capital flows, Private and Government capital flows, Institutional and Personal capital flows, etc are the varied forms

1.4.2 Causes of Trade and Investment Flows

You may note that the same factors that spur firms to go global are by and large the reasons for trade and investment flows as well. Some of those and other factors are presented now.

i. Difference in Factor Endowments: Trade and investment flows are influenced by **difference in factor endowments.** The world is known for the skewed distribution of factors of resources. Hence production capabilities, possibilities and scales differ across the nations. Eventually, goods flow across nations. Nowadays, resources themselves flow globally.

ii Cost Advantage: Trade and investment flows are goaded by **cost advantage.** Cost leadership is what international firms aim at in a world of thinning down margins. Trade in goods is the cause and effect of comparative cost benefits. Even resources flow across nations to complement another resource that is cheaper in the destination nation. Result is the reduction in overall cost. Technology resources are flowing into China and India, so as to compliment the cheaper human resources available therein.

iii Patterns of Specialization: Trade and investment flows are triggered by **patterns of specialization.** Countries specialize. Some especially, Germany, Japan, UK and USA are good manufacturing machine tools and equipment, some like the USA, Japan, Korea and Germany are good in Automobiles, some like the USA, Singapore and India are good in IT and IT enabled services, some like the USA and France are good in Aircrafts, some like Denmark and UK and USA are good in food products, some like Switzerland, India are good in pharmaceutical goods etc. Specialization spells need for trade flows.

iv Profit from Exchange: Trade and investment flows are motivated by **profit from exchange.** Milton Friedman would say the sole purpose of businesses is making profit by serving the society. Profit sources are many; one is international exchange. Tiruppur in Tamilnadu gained international reputation as a production hub of ready-to-wear garments because it gained through international exchanges. Export sales guarantee more profit per unit sale than comparable domestic sale.

v Diversification of Sources & Markets for Physical & Financial Products and Risk: Trade and investment flows are propelled by the need for **diversification of sourcing and markets both for physical and financial products.** Multiple sources and

NOTES

markets both for inputs and outputs and both for physical and financial inputs are essential to ward off uncertainties of supply chain and consumer patronage.

vi Exploitation of Natural Resources: Investment and trade flows are driven by profit-seeking transnational corporations that are interested in the **exploitation of natural resources.** This pattern of trade and investment leads to a high growth, though that is subject to the vicissitudes of terms-of-trade and risk-return aspects of foreign investments. Over time, the economic base of some countries even get shifted from primary goods producers to manufacturing entities, primary goods producers to service providers, or from manufacturing entities to services. This leads to significant foreign investment and trade in the secondary and tertiary sectors.

vii Policy "U" turn Towards Marketization by Many Economies: Since the later part of the 20th century, change from the **'inward-looking import-substitution oriented development framework'** to the **'outward-looking export-led growth oriented development framework**', along with structural adjustment programmes like economic liberalization, privatization and globalization (LPG) has been taking place leading to increased opening and reform of many national and regional economies. The market-opening policies, including trade liberalization, macroeconomic reforms (such as the non-directed monetary policies, fiscal prudence and flexible exchange rates in some countries), and privatization have led to significant dependence on trade and investment inflows as trusted ways to economic development.

viii Common Market / Currency / Economy: At the sub-regional level, the policy of **Common Market / Currency / Economy** has facilitated intra-regional trade and investment. This has been manifested in the development of regional firms and a number of mergers and acquisitions to confront external competition. Strategies in areas such as technology adaptation, marketing and human resource development to develop competitive advantage are also side by side taken up so as to optimize beneficial effects of trade and investment flows across the globe.

ix Bilateral Trade / Investment and Economic Relationship: Countries also step up bilateral trade and investment flows substantially, taking due note of the increasingly diverse and considerably large nature of the **bilateral trade and economic relationship.** Countries want to coalesce in economic paradigm so that mutual understanding and growth result.

x Enabling Multilateralism along with Regional Pluralism: Finally, multilateralism in the form of GATT & WTO and World Bank & Multilateral Investment Guarantee Agency (MIGA) besides others, co-existing with regional pluralism in the form of regional trade blocks and agreements between trade blocks

NOTES

1.4.3 Trend in Trade Flows

Trade flows refer to trade in merchandize and services across the globe. Trade in merchandize refers to both export and import of commodities, goods, products, equipments plants, and machinery. That is all visible items. Trade in service refers to both export and import of services, or invisibles like insurance, logistics, consultancy, technology, etc. the trend in these exports and imports is dealt in this section.

Table 1.3 gives old and recent statistics on global trade flows – merchandize exports. Global exports of merchandize had been a paltry $ 59 billion in 1948 and $ 84 bn in 1953, recording a simple growth of 8.2% per annum. Between 1953 and 1963 the simple annual growth was 8.6 %. Between 1963 and 1973, the growth was 27% p.a. In the next 3 decennials periods (1973 -83, 1983 -93 and 1993 -203) the annual growth rates were, respectively, 22%, 10% and 10%. In 2003 the global merchandize exports recorded a figure of $ 7371 billion and in the recent year 2006 it stood at $ 11783 bn. Between 2003 and 2006, the annual average simple growth % was 20. The period 1973 -83 recorded the highest growth rate followed by the recent period, 2003-06.

Table 1.3: World merchandise exports by Region and Selected economy

Year	1948	1953	1963	1973	1983	1993	2003	2006
World (S bn)	**59**	**84**	**157**	**579**	**1838**	**3675**	**7371**	**11783**
World	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
North America	**28.1**	**24.8**	**19.9**	**17.3**	**16.8**	**18.0**	**15.8**	**14.2**
United States	21.7	18.8	14.9	12.3	11.2	12.6	9.8	8.8
Canada	5.5	5.2	4.3	4.6	4.2	4.0	3.7	3.3
Mexico	0.9	0.7	0.6	0.4	1.4	1.4	2.2	2.1
S& C America	**11.3**	**9.7**	**6.4**	**4.3**	**4.4**	**3.0**	**3.0**	**3.6**
Brazil	2.0	1.8	0.9	1.1	1.2	1.0	1.0	1.2
Argentina	2.8	1.3	0.9	0.6	0.4	0.4	0.4	0.4
Europe	**35.1**	**39.4**	**47.8**	**50.9**	**43.5**	**45.4**	**45.9**	**42.1**
Germany	1.4	5.3	9.3	11.6	9.2	10.3	10.2	9.4
France	3.4	4.8	5.2	6.3	5.2	6.0	5.3	4.2
UK	11.3	9.0	7.8	5.1	5.0	4.9	4.1	3.8
Italy	1.8	1.8	3.2	3.8	4.0	4.6	4.1	3.5
CIS	-	-	-	-	-	**1.5**	**2.6**	**3.6**
Africa	**7.3**	**6.5**	**5.7**	**4.8**	**4.5**	**2.5**	**2.4**	**3.1**
South Africa	2.0	1.6	1.5	1.0	1.0	0.7	0.5	0.5
Middle East	**2.0**	**2.7**	**3.2**	**4.1**	**6.8**	**3.5**	**4.1**	**5.5**
Asia	**14.0**	**13.4**	**12.5**	**14.9**	**19.1**	**26.1**	**26.2**	**27.8**
China	0.9	1.2	1.3	1.0	1.2	2.5	5.9	8.2
Japan	0.4	1.5	3.5	6.4	8.0	9.9	6.4	5.5
India	2.2	1.3	1.0	0.5	0.5	0.6	0.8	1.0
Australia &NZ	3.7	3.2	2.4	2.1	1.4	1.5	1.2	1.2
6 East Asia traders	3.4	3.0	2.4	3.4	5.8	9.7	9.6	9.6
Memorandum items								
EU	-	-	27.5	38.6	30.4	36.1	42.4	38.5
USSR, former	2.2	3.5	4.6	3.7	5.0	-	-	-
WTO Members	60.4	68.7	72.8	81.8	76.5	89.5	94.3	93.9

NOTES

Another important trend observed is that the share of North America, comprising, the USA, Canada and Mexico in world merchandize exports dwindled steadily from 28.1% in 1948, to 24.8% in 1953, to 19.9% in 1963, to 17.3% in 1973 and to 16.8% in 1983. In 1993 it rose to 18.0%, only to fell down to 15.8% in 2003 and further down to 14.2% in 2006. During the same period, a similar fate was shared by the South and Central Americas, and the Africa. But the Europe recorded a growing share upto 1973, and then a decline, though its position in 2006 (at 42.1%) is better than in 1948 (at 35.1%). Smart performance was shown by Germany, but UK showed a depleting performance. The Asian share almost doubled from 14% in 1948 to 27.8% in 2006. China's share in the last 1.5 decades was remarkable, though Japan showed some shakiness. India is yet to regain its glorious past, though absolute figures are good.

Table 1.4 gives old and recent statistics on global trade flows – merchandize imports. Global exports of merchandize had been a paltry $62 billion in 1948 and $ 85 bn in 1953, recording a simple growth of 8% per annum. Between 1953 and 1963 the simple annual growth was 9.3 %. Between 1963 and 1973, the growth was 26.3% p.a. In the next 3 decennials periods (1973 -83, 1983 -93 and 1993 -203) the annual growth rates were, respectively, 21.6%, 10% and 10.3%. In 2003 the global merchandize imports recorded a figure of $ 7650 billion and in the recent year 2006 it stood at $ 12113 bn. Between, 2003 & 2006, the annual average simple growth was 19.4%. The period 1973-83 recorded the highest growth, followed by the recent period, 2003-06.

Table 1.4: World merchandise imports by Region and Selected economies

Year	1948	1953	1963	1973	1983	1993	2003	2006
World ($ bn)	**62**	**85**	**164**	**595**	**1882**	**3770**	**7650**	**12113**
North America	**18.5**	**20.5**	**16.1**	**17.2**	**18.5**	**21.5**	**22.6**	**21.0**
United States	13.0	13.9	11.4	12.3	14.3	16.0	17.0	15.8
Canada	4.4	5.5	3.9	4.2	3.4	3.7	3.2	3.0
Mexico	1.0	0.9	0.8	0.6	0.7	1.8	2.3	2.2
S & C America	**10.4**	**8.3**	**6.0**	**4.4**	**3.8**	**3.3**	**2.5**	**3.0**
Brazil	1.8	1.6	0.9	1.2	0.9	0.7	0.7	0.8
Argentina	2.5	0.9	0.6	0.4	0.2	0.4	0.2	0.3
Europe	**45.3**	**43.7**	**52.0**	**53.3**	**44.2**	**44.8**	**45.3**	**43.1**
Germany	2.2	4.5	8.0	9.2	8.1	9.1	7.9	7.5
UK	13.4	11.0	8.5	6.5	5.3	5.6	5.2	5.1

NOTES

France	5.5	4.9	5.3	6.3	5.6	5.8	5.2	4.4
Italy	2.5	2.8	4.6	4.7	4.2	3.9	3.9	3.6
CIS Countries	-	-	-	-	-	**1.2**	**1.7**	**2.3**
Africa	**8.1**	**7.0**	**5.2**	**3.9**	**4.6**	**2.6**	**2.1**	**2.4**
South Africa	2.5	1.5	1.1	0.9	0.8	0.5	0.5	0.6
Middle East	**1.8**	**2.1**	**2.3**	**2.7**	**6.2**	**3.4**	**2.7**	**3.1**
Asia	**13.9**	**15.1**	**14.1**	**14.9**	**18.5**	**23.3**	**23.1**	**25.0**
China	0.6	1.6	0.9	0.9	1.1	2.8	5.4	6.5
Japan	1.1	2.8	4.1	6.5	6.7	6.4	5.0	4.8
India	2.3	1.4	1.5	0.5	0.7	0.6	0.9	1.4
Australia &N Z	2.9	2.3	2.2	1.6	1.4	1.5	1.4	1.4
6 East Asian traders	3.5	3.7	3.1	3.7	6.1	9.9	8.2	8.6
EU	-	-	29.0	39.2	31.3	34.3	41.6	39.2
USSR, former	1.9	3.3	4.3	3.5	4.3	-	-	-
WTO Members	52.9	66.0	74.2	89.1	83.9	88.7	96.1	95.8

Another important trend observed is that the share of North America, comprising, the USA, Canada and Mexico in world merchandize imports slightly increased from 18.5% in 1948, to 20.5% in 1953, to 16.1% in 1963, to 17.2% in 1973 and to 18.5% in 1983 to 21.5% in 1993 and to 22.6% in 2003. It slightly fell down to 21% in 2006. During the same period, a similar fate was shared by the South and Central Americas, and the Africa. But the Europe recorded a growing share upto 1973, and then a decline. Its position in 2006 was 43.1% compared to 45.3% in 1948. Rising imports are recorded by Germany and Italy, while UK and France showed a declining imports share. The Asian share almost doubled from 13.9% in 1948 to 25% in 2006. China's share in the last 1.5 decades was remarkable, though Japan showed some peaks and troughs.

NOTES

1.4.4 Trend in Investment Flows

Foreign investments mean investments beyond borders. Of late investment flow is becoming increasingly borderless. Search for investment opportunities anywhere across the globe is the order of the day. So also search for funds. Territory-free demand for finance by firms, governments or individuals and investment of the same by firms, governments or individuals are the thrusts of the world now. **Peter Drucker** said, to maintain substantial market standing on an important area, a business concern requires physical presence as a producer in that area too. Such presence invariably leads to investment in overseas areas.

Competencies gained through trade leveraged through FDI: Global trade governed by the system of comparative costs, leads to global investments as well since investment follows trade to leverage competencies gained through trade. The early twentieth century saw the growth of nationalist forces first on the political plane and then on the economic-finance-trade planes as well. While nationalist feelings are fine in the political arena, the same are not so in the economic-finance-trade contexts in view of economic interdependence of nations. And this was realized in the last quarter of the 20th century and that globalist feelings, replacing the nationalist feelings on economic-finance-trade planes emerged almost all over the world, including China, Soviet Union and prominent East European nations, which were core communist ideology driven economies and also the mid-path economies like India. This is the re-dawn of the legacy of Adam Smith, the greatest political economist of the 18th century who advocated free trade and hence global investment.

Foreign Direct Investment (FDI) is investment in business which involves **substantial ownership and control, entrepreneurial risks, technology and management transfer and hosts of implications for the host country and the firm concerned**. FDI typically takes the form of starting a subsidiary, acquiring a stake in an existing firm or starting a joint venture in the foreign country. Direct investment and management of the firms concerned normally go together. If the investor has only a sort of property interest in investing the capital in buying equities, bonds, or other securities abroad, it is referred to as foreign portfolio investment. That is, in the case of portfolio investments, the investor uses capital in order to get a return on it, but has not much control over the use of the capital. Hare we focus on FDI. Table 1.5 gives the trend in FDI flows.

NOTES

Table 1.5: Selected Indicators of FDI (Fig. in billion US $)

Details	1982	1990	2005	2006
FDI inflows	59	202	946	1 306
FDI outflows	28	230	837	1 216
Inward FDI stock	637	1 779	10 048	11 999
Outward FDI stock	627	1 815	10 579	12 474
Income on inward stock of FDI	47	76	759	881
Income on outward stock of FDI	46	120	845	972
Cross-border M&A	..	151	716	880
GDP current prices	12 002	22 060	44 486	48 293
Gross Capital formation	2 611	5 083	9 115	10307

Global FDI inflow was a feeble figure of $59 bn in 1982 accounting for roughly 0.5 % of the then Global GDP (GGDP) of $ 12002 bn. The figure rose to $202 bn in 1990 accounting for roughly 0.9 % of the GGDP of $ 22060 bn. By 2005 the FDI flows reached $946 bn or 2.1 % of GGDP and in 2006 the figure touched $1306 bn or 2.7% of GGDP. A greater part of FDI flows is accounted by cross-border Mergers and Acquisitions (M&A). The upward trend in foreign direct investment (FDI) that began in 2004 accelerated further in 2006. FDI flows increased in all the major country groups, namely, developed countries, developing countries and the transition economies of South-East Europe and the Commonwealth of dependent States (CIS) but at varying rates.

According to the UNCTAD, the sustained growth of FDI and related international production primarily reflected the strong economic performance and increasing profits of many countries in the world, further liberalization of their policies, and other specific factors such as currency movements, stock exchange and financial market developments and high commodity prices. Increases in cross-border mergers and acquisitions (M&As), fuelled substantially by Private Equity Funds, also added to FDI growth. **FDI was at its peak in 2000 with $1,411 billion.**

FDI flows to developed and Developing Worlds: FDI inflows in 2006 were 38% higher than in 2005, approaching the peak of $1,411 billion reached in 2000. Although FDI flows to all three major country groups rose, they varied greatly among regions and countries. FDI flows to developed countries in 2006 rose by 45%, well over the growth rates of the previous two years, to reach $857 billion. The United States regained its position as the world's leading FDI recipient, overtaking the United Kingdom, which had led in 2005. The European Union (EU) remained the largest host region, with 41% of total FDI inflows. FDI inflows to developing countries and economies in transition rose by 21%

NOTES

and 68%, respectively, to new record levels for them. UNCTAD figures say that the Developing Asia retained its strong attraction for investors, accounting for more than two thirds of the total inflows to all developing countries in 2006.

FDI inflows Africa: In Africa, FDI inflows exceeded their previous record set in 2005. High prices and buoyant global demand for commodities were again key factors. The oil industry attracted investment from TNCs based in both developed and developing countries. Cross-border M&As in the extractive industries rose five-fold to $4.8 billion. As in previous years, according to UNCTAD, most of the inflows were concentrated in West, North and Central Africa. However, inflows remained small in low-income economies with few endowments of natural resources.

FDI inflows Latin America and the Caribbean: Inflows into Latin America and the Caribbean rose by 11% in 2006. However, if the offshore financial centres are excluded, they remained almost unchanged over the previous year.

FDI inflows Mexico, Brazil: Mexico was the largest recipient followed by Brazil. While inflows to Mexico were similar to 2005, those to Brazil rose by 25%.

FDI inflows Andean Group: Andean Group is a trade organization in Lima, Peru. In 1969, Bolivia, Chile, Colombia, Ecuador, and Peru established the group. In 1973, Venezuela joined. Chile quit in 1976, as did Peru in 1992. The group created a free trade area called the Andean Pact in 1992. In the Andean group of countries, the commodity price boom induced a more restrictive regulatory environment governing TNC participation in the extractive industries. The possibility of additional regulatory changes and of their spread to more countries may have raised uncertainty among investors in the primary sector, resulting in lower FDI flows to some countries in the region. In addition, high commodity prices and resulting improvements in current-account balances led to an appreciation of the currencies of some mineral-rich countries in the region, potentially harming the prospects for FDI in other export-oriented activities.

FDI inflows to South, East and South-East Asia and Oceania: FDI inflows to South, East and South-East Asia and Oceania maintained their upward trend, reaching a new high in 2006 of $200 billion, an increase of 19% over the previous year. At the sub-regional level, the shift in favour of South and South-East Asia continued. China, Hong Kong and Singapore retained their positions as the three largest recipients of FDI in the region. Outward FDI from the region surged, driven by the rapid rise in FDI from all the Asian sub-regions and major economies. FDI inflows to Oceania remained small, at less than $400 million.

FDI flow to West Asia: In West Asia, FDI flows both inward and outward, maintained their upward trend in 2006. Turkey and the oil-rich Gulf States continued to attract the most FDI inflows, achieving record levels in 2006 in spite of geopolitical uncertainty in parts of the region. Energy-related manufacturing and services were the most targeted

NOTES

activities. Countries with large financial resources, led by Kuwait, accounted for most of the rise in outward FDI from the region. Cross-border M&As continued to be the main mode of outward FDI, particularly by State-owned enterprises. The regions closer ties with economies in other parts of Asia and Africa support its energy-related FDI.

FDI inflows South-East Europe and the CIS: FDI inflows to the 19 countries of South-East Europe and the CIS expanded significantly in 2006, for the sixth consecutive year, and they more than doubled in the regions largest host country, the Russian Federation. The continued rise in FDI flows across regions largely reflects strong economic growth and high performance in many parts of the world.

Factors fuelling up the FDI flows: Among the different factors, **cross-border M&A,** which account for a large share of FDI flows, is a great factor. The number of green-field and expansion investment projects increased by 13% to 11,800 projects, notably in developing countries and in the services sector. In 2006, FDI inflows accounted for half of all net capital flows to developing countries. Thus, as in recent years, FDI flows continued to be the most important and stable source of external financing for developing countries. Mobilizing international resources for development, including FDI, was set out as one of the objectives in the Monterrey Consensus.

Global FDI flows also rose as a result of a **weakening dollar in 2006**. The United States attracted large inflows from both the euro area and Japan. Overall, however, the amounts in 2006 (as well as 2005) were not much higher than those of the 1990s. The sharp appreciation of the euro in recent years has not led to as strong increase in FDI outflows from the euro area into the United States and Japan, possibly suggesting that TNCs from the countries in the euro area are reacting less to exchange rate changes than in the past. This is probably because they have already reached a relatively high degree of internationalization, which makes their profits less vulnerable to exchange rate changes vis-à-vis particular host countries.

Moreover, TNC strategies are now influenced by other **secular developments**. For example, the creation of the euro area has promoted greater regional integration and concentration of economic activity within the EU and led to increased intra-EU FDI flows to the common currency area as well as to the United Kingdom and the EU accession countries.

Increased corporate profits and higher stock values, also partly explain rising global FDI flows. For example, the profits-to-sales ratio of the United States top 500 firms was the highest for the past two decades, in 2006 and profits of Japanese firms have continued to rise, setting new records every year since 2003. Similarly, profits of EU companies have surged. In the United Kingdom, for example, the net rate of return of private non-financial corporations in 2006 rose to an all-time high (United Kingdom, National Statistics Office, 2007). Profits earned abroad by foreign affiliates were also

NOTES

high. Income on FDI (i.e. repatriated profits and reinvested earnings as recorded in host countries balance of payments) rose another 29% in 2006, following a 16% rise in 2005. In the 93 countries for which data on all three components of FDI, namely equity investments, reinvested earnings and other capital (essentially intra-company loans) were available, reinvested earnings in 2006.

QUESTIONS TO CONTEMPLATE AND DELIBERATE

Q 1.4.a What do you mean by the global trade and investment flows? What are the types and causes of trade flows and investment flows?

Q 1.4.b Present the trend in global trade in merchandize and services with appropriate data and discuss the trend pattern.

Q 1.4.c Examine the trend in global investment flow and its regional patterns.

1.5 ECONOMIC THEORIES

International trade and international investment patterns and trends are sought to be explained in terms of theories. The causes, effect and courses of international trade and investment are visualized in the theories. There many theories, because the intricacies and dynamics of trade and investment cannot be captured by any one theory for it is too difficult for few minds to study the minds of many We have many theories of trade and investment..

1.5.1 Theories of International Trade

Theory of mercantilism, theory of neo-mercantilism, absolute cost advantage theory, comparative cost advantage theory, Heckscher-Ohlin Theory of factor proportion, Country similarity theory, International Product life Cycle theory, Country Size theory, Independence-interdependence-dependence theory, Strategic Rivalry theory, Porter’s Competitive Advantage theory, etc are dealt.

1.5.1.1 Theory of Mercantilism

The mercantilists proposed **theory of mercantilism**. They were a group of economists who preceded Adam Smith. The foundations of economic thought between 1500 and 1800 were based on mercantilism. Mercantilists believed that the world had a finite store of wealth; therefore, when one country got more, other countries had less. Mercantilists restricted imports and encouraged or subsidized exports as a conscious policy to make their citizens better off. Mercantilists judged the success of trade by the size of the trade balance.

Mercantilism was a sixteenth-century economic philosophy that maintained that a country’s wealth was measured by its **holdings of gold and silver**. This required that the countries to maximize exports and minimize imports. The logic was transparent to sixteenth-century policy makers that if foreigners bought more goods from us than we bought from

NOTES

them, then the foreigners had to pay us the difference in gold and silver, enabling us to amass more treasure. With that treasure we could expand the nation's global influence.

Politically, mercantilism is popular with many manufactures and their workers. Export-oriented manufacturers favoured mercantilist trade policies, such as those giving subsidies or tax rebates, which stimulated their sales to foreign buyers. Domestic manufacturers threatened by foreign imports endorsed mercantilist trade policies, such as those imposing tariffs or quotas, which protected them from foreign competition according to Mahoney, Trigg, Griffin, & Pustay.

Mercatilists pressed for favourable balance of trade (BOT) or balance of payments (BOP) as against the unfavourable one. In a way it is good because your currency appreciates with mounting surplus on the forex front, and the country can attract more foreign capital infusion further strengthening the country's economy, infrastructure, etc. May be today China and Japan with enormous favourable BOT and BOP get all the benefits envisaged by mercantilists.

But the problem is can a country stick to continuously enormous favourable BOT and BOP for ever? If every country vies for the same, there will only be autarchy. Besides, most members of society were hurt by mercantilist policies of pampered exporters and penalized importers. Government subsidies of exports for selected industries were paid for by taxpayers. This is distortion of trade and interference in efficient allocation of resources. Actually those countries which pursued a policy of import-restriction in the end grew less. Example India, until mid 1990s. Those that ran heavy deficits grew well. Example USA, till recently.

Evaluation: Mercantilist writers have been lauded and criticized in the literature on foreign trade at least since Hume's Political Discourses in 1752. Mercantilists have been criticized for everything from their views regarding the gains from trade to their self-promotion of the merchant's role in society as being important. Mercantilist writers assumed that the economy will generally operate at a pace that leaves resources –land and labor – idle, but in reality the economy naturally tends to full employment. This is a "flaw" in the logical foundation of mercantilist thought.

The regime of WTO has moved the world away from mercantilism by pressing for freer trade with reduced protectionism.

1.5.1.2 Theory of Neo-Mercantilism

Mercantilism is still in vogue. Mercantilist policies are politically attractive to some firms and their workers, as mercantilism benefits certain members of society. Modern supporters of these policies are known as **neo-mercantilists, or protectionists.** The neo-mercantilists want higher production through full employment and that every industry

NOTES

produces an exportable surplus leading to favourable BOT. Consciously or otherwise, every country is concerned about increasing export earnings. The merits of surging forex surplus built through exports speaks well of a country's capability to cater to world's needs qualitatively, quantitatively and in varied product/service ranges. Right now China, Japan, Singapore, Korea and Taiwan have the rarity of great export surplus. We cannot say they are neo-mercantilists, but they have huge export surplus. Every country does what is possible to meet this end. But the modern trade emphasis is 'Export more and Import more'.

1.5.1.3 Theory of Absolute Cost Advantage

Adam Smith was the first to come up with the theory of absolute advantage. **Theory of Absolute Cost Advantage** suggests that a country should produce and export those goods and services for which it is more efficient than other countries and hence has absolute cost advantage, and import those goods and services for which other countries are more efficient than it and hence enjoy absolute cost advantage over it.

According to Adam Smith, mercantilism's basic problem is that it confuses the acquisition of gold and silver with the acquisition of wealth. In his celebrated book, 'An Inquiry into the Nature and Causes of the Wealth of Nations' (1776), Adam Smith attacked the intellectual basis of mercantilism and demonstrated that mercantilism actually weakens a country. Smith maintained that a country's true wealth is measured by the wealth of all its citizens, not just that of its monarch (Mahoney, Trigg, Griffin, & Pustay, 1998).

Sources of Advantages: The sources of advantage could be many and diverse. **Natural advantage** because of endowments of natural resources like, oil & gas, minerals and metals, valleys and mountains, waters and beaches, climate and eco-system, etc is a great advantage. The middle-east's meteoric rise is attributed to the oil & gas deposits. Tourism potentials are mostly nature-made. Gold deposits in South Africa are one of the causes of the country's richness. Countries with large deposits of Uranium will rule the world in course of time because of the multiple applications of the resource in peace and disturbance. But natural resource based advantage is finite. **Acquired Advantage** is derived from education, knowledge, skills, technology, innovation and R&D capabilities. Today, the acquired advantages command more respects because of its infiniteness. All the developed countries in the world owe their growth to acquired advantage rather than natural advantage. To harness the natural resource effectively, technology is needed, which is an acquired advantage. Production possibilities are enhanced with more acquired advantages, than with natural advantages.

Mechanism of the theory: A country is said to be more efficient than another country, if it can produce more output (goods) for a given quantity of inputs, such as labour or capital inputs. An example is that there are only two countries, India and USA. They both produce Buses and Cars. With 1 unit of labour & capital mix, India can produce 6 Buses or 2 Cars, where as USA with the same 1 input-mix can produce 2 Buses or 5 Cars.

NOTES

Economists use the term **absolute advantage** when comparing the efficiency of one person, firm or nation with that of another. The producer that requires a smaller quantity of inputs to produce a product or more units of output per given input level, is said to have an absolute advantage in producing that good. With trade, countries can specialize on the lines of individual efficiencies and that total output of both the products will be more, compared to total output obtainable when countries do not trade and specilize.

Production level without trade or the position of Autarchy: Without trade both will produce both the goods. Say out of their 100 units of labour & Capital mix, each, 50% is devoted for Buses and the other 50% for Cars. Then, India would have produced, 300 buses (6 x 50) and 100 cars (2 x 50) and USA produced 100 buses (2 x 50) and 250 cars (5 x50). Total production of buses by both the countries = 300 buses+ 100 buses = 400 buses. Total production of cars by both the countries = 100 cars + 250 cars = 350 cars.

Production level with trade: India has an absolute advantage over USA, when producing Buses, and USA has an absolute advantage over India, when producing Cars. This suggests that India should concentrate on Buses and export some of its Buses to USA, and USA should concentrate on Cars and export some of its Cars to India. Table 1.6 gives the position.

Table 1.6 Absolute Cost Advantage

Outputs (per given quantum of inputs, say 1 unit of labour & capital)	India	USA	Efficiency	Action
Buses	6	2	6/2 = 3	India is 3 times efficient in Buses against USA. India exports Buses
Cars	2	5	5/2 = 2.5	USA is 2.5 times efficient in Cars against India. USA exports Cars
Opportunity cost of Buses over Car; that is cars foregone to get 1 Bus	2/6=1/3	5/2=2.5	--	--

Source: The Author

NOTES

With total specialization along the lines of absolute advantage, India can produce 6 x 100 = 600 buses and USA can produce 5 x 100 = 500 cars. See the output smartly rises by a big margin of 200 buses and 150 cars with trade against the position autarchy.

Now let us assume that both countries have 100 units of labour

Merits of the Theory: There emerges specialization in lines of production across the countries. Specialization has its advantages of quality enhancements, innovation, cost minimization and so on. With the well earned export revenue, imports can be funded. There is societal advantage.

Limitations of the theory: The main plank of the theory, that is, specialization comes under the lens of scrutiny. Specialization has its doses of demerits. For strategic reasons countries don't want specialization. The absolute advantage theory requires that to effect trade between countries, one country is to be superior in one product and the other in a different product. What about a situation, mostly this is the reality, when one country is superior to other in production of both the products? Will there be no trade between countries?

1.5.1.4 Theory of Comparative Cost Advantage

David Ricardo, the early nineteenth-century British economist solved the problem of the theory of absolute cost advantage, by developing the **theory of comparative cost advantage**. The theory of comparative cost advantage, states that a country should produce and export those goods and services for which it is relatively more efficient than are other countries and import those goods and services for which other countries are relatively more efficient than it.

Mechanism of the theory: Absolute cost advantage suggests that no trade would occur if one country has an absolute advantage over both products. The differences between absolute and comparative cost advantage theories are subtle. Absolute advantage looks at absolute efficiency differences, comparative advantage looks at relative efficiency differences. Take India and USA again as examples, this time India is better than USA at producing both products Buses and Cars. India produces 6 Buses for every 4 Cars, and USA produces 2 Buses for every 3 Cars.

Absolute advantage would suggest that no trade should occur, because India is more efficient than USA in producing both goods. The theory of comparative advantage, suggests that trade should still occur. India has advantages in both, but comparatively more advantage than USA in production of Buses (1.5 Buses for every Car or 0.67 Car for every Bus). USA has disadvantage in both, but comparatively less disadvantage in the production of Cars (1.8 Cars for every Bus or 0.56 Bus for every Car).

NOTES

Production level without trade or the position of Autarchy: Without trade both will produce both the goods. Say out of their 100 units of Labour & Capital mix, each, 35% is devoted for Buses and the other 65% for Cars. Then, India would have produced, 390 buses (6 x 65) and 140 cars (4 x 35) and USA produced 130 buses (2 x 65) and 126 cars (3.6 x35). Total production of buses by both the countries = 390 buses+ 130 buses = 520 buses. Total production of cars by both the countries = 140 cars + 126 cars = 266 cars.

Economists use the term comparative cost advantage when describing the opportunity cost of two producers. The producer who has the smaller opportunity cost of producing a good is said to have a comparative cost advantage in producing that good. Table 1.7 explains the comparative cost advantage theory, the superiority of one country (India) over the other (the USA) in both the products, the opportunity cost of Buses over cars and that of car over Buses and the resulting lines of specialization and eventual lines of export.

Table 1.7 Comparative Cost Advantage

Outputs (per given quantum of input, say labour)	India	USA	Efficiency picture and action
Buses	6	2	6/2 = 3. India is 3 times efficient in Buses against USA.
Cars	4	3.6	4/3.6 = 1.11. India is 1.11 times efficient in Cars against USA. USA exports Cars
Opportunity cost of Buses over Car; that is number of Cars foregone to get 1 Bus.	4/6=2/3	3.6/2=1.8	Opportunity cost of Buses is lower for India as against the USA. So India goes for making Buses and its eventual export to the USA.
Opportunity cost of Car over Buses; that is number of Buses foregone to get 1 Car	6/4=1.5	2/3.6=0.56	Opportunity cost of Car is lower for USA as against India. So USA goes for Car making and its eventual export to India.

Source: The Author

Production level with trade: India has comparatively more advantage over USA, when producing Buses against Cars, and USA has comparatively less dis-advantage over India, when producing Cars as against Buses. This suggests that India should concentrate on Buses and export some of its Buses to USA, and USA should concentrate on Cars and export some of its Cars to India. With this total specialization along the lines of absolute advantage, India can produce 6 x 100 = 600 buses and USA can produce 3.6 x 100 = 360 cars. See with specialization, the output of buses smartly rises by a big margin of 80 buses, and output of cars rises by 94 cars as against the position autarchy. So it pays to specialize on the lines of comparative costs and trade.

Merits of the theory: Free trade is the only way to achieve efficient production of goods and services. It is how producers are able to find the lowest cost method of production in a global economy. In the long run, consumers in both countries will be better off with trade than without trade. All the advantages of specialization and free trade are the favourable points of the theory.

Limitations of the theory: First limitation is that the assumption of full employment. **Lack of validity of the assumption of full employment is** one limitation. With huge unemployment of human resources in most developing and underdeveloped countries, the validity of the theory stands questionable. This may force them to enter into areas of production not efficient to enter upon. Second, there has to be economic diversification, rather than specialization for the reasons of risk diversification. The **demerits of specialization** are a drain on the soundness of the theory. Third, **unequal sharing of benefits of trade** is the next drawback. The benefits from trade must be equitably shared between countries, but not. The bargaining power of nations counts much here. Generally terms of trade are always against the poor countries. Hence they are poor! Fourth, flaw in comparative cost advantage theory is that it assumes that all the factors of production stay within one country. The theory assumes that when export demand favors one product over another, businesses easily change from producing one product to producing another. But, factor markets today are international for capital and not for land or labor: Capital can cross national boundaries easily while labor cannot. When capital crosses national boundaries, then production is moved to the lower cost country; employment increases in the foreign country instead of moving to another business within the same country. Employment and welfare in the higher cost country is reduced; consumers and producers in the higher cost country suffer. This is exactly what happens with out-sourcing, plant relocation in favour of cheap-labour countries like India and China. Further, trade reduces consumer and producer welfare in at least one country when one or more of the factors of production are able to cross national boundaries and others cannot. Land is absolutely immobile and labor is mostly immobile; perhaps it is time to recognize that this theory does not have universal application. Fifth drawback is the **transportation cost**. Ex-factory cost is not to be the basis, rather delivered cost should be the basis of comparative cost. Finally, the theory deals with products and not services. The **exclusion of services**, when services are more traded across borders, is a limitation of the theory.

Evaluation of the theory: It must be noted that the theories of absolute and comparative cost advantages are only pinpointing the broad contours of economic activities and do not thrust 100% specialization on each nation.

NOTES

1.5.1.5 Heckscher-Ohlin Theory of Factor Proportion

Heckscher-Ohlin Theory was first developed by Eli Heckscher (1879-1952) in 1919. Later it was tuned by fellow Swedish economist Bertil Ohlin (1899-1979) in 1933. The Heckscher-Ohlin trade theory is a theory to explain the existence and pattern of international trade based on a comparative cost advantage between countries producing different goods. Heckscher and Ohlin state that this advantage exists because of the relative resource endowments of the countries trading.

Mechanism of the theory: The Heckscher-Ohlin theory presents that international trade occurs because of the differences in the supply of production factors. Those goods that require a large amount of the abundant factor, thus the less costly factor, will have lower production costs, enabling them to be sold for less in international markets. Countries such as Australia with relatively large amounts of land do export land intensive products (eg, grain and cattle) whereas a country like India or China with abundant labour would export labor intensive products like call-centres, toys, textiles and the like.

Factor proportion decides the product to be exported. If labour is abundant in regard to capital, labour intensive goods will be cheaper and would be exported and if capital is abundant in relation labour, capital intensive products would be exported. Similarly, if land is abundant in regard to labour, land-intensive products like wheat or wool would be cheaper to produce and export and if labour is abundant in regard to land, labour intensive products like toys or handi-crafts would be cheaper to produce and export. How is the abundance of one or the other factor determined? This isestablished either through relative prices or relative ratio of physical quantities. In the price route, through isoquants and factor price ratios, the abundant resource is identified. Steep slope or shallow slope of price lines decides which resource is abundant in which country. Through physical quantity route, if the inequality, $K_A/L_A > K_B/L_B$ holds country A is capital rich and B is labour rich and vice versa.

Merits of the Heckscher-Ohlin theory: Cost advantage theories of Adam Smith and Ricardo did not tell the products in which countries will have cost advantage. Their assumption was that the market mechanism will direct the producers choosing the products in which they would excel. But market isn't free always or efficient. This problem is sought to be answered by Heckscher-Ohlin. Product that depends on abundant resource will be cheaper.

Limitations of the Heckscher-Ohlin theory: First limitation arises from the assumptions of the theory. One assumption is that the prices of the factor depended only on the factor endowment or its supply in relation to demand. This is however untrue as **factor prices are not set in a perfect market**. There are such factors to consider such as legislated minimum wages and benefits force the cost of labor to rise to a point greater than the value of the product than many workers can produce. **Second limitation** is that,

NOTES

when a product can be produced by either cpital or labour, the theory could not forward the way direction of trade and composition of trade can take place. In Canada capital intensive method is followed for wheat cultivation and in India labour intensive method is followed for the same. Will India or Canada export wheat? The answer depends on cost contours in respective contexts. **Third limitation** is that **how to ascertain factor endowments**? In terms of price ratios or in terms of physical quantity? **Fourth limitation** is that like other earlier theorists, Heckscher-Ohlin, also **assumed factor immobility.** That is not at true now. Finally, **what is efficient production**? Is it same as cheaper production? No. Money cost and real cost are always different. A country despite having a resource in abundant, may not be releasing the same for full exploitation with the intention of preserving it for future requirement.

Leontief paradox and Heckscher-Ohlin theory: Many economists attempted to disprove the Heckscher-Ohlin theory. The Russian-born American economist Wassily Leontief (1906-1999) in 1954 examined US foreign trade and found that US exports were more labor intensive and imports were more capital intensive (the Leontief paradox), though USA is capital rich and labour deficient country. This paradox, however, failed to empirically validate the country based Heckschler-Ohlin theory. Because it is not the physical quantity, but the capability quantity of the factors in questions that counts in reality. American labour is more capable; hence America's export might have been labour intensive products.

Evaluation: One important conclusion of Heckscher-Ohlin was that international trade is but a special form of inter-regional trade and that the myths that go with international trade are simply deflated. The theory sets the basic tenets of international trade in specific products as such.

1.5.1.6 country similarity theory

Country similarity theory was developed by a **Swedish economist named Steffan Linder**. Country similarity refers to what? Is it similarity of location or culture or political/ economic interests or technological capability (that is acquired advantage) or natural advantage or lack of it? Traditional theories speak of difference in demand or supply conditions or both as a necessary condition for trade between countries. That is, the traditional theories are built upon differences. But the similarity theory is built of identical features of nations in trade. 8 out of top 10 trading partners of the USA are developed economies. Globally 11 out of 12 largest players in world trade are developed nations.

Developed countries trade more with developed countries: Products of a developed country match demand and user conditions of another developed country only. Hence the similarity in development pace decides trade between countries. The reasoning is that a developed country introduces a new product and similarly developed countries find the product quite useful and hence go for the same. This is because needs become more or less common in countries with similar levels of development. The industrialized

NOTES

countries produce more; hence people's spend power is high; the power is apportioned between domestic and foreign goods, both of course catering to similar need satisfaction.

Countries in same cultural milieu trade more amongst themselves: Countries in same cultural milieu will have similar demands as for as cultural products/services like family functions, rites, rituals, entertainments, religious ceremonies and so on. Cross country offerings are more. Countries with no similarity either by cultural, technological or other basis may not trade. While countries in the northern hemisphere trade intensively inter se, countries in the southern hemisphere do not trade intensively. The pointed out reason is that no historic ties amongst the countries. Perhaps the traders do not want to taste new shores.

Countries in similar geo-features trade inter se more: Countries in similar geo-features like ecological or climatic factors will mutually cater to cross border demands. A kind of cross-border monopolistic competition emerges with firms vying for cross-country market share with the thrust on product differentiation.

Countries with similar political and economic interests trade more inter se: Trade between countries with similar political and economic interests is more common than between countries that differ. Cuba and US are in the same continent, but due to political ideological differences they scarcely trade for over 5 decades. Cuba is a good source of supply of sugar. But US prefers not to taste Cuban sugar. EU countries amongst themselves pulled down all protectionist impediments to trade and intra-regional trade is highest, because they have similar geo-features.

Intra-industry trade abetted by similarity factor: Similarly placed countries' capabilities as well as needs happen to be similar. So, quite a lot of intra-industry trade among these similarly placed countries happens. US exports good lot of road vehicles and imports much road vehicles as well too. Needs are same across the nations. Offerings are also same across the nations, but product differentiation is built through top gear promotion. Intra industry trade happens because of sheer dispersed desire for foreign brands. Intra-industry trade accounts for approximately 40 per cent of world trade.

Steffan Linder believed that international trade of manufactured goods occurred between countries at the same stage of economic development that shared the same consumer preferences. Therefore the country similarity theory consists of the value that most trade in manufactured goods should be between nations with similar per capita income, and that intra industry trade in manufactured goods should be common.

1.5.1.7 International Product Life Cycle Theory (IPLC)

A new product progresses through a sequence of stages from 'introduction' to 'growth', to 'maturity' and finally to 'decline' stage. This sequence is known as the product life cycle (PLC) Each stage depicts a different marketing situation requiring different

NOTES

marketing strategy and the marketing mix. As a prelude to IPLC, PLC as such is briefly presented. **But in the end you will find that PLC and IPLC are not that similar to have near similar names.**

Product Life Cycle (PLC) indicates that products have four things in common: (i) they have a limited lifespan; (ii) their sales pass through a number of distinct stages, each of which has different characteristics, challenges, and opportunities; (iii) their profits are not static but increase and decrease through these stages; and (iv) the financial, human resource, manufacturing, marketing and purchasing strategies that products require at each stage in the life cycle varies (Kotler and Keller, 2006). PLC has four stages namely introduction, growth, maturity and decline. The marketing mix variables distinctly vary in these stages. The same is presented below.

Introduction Stage: In the stage, the firm seeks to build product awareness and develop a market for the product. Market crystallization takes place now through product branding and quality definition. Intellectual property protection such as patents and trademarks are obtained. Penetration pricing to build market share rapidly, or high skim pricing to recover development costs is followed depending on market, competitive and cost conditions. Distribution is selective until consumers show acceptance of the product. Promotion is aimed at innovators and early adopters. Marketing communications seeks to build product awareness and to educate potential consumers about the product. The product is said to be a question mark or problem child.

Growth Stage: Successful introduction launches the product into the growth orbit. During the growth stage, profit growth rate outsmarts sales growth rate; both rates outsmart the respective figures of the introduction stage. The firm seeks to build brand preference and increase market share. Product quality is maintained and add on features and support services are added. Pricing is either maintained or small change may be initiated depending on competition. Wider distribution is followed demand increases and customers accept the product. Promotion is aimed at a broader audience. The product is said to be a star.

Maturity Stage: At maturity, the strong growth in sales diminishes; a little later sales peaks, but rate of growth in sales reaches plateau.. Competition appears with similar products. The primary objective at this point is to defend market share while maximizing profit. Product enhancement, brand extension, etc are tried to differentiate the product from that of competitors. Pricing lowering is resorted to ward off new competitors and counter the existing competition from gaining further ground. Intensive distribution and incentives to channel partners may be offered to push the products to customers. Promotion emphasizes value for money, service network and brand and product distinctions. The product is referred to as a cow.

NOTES

Decline Stage: The hey days are over. As sales decline, the firm has several options. Rejuvenate the product, by adding new features and finding new uses. The price may be maintained with the new features packed into. If all this does not work, harvest the product or divest by disposing off the facilities. Discontinue the product, liquidating remaining inventory or selling it to another firm that is willing to continue the product. In this context the product is referred to as 'dog' to be shown the door out.

The **International product life cycle theory** developed in the late 1960s by **Raymond Vernon** and his associates, particularly, **Louis Wells** is a significant contribution to international trade. Vernon's hypothesis was an attempt to advance the trade theory beyond the static framework of the comparative advantage of David Ricardo and other classical economists. It explored hitherto ignored or unexplained areas of international trade theory such as timing of innovation, effects of scale economies and the role of uncertainty and ignorance in trade patterns. Raymond Vernon, attempting to explain patterns of international trade, observed a circular phenomenon in the composition of trade between countries in the world market. Advanced countries, which have the ability and competence to innovate as well as high-income levels and mass consumption become initial exporters of goods. However, they lose their exports initially to developing countries and subsequently to less developed countries and eventually become importers of these goods. The theory generally applies to established companies in industrialized countries who expand their product range.

The theory is broken up into five major stages namely **Release, Export, Foreign Production, Foreign Competition in export market and Import Competition in Home Market.** These stages of the IPLC are dealt now.

Release in the home market: As competition tends to be fierce, producers are forced to search constantly for better ways to satisfy their customer needs. The core elements in new product design are gained from customer feedback from previous models. Once the product enters the domestic market and begins to create a positive reputation, the demand increases and hence we come to an end of the first stage of the IPLC.

Export to the foreign markets: As the product receives positive customer response, the international demand for the product begins. The manufacturer begins exporting to increase its market share. An example of this was the personal computer (PC) craze of the early 80's. In 1985, 55,000 PCs were sold in the United States, by 1984 the industry had experienced a 136-fold increase to 7 million PCs (Richter-Buttery, 1998).

Produce in the Foreign markets: As demand increases with the new global market, it becomes economically feasible to begin local production in various nations. By sharing technology on the manufacturing of the product, the company has lost an advantage. The end of this stage signifies the highest point in the International Product Life Cycle Theory.

NOTES

Foreign Competition in exports markets: This is a threatening stage for the company. Local manufactures have gained experience in producing and selling their product, hence their costs have fallen. As they have saturated their initial market, they may begin to look elsewhere (ie. other nations) to promote their product. The reason that this is threatening for our company is that this other nation may have a competitive advantage and this places stress on our market share.

Import Competition in the Home Market: If the competitors have a competitive advantage, or they reach the economies of scale needed, they will enter the original home market. At this stage the competitors will have a quality product which will be able to undersell the original manufactures. Eventually they will be pushed out from the market and imports will supply the home nation. Eventually, as the product's technology becomes more renowned, developing nations will enter the market. This will begin the International Product Life Cycle again, as these nations have a competitive edge with their low labour costs. 'With future innovations and new products and services the eventuality is that it's value and hence its price is likely to diminish'.

Merits of the IPLC theory: The IPLC theory well captures the stages of competition that a product faces as it takes its global sojourn. Initially it smashes everyone, but in the later stages it gets edged out even in its home turf.

Demerits of the IPLC theory: The IPLC theory does have its disadvantages. Perhaps the most recognizable is the assumption that products are released initially in the domestic markets. Many globalised companies tend to release their new product lines internationally, not domestically, hence this theory cannot be applied to many of today's products. It seems the an ideal alternative name to the theory is International Competitive Life Cycle (ICLC).

1.5.1.8 Trade Theory of Country Size

Country size has some definite relation to international trade as to what is traded, how much is traded and so on. The classical theories do not go into country-by-country differences in size to deal with the lines of specialization. When a small and big country are involved, the small country may be pushed into specialization, but not the big one for all its need for the other product can't be produced by the other small country, nor that small country take all export surplus of the big nation resulting from specialization. Thus a nexus exists between global trade and country size.

Vastness of Country size and Variety of Resources go together: Size of a country is measured by the geographical space here. Big countries have vast space and hence more and diverse resources. With that they could be self reliant. Considering their size, their exports and imports are less as against those of small countries with fewer resources. Big countries like India, China, Brazil, etc import much less portion of their

NOTES

consumption and export much less portion of their production as against small countries like the Netherlands, Iceland, Uruguay, Singapore, Taiwan, Dubai or Oman. Much of this situation is explained by the fact vast countries have diverse resources and small ones have fewer.

Vastness of country size and High transport cost go together, reducing global trade: Cost advantage theories conveniently ignored transport cost to international markets. For small countries in trade relations, transport cost to international borders and from there to international markets is lower. For big countries in trade relations, transport cost to international borders and from there to international markets is higher. For most production and market locations in US, the average distance to any market or production locations in Mexico or Canada is more than 100 miles. For most production and market locations in the Netherlands, the average distance to most of its overseas market or source locations is less than 100 miles. Netherland prefers to have more international trade as the transport cost is lower.

Vastness of Economy and International Trade go together: Instead of physical space, size can be measured by the GDP and Per-capita income. Normally big ones tend to trade more internationally, because they can cater to international consumers as they have technology and can import more as well as they long pockets to pay for the same as well.

Long-production runs and international trade go together: Products with longer production runs are generally produced in fewer countries/locations than those with shorter production runs, which are produced in many countries/locations. The former need to be traded globally, while the later gets consumed within the domestic market. Steel is globally traded more because of its longer production run, while soft-drinks are just domestically traded as these have shorter production run. Usually products with long-production runs are favoured by vast economies.

1.5.1.8 Trade Theory of Technology Gap

Technology gap theory views technological asymmetries as important long run determinants of trade flows. Moreover, it also captures interactions between trade flows and changes in long run growth patterns and levels of employment.

A model of technology gap was first written by **Josiah Tucker** in the mid-1700s. Tucker was the first writer to posit a "formal" model which made use of dynamic gains from trade in accounting for the evolution of trade patterns. In other words, Tucker developed cumulative causation model of trade in which the gains provided by specialization from trade create new opportunities for further growth and trade.

NOTES

Tucker was profoundly interested in the relationship between the growth of poor countries and that of rich ones such as, his homeland, England. Specifically, several writers had expressed concern that England's export markets would be taken over by poorer countries that could produce goods cheaper because of their lower wages and other costs. Tucker responded with an increasing returns argument that demonstrated the cost advantages of richer countries in the production of the most complex commodities:

The rich country not only has the best tools and technologies, but also the "superior Skill and Knowledge (acquired by long Habit and Experience) for inventing and making of more." Moreover, the rich country need not rely only on the "genius" of its own manufacturers and farmers to maintain this pace of innovation. The high wages, easier access to capital, and greater 'Exertion of Genius, Industry, and Ambition' will cause the best and brightest of the poor countries to emigrate to the rich ones, draining the 'Flower of its [the poor countries] inhabitants'. This brain drain opens 'larger competencies', creates more employment for the natives, helps and improves old manufactures, and sets up new ones; thus impoverishing competitors, and the same time enriching tech. superior'.

The technology gap theory of trade tells that a country that is competitive in the production of the complex goods will rule the global trade and achieve higher level of economic development. Poor countries produce simple commodities cheaply, while the more complex commodities are cheaper in the rich countries. Third world countries because of their technological backwardness are either primary goods exporters or just exporters of ores, while developed countries trade in top end electronic goods, pharmaceuticals, destructive missiles, etc.

1.5.1.9 Trade Theory of Independence, Interdependence and Dependence

Independence – Interdependence – Dependence Theory of Trade tries to read trade patterns and policies of countries based on their degree of independence or dependence or interdependence on rest of the world. See this is a continuum: Independence – Interdependence – Dependence. The polar extremes are Independence at one pole and Dependence at the other. **Independence stops trade, while dependence boosts trade.**

Independence: Independence is being self-reliant. Well one cannot be self-reliant. Yet one country may choose to be independent and the cost of such obstinacy is self-denial of life's luxuries, comforts and necessities that can be afforded without difficulty. It may be a government policy to remain independent. This austerity could cost the country heavily. Hence governments plan independence sans difficulty for citizens. Few countries in the world maintain a vast reserve of essential minerals and even don't touch own oil fields, so that in future if foreign supplies are cut for whatever reason these built/unexplored stocks could be used. Thus a policy of independence hurts global trade patterns for the present and the future.

NOTES

Interdependence: Interdependence is the middle of the continuum. France and Germany are mutually dependent on each other almost to same extent. This level of interdependence leads to more intra-industry trade or more aptly captive trades amongst group concerns (MNCs and Affiliates) in different countries. Too much mutual dependence is also not good when something happens disrupting your supply line.

Dependence: Dependence is being in a state of forced relationship. Here, trade relationship. With skewed resource endowments, countries depend on few products for exports, few countries to trade with and so on. Third world countries because of their technological backwardness are either primary goods exporters or just exporters of ores. Sultanate of Oman depends too much on one product, Oil and Gas, as its prime export revenue source. Of course emerging economies depend on few products and few markets for their exports and imports as well. Among the developed nations, one nation that makes major portion of its export revenue (>25%) from a primary product, fish, is Iceland. Again one developed country, Canada, depends so much on one country, the USA, for over 50% of its exports. Similarly, Mexico depends on the USA for over 60% of its foreign trade. But the USA's dependence on Mexico for trade is just 10%. So, USA's policy on trade will affect Mexico, but Mexico's policy will not affect the USA. That is the disadvantage of too much dependence.

1.5.1.11 Porter's Theory Of National Competitive Advantage/Porter's Diamond

Michael Porter's book, 'The Competitive Advantage of Nations', published in 1990, based on a study of 100 firms in 10 developed nations was a landmark work on corporate strategy making on the competitive sphere. Porter develops a new theory of how nations, states, and regions compete and their sources of economic prosperity.

How Switzerland, a nation with few natural resources, is a world leader in the production of chocolates? How Japan, a country whose economy was in shambles after World War II, is now a global leader in making low cost, mass-produced, quality, high-technology products? Number of factors go beyond natural resources. Some of them are: a sizeable demand from sophisticated consumers, an educated and skilled workforce, intense competition in the industry, and the existence of related and supporting suppliers, government policies and demand conditions.

First, Porter argues that companies should be 'participating in national markets with the strongest rivals and most demanding customers, in order to build 'international competitiveness'. As a company faces more competition, it strives to make themselves more efficient in order to have an edge over their competitors and maximize profits. Yes, competition is the driving force of engine of success. The factors most important to competitive advantage in most industries, are not inherited but are created within a nation, through processes that differ widely across nations and among industries. When a new firm emerges in one country, domestic suppliers start competing for business. Thus through

NOTES

this competition, quality is bound to increase and prices will decrease which in turn reinforces and gives the industry a competitive advantage in the international market. The pattern of competition at home also has a profound role to play in the process of innovation and the ultimate prospects for international success. A firm's strategy and competition in domestic market shapes its performance in the international market. In some cases strategies used in the domestic market can be applied internationally with little or no modifications. However, sometimes it is not so easy.

1.5.1.12 Global Strategic Rivalry Theory

The Global Strategic Rivalry theory was developed in the 1980s as a means to 'examine the impact on trade flows arising from global strategic rivalry between Multi National Corporations.' It explores the notion that in order to stay viable, firms should exploit their competitive advantage globally and try to keep it sustainable. There are many ways in which a firm can hold a competitive advantage, these include; Owning intellectual property rights, Investing in research and development, Achieving economies of scale or scope, Exploiting the experience or learning curve, Forging strategic alliances and Strategic mergers and acquisitions.

Owning intellectual property rights: Intellectual property laws confer a bundle of exclusive rights in relation to the particular form or manner in which ideas or information are expressed or manifested, and not in relation to the ideas or concepts themselves. The term "intellectual property" denotes the specific legal rights which authors, inventors and other IP holders may hold and exercise, and not the intellectual work itself. Owning intellectual property rights boosts one's worth. Thomas Alva Edison, nicknamed as, "The Wizard of Menlo Park," had amazing inventive talent. Over his lifetime, more than 1,300 patents were issued in his name, far more than have been credited to any other individual in American history. Patents are there for crazy inventions as well like this one: A device for protecting the ears of animals, especially long-haired dogs, from becoming soiled by the animal's food while the animal is eating. Ok, your pet might look better without dirty hair, but it's going to look pretty dumb wearing this thing! Apart joke, the essence is that firms with more patents competes effectively and edges out the smaller competitors. Table 1.8 gives the patents issued by US Patents & Trademark Office to top 10 Patentees in 2004. World IT leader, IBM is on the top. The next is Matsushita Electric Industrial Co., Ltd., with 1300 patents less than IBM. It is this difference which works as strategic rivalry.

Investing in research and development: Investment in research and development is the surest way to reach the top of invention, innovation and patent ownership. Thomas Alva Edison said, Genius = 1 percent inspiration + 99 percent perspiration. He encouraged all people to offer hard work. R&D is perspiration with flash of inspiration. To excel rivals, R&D capability is needed. American firms know this very well. American firms spend around $200 billion on R&D annually, much of it on computing and communications.

NOTES

Microsoft, for example, spent around $6.6 billion last year, 2006; IBM and Intel spent about $6 billion each; and Cisco Systems and Hewlett-Packard (HP) spent around $4 billion each. Most of this money went into making small incremental improvements and getting new ideas to market fast. IBM, GE and MS are leaders in their chosen field because of their R&D commitments.

Table: 1.8 No. of Patents issued by US Patents & Trademark Office to top 10 Patentees

Rank 2004	No. of Patents 2004	Company
1	3248	International Business Machines
2	1,934	Matsushita Electric Industrial Co., Corporation
3	1,805	Canon Kabushiki Kaisha Ltd.
4	1,775	Hewlett-Packard Development
5	1,760	Micron Technology, Inc. Company
6	1,604	Samsung Electronics Co., Ltd.
7	1,601	Intel Corporation
8	1,514	Hitachi, Ltd
9	1,310	Toshiba Corporation
10	1,305	Sony Corporation

Source: Website of US Patents & Trademark Office

IBM, world leader in IT, has eight laboratories on three continents, each with its own personality and expertise. At its Zurich Research Laboratory around 300 scientists representing over 20 nationalities concentrate on areas such as microelectronics, nanotechnology and computer security. Researchers are judged on the basis of patents and papers. IBM knows it must add intellectual property to its offerings.

Starting with his invention of the light bulb, Thomas Edison ignited General Electic's (GE) spirit of innovation and discovery. By 1978 itself GE was first to reach 50,000th patent. GE has more than 3,000 of the best and brightest researchers spread out at four multi-disciplinary facilities around the world. Headquartered in Niskayuna, New York, it also has facilities in Bangalore, India; Shanghai, China; and Munich, Germany. It is delivering the innovations and breakthroughs that are driving growth for GE's businesses and revolutionizing markets. It believes in, 'imaginations = innovations'. Innovations come from most unlikely sources often. A sea-shell can help lower energy cost; a butterfly can help enhance security in subway stations; a lotus leaf can help reduce delays in airports. How?

NOTES

Through nano-technology; that is the unlikely source. That is what R&D can do, GE has learnt.

Microsoft Research houses 400 researchers in Redmond, Washington. It boasts another 300 around the world. Nearly all of its budget is spent on commercially orientated projects. In the real world, it is not just a big ‘D’ and a big ‘R’—it’s a continuum. The company performs basic research. But Microsoft also works with its product teams to move those technologies into its products. Microsoft has a team of a dozen people whose sole responsibility is to handle technology transfer. Sometimes researchers move from the laboratories to work with product teams. Thus these successful companies invest in R&D to grow strategic in a world full of rivals vying to outwit others.

Achieving economies of scale or scope: Achieving economies of scale or scope is in fact leveraging your existing strengths. Scale economies help reduce cost, pass the benefit to consumers and expand market share. It is very important that your capacity is fully utilized. To use its excess capacity of printing and distribution, The Hindu group of Chennai launched a Business daily, The Hindu Business Line in 1994. Today it is a great success. The launch is a good example of ‘Achieving Economies of Scale and Scope’ that few rivals can match.

Exploiting the Learning Curve: Learning curve refers to a relationship between the duration of learning or experience and the resulting progress. A cognitive psychological concept, Learning Curve, over time the phrase has acquired a broader interpretation, and expressions such as “experience curve”, “improvement curve”, “cost improvement curve”, “progress curve”/”progress function”, “startup curve”, and “efficiency curve” are often used interchangeably, depending on the context. Businesses that use learning curve excel well as they learn to cut cost and add value faster than other and outsmart competitors. A company can reduce overall unit cost by 20 to 30% each time it doubles output, if learning curve effect works well. So, if the first unit costs $ 1000, the next costs $ 700 to $ 800, the fourth unit costs $ 490 to $ 640 and so on. A host of factors, like rectangle- hyperbolic fall in fixed cost of production per unit, rise in dexterity levels and nuances of handling shop-floor issues, quantity discounts on purchase owing to large volume orders, etc help reduce cost per unit. Such cost advantages would threaten new entrants. So cost leadership results from learning curve effect which could be a strategic advantage.

Strategic Alliance: A Strategic Alliance is a formal relationship formed between two or more parties, usually those in the same business line (i) as horizontals competing with each other in the same or different geographies or (ii) as verticals serving each other in complementary mode, to pursue a common goal or meet a critical business need while remaining independent organizations. One alliance partner might bring products, distribution channels or manufacturing capability and the other project funding, capital equipment, knowledge, expertise, or intellectual property. The alliance’s emphasis is ‘synergy’ and

NOTES

‘competitive advantage’. A good example of strategic alliance, is the alliance between **Qantas** and **British Airways.** Qantas is the largest private airline in Australia and has solid air route throughout the Asia Pacific region, likewise British airways had strong network within Europe, North Atlantics, and North America. By forming an alliance in 1993, both companies strategically positioned themselves to have a strong worldwide network. **Microsoft and Nortel** announced a strategic alliance based on a shared vision for unified communications in 2006. By engaging the companies at the technology, marketing and business levels, the alliance will allow both companies to drive new growth opportunities and has the potential to ultimately transform businesses communications, reducing costs and complexity and improving productivity for customers.

Mergers and Acquisitions: The strategy of Mergers and Acquisitions, sweeping through the corporate, refers to deals involving buying, selling and combining of different companies that can form a new company to usher in a fast track collective growth. Merger is a tool used by companies for the purpose of expanding their operations often aiming at an increase of their long term profitability. An acquisition, also known as a takeover, is the buying of one company (the ‘target’) by another. An acquisition may be friendly or hostile. A smaller firm may also acquire a larger or longer established company and keep its name for the combined entity. This is known as a reverse takeover. Globally, mergers totaled a record $4.38 trillion in 2007, up 21 percent from 2006. Despite a sharp decline in deal-making at mid-year, merger volume in 2007 hit a record $1.57 trillion in the United States, up 5.5 percent from the previous year, according to research firm Thomson Financial. But, for the first time in five years, U.S. lagged deal-making in Europe, where mergers totaled $1.78 trillion. In fact, Year 2007 saw the biggest buyout frenzy since 2000, as 42 FORTUNE 1,000 corporations were acquired. Biggest of all deals was the AT&T’s acquisition of Bellsouth at $ 101.8 billion, followed by ConokoPhilip’s acquisition of Burlington Resources at $ 35.0 billion, followed by Boston Scientific’s acquisition of Guidant at $ 25.1 billion and so on. These 42 deals alone added up to $ 375 bn.

1.5.2 Theories of International Investments

International investments mean investments beyond borders. International investments refer to investments by entities of a nation in nations other than their own. Foreign investments involve export of capital. The opportunity for International investments is directly emanating from economic reformist policies adopted by most of the countries of the world including centrally planned and command economies. Liberalization, Privatization and Globalization (LPG) are vigorously pursued by the countries giving an up-thrust on investment opportunities.

Broadly there are two types of foreign investment, namely, foreign direct investment (FDI) and foreign portfolio investment (FPI). FDI refers to investment in a foreign country where the investor retains control over the investment. It typically takes the form of starting

NOTES

a subsidiary, acquiring a stake in an existing firm or starting a joint venture in the foreign country. Direct investment and management of the firms concerned normally go together. If the investor has only a sort of property interest in investing the capital in buying equities, bonds, or other securities abroad, it is referred to as portfolio investment. That is, in the case of portfolio investments, the investor uses capital in order to get a return on it, but has not much control over the use of the capital.

FDIs are governed by long-term considerations because these investments cannot be easily liquidated. Hence, factors like long-term political stability, government policy, industrial and economic prospects, etc., influence the FDI decision. However, portfolio investments, which can be liquidated fairly easily, are influenced by short-term gains. Portfolio investments are generally much more sensitive than FDIs to short term uncertainties.

Foreign investment and foreign trade are related. 60 - 70 % of world trade is directly or indirectly connected to FDI. 50 % of world trade is either within the same organizational entity (intra-firm trade) or between parties which engage in co-operative relationship.

1.5.2.1 Types of theories of International investment

The theories of international investment seek to explain the reasons for international investment. Theories of international investment can essentially be divided into two categories: **Micro (industrial organization) theories** and **Macro (cost of capital) theories.**

The **micro economic** orientations differed between the earlier and subsequent literatures. The early literature that explains international investment in micro economic terms focuses on **market imperfections, and the desire of multinational enterprises to expand their monopolistic power**. Subsequent literature centered more on **firm-specific advantages owing to product superiority or cost advantages, stemming from economies of scale, multi-plants economies and advanced technology, or superior marketing and distribution** According to this view, multinationals find it cheaper to expand directly in a foreign country rather than through trade in cases where the advantages associated with cost or product are based on internal, indivisible assets based on knowledge and technology. Alternative explanations for international investment have focused on regulatory restrictions, including tariffs and quotas that either encourage or discourage cross-border acquisitions, depending on whether one considers horizontal or vertical integrations.

Studies examining the **macro economic effects** of exchange rate on international investment centered on the positive effects of an exchange rate depreciation of the host country on international investment in-flows, because it lowers the cost of production and investment in the host countries, raising the profitability of foreign direct investment. The wealth effect is another channel through which a depreciation of the real exchange rate

NOTES

could raise international investment. By raising the relative wealth of foreign firms, a depreciation of the real exchange rate could make it easier for those firms to use retained profits to finance investment abroad and to post a collateral in borrowing from domestic lenders in the host country.

1.5.2.2 Specific theories of International investment

Now certain specific theories of international investments be considered.

i **Theory of Capital Movements:** The earliest theoreticians, who assumed, in the classical tradition, the existence of a perfectly competitive market, considered foreign investments as a form of factor movement to take advantage of the differential profit. The validity of this theory is clear from the observation of the noted economist Charles Kindleberger that under perfect competition, foreign direct investment would not occur and that would be unlikely to occur in a world where in the conditions were even approximately competitive.

ii **Market Imperfections Theory:** One of the market imperfections approach to the explanation of the foreign investments is the ***Monopolistic Advantage Theory*** propounded by Stephen in 1960. According to this theory, foreign direct investment occurred largely in oligopolistic industries rather than in industries operating under near perfect condition. Hymer suggested that the decision of a firm to invest in foreign markets was based on certain advantages the firm possessed over the local firms (in the foreign country) such as economics of sale. Superior technology or skills in the fields of management, production, marketing and finance. Kindleberger also argued that market imperfections were the basis of foreign investment. The Market Imperfections Theory does not answer several questions related to the foreign investment. For example, why does a firm prefer foreign investment to other alternative market entry modes like exporting, licensing, franchising etc.?

iii **Internationalization Theory:** According to the Internationalization Theory, which is an extension of the Market Imperfection Theory, foreign investment results from the decision of a firm to internalize a superior knowledge (i.e., knowledge within the firm to maintain the competitive edge). For example, if a firm decides to externalize its know how by licensing a foreign firm, the firm (the licensor) does not make any foreign investment in this respect but, on the other hand, if the firm decides to internalize it may invest in production facilities. Methods of Internalization include formal ways like patents and copy rights and informal ways like secrecy and family networks.

iv **Appropriability Theory:** According to Appropriability Theory, affirm should be able to appropriate (to keep for its exclusive use) the benefits resulting from a technology it has generated. If this condition is not satisfied, the firm would not be able to the cost of technology generation and, therefore, would have no incentive for research and

NOTES

development. MNCs tend to specialize in developing new technologies which are transmitted efficiently through their internal channels. It is obvious that the Appropriability Theory is similar to internalization theory in terms of creating an internal market (internal channel) for exploiting the firm's specific advantages.

v **Location Specific Advantage Theory:** The Location Specific Advantage Theory suggests that foreign investment is pulled by certain location specific advantage. According to Hood and Young, there are four factors which are pertinent to the Location Specific Theory. They are:Labour costs, Marketing factors (like market size, market growth, state of development and local competition)**,**Trade barriers and Government policy. The above factors have, of course, very important bearing on foreign investment. However, there are also other factors like cultural factors which influence foreign investment. Further, it is the total cost, and not labour cost alone, that is important.

vi **International Product Life Cycle Theory:** According to the Product Life Cycle Theory developed by **Raymond Vernon and Lewis T. Wells**, the production of a product shifts to different categories of countries through the different stages of the product life cycle. According to this theory a new product is first manufactured and marketed in a developed country like U.S. (because of favourable factors like large domestic market, entrepreneurship and ease of organizing production). It is then exported to other developed markets. As competition increases in these markets, manufacturing facilities are established there to cater to these markets and also export to the developing countries. As the product becomes standardized and competition further intensifies, manufacturing facilities are established in developing countries to lower production costs and due to other reasons. Competition in foreign markets heats up. Later the developed country markets may also be serviced by exports from the production units in the developing countries and that import competition in the home market threats the market share therein.

vii **Electric Theory: John Dunning** (1993) has attempted to formulate a general theory of international production by combining the postulates of some of the other theories. It is generally accepted that Dunning's ownership–location–internalization (OLI) framework (ownership-specific advantages, locational factors, and internalization) is most useful in analyzing and explaining FDI. According to Dunning, foreign investment by MNCs, results from three comparative advantages which they enjoy, viz, Firm specific advantages, Internationalization advantages and Location specific advantages.

Firm specific advantages results from the tangible and intangible resources held exclusively, at least temporarily, by the firm and which provide the firm a comparative advantage over other firms. The Firm specific advantages would not result in foreign investments unless the firm internalizes these advantages. Even when a firm internalizes its exclusive resources it may be able to serve a foreign market without foreign investment, for

NOTES

example by exporting. Therefore, for the production to take place in the foreign country there should be some location specific advantages.

One important deficiency of the Electric Theory is that it does not explain the foreign investment for acquisitions which have become a very important route to internationalization. The prevalence of networking in inter-firm and intra-firm trade demonstrated by the Hong Kong experience does not undermine the OLI framework in any significant way. Indeed, networking is a form of internalizing the cross-border market in intermediate products to minimize transaction costs. Complete internalization occurs in such cases as the parent–affiliate relationship and the inter-affiliate relationship in the same group. Inter-firm networking is something of greater interest because it represents only partial internalization.

viii Oligopolistic Reaction Theory: According to the theory of Oligopolistic Reaction and Multinational Enterprises, when one firm, especially the leader in oligopolistic industry, entered a market, other firms in the industry followed as a defensive strategy, i.e., to defend their market share from being taken away by the initial investor with the advantage of local production. Graham noted that there was a tendency for across advantage by European and American firms in certain oligopolistic industries. When American firms invested in Europe, the European firms to foreign firms retaliated by investing in America and vice versa, this was mostly a retaliatory strategy. There are also other reasons for investment like following the customer (for example, Japanese and European investment in Silicon Valley.)

QUESTIONS TO CONTEMPLATE AND DELIBERATE

Q 1.5.a Present a brief explanation of the different theories of international trade.

Q 1.5.b What are the basis, merits and demerits of cost advantage theories of global trade?

Q.1.5.c Discuss the basis of presentation of Heckscher-Ohlin theory of factor proportion and the paradoxes associated therewith.

Q 1.5.d. Examine the propositions of country size, country similarity and country independence- dependence continuum theories of international trade.

Q 1.5.e Explain the bases of argument of International PLC and Porter's Competitive Advantage theories of international trade.

Q 1.5.f Explain the lines of argument of the Strategic Rivalry and the Technological gap theories of international trade.

Q 1.5.g Explain the different theories of international investment? Pick out any two most important ones.

NOTES

1.6 FORMS OF INTERNATIONAL BUSINESS

International business can take different forms. The choice of form is very important. The desire to be close the market, the need for 'do it yourself', tariff barriers, risk diversification and increased potential to reach other neighbouring markets in due course will make a firm choose ownership forms. In the absence of these requirements, non-ownership forms may be followed.

Table 1.9 gives a brief sketch of the same. And these are explained briefly below.

Table 1.9 International Business Forms

Forms of International Business		
Modes	**Functions**	**Overlying Alternatives**
Non-Ownership forms: Merchandize Export, Import and counter trade, Service Export and Import, Licensing and Franchising, Contract manufacturing, Turnkey operations and Management control	Marketing Production Accounting Finance Human Resources	Choice of countries Choice of Controls Choice of Instruments Choice of Personnel Choice of other resources
Ownership forms: Foreign Investment (Wholly owned subsidiaries, Assembly Operations, Joint Ventures, Strategic Alliances, Mergers & Acquisitions, etc)		

Source: The author

1.6.1 Non-ownership forms

Non-ownership forms involve doing international business without ownership interests in the foreign countries concerned. These are (a) Merchandize export, import & counter trade, (b) Service Export and Import, (c) Licensing and Franchising, (d) Contract Manufacturing, (e) Management contracts and (f) Turnkey Contracts. These forms are less risky as pull out is easy in times need.

a. Merchandize Exporting, Importing and counter trade: In economics, exchange of physically tangible goods between countries, involving the export, import, and re-export of goods at various stages of production is referred to trade in merchandize or tangible or

NOTES

visible items. The section of the balance of payments (BOP) dealing with this is called 'balance on trade'. Merchandize trade is distinguished from invisible trade, which involves the export and import of physically intangible items such as services (covering receipts and payments arising from activities such as customer service or shipping, income from foreign investments, etc).

Exporting and importing are the basic and fundamental limbs of international business by a firm. These are the most traditional mode of entering the international market. Resulting international trade has been growing much faster than the world output resulting in greater world economic integration.

i. Exporting is the appropriate strategy when one or more of the following conditions prevail.

i. The volume of foreign business is not large enough to justify overseas production.

ii. Cost of production in the foreign market is high.

iii. The foreign market is characterized by production bottlenecks like infrastructural problems, problems with materials supplies etc.

iv. There are political or other risks of investment in the foreign country.

v. The company has no permanent interest in the foreign market concerned or that there is no guarantee of the market available for a long period.

vi. Foreign investment is not favoured by the foreign country concerned.

vii. Licensing or contract manufacturing is not a better alternative.

Strategic advantages of exporting: Using excess capacity, cost reduction, risk spreading, higher top and bottom lines, leveraging brad equity overseas, exploring possibilities for production overseas, endearing the overseas environment prior to big scale launching, etc important advantages of exporting.

ii. Importing is favoured rather than home production when the following conditions exist:

i. The volume of domestic requirement is not large enough to justify home production.

ii. Cost of production in the home market is high.

iii. The home market is characterized by production bottlenecks like infrastructural problems, problems with materials supplies etc.

iv. The company has permanent interest in the foreign market concerned or that there is a possibility overseas production may be resorted to soon.

NOTES

v. Foreign investment is favoured by the foreign country concerned with tax breaks and other sops.

Strategic advantages of importing: Better quality supplies/components/products, complememting home production/product range, taking up import competition in the home market through cost-effective or quality enhanced imports, spreading risks of supply concerns important advantages of importing.

iii. Counter trade: Counter trade is used as a strategy to increase exports, particularly by the developing countries. Counter trade has been successfully used by a number of companies as an entry strategy. For example, Pepsi Co gained entry to the USSR by employing this strategy. Counter trade is a form of international trade in which certain export and import transactions are directly linked with each other and in which import of goods are paid for by export of goods, instead of money payments. In the modern economies, most transactions involve monetary payments and receipts, either immediate or deferred. As against this, "counter trade refers to a variety of unconventional international trade practices which link exchange of goods - directly or indirectly - in an attempt to dispense with currency transactions".

b. Service Export and Import

Most manufacturing firms indulge in service imports when they hire a foreign cargo ship to export their goods abroad or to bring home an imported machinery or a load of raw materials. Similarly insurance service on export or import cargo get exported or imported depending on whether domestic or foreign insurer is involved. When a firm sends its executives abroad for conference or trade negotiation, service imports are involved when foreign airlines/hotels are used. When a firm brings executive personnel from abroad for conference or trade negotiation to home country, service exports are involved when foreigners use domestic airlines / hotels are used. Thus tourism, transportation, insurance, banking, education, consultancy, etc involve service exports and imports depending on whether foreign exchange is ultimately earned by the firm or spent. Nowadays manufacturing firms themselves have their financial/insurance subsidiaries and that their visible trade transactions give rise to invisible trade actions as well.

c. Licensing and Franchising

Licensing and Franchising, which involve minimal commitment of resources and effort on the part of the international marketer, are easy ways of entering the foreign markets. Under international licensing, a firm in one country (the licensor) permits a form in another country (the licensee) to use its intellectual property (such as patents, trade marks, copyrights, technology, technical know-how, marketing skill or some other specific skill). The monetary benefit to the licensor is the royalty or fees which licensee pays. In many countries, such fees or royalties are regulated by the government; it does not exceed five per cent of the

NOTES

sales in many developing countries. A licensing agreement may also be one of cross licensing, wherein there is a mutual exchange of knowledge and/or patents. In cross0licensing, a cash payment may or may not be involved.

d. Contract Manufacturing

Under contract manufacturing, a company doing international marketing contracts with firms in foreign countries to manufacture or assemble the products while retaining the responsibility of marketing the product. This is a common practice in international business. Contract manufacturing has the following advantages.

The company does not have to commit resource for setting up production facilities.

It frees the company from the risks of investing in foreign countries.

If idle production capacity is readily available in the foreign country, it enables the marketer to get started immediately.

e. Management Contracting

Under the management contract, the firm providing the management know-how may not have any equity stake in the enterprise being managed. In short, in a management contract the supplier brings together a package of skills that will provide an integrated service to the client without incurring the risk and benefit of ownership. Thus, as Kotler observes, management contracting is a low-risk method of getting into a foreign market and it starts yielding income right from the beginning. The arrangement is especially attractive if the contracting firm is given an option to purchase some shares in the managed company within a stated period. Management contract could, sometimes, bring in additional benefits for the managing company. It may obtain the business of exporting or selling otherwise of the products of the managed company or supplying the inputs required by the managed company.

f. Turnkey Contracts

Turnkey contracts mean that the contractor will do all the work needed to fix up a working network for you. All you have to do is ‘open the door’ or ‘Turn the key’ and step into a working system. Turnkey contracts are common in international business in the supply, erection and commissioning of plants, as in the case of oil refineries, steel mills, cement and fertilizer plants etc; construction projects and franchising agreements. “A turnkey operation is an agreement by the seller to supply a buyer with a facility fully equipped and ready to be operated by the buyer’s personnel, who will be trained by the seller. The term is sometimes used in fast - food franchising when a franchiser agrees to select a stone site, build the store, equip it, train the franchisee and employees and sometimes arrange for the financing”. Turnkey project contracting firms have rich experience in the field, provide

NOTES

complete solution – from lay-outing to handing over to production and are the single source responsibility. In Dec 2007, Ericsson has signed turnkey contracts as the total solution provider and prime integrator of Metropolitan Area Networks (MAN) to support the launch of seven digital cities across Greece. Under the agreements Ericsson will supply and install fiber optic telecommunications networks in the municipalities of Agrinio, Chania, Ermoupolis, Ierapetra, Iraklio, Kozani and Rethymno. The networks will initially link municipal buildings, such as the general hospital, town hall, schools and universities.

1.6.2 Ownership or Foreign Direct investments forms

Ownership form involve when the firm decides to own production/distribution facility in the foreign land. Eventually foreign investment gets involved. There are many alternatives like wholly owned subsidiaries, JVs, Strategic alliances, M&A, etc..

a. **Wholly Owned Manufacturing Facilities:** Companies with long term and substantial interest in the foreign market normally establish fully owned manufacturing facilities there. As Drucker points out, "it is simply not possible to maintain substantial market standing in an important area unless one has a physical presence of a producer". A number of factors like trade barriers, differences in the production and other costs, government policies, etc., encourage the establishment of production facilities in the foreign markets.

b. **Assembly Operations:** As Miracle and Albaum point out, a manufacturer who wants many of the advantages that are associated with overseas manufacturing facilities and yet does not want to go that far may find it desirable to establish overseas assembly facilities in selected markets. In a sense, the establishment of an assembly operation represents a cross between exporting and overseas manufacturing. RF Micro Devices, Inc. has established an assembly facility at its Beijing, China, location to provide internal module packaging capabilities. The new facility is expected to help streamline RFMD's manufacturing supply chain and contribute directly to the company's ongoing gross margin improvement plan. RFMD expects to lower its overall manufacturing cost structure, provide for guaranteed assembly capacity and enable cycle time reductions. Cycle time reductions will be driven by both reduced time in transit to third-party suppliers as well as enhanced proximity to handset production, which is increasingly located in Asia. Additionally, by housing its new assembly operations in its existing Beijing facility, RFMD significantly strengthens its position as a one-stop shop for semiconductor assembly, test and tape and reel.

c. **Joint Venture:** Joint venture is a very common strategy of entering the foreign market. In the widest sense, any form of association which implies collaboration for more than a transitory period is a joint venture (pure trading operations are not included in this concept).

NOTES

There are different types of joint ventures. These are as follows:

i **Joint ventures by adoption:** Acquisition of part of the equity in a foreign entrepreneurial company, whereby the foreign company becomes adopted unit of the joint venturer along with the promoter.

ii **Joint ventures by rebirth**: When the foreign partner transfers technology to an ailing domestic business and takes equity stake in the revived business.

iii **Joint ventures by procreation**: A truely new venture is born out of a marriage between the technical and/or market-know how of the partners.

iv **Joint ventures through family ties:** This occurs when suppliers join together with each other or when a manufacturer takes an equity position in a supplier business.

Joint ventures are good as these involve strengths of the partners mingled and magnified and synergies emanate. Joint ventures lead to synergies driven through core-competencies. There are technical, financial, production, marketing and managerial synergies to drive from joint ventures. Multinational companies enter foreign countries through joint venture when a JV is viable, i.e., the local firm's profits under a JV always exceed the corresponding levels under direct FDI. However, when protection of IPRs (intellectual property rights) is important, FDI may be preferred to a JV. This is one of the reasons when IT and Pharma MNCs enter third worlds with poor protection of IPRs, they take a wholly owned subsidiary rather than a JV. Strengthening the IPR regime serves as a priority to induce a JV and with it technology transfer. But sometimes, the host government may press for JV instead a FDI. In the 1980s and 1990s, joint ventures were required by the Chinese government. But now there are no restrictions for most sectors of the manufacturing industry, he said.

d. Third Country Location: Third country location is sometimes used as an entry strategy. When there are no commercial transactions between two nations because of political reasons or when direct transactions between two nations are difficult due to political reasons or the like, a firm in one of these nations which wants to enter the other market will have to operate from a third country base. For example, Taiwanese entrepreneurs found it easy to enter People of Republic of China through bases in Hong Kong.

e. Mergers & Acquisitions: Mergers & Acquisitions (M & A) have been a very important market entry strategy as well as expansion strategy. A number of Indian companies have also used this entry strategy. Mergers & acquisitions have certain specific advantages. It provides instant access to markets and distribution network. As one of the most difficult

NOTES

areas in international marketing is the distribution, this is often a very important consideration for M & A. Another important objective of M and A is to obtain access to new technology or a patent right. M and A also has the advantage of reducing the competition.

f. Strategic Alliance: Strategic alliance has been becoming more and more popular in international business. This strategy seeks to enhance the long term competitive advantage of the firm by forming alliance with its competitors, existing or potential in critical areas, instead of competing with each other. "The goals are to leverage critical capabilities, increase the flow of innovation and increase flexibility in responding to market and technological changes". Strategic alliance is also sometimes used as a market entry strategy. For example, a firm may enter a foreign market by forming an alliance with a firm in the foreign market for marketing or distributing the former's products. A U.S. pharmaceutical firm may use the sales promotion and distribution infrastructure of a Japanese pharmaceutical firm to sell its products in Japan. In return, the Japanese firm can use the same strategy for the sale of its products in the U.S. market. Strategic alliance, more than an entry strategy, is a competitive strategy.

QUESTIONS TO CONTEMPLATE AND DELIBERATE

Q 1.6. a What are the forms of international business? Briefly present the features of ownership and non-ownership forms.

Q 1.6. b Explain the merits and shortcomings of alternative non-ownership forms of international business

Q 1.6. c Explain the features of alternative forms of international business under the ownership or the FDI format

Q 1.6. d What is an international JV? What are its types? Under what circumstances this is preferred to a 100% subsidiary?

1.7 TRADE POLICY

Trade policy contains guidelines for action. Trade policy is the official pronouncement released by the Governments of respective nations periodically containing the priorities, assistances, concessions, preferences, etc for exporters and importers, norms and eligibilities for availing the concessions and assistances, regulations and rules, procedures and documents, etc. In India, trade policy is released once in 5 years, with annual supplements. Trade policy regimes have national priorities in mind, but of late WTO requirements, Regional Trade bloc requirements, etc need to be accounted for.

1.7.1 Agencies in the formulation and implementation Trade policy

Trade policy formulation and implementation remains with the Department of Commerce, in the Ministry of Commerce and Industry, in consultation with other key

NOTES

ministries such as the Ministry of Finance, Ministry of Agriculture, as well as ministries relating to services, and the Reserve Bank of India. Trade policy is formulated and drafted in consultation with State and Union territory governments, industry and farmers' associations, trade bodies, research and academic institutions, and other stakeholders.

The policies are announced for a five-year period, along with annual reviews, in the Foreign Trade Policy (previously known as the Export-Import Policy), which is accompanied by the Handbook of Procedures. The Foreign Trade Policy and Procedures are implemented by the Directorate General of Foreign Trade (DGFT), while advice on tariff and related issues is provided by the Tariff Commission, both based in the Ministry of Commerce and Industry.

Other key departments of the Ministry of Commerce and Industry include the Directorate General of Anti-dumping and Allied Duties, which deals with investigations and recommends action to be taken on anti-dumping and countervailing measures; and the Directorate General of Commercial Intelligence and Statistics (DGCI&S), responsible for collecting, compiling, and disseminating data on trade. Coherence and consistency between trade and other economic policies is maintained through inter-ministerial consultations prior to any key Cabinet decisions on policy.

The Department of Commerce also deals with trade policy relating to plantation crops (tea, coffee, rubber, cardamom, and tobacco), special economic zones, and export promotion and credit guarantee schemes through a number of autonomous bodies and state-owned enterprises (SOEs). The SOEs are the State Trading Corporation of India (STC), STCL Limited, MMTC limited, PEC Limited, Export Credit Guarantee Corporation of India Limited (ECGC), and the India Trade Promotion Organization (ITPO). The STC, STCL, and MMTC are also involved in state-trading activities.

Exports have been a major policy focus in recent years and the Department of Commerce is assisted in this function by several advisory bodies. These include the Board of Trade, reconstituted in 2005 to maintain dialogue with traders and industry to promote exports, and the Export Promotion Board to provide policy and infrastructural support for increasing exports. The Government also, from time to time, sets up ad hoc groups for advice, including on trade and related policies. Dialogue is also maintained directly with industry, through for example, the Chambers of Commerce, including the Confederation of Indian Industry (CII), the Federation of Indian Chambers of Commerce and industry (FICCI) and the Associated Chambers of Commerce (ASSOCHAM). The Internet is also increasingly used for soliciting stakeholders' views and comments when formulating laws or policies.

Although India does not have an independent authority to review government policy, policy is examined on a regular basis through mechanisms such as parliamentary committees. The Comptroller and Auditor General (CAG) of India, who is appointed by the President

NOTES

and is independent of both the Executive and Legislative branches of government, audits government accounts both at the central and state levels, including those of public sector enterprises and individual government programmes. The CAG audits include a report on whether government programmes have achieved their objectives and provided the intended benefits. The reports are presented to the President (or the President's representative in a State) and then referred to parliamentary committees such as the Public Accounts Committee (PAC) or the Committee on Public Undertakings (CPU) who present their findings and recommendations to Parliament. Government policies are also analysed by taskforces and committees established on an ad hoc basis.

1.7.2 Trade Policy Objectives

Trade policy is not as an end in itself, but is a tool to further economic growth and development. The Foreign Trade Policy aims to double India's share of global merchandise trade by 2009, over the 2004 level, and to use trade to generate employment. While exports are a key goal, the Foreign Trade Policy acknowledges the importance of facilitating imports required to stimulate the economy and calls for a simplification of import procedures and reduction of import barriers, and coherence and consistency between trade and other economic policies.

Nevertheless, exports continue to be a key focus. The Government in its Medium-term Export Strategy, issued in January 2002, targeted compound annual export growth of almost 12% over 2002-07, in order to achieve 1% of world exports by 2006-07. The Export Strategy called for, *inter alia*, further rationalization of tariffs, tax rebates, reducing transaction costs, improving export infrastructure, expanding free-trade agreements, and enhancing the use of export promotion programmes to increase exports further. The goal of doubling India's share of global merchandise trade by 2009 is to be achieved, *inter alia*, through further liberalization of controls and simplification of export procedures, and by "neutralizing the incidence of all levies and duties on inputs used in export products based on the fundamental principle that duties and levies should not be exported".

To implement this policy, there are a number of duty-neutralizing schemes. In addition to measures such as the export promotion capital goods scheme, export-oriented units, technology parks, free-trade zones and duty drawback, new schemes have been added. These include sectoral initiatives in agriculture and village industries, handicrafts and handlooms, gems and jewellery, and leather and footwear. By reducing import barriers, through improved and faster customs clearance and reduced or no import duties, it is likely that these schemes are facilitating exports of the targeted products. However, duty forgone from export promotion schemes in 2004-05 was estimated at over Rs 354 billion, suggesting that their cost is high. The new schemes add to the already complex network of measures, which, according to a report by the Planning Commission, resulted in "administrative difficulties in monitoring".

1.7.3 Trade Agreements

NOTES

Trade agreements present the rights, responsibilities, privileges, grievance systems, etc of parties to the trade agreement. These could be multilateral (as with WTO), regional (as with regional trade blocs), bilateral (with the two participating countries). Trade policy of countries actually must reflect the agreements reached under trade policy.

1.7.3.1 World Trade Organization

India is an original Member of the WTO and provides MFN treatment to all Members and other countries. It has accepted the Fourth and Fifth Protocols and is a Member of the Information Technology Agreement. It is not a party to the WTO Government Procurement Agreement (GPA). Like all Members, India is required to make regular notifications on its trade-related laws and measures.

India is an active Member of the WTO. In the current negotiations, it has submitted proposals relating to, *inter alia*, agriculture, **non-agriculture market access** (NAMA), services, disputes, competition policy, trade facilitation, rules, TRIPS, and special and differential treatment. A number of these proposals were made jointly with other Members and in many instances with developing countries, including the G-20, G-33, and NAMA-11 groups. India's position prior to the launch of the Doha Round of negotiations placed emphasis on securing the objectives outlined in the mandated negotiations and the implementation issues raised by a number of developing countries. At the Ministerial Conference in Cancun, in September 2003, and in Hong Kong, China in December 2005, India stressed the need to address agricultural subsidies in rich countries and tariff and non-tariff barriers maintained by these countries on products of export interest to developing countries. India believes that the interests of its 650 million rural poor, who are dependent on agriculture for a livelihood, cannot be jeopardized. It is therefore emphasizing special and differential treatment through proportionately lower overall bound tariff reduction commitments by developing countries, coupled with a special safeguard mechanism and a list of special products vital to ensuring livelihoods and food security of farmers in developing countries.

With regard to NAMA, (NAMA products include fish and fishery products, wood and forestry products, electronics, manufactures, automotive products, machinery, textiles, clothing, leather, chemical products, and mining products) India, along with its coalition partners, believes that: progress must be made on achieving a fair, balanced, and development-oriented set of modalities based on the mandated principles of placing development concerns at the heart of the negotiations; ensuring less than full reciprocity in reduction commitments for developing countries; achieving a comparable level of ambition

NOTES

with regard to agricultural market access; and appropriate flexibilities to manage adjustment costs and address development needs. On services, India seeks increased market access especially through liberalization of professional services trade in modes 1 and 4, while securing a balance in the outcome of commitments across all modes and sectors and the negotiations on domestic regulations. India emphasizes that meaningful and effective special and differential treatment must be integral to the negotiations in accordance with the mandate, and that issues of particular concern to developing countries should be addressed.

Since 2002, India brought complaints with regard to Members' anti-dumping and countervailing measures, rules of origin, and tariff preferences to developing countries in the WTO. It has also been involved in five cases as defendant covering issues relating to the automotive sector, import restrictions, and anti-dumping measures (Table AII.2). In addition, India has been involved as third party in 16 cases brought to the DSB since 2002.

The government, in particular, needs to focus on the services sector. This is an area of dynamic comparative advantage. India need to ensure it has a clear strategy for expansion of trade in healthcare, education and tourism, in addition to IT and ITeS. India needs to seek involvement of the private sector in strategy formulation. In conjunction with the above trade policy measures, complementary policies such as a modern infrastructure network (especially airports and ports), reliable access to water and electricity, flexible labour laws and de-reservation for the small-scale sector need to be in place. Finally, focus on maintaining sound macroeconomic policies, with an emphasis on reducing the overall fiscal deficit is needed.

1.7.3.2 Regional trade agreements

Although India has been a firm supporter of multilateral liberalization, it has also sought out regional trade agreements in recent years. While India continues to attach primacy to the multilateral trading system to improve living standards, it believes that RTAs are building blocks that supplement the gains from multilateral trade liberalization. Since signing the Bangkok Agreement in 1975, India has signed agreements mainly with other developing countries (such as the GSTP) and within the region (SAFTA), and with some of its neighbours. Current negotiations include strengthening regional ties, for example, through the South Asian Association for Regional Cooperation and the BIMST-EC, but India is also seeking to develop ties with other regional groupings, such as ASEAN and MERCOSUR. Recent trade agreements, including with Singapore, go beyond negotiations on goods, to include services and investment.

i. South Asian Association for Regional Co-operation (SAARC)

The SAARC, an agreement for regional cooperation among Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka, was established at the first SAARC

NOTES

Summit in Dhaka on 7 8 December 1985. In April 1993, the members of SAARC signed the SAARC Preferential Trading Arrangement (SAPTA), which provided limited preferential market access. The Agreement on a South Asia Free Trade Area (SAFTA) was signed during the 12th SAARC Summit, held in Islamabad, on 4-6 January 2004. The preferences exchanged under SAPTA will continue to be available to SAPTA members until the tariff liberalization under SAFTA is complete (2008 for non-LDC member preferences for LDCs and 2012 for LDC members). Following three rounds of SAPTA negotiations, in which India offered tariff concessions at the HS six-digit level on 2,576 lines, additional concessions were given on 364 HS six-digit level lines in the fourth round. Special concessions are granted for least developed country members (Bangladesh, Bhutan, Maldives, and Nepal). Tariff reductions under the SAFTA are expected to be phased in by 2008 for non-LDC member preferences for LDCs (including India) and by 2012 for LDC members of SAFTA. SAFTA members have also excluded certain products from tariff reductions: India has notified 744 imports from LDC members and 865 from non-LDC members. Tariff reduction under SAFTA came effective on 1-7-2006.

ii. Asia Pacific Trade Agreement

The Asia Pacific Trade Agreement (APTA), originally known as the Bangkok Agreement, was signed on 31 July 1975 by Bangladesh, India, Lao PDR, Republic of Korea, Philippines, Sri Lanka, and Thailand; China acceded to the Agreement in April 2001. The APTA entered into force on 1 September 2006 under an amendment to the original agreement. India offers tariff preferences on some 570 tariff lines at the six-digit level, and an additional 48 tariff lines to LDC members.

iii. BIMST-EC

The Bay of Bengal Initiative for Multi-sectoral, Technical and Economic Cooperation (BIMST-EC), originally known as BIST-EC was signed on 6 June 1997 by Bangladesh, India, Sri Lanka, and Thailand; Myanmar joined the agreement in 1997, and Nepal and Bhutan joined in 2004. In February 2004, BIMST-EC members signed a Framework Agreement to form a free-trade area by 2012. Although this agreement provides for negotiations to be concluded on goods by December 2005, and on services and investment by 2007, these deadlines have not been met due to the complexity of issues involved and economic and political developments in member states.

iv. Agreement with Sri Lanka

India signed a free-trade agreement with Sri Lanka on 28 December 1998, which entered into effect on 1 March 2000. Under the FTA India reduce tariffs in phases, and eliminate them completely in March 2003, except for a negative list comprising 429 items

NOTES

including garments, plastics and rubber, alcoholic spirits, and coconut oil. India also maintains tariff quotas on tea and garments under the FTA. The tariff quota for tea is currently 15 million kg per year, at a preferential rate of 50% of the MFN duty. The tariff quota for garments is 8 million pieces per year, of which 6 million should be manufactured using fabrics of Indian origin and enter at zero rates of duty; the remaining two million pieces receive a margin of preference of 75% of the MFN rate. In addition, imports of tea may only enter through the ports of Kochi and Kolkata, while garments may be imported only through the ports of Chennai, Mumbai, and Jawaharlal Nehru Port, Mumbai. Furthermore, according to a Public Notice issued by the Directorate General of Foreign Trade on 21 November 2006, imports of vanaspati, including bakery shortening and margarine, are subject to an "overall quantitative limit" of 250,000 tonnes per year under the Indo–Sri Lanka Free Trade Agreement. The agreement also has provisions for the use of anti-dumping and safeguard measures as well as provisional suspension of preferences in case of balance of payments difficulties.

India and Sri Lanka are currently negotiating a Comprehensive Economic Partnership Agreement (CEPA), which would include trade in services and economic cooperation in other areas. According to the authorities, no date has been set for completion of the negotiations.

v. Comprehensive Economic Cooperation Agreement with Singapore (CECA)

The CECA was signed on 29 June 2005 and became effective on 1 August 2005. The agreement was the first signed by India that covered not only goods, but also services and investment. Tariff concessions are to be phased in between 1 August 2005 and 1 April 2009 (Table II.1). Products excluded from commitments, including agricultural products, alcoholic beverages, minerals, chemicals, rubber products, and textiles and clothing products (6,551 tariff lines or over half of the tariff), will remain subject to MFN duties. Currently, India offers tariff preferences at the HS eight digit level on some 5,111 lines, although the MFN tariff on several of these lines is already zero, implying that preferences are effectively offered on only 4,884 tariff lines.

India's commitments on financial services go beyond its commitments in the GATS, including commitments in life insurance services, additional commitments in non-life insurance, commercial presence for three banks from Singapore including up to 15 branches over four years, subject to certain limitations and higher equity limits in local banks. In the investment chapter, commitments were made to protect investment, including through specific commitments on expropriation and compensation for any expropriation. The CECA also exempts investment from Singapore from capital gains taxation.

NOTES

vi. Framework Agreement for Establishing a Free Trade Area with Thailand

The Framework Agreement for establishing a Free Trade Area was signed by India and Thailand on 9 October 2003. Although the text of the agreement covers trade in goods, services and investment, specific commitments were made only with regard to trade in goods. An early harvest scheme includes phased tariff elimination for 82 products at the HS six-digit level, by 1 September 2006.

vii. Other regional trade arrangements

Consultations between India and ASEAN Economic Ministers were held on 15 September 2002 when it was decided to establish an ASEAN–India Economic Linkages Task Force (AIELTF) to prepare a draft Framework Agreement to enhance bilateral trade. The first ASEAN–India Summit was held on 5 November 2002 in Cambodia, where India committed, *inter alia,* to provide special and differential treatment to ASEAN members based on their level of development, and to aligning its peak tariffs to East Asian levels by 2005.

The Framework Agreement on Comprehensive Economic Co-operation was signed by India and ASEAN heads of state on 8 October 2003. The agreement includes trade in goods, services, and investment. The early harvest programme, including exchange of tariff concessions, was expected to commence on 1 January 2007. Closer trade and investment ties are also sought with the European Union and the United States, through the India–EU Strategic Partnership signed on 7 September 2005 and the US–India Trade Policy Forum, which held its first meeting on 12 November 2005. Under the former, a High Level Trade Group was established to explore ways to deepen trade and investment relations and reported to the next summit meeting in October 2006. A decision was taken to negotiate a broad-based trade and investment agreement. The first meeting of the US–India Trade Policy Forum discussed tariffs and non-tariff barriers to trade, agriculture, investment, services, intellectual property, and the Doha Round. It agreed to establish focus groups on agriculture, tariffs and non tariff barriers, services, investment, and innovation and creativity. The meetings of the Trade Policy Forum are held at regular intervals several times during a year.

India is exploring the possibility of establishing a Comprehensive Economic Cooperation Agreement with the Southern African Customs Union (Botswana, Lesotho, Namibia, South Africa, and Swaziland), and has signed preferential agreements with Afghanistan (6 March 2003), MERCOSUR (19 March 2005), and Chile (8 March 2006).

NOTES

India's commitments under the PTA with Afghanistan include 38 tariff lines at the HS six-digit level, with preferences ranging from 50% to 100% of the MFN tariff rate. The PTA has been in operation since 13 May 2003. A Framework Agreement to Promote Economic Co-operation, which aims to identify the potential for cooperation in trade in goods and services, investment, and other areas, was signed with MERCOSUR on 25 January 2004. As a first step, India has offered commitments on 450 tariff lines at the HS eight digit level, with preferences ranging from 10% to 100% of the MFN rate. Under a Framework Agreement to Promote Economic Co-operation signed with Chile, on 20 January 2005, India's offer includes 178 tariff lines at the HS eight-digit level, with preferences ranging from 10% to 50% of the MFN rate. In parallel, a meeting of the joint study group was held during the preferential trade agreement negotiations in November 2005 to explore the possible next steps. The PTAs with MERCOSUR and Chile are not yet in force.

The bilateral agreement with Nepal was extended up to 5 March 2007, apparently without change. India's free-trade agreement with Bhutan, conducted in local currency, was extended on 29 July 2006 for ten years, while its bilateral trade cooperation agreement with Bangladesh was extended for three years, from 1 April 2006. India also maintains transit agreements with Bangladesh and Nepal.

India is negotiating a number of trade agreements including with the Republic of Korea, Mauritius, and the Gulf Cooperation Council, and has also set up joint study groups to explore the feasibility of comprehensive economic cooperation agreements with China, Japan, Indonesia, Malaysia, Australia, and the Russian Federation.

viii. Other trade arrangements

India is a participant in the Global System of Trade Preferences (GSTP) among developing countries. Under the GSTP, which entered into force in India on 19 April 1989, India offers tariff preferences for a limited number of products. Two rounds of negotiations have been completed and a third is expected to be completed by 2007. It appears also that India is considering giving duty-free and quota-free market access to least developed countries, but no further details are available. Under the Generalized System of Preferences (GSP), India receives preferential access to the markets of Bulgaria, Canada, the European Communities, Japan, New Zealand, Norway, Russian Federation, Turkey, Switzerland, and the United States.

1.7.4 Foreign Investment Regime

India has continued to liberalize its foreign investment regime gradually. Procedures for applying for and obtaining FDI approval are essentially unchanged; the main changes in policy have been to the entry route and a relaxation in equity restrictions in a number of

NOTES

sectors. FDI policy is formulated by the Department of Industrial Policy & Promotion (DIPP) in the Ministry of Commerce and Industry. The Investment Promotion Desk and the Foreign Investment Implementation Authority, under the Secretariat for Industrial Assistance (SIA) in the DIPP, are concerned with investment promotion and facilitating implementation of approvals. The Foreign Investment Promotion Board (FIPB), based in the Ministry of Finance, is responsible for granting approval for FDI in sectors/activities where prior government approval is required.

A May 2002 report on reforming the investment approval and implementation procedures concluded that, despite economic liberalization, FDI had not entered India to the degree expected; and this was due to several constraints, including in the complexity of procedural requirements of several laws and regulations, as well as transparency in the approval procedures. In response, the Foreign Investment Implementation Authority (FIIA) was established in August 1996. The FIIA, which is based in the DIPP, provides assistance to foreign investors encountering approval or operational difficulties. The FIIA is assisted by a Fast Track Authority in each sector, and includes representatives across the Government, including state governments, and agencies involved in the particular project. India also continues to streamline foreign investment regulations, and reduce or remove equity restrictions. In the latest move to rationalize policy further, in February 2006 equity restrictions were lifted in several activities, including brewing and distillation of alcohol; manufacturing activities in products subject to industrial licensing within 25 km of large cities; and in sensitive sectors such as the manufacture of explosives and hazardous chemicals, and “greenfield” airports, where investment has been permitted under the automatic route subject to sectoral regulations and, where applicable, an industrial licence under the Industries (Development and Regulation) Act.

1.7.4.1 Legislation and approval procedures

Although there is no specific FDI legislation, FDI policy is incorporated in the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000, notified under the Foreign Exchange Management Act, 1999. Foreign investment is at present permitted up to varying levels of equity in most sectors, but it is prohibited in: retail trading (except single brand product retailing); atomic energy; lottery business; and gambling and betting.

There are two routes for FDI. FDI up to 100% may take place through the automatic route, requiring only a notification to the regional office of the Reserve Bank of India (RBI) within 30 days of receipt of the investment and within 30 days of issuing shares to foreign investors. The automatic route is permitted for all activities except: investment in two industries subject to compulsory industrial licensing (manufacture of cigars and cigarettes of tobacco products, and defence-related items); equity investment above 24%

NOTES

for manufacture of items reserved for the small-scale sector; where the foreign partner has an existing venture in India in the same field on 12 January 2005 (except where investment is by a venture capital fund registered with the Securities and Exchange Board of India (SEBI); where investment by either party is less than 3% in the existing joint venture; and if the existing joint venture is defunct or sick); and investment in certain sectors, as specified, above the overall permitted foreign equity ceilings.

In such cases, prior approval is required by the Government. Proposals are considered by the FIPB in the Ministry of Finance, Department of Economic Affairs (DEA). Applications seeking FIPB approval are received in the DEA, except for investment proposals by non-resident Indians, for single brand product retailing or in an export-oriented unit, which are received and processed by the DIPP. Investments in an Indian company under the Portfolio Investment Scheme are not covered by the FDI policy and require prior approval from the Securities and Exchange Board of India (SEBI), while foreign investors setting up branches, liaison or project offices would be covered by the provisions of the Foreign Exchange Management (Establishment of a branch/liaison office or project office in India) Regulations 2000, under the Foreign Exchange Management Act (FEMA).

Foreign investment proposals must be accompanied by details of all investors; existing or proposed activities; details of the project, including cost, proposed employment, and exports and foreign exchange requirements; and financial details of the company, such as paid up capital, percentage held by foreign or non-resident investors, and any shares to be issued or already issued. FIPB decisions must normally be made and communicated to the investors within 4-6 weeks unless additional information on the proposal is required. According to the authorities, normally these deadlines are met on 90% of proposals, provided information is complete. The FIPB works within established guidelines, considering, *inter alia*, whether the project meets certain norms such as value added or export earnings (for export-oriented units or the small-scale sector), and whether it involves technical collaboration, along with the nature of the technology to be transferred. Approval by the FIPB is subject to clearance being obtained under relevant national and state laws and regulations. Once approval has been granted, the investor must obtain clearance from other central or state government agencies, including those responsible for foreign exchange, pollution control and environmental clearance as well as land acquisition, power, etc. The number of clearances required from individual agencies, and the time taken for each, were among the major bottlenecks identified by the Committee to examine investment procedures and implementation in September 2001. To address this problem, several states have established single-window approval systems for investment proposals made within the state. Further, sectoral guidelines are reviewed to streamline them and render them more transparent.

NOTES

1.7.4.2 Incentives

While no incentives are targeted specifically at foreign investors, both central and state governments provide investment incentives for domestic and foreign investors. The Central Government's incentives include a 100% tax exemption on profits for infrastructure development and operation; a tax exemption for exports for a period of ten years; a tax exemption for the first five years and a 50% exemption for the next five years, for investorin the Special Economic Zones. There are also capital investment subsidies for new industrial units and for expansion of these units in the north-eastern region and states that are covered by a special package scheme, introduced in January 2003; the incentives include a subsidy of 15% of investment in plant and machinery, up to a maximum of Rs 3 million for all new units and for expansion of existing units. Similar schemes also exist for the state of Jammu and Kashmir. State governments offer investment incentives mainly in the form of exemptions on the payment of charges for electricity, registration fees, and stamp duty, as well as reservation of land, *inter alia,* for export-oriented units and foreign investors.

QUESTIONS TO CONTEMPLATE AND DELIBERATE

Q 1.7.a What is trade policy? State its objectives and the agencies involved in its formulation.

Q 1.7.b Explain the role of WTO agreements & regional accords as components of trade policy.

Q 1.7.c Discuss the policy and incentives for promoting international investments.

1.8 EXPORT PROMOTION

Export promotion has been one of the main planks of foreign trade policy of most countries. With increasing export earnings, the benefits of enhanced domestic employment, rising revenues to companies and government, rise in standard of living, expanding overseas operations funded by export surplus, appreciation of domestic currency, raising forex reserve, no pressure to borrow from world markets – institutional or otherwise, an acknowledgement of capabilities of domestic people and firms, etc emanate. Also, in the world of rising oil prices, countries with no or far less oil reserves have to depend on exports to pay for rising oil import bills. Thus exports benefit a nation in many ways, but the world market is competitive, because every firm/country wants to export more. To have the edge over others in the global market, governments provide some promotional measures to firms to increase their export competitiveness. These measures are: **Financial, Fiscal, Facilitative, Favours and Felicitating.**

NOTES

1.8.1 Financial Services for Exporters

Exporters are given priority finance at concessional terms of lending by financial and banking institutions under a kind of directive lending. Even specialist financial institutions are created to exclusively cater to export firms.

Commercial banks and the special Export-Import Bank of India, in short, EX-IM Bank, serve the exporting community by providing **credit finance** to exporters. The EX-IM bank functions as the principal financial institution for coordinating the working of institutions engaged in financing export and import of goods and services with a view to promoting the country's international trade. Another facility is **credit guarantee.**

a. Credit by EX-IM bank, Commercial Banks and ECGC for exporters

Pre-shipment credit, Post Shipment credit, Supplier's Credit, Credit for Project Exporters, Credit for Exporters of Consultancy and Technological Services, and Guarantee facilities are different assistances offered by EX-IM bank, Commercial Banks, Export Credit and Guarantee corporation, etc.

Pre-shipment Credit facility, in Indian Rupees and foreign currency, provides access to finance at the manufacturing stage - enabling exporters to purchase raw materials and other inputs. **Supplier's Credit facility** enables exporters to extend term credit to importers (overseas) of eligible goods at the post-shipment stage. **Credit facility for Project exporters** to meet rupee expenditure on overseas project export contracts on mobilization / acquisition of materials, personnel and equipment etc is also offered. **Credit facility to exporters of consultancy and technology services**, so that they can, in turn, extend term credit to overseas importers is also provided. EX-IM bank offers **Rediscounting Facility** to commercial banks, enabling them to rediscount export bills of their SME customers, with usance not exceeding 90 days. EX-IM bank also offers **Refinance of Supplier's Credit**, enabling commercial banks to offer credit to exporters of eligible goods, who in turn extend them credit over 180 days to importers overseas. Companies executing contracts within India, but which are categorized as Deemed Exports in the Foreign Trade Policy of India or contracts secured under international competitive bidding or contracts under which payments are received in foreign currency, can avail of **credit under Finance for Deemed Exports facility**, aimed at helping them meet cash flow deficits. Overseas buyers can avail of **Buyer's Credit,** for import of eligible goods from India on deferred payment terms. **Special schemes are available for Small and Medium enterprises (SMEs), rural grass-root enterprises and Agri-exporters**.

b. Funding for Exporting Companies

EX-IM bank, term lending financial institutions and commercial banks provide term Finance under different schemes: Equity Participation, Project Finance, Equipment Finance, Import of Technology & Related Services, Domestic Acquisitions of

NOTES

businesses/companies/brands and Export Product Development/ Research & Development. Under General Corporate Finance Working Capital Finance (For Exporting Companies) Working Capital Term Loans [< 2 years], Long Term Working Capital [upto 5 years], Export Bills Discounting, Warehousing Finance, Export Lines of Credit, Export Packing Credit and Cash Flow financing are extended. Letter of Credit facility is also extended to importers.

Funding for overseas acquisition: The schemes for financing Indian Company's equity participation in the overseas Joint Venture (JV)/ Wholly Owned Subsidiary (WOS), Term & Working Capital to the overseas JV / WOS, Finance (for equity/debt component) for acquisition of overseas businesses / companies including leveraged buy-outs including structured financing options and Direct Equity are available with Exim Bank, selected commercial banks and term lending financial institutions.

c. Line of Credit

Line of credit is a facility where a foreign institution, generally government or government owned, is provided finance which in turn extends the funds to a domestic institution that takes designated works or projects in the foreign country concerned. This is a tripartite arrangement, of which one is the Indian financing institution, the second is an Indian firm carrying out a project oversea and the third is the foreign government or financing agency.

d. Export Credit Guarantee service

Apart providing finance for exporters, insurance against risk of default on the part of importers is a very great need. To provide this guarantee, Export Credit Guarantee Corporation of India (ECGC) was established in the year 1957 by the Government of India to strengthen the export promotion drive by covering the risk of exporting on credit. ECGC is the fifth largest credit insurer of the world in terms of coverage of national exports. It provides a range of credit risk insurance covers to exporters against loss in export of goods and services. Offers guarantees to banks and financial institutions to enable exporters to obtain better facilities from them. Provides Overseas Investment Insurance to Indian companies investing in joint ventures abroad in the form of equity or loan

1.8.2 Facilitating Services for Exporters

There are scores of institutions that render varied services to exporters. There are Export Promotion Councils for major product groups, Commodity Boards for selected plantation and other crops, Trade Authorities for few product classes that render a range of services for product/service/commodity items that they are responsible.

NOTES

a. Services extended

Exploration of overseas market, Identification of items with export potential, Market survey and up-to-date market intelligence, Contact with protective buyers to interest them in the exporters' products, Providing the export company's profile to overseas buyers and vice-versa, Advice on international marketing, Display of selected product groups, Arrangement for supply of indigenous and imported raw materials for export production, Resolving shipping and transport problems, Advice on export finance banking and insurance, Extensive publicity in India and abroad, Participation in Trade Fairs and Exhibitions abroad, Deputation of trade delegations, study teams and sales teams to foreign markets, Organizing Buyer-Seller Meets in India and abroad, Catering to other developmental needs, Collecting, collating and disseminating world market intelligence, Updating the information on global trends in fashion & design, product development and adaptation, Dissemination of information of commercial and technological nature through seminars, news bulletins and magazines, Organizing participation of Indian exporters in international fairs and buyer-seller meets, Organizing visits of buyers' delegations from different countries, Liaising with various international organizations dealing with trade information, Leading trade delegations to potential markets globally, Formulating Inter-State trade Council to engage State Governments in providing an enabling environment for promotion of international trade, etc.

b. Facilitating Institutions: Export Promotion Councils and Authorities

i. Agricultural and Processed Food Products Export Development Authority, ii. Marine Products Exports Development Authority, iii. Apparel Export Promotion Council, iv. Building Materials and Technology Promotion Council, v. Carpet Export Promotion Council, vi. Cashew Export Promotion Council of India, vii. Chemicals & Allied Products Export Promotion Council, viii. Council for Leather Exports, ix. Cotton Textiles Export Promotion Council, x. Electronics & Computer Software Export Promotion Council, xi. Engineering Export Promotion Council, xii. Export Promotion Council for Handicrafts, xiii. Gem and Jewellery Export Promotion Council, xiv. Handloom Export Promotion Council, xv. Silk Export Promotion Council, xvi. Synthetic & Rayon Textile Export Promotion Council, xvii. Wool & Woolens Export Promotion Council, xviii. Jute Manufactures Development Council, xix. Plastics and Linoleums Export Promotion Council, xx. Powerloom Development & Export Promotion Council, xxi. Cotton Textile Export Promotion Council, xxii. Shellac Export Promotion Council, and xxiii. Sports Goods Export Promotion Council.

c. Facilitating Institutions: Commodity Boards and Other Agencies

Asia Pacific Textile Clothing Forum, Central Silk Board, Coconut Development Board, Coir Board, Federation of Indian Export Organizations (FIEO, India Trade Promotion Organization, Indian Institute of Foreign Trade, National Agricultural Cooperative Marketing Federation of India Limited (NAFED), National Dairy Development Board, National Horticulture Board, National Oilseeds and Vegetable Oils Development Board, National Medicinal Plants Board, Patent Facilitating Centre, etc.

1.8.3 Fiscal Concession for Exporters

Fiscal concessions are in the form of tax concession on profit from export business, import duty concession on imports for supporting export activities, excise duty concession for export activities, exemption from certain levies on exports, etc.

i Export cess on export of all agricultural and plantation commodities levied under various Commodity Board Acts was waived.

ii No safeguard and antidumping duty to be levied on inputs under advance license for deemed export supplies made to ICB (International Competitive Bidding) projects.

iii EPCG Scheme will facilitate the modernization of retail sector by allowing concessional duty imports. For this the retailer should have a minimum covered shopping area of 1000 square meters.

iv Duty free import of inputs based on the past export performance, import of mono filament long line system for tuna fishing at concessional duty and establishes a self removal for clearance of waste of perishable commodities.

v Entitlement of duty free imports of samples enhanced to Rs. 3 lakhs for gems..

vi EOUs can claim IT exemption within a period of 12 months from the date of exports.

vii All actions by Income Tax authority on DEPB benefits have been stopped by Prime Minister with immediate effect. The matter is to be decided at economic advisory council headed by Prime Minister in the next 30 days

viii Export obligation for specified projects shall be calculated based on concessional duty permitted to them. This would improve the viability of such projects. An EPCG license can also be issued for import of capital goods for supply to projects notified by the Central Board of Excise and Customs under S.No.441 of Customs Exemption Notification No.21/2002 dated 01-03-2002 wherein the basic customs duty on imports is 10% with a CVD of 16%.The export obligation for such EPCG licenses would be eight times the duty saved. The duty saved would be the difference between the effective duty under the aforesaid Customs Notification and the concessional duty under the EPCG Scheme.

ix Fiscal Relief to EOUs:

NOTES

a. EOUs shall be exempted from Service Tax in proportion to their exported goods and services.

b. EOUs shall be permitted to retain 100% of export earnings in EEFC accounts.

c. Income Tax benefits on plant and machinery shall be extended to DTA units which convert to EOUs.

1.8.4 Favours for Exporters

i Realizing that great potential and opportunities exist in the manufacturing sector, Annual supplement introduces a number of measures to enhance the competitiveness of manufacturing sector.

ii To promote accelerated export performance, balance export obligation will be waived for the exporters completing 75% of their export obligation in half the prescribed export obligation period.

iii Reduced export obligation and enhanced time available for exports under the EPCG Scheme for the imports made by the agriculture sector.

iv Reduced obligation at six times the duty saved amount as against the normal eight times for imports made by the SSI sectors under the EPCG Scheme.

v Export of poultry and dairy products and their value added products facilitated by granting them duty credit @ 5% of the FOB value of the exports under the Vishesh Krishi Upaj Yojna.

vi Supply of gold of 0.995 and above purity allowed for release for export purposes.

vii For units de-bonding from EOU's, a simplified procedure is being worked out. Similarly, capital goods can be transferred to other units by simply intimating Central Excise & Development Commissioner.

viii Reducing congestion at the major ports. The facility for export obligation discharge in rupee payment under the EPCG has been extended to the minor ports, ICDs and CFS also.

ix Single common application form called Aayaat Niryaat Form introduced reducing the size of the form by more than 60%.

x Thee categories of advance licenses merged into a single category

xi Annual advance license, which was available only to status holders, will now be available to all the exporters with some export performance.

xii Export obligation extension for five years under advance licence based on BIFR rehabilitation package.

NOTES

xiii Bank guarantee thereshold reduced for units in Agri export zones and established service providers and a category of manufacturer exporters.

xiv Simplified clubbing norms under the advance license and EPCG Scheme will help exporters in regularizing their cases.

xv Chartered Engineer Certificate in lieu of Central Excise Certificate for non-excisable units and those importing spares will be accepted as installation certificate. This will reduce the transaction time.

xvi Imports made under Served from India Scheme can be transferable within the group companies and managed hotels. The provision will allow bulk sourcing and better utilization of the entitlement.

xvii Government has decided to develop a trademark for Handloom on lines similar to 'Woolmark' and 'Silkmark' . This will enable handloom products to develop a niche market with the distinct identity.

xviii All Export Promotion Council shall open a separate Cell to involve and encourage youth and women entrepreneurs in export effort.

xix Minister of Commerce and Industry invited Suggestions on a proposal to change the names of Export Promotion Councils to 'Trade Promotion Council.

xx Technological upgradation under EPCG scheme has been facilitated and incentivised.

xxi Transfer of capital goods to group companies and managed hotels now permitted under EPCG.

xxii In case of movable capital goods in the service sector, the requirement of installation certificate from Central Excise has been done away with.

xxiii When Capital Goods are imported for pre/post – production or license is taken for import of spares, the license holder shall fulfill the export obligation by export of products manufactured from the plant/project to which the pre/post-production capital goods/spares are related.

xxiv The agro units in the agri export zones would also have the facility of moving the capital good(s) imported under the EPCG within the agri export zone. Service provider in Agri export zone shall have the facility to move or shift the capital goods within the zone provided he maintains accurate record of such movements. However, such equipments shall not be sold or leased by the license holder.

xxv Star Export Houses shall be eligible for a number of privileges including fast-track clearance procedures, exemption from furnishing of Bank Guarantee, eligibility for consideration under Target Plus Scheme etc.

NOTES

xxvi Favours to EOUs

a. Import of capital goods shall be on self-certification basis for EOUs.

b. For EOUs engaged in Textiles & Garments manufacture leftover materials and fabrics upto 2% of CIF value of quantity of import shall be allowed to be disposed of on payment of duty on transaction value only.

c. Minimum investment criteria shall not apply to Brass Hardware and Hand-made jewellery EOUs (this facility already exists for Handicrafts, Agriculture, Floriculture, Aquaculture, Animal Husbandry, IT and Services).

xxvii. Favours to Free Trade and Warehousing Zone

a. A new scheme to establish Free Trade and Warehousing Zone has been introduced to create trade – related infrastructure to facilitate the import and export of goods and services with freedom to carry out trade transactions in free currency. This is aimed at making India into a global trading-hub.

b. FDI would be permitted up to 100% in the development and establishment of the zones and their infrastructural facilities.

c. Each zone would have minimum outlay of Rs.100 crs and 5 lakh sq.mts. built up area.

d. Units in the FTWZs would qualify for all other benefits as applicable for SEZ units.

xxviii. Common Facilities Centre

Government shall promote the establishment of Common Facility Centres for use by home-based service providers, particularly in areas like Engineering & Architectural design, Multi-media operations, software developers etc., in State and District-level towns, to draw in a vast multitude of home-based professionals into the services export arena.

xxix. Procedural Simplification & Rationalization Measures

a. All exporters with minimum turnover of Rs. 5 crores and good track record shall be exempt from furnishing Bank Guarantee in any of the schemes, so as to reduce their transactional costs.

b. All goods and services exported, including those from DTA units shall be exempt from Service Tax.

c. Validity of all licenses/entitlements issued under various schemes has been increased to a uniform 24 months.

NOTES

d. Number of returns and forms to be filed have been reduced. This process shall be continued in consultation with Customs & Excise.

e. Enhanced delegation of powers to Zonal and Regional Offices of DGFT for speedy and less cumbersome disposal of matters.

f. Time bound introduction of Electronic Data Interface (EDI) for export transactions. 75% of all export transactions to be on EDI within six months.

xxx. Facilities at Pragati Maidan

a. In order to showcase our industrial and trade prowess to its best advantage and leverage existing facilities, Pragati Maidan will be transformed into a world-class complex.

b. There shall be state-of-the-art, environmentally-controlled, visitor friendly exhibition areas and marts.

c. A huge Convention Centre to accommodate 10,000 delegates with flexible hall spaces, auditoria and meeting rooms with high-tech equipment, as well as multi-level car parking for 9,000 vehicles will be developed within the envelope of Pragati Maidan.

xxxi. Legal Aid

Financial assistance would be provided to deserving exporters, on the recommendation of Export Promotion Councils, for meeting the costs of legal expenses connected with trade – related matters.

xxxii. Grievance Redressal

A new mechanism for grievance redressal has been formulated and put into place by a Government Resolution to facilitate speedy redressal of grievances of trade and industry

xxxiii. Quality Policy

a. DGFT shall be a business-driven, transparent, corporate oriented organization.

b. Exporters can file digitally signed applications and use Electronic Fund Transfer Mechanism for paying application fees.

c. All DGFT Offices shall be connected via a central server making application processing faster. DGFT Head Quarters has obtained ISO 9000 certification by standardizing and automating procedures.

NOTES

xxxiv. Bio Technology Parks

Biotechnology Parks to be set up which would be granted all facilities of 100% EOUs.

xxxv. Co-Acceptance/Avalisation:

Co-acceptance/Avalisation is introduced as equivalent to irrevocable letter of credit to provide wider flexibility in financial instrument for export transaction.

xxxvi. Revamping Boards of Trade

The Boards of Trade shall be revamped and given a clear and dynamic role. An eminent person or expert on trade policy shall be nominated as President of the Board of Trade, which shall have a Secretariat and separate Budget Head, and will be serviced by the Department of Commerce.

xxxvii. Web chat

The Office of the Director General of Foreign Trade has opened a chat window on its website: (http://dgft.delhi.nic.in) for interacting with the trade and industry to reply to queries on the Foreign trade Policy. This web based interface would(http://dgft.delhi.nic.in) for interacting with the trade and industry to reply to queries on the Foreign trade Policy. This web based interface would be held from 3.00 p.m. to 5.00 p.m on the second Wednesday of every month.

1.8.5 Felicitative Encouragements to Exporters

a. Target Plus

A new scheme to accelerate growth of exports called “Target Plus” has been introduced. Exporters who have achieved a quantum growth in exports would be entitled to duty free credit based on incremental exports substantially higher than the general actual export target fixed.(Since the target fixed for 2004-05 is 16%, the lower limit of performance for qualifying for rewards is pegged at 20% for the current year). Rewards will be granted based on a tiered approach. For incremental growth of over 20%, 25% and 100%, the duty free credits would be 5%, 10% and 15% of FOB value of incremental exports.

b. New Status holder Categorization:

The Scheme of status holders continues but the categorization of status holders from Export House, Trading House, Star Trading House and Super Star Trading House has been changed to one Star Export House, two Star Export House, three Star Export House, four Star Export House and five Star Export House. Star Export Houses shall be eligible for a number of privileges including fast-track clearance procedures, exemption from furnishing of Bank Guarantee, eligibility for consideration under Target Plus Scheme

NOTES

etc. The revised threshold limit for the recognition has also been lowered as can be seen from the table 1.10 below.

Table 1.10: Cumulative Performance in Previous 3 Years for Star House Status

No.	Category	Total Performance over three years
1	One Star Export House	Rs. 15 Crores
2	Two Star Export House	Rs. 100 Crores
3	Three Star Export House	Rs. 500 Crores
4	Four Star Export House	Rs. 1500 Crores
5	Five Star Export House	Rs. 5000 Crores

Units in Small Scale Industry/Tiny Sector/Cottage Sector, Units registered with KVICs/KVIBs, Units located in North Eastern States, Sikkim and J & K. , units exporting handloom / handicrafts / hand knotted or silk carpets, exporters exporting to Countries in Latin America/CIS/sub-Saharan Africa as listed in Appendix – 17C, units having ISO 9000 (series) / ISO 14000 (series) / WHOGMP / HACCP / SEICMM level-II and above status granted by select agencies, exports of services and exports of agro products shall be entitled for double weightage of export made for grant of Star Export House status.

QUESTIONS TO CONTEMPLATE AND DELIBERATE

Q 1.8.a Give an account of the need for and types of financial promotional measures for exports in India.

Q 1.8.b Present the facilities extended by Government agencies in India to promote exports.

Q 1.8.c Explain the fiscal concessions extended for export promotion.

Q 1.8.d Examine some of the favours extended to export businesses in India.

Q 1.8.e Explain how are performing exporters felicitated by recognition by Government in India.

1.9. EXPORT DOCUMENTS AND PROCEDURES

Export business involves quite a lot of documents and procedures. All these are prescribed in the trade policy pronouncements of specified authority in each country. A

NOTES

good knowledge of this is essential to ensure that the business goes unhindered and benefits availed and cost minimized.

1.9.1 Export Documents

Export documents are more or less common globally, because this is a global business and therefore standardization of documents is god for trading partners. However, documents slightly differ depending upon the mode of export, by ship, by land or by post. These are dealt now from the Indian perspective.

1.9.1.1 Documents commonly needed for Export by Ship

Certain documentation takes place while exporting. Special documents may be required depending on the type of product or destination. Certain export products may require a quality control inspection certificate from the designated Inspection Agency. Some food and pharmaceutical product may require a health or sanitary certificate for export.

The following documents are commonly used in exporting, but specific requirements vary by destination and product. **Shipper's Export Declaration; Shipping Bill/ Bill of Export; Commercial invoice; Certificate of Origin; Bill of Lading; Temporary Import Certificate / ATA CARNET; Insurance certificate; Export Packing List; Import License; Consular Invoice; Inspection Certification; Dock Receipt and Warehouse Receipt; Destination Control Statement.**

i **Shipper's Export Declaration:** The Shipper's Export Declaration is the most common of all export documents. It can be electronically filed.

ii **Shipping Bill/ Bill of Export:** Shipping Bill/ Bill of Export is the main document required by the Customs Authority for allowing shipment. Usually the Shipping Bill is of four types and the major distinction lies with regard to the goods being subject to certain conditions which are: **Export duty/ cess; Free of duty/ cess; Entitlement of duty drawback; Entitlement of credit of duty under DEPB Scheme; Re-export of imported goods**

Documents required for the processing of the Shipping Bill:

a. GR forms (in duplicate) for shipment to all the countries.

b. Four copies of the packing list mentioning the contents, quantity, gross and net weight of each package.

c. Four copies of invoices which contains all relevant particulars like number of packages, quantity, unit rate, total f.o.b./ c.i.f. value, correct & full description of goods etc.

d. Contract, L/C, Purchase Order of the overseas buyer.

NOTES

e. AR4 (both original and duplicate) and invoice.

f. Inspection/ Examination Certificate.

Formats of Shipping Bill:

a. White Shipping Bill in triplicate for export of duty free of goods.

b. Green Shipping Bill in quadruplicate for the export of goods which are under claim for duty drawback.

c. Yellow Shipping Bill in triplicate for the export of dutiable goods.

d. Blue Shipping Bill in 7 copies for exports under the DEPB scheme.

iii **Commercial invoice:** A bill for the goods from the seller to the buyer. These invoices are often used by governments to determine the true value of goods when assessing customs duties. Governments that use the commercial invoice to control imports will often specify its form, content, number of copies, language to be used, and other characteristics.

iv **Certificate of Origin:** The Certificate of Origin is only required by some countries. In many cases, a statement of origin printed on company letterhead will suffice. Special certificates are needed for countries with which the Free Trade Agreements are entered.

v **Bill of Lading:** Bill of Lading is a contract between the owner of the goods and the carrier (as with domestic shipments). For vessels, there are two types: a straight bill of lading which is non-negotiable and a negotiable or shipper's order bill of lading. The latter can be bought, sold, or traded while the goods are in transit. The customer usually needs an original as proof of ownership to take possession of the goods

vi **Temporary Import Certificate / ATA CARNET:** An ATA Carnet (also known as, "Merchandise Passport") is a document that facilitates the temporary importation of products into foreign countries by eliminating tariffs and value-added taxes (VAT) or the posting of a security deposit normally required at the time of importation.

vii **Insurance certificate:** Insurance certificate is used to assure the consignee that insurance will cover the loss of or damage to the cargo during transit. These can be obtained from your freight forwarder.

viii **Export Packing List:** Export Packing List is considerably more detailed and informative than a standard domestic packing list. It itemizes the material in each individual package and indicates the type of package, such as a box, crate, drum,

NOTES

or carton. Both commercial stationers and freight forwarders carry packing list forms.

ix **Import License:** Import licenses are the responsibility of the importer. Including a copy with the rest of your documentation, however, can sometimes help avoid problems with customs in the destination country.

x **Consular Invoice:** Consular Invoice is required in some countries, it describes the shipment of goods and shows information such as the consignor, consignee, and value of the shipment. If required, copies are available from the destination country's Embassy or Consulate in the country.

xi **Air Way Bills:** Air freight shipments are handled by air waybills, which can never be made in negotiable form.

xii **Inspection Certification:** Inspection Certification is required by some purchasers and countries in order to attest to the specifications of the goods shipped. This is usually performed by a third party and often obtained from independent testing organizations.

xiii **Dock Receipt and Warehouse Receipt:** Dock Receipt and Warehouse Receipt is used to transfer accountability when the export item is moved by the domestic carrier to the port of embarkation and left with the ship line for export.

xiv **Destination Control Statement**: Destination Control Statement appears on the commercial invoice, and ocean or air waybill of lading to notify the carrier and all foreign parties that the item can be exported only to certain destinations.

1.9.1.2 Documents Required for Exports by Land

For the goods which are cleared by Land Customs, Bill of Export (also of 4 types - white, green, yellow & pink) is required instead of Shipping Bill. Besides, other documents as above are needed.

1.9.1.3 Documents Required for Exports by Post

Documents required for export by post parcel depend on the type of product or destination. Certain export products may require a quality control inspection certificate from the designated Inspection Agency. Some food and pharmaceutical product may require a health or sanitary certificate for export.

Customs Declaration Form: Customs Declaration Form is prescribed by the Universal Postal Union (UPU) and international apex body coordinating activities of national postal administration. It is known by the code number CP2/ CP3 and to be prepared in quadruplicate, signed by the sender.

NOTES

Dispatch Note or CP2**:** Dispatch Note or CP2 is filled by the sender to specify the action to be taken by the postal department at the destination in case the address is non-traceable or the parcel is refused to be accepted.

Prescriptions of minimum and maximum parcel sizes: Minimum size: Total surface area not less than 140 mm X 90 mm. **Maximum size:** Lengthwise not over 1.05 m. Measurement of any other side of circumference 0.9 m./ 2.00 m. **Maximum weight:** 10 kg usually, 20 kg for some destinations.

Commercial invoice: Commercial invoice is issued by the seller for the full realizable amount of goods as per trade term.

Consular Invoice**:** Consular Invoice is mainly needed for the countries like Kenya, Uganda, Tanzania, Mauritius, New Zealand, Burma, Iraq, Australia, Fiji, Cyprus, Nigeria, Ghana, Zanzibar etc. It is prepared in the prescribed format and is signed/ certified by the counsel of the importing country located in the country of export.

Customs Invoice: Customs Invoice is mainly needed for the countries like USA, Canada, etc. It is prepared on a special form being presented by the Customs authorities of the importing country. It facilitates entry of goods in the importing country at preferential tariff rate.

Legalized Invoice: Legalized Invoice shows the seller's genuineness before the appropriate consulate/ chamber of commerce/ embassy. It do not have any prescribed form.

Certified Invoice: Certified Invoice is required when the exporter needs to certify on the invoice that the goods are of a particular origin or manufactured/ packed at a particular place and in accordance with specific contract. Sight Draft and Usance Draft are available for this. Sight Draft is required when the exporter expects immediate payment and Usance Draft is required for credit delivery.

Packing List: Packing List shows the details of goods contained in each parcel/ shipment.

Certificate of Inspection: Certificate of Inspection shows that goods have been inspected before shipment.

Black List Certificate: Black List Certificate is required for countries which have strained political relation. It certifies that the ship or the aircraft carrying the goods has not touched those country(s).

NOTES

Weight Note: Weight Note is required to confirm the packets or bales or other form are of a stipulated weight.

Manufacturer's/ Supplier's Quality Inspection Certificate: Manufacturer's Quality Inspection Certificate is required in addition to the Certificate of Origin for few countries to show that the goods shipped have actually been manufactured and are available.

Certificate of Chemical Analysis: Certificate of Chemical Analysis is required to ensure the quality and grade of certain items such as metallic ores, pigments, etc.

Certificate of Shipment: Certificate of Shipment signifies that a certain lot of goods have been shipped.

Health/ Veterinary/ Sanitary Certification: Health/ Veterinary/ Sanitary Certification is required for export of foodstuffs, marine products, hides, livestock etc.

Certificate of Conditioning: Certificate of Conditioning is issued by the competent office to certify compliance of humidity factor, dry weight, etc.

Antiquity Measurement: Antiquity Measurement is issued by Archaeological Survey of India in case of antiques.

Transhipment Bill: Transhipment Bill is used for goods imported into a customs port/ airport intended for transhipment.

Shipping Order: Shipping Order is issued by the Shipping (Conference) Line which intimates the exporter about the reservation of space of shipment of cargo through the specific vessel from a specified port and on a specified date.

Cart/ Lorry Ticket: Cart/ Lorry Ticket is prepared for admittance of the cargo through the port gate and includes the shipper's name, cart/ lorry No., marks on packages, quantity, etc.

Shut Out Advice: Shut Out Advice is a statement of packages which are shut out by a ship and is prepared by the concerned shed and is sent to the exporter.

Short Shipment Form: Short Shipment Form is an application to the customs authorities at port which advises short shipment of goods and required for claiming the return.

Shipping Advice: Shipping Advice is prepared in aligned document to be used to inform the overseas customer about the shipment of goods.

NOTES

1.9.1.4. Import documents

An importer shall submit to customs authorities import documents before imported goods are removed from storage at the transporter, placed in a bonded warehouse or removed from a bonded warehouse or a free zone for disposal domestically; the documents shall be submitted to customs no later than 3 months from the date of arrival of the vessel which transported the goods to the country.

Import documents shall be submitted to the director of customs in the customs district where the goods are unloaded from the vessel, unless the goods are transported undeclared to another customs district and arrangements are made for customs treatment there.

i. Documents that shall be submitted

The following documents shall be submitted with an import declaration, as far as applicable:

a Commercial Invoice : The Commercial invoice shall contain the following information:

- Name and address of the seller (consignor),
- Name and address of the buyer (consignee)
- Place and date of issue,
- When the sale took place,
- Number of pieces, type of packing, weight, marks and numbers,
- The goods contained in a consignment, type, make and quantity (number, weight or measurements, as the case may be),
- The selling price of individual articles and the currency in which the price is specified, terms of payment, payment conditions and delivery conditions, discounts and other deductions and the reasons for granting such discounts or making such deductions.

b Bill of lading or a transport document issued in connection with the transport of the goods; however when there is submitted a bill covering freight charges or a notice from the transporter to the consignee concerning a consignment of goods, and these documents contain the same information as specified in regular bills of lading, a bill of lading need not be submitted unless specially requested.

NOTES

c **Bill covering freight charges**

d **Certificate of origin** when preferential customs treatment is requested in accordance with international agreements to which Iceland is a party, unless a declaration of origin has been entered on the invoice,

e **Other documents** concerning the imported goods which are of relevance to their customs treatment, e.g. **import license** when required, a confirmation of an **authorization for special customs treatment** when such is the case, or other certificates required in special circumstances.

An original or a copy of the documents listed above may be submitted to customs. An importer may submit such import documents which he has received in other forms than in writing, for example by computer media or telecommunications. If customs authorities deem it necessary, they can always stipulate that an importer must submit an original of the aforementioned documents.

1.9.2. Export Procedures

There are legal and operational procedures involved. Legal procedures are a bit cumbersome. The operational procedures are regarding one's preparedness to reach global markets with one's production, marketing and other business oriented operational skills.

1.9.2.1 Legal procedures

Obtaining Import-Export Code Number, License / certificate / permission for export of restricted items, Export of items reserved for SSIs by non-SSIs, Furnishing of export returns in non-physical form, etc. are some important legal procedures to be followed.

a. Obtaining Import-Export Code Number and RCMC

Obtaining Import-Export code number is the first legal step involved in exporting. This is to be obtained from the Director General Foreign Trade (DGFT).

Application for IEC Number: Application for grant of IEC number shall be made by Registered/Head Office of the applicant to the Regional Authority under whose jurisdiction, the Registered office of company and Head office in case of others, falls in the 'Aayaat Niryaat Form' and shall be accompanied by documents prescribed therein. In case of STPI/ EHTP/ BTP units, Regional Offices of the DGFT having jurisdiction over district in which the Registered/ Head Office of the STPI is located shall issue or amend the IECs. Only one IEC would be issued against a single PAN number. Any proprietor can have only one IEC number and in case there are more than one IECs allotted to a proprietor, the same may be surrendered to the Regional Office for cancellation.

NOTES

IEC Format and Statements: The Regional Authority concerned shall issue an IEC number in the format.. A copy of such IEC number shall be endorsed to the concerned banker (as per details given in the IEC application form). A consolidated statement of IEC numbers issued by Regional Authority shall be sent to the offices of the Exchange Control Department of the RBI.

Validity of IEC Number.: An IEC number allotted to an applicant shall be valid for all branches/divisions/units/factories as indicated in the format of IEC. Where an IEC Number is lost or misplaced, the issuing authority may consider requests for grant of a duplicate copy of IEC number, if accompanied by an affidavit.

Obtaining RCMC: An exporter desiring to obtain a Registration-cum-Membership Certificate (RCMC) shall declare his main line of business in the application, which shall be made to the Export Promotion Council (EPC) relating to that line of business. However, a status holder has the option to obtain RCMC from Federation of Indian Exporters Organization (FIEO). Notwithstanding anything stated above, exporters of Drugs & Pharmaceuticals shall obtain RCMC from Pharmexcil only. Further, exporters of minor forest produce and their value added products shall obtain RCMC from Shellac Export Promotion Council. The service exporters (except software service exporters) shall be required to obtain RCMC from FIEO. In respect of exporters having their head office/ registered office in the State of Orissa, RCMC may be obtained from FIEO office in Bhuvaneshwar irrespective of the product being exported by them.

In order to give proper guidance and encouragement to the Services Sector, an exclusive Export Promotion Council for Services shall be set up. In addition, an exporter has the option to obtain an RCMC from FIEO or any other relevant EPC if the products exported by him relate to those EPCs. In case an exporter desires to get registration as a manufacturer exporter, he shall furnish

evidence to that effect. Prospective/potential exporters may also, on application, register and become an associate member of an export promotion council. The exporter shall furnish quarterly returns/ details of his exports of different commodities to the concerned registering authority. This will be in addition to any other returns as may be prescribed by the registering authority. However, status holders shall also send quarterly returns to FIEO in the format specified by FIEO.

b. License/certificate/permission for export of restricted items

An application for grant of a license/certificate/permission for import or export of items mentioned as restricted in ITC (HS) may be made in the form relevant and to the specified Regional authorities. An Inter-Ministerial Working Group in DGFT shall consider applications for export of Special Chemicals, Organisms, Materials, Equipment and Technologies (SCOMET) as per specified guidelines and case by case.

NOTES

EXIM Facilitation Committee: Restricted item license/certificate/permission may be granted by the Director General of Foreign Trade or any other Regional Authority authorized by him in this behalf. The DGFT/Regional Authority may take the assistance and advice of a Facilitation Committee. The Facilitation Committee will consist of representatives of Technical Authorities and Departments/ Ministries concerned.

c. Identity Cards

To facilitate collection of license/ certificate/ Authorization/permissions and other documents from DGFT Head Quarters and Regional Authorities, identity cards may be issued to the proprietor/ partners/ directors and the authorized employees(not more than three), of the importers and exporters. However in case of limited companies, the Head of the Regional Office may approve the allotment of more than three identity cards per company.

d. Export of items reserved for SSIs by non-SSIs and Free of cost exports

Export of items reserved for SSIs by non-SSIs: Units other than small scale industrial units (SSIs) are permitted to expand or create new capacities in respect of items reserved for the small scale sector, subject to the condition that they obtain an Industrial license under the Industries (Development and Regulation),Act, 1951. It is a condition of such license that the manufacturer shall undertake export obligation as may be specified by the Ministry of Industry and the licensee is required to furnish a Legal Undertaking to the Directorate General of Foreign Trade in this behalf. The Directorate General of Foreign Trade shall monitor the export obligation.

Free of cost exports: The star export house status holders shall be entitled to export freely exportable items on free of cost basis for export promotion subject to an annual limit of Rs.10 lakh or 2% of the average annual export realization during the preceding three licensing years whichever is higher.

e. Export Payment Realization

Advance Payment: In case, payment is received in advance and export/ deemed exports takes place subsequently, the application for a license/certificate/ Authorization/ permission shall be filed within specific period following the month during which the exports/deemed exports are made, unless otherwise specified.

Payment through ECGC cover: In cases where the export has been completed but the payment has not been realized from the buyer, such exports shall be taken into account for the purpose of benefits under the ECGC Policy provided the payment has been realized by the Indian exporter through ECGC cover.

NOTES

Payment through General Insurance Cover: In cases where exports have been made and payment realized through the General Insurance Cover on account of transit loss or other circumstances, the amount of the insurance cover paid would be treated as payment realized on account of exports under the various export promotion schemes.

Exporter in direct negotiation: In cases where the exporter directly negotiates the document (not through the authorized dealer) with the permission of the RBI, he is required to submit the following documents for availing of the benefits under the export promotion schemes:

a. Permission from RBI allowing direct negotiation of documents (however this is not required for status holders who have been granted a general permission),

b. Copy of the Foreign Inward Remittance Certificate(FIRC) as per Form 10-H of the Income Tax department in lieu of the BRC and

c. Statement giving details of the shipping bills/ invoice against which the FIRC was issued.

Offsetting Export Proceeds: Subject to the specific approval of the Reserve Bank of India, any payable, or equity investment made by a licensee/ Authorization holder under any export promotion scheme, can be used to offset receipts of his export proceeds. In such cases, the offsetting would be equal to the realization of the export proceeds and the exporter would have to submit additional documents to this aspect as may be fixed.

f. Quality Certification

It has been a constant endeavor to promote quality standards in the export product / units manufacturing the export product. One of the salient features incorporated in the Foreign Trade Policy for the promotion of quality standards is the grant of Star Export House status on achievement of a lower threshold limit for units having ISO- 9000 (series), ISO-14000 (Series) or HACCP certification or WHOGMP or SEI CMM level-2 & above status/certification.

g. Export by post and exports by samples

Export by post: In case of export by post, the exporter shall submit the following documents in lieu of documents prescribed for export by sea/air.

a. Bank Certificate of Export and Realization as prescribed

b. Relevant postal receipt.

c. Invoice duly attested by the Customs.

NOTES

Exports by sample: Exports of bona-fide trade and technical samples of freely exportable item shall be allowed without any limit.

h. Accounts

The star export status holder shall maintain true and proper accounts of its exports and imports based on which such recognition has been granted and the exports and imports made during the validity period of such recognition certificate. The record shall be maintained for a minimum period of three years from the expiry of the validity of such certificate. These accounts shall be made available for inspection to the regional authority or any authority nominated by the Director General of Foreign Trade.

i. Furnishing of e-export returns & Electronic Data Interchange (EDI)

Furnishing of export **returns in non-physical form, that is electronic form,** is allowed now. All the export returns made in non- physical form by using communication links including high speed data communication links, internet, telephone line or any other channel which do not involve the Customs authorities has to be compulsorily reported on quarterly basis to the Electronic and Software Export Promotion Council in the prescribed format. **Electronic Data Interchange (EDI) facility** is extended to all exporters. The facility of electronic filing of applications shall be available to all exporters. Under this scheme, an exporter would be able to file his application on the DGFT website at http://dgft.gov.in. The application will then be processed in accordance with the prevalent rules and regulations. The applicant will have to visit the concerned office to hand-over the hard copy of the application along with the requisite documents including the application fee. The authorization/license shall be issued on receipt of the hard copies of the documents as mentioned above after due scrutiny as prescribed. Authorization /license issued using DGFT Electronic Application System shall be transmitted electronically to the Customs through EDI Mode. This shall also obviate the need for verification of authorizations /licenses before allowing clearance.

j. Vishesh Krishi and Gram Udyog Yojana

The application for grant of credit under Vishesh Krishi and Gram Udyog Yojana for export made from 01.04.2006 onwards shall be made to the regional authority concerned in the Aayaat Niryaat Form along with the documents prescribed therein. The applicant may file one or more applications subject to the condition that each application shall contain not more than 25 shipping bills. All the shipping bills in any one application must relate to exports made from one Customs House only. This procedure will equally apply to the exports made from 01.04.2005 till 31.03.2006 under the then Vishesh Krishi Upaj Yojana. The application for obtaining credit shall be filed within a period of twelve months from the date of exports or within six months from the date of realization or within three months from the date of printing/ release of shipping bill, whichever is later, in respect of shipments for

NOTES

which the claim have been filed. The application in the 'Aayaat Niryaat Form' shall be accompanied by Export Promotion copy of the shipping bill and bank realization certificate. For direct as well as third party exports, the Export documents, viz., Export Order, Invoice, GR form, Bank Realization Certificate should be in the name of applicant only. In cases where the applicant applies for the credit entitlement certificate after realization or shipments are made against irrevocable letter of credit or bill of exchange is unconditionally Avalied/ Co-Accepted/ Guaranteed by a bank and the same is confirmed by the exporters bank and certified by the bank in the relevant Bank certificate of export and Realization, the credit entitlement certificate shall be issued with transferable endorsement. In other cases, the credit entitlement certificate shall be initially issued with non-transferable endorsement. Upon realization of export proceeds, such credit entitlement certificates can be endorsed as transferable, if the applicant so desires.

1.9.2.2 Operational procedures

In order to be successful in exporting one must fully research export markets. No one should ever try to tackle every market at once. Many enthusiastic persons bitten by the export bug, fail because they bite off more than they can chew. Overseas design and product requirements must be carefully considered. Always sell as close to the market as possible. The fewer intermediaries one has the better, because every intermediary needs some percentage for his share in his business, which means less profit for the exporter and higher prices for the customer. All goods for export must be efficiently produced. They must be produced with due regard to the needs of export markets. It is no use trying to sell windows which open outwards in a country where, traditionally, windows open inwards. The risk of failure in export markets can be minimized by intelligent use of research. Before committing to a large-scale operation overseas, try out on a small scale. Use a sample test, and any mistakes can then be corrected without much harm having been done. While the test campaign may appear to cost more initially, remember that some of the cost will be repaid by sales, so that test marketing often turns out to be cheaper. Making effective business correspondence, Selecting the markets, Selecting prospective buyers, Selecting channels of distribution ,Negotiating with prospective buyers, Processing an export order, Entering into export contract, Export pricing and costing and Understanding risks in international trade are needed for success.

QUESTIONS TO CONTEMPLTE AND DELIBERATE

Q 1.9.a Present the documents needed in India for Export by Ship.

Q 1.9.b Briefly discuss the documents needed in India for Export by Land and by Post.

Q 1.9.c Discuss the legal and operational procedures for exporting from India

NOTES

1.10 FOREX MANAGEMENT

Foreign exchange management is a talented work. The world's best brains are at it. Foreign exchange management is a great dynamic task of MNCs and those involve themselves in international business. It is said, in forex dealings, long term means, not longer than 10 minutes. That is, transactions have to be executed very quickly in order to book gains or avoid losses. Lest, best brains elsewhere seal the deal. Before we get deeper into forex management, certain fundamental concepts need to be learnt.

1.10.1 Basics and Macro Aspects of Forex

Foreign exchange: 'Foreign exchange' **as a noun** refers to stock of foreign money an entity is having. It includes foreign currencies and foreign currency denominated assets held by an entity. Foreign exchange is the monetary claims that the national entities and individuals of a country have over the rest of the world. Foreign exchange is a vital instrument in the globalized economy. Foreign exchange **as an action** refers to the simultaneous transaction of one currency for another.

ISO Currency Codes for uniform identification: In a global trade when coded are used for different currencies, standardization is needed in codes. ISO released Currency Codes and some codes and the currencies are: USD = US Dollar, EUR = Euro, JPY = Japanese Yen, GBP = British Pound, CHF = Swiss Franc, CAD = Canadian Dollar, AUD = Australian Dollar, NZD = New Zealand Dollar, INR =Indian Rupee and so on. Besides, Certain Currency Pairs have been coded as follows: EUR/USD = "Euro"; USD/JPY = "Dollar Yen"; GBP/USD = "Cable" or "Sterling"; USD/CHF = "Swissy"; USD/CAD = "Dollar Canada" ; AUD/USD = "Aussie Dollar"; and NZD/USD = "Kiwi".

Exchange Rate: Exchange Rate is the value of one currency expressed in terms of another. The exchange rate (a.k.a the foreign-exchange rate, forex rate or FX rate) between two currencies specifies how much one currency is worth in terms of the other. For example an exchange rate of 39 Indian rupees (INR) to the United States dollar (USD) means that a sum of Rs 39 is worth the same as USD 1.

Dynamics of FX rates: Forex rates dynamically change, round the day, round the week, round the year. It is the market without holidays. As forex rates change, the value of transactions change resulting in changes in expected/realized revenues or gains, expenses or losses, assets and liabilities and net worth.

Exchange rate fluctuation lead to Brickbats and Bouquets: The textile exporters, especially the Tirupur garment exporters were seriously affected as the Rupee started gaining against the greenback (that is the US Dollar) and that Government had to come to their

NOTES

rescue with some fiscal relief packages. Indian IT companies and other exporters in the country also have this problem, but they were not that much affected to make a big cry. But Indian importers are pretty happy as US Dollar is cheaper and that the imports are cheaper. That is what forex rate movement can do, brickbat one group and bouquet the other. When does it hit? When does it help? Whom does it hit? Whom does it help? These are not precisely predictable. Hence are the need for deep analysis and timely action/reaction as signs and signals. So, international business community is wedded to studying the mechanics of forex rate determination, the trend in the rates, ways of protecting against risks, ways of making a profit benefitting from rate changes, and so on. The efforts are always at avoiding Brickbats and seizing Bouquets.

1.10.1.1 Forex Market- the Biggest & the Otc Type

Forex market is by far the largest market in the world, in terms of traded value. It includes trading between large banks, central banks, currency speculators, multinational corporations, governments, and other financial markets and institutions. Foreign exchange market is an Over-the-counter (OTC) market where brokers/dealers negotiate directly with one another. There is no central exchange or clearing house. Banks throughout the world participate. As the Asian trading session ends, the European session begins, then the US session, and then the Asian begin in their turns. Traders can react to news when it breaks, rather than waiting for the market to open.

The average daily trade happening in the forex markets across the globe exceeded US$1.9 in 2004. The 2007 Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity survey by the Bank for International Settlements shows an unprecedented rise in activity in traditional foreign exchange markets compared to 2004. Average daily turnover rose to $3.2 trillion in April 2007, an increase of 71% at current exchange rates and 65% at constant exchange rates This increase was much stronger than the one observed between 2001 and 2004. Table 1 11 gives the global forex market daily average turnover.

Table 1. 11 Global Forex Market Daily Averages Turnover - in April, in USD billions

Instrument	1992	1995	1998	2001	2004	2007
Spot transactions	394	494	568	386	621	1,005
Outright forwards	58	97	128	130	208	362
Foreign exchange swaps	324	546	734	656	944	1,714
Estimated gaps in reporting	43	53	61	28	107	129
Total "traditional" turnover	820	1,190	1,490	1,200	1,880	3,210
Turnover at April 2007 exchange rates	880	1,150	1,650	1,420	1,950	3,210

NOTES

Major World Forex Market Centres and Top Traders: The biggest geographic trading centre is the UK, primarily London. The UK extended its leading share of global foreign exchange trading to 34% in April 2007 from 31% in April 2004 according to the new edition of IFSL's Foreign Exchange report. Twice as many dollars are traded on the foreign exchange market in the UK than in the US, and more than twice as many Euros are traded in the UK than in all the euro-area countries combined. Foreign owned institutions accounted for around 70% of foreign exchange trading in London in April 2007. Other large centres, New York, Tokyo, Germany, and Singapore, saw a decline in their shares during this period, the US from 19.2% to 16.6%, Tokyo from 8.3% to 6.0% and Germany from 4.9% to 2.5%.

Table 1.12 gives the Top 10 forex dealers as of May 2006.

Table 1.12: Top 10 Currency Traders% of overall volume, May 2006

Rank	Name	% share	Rank	Name	% share
1	Deutsche Bank	19.26	6	Goldman Sachs	5.25
2	UBS	11.86	7	HSBC	5.04
3	Citigroup	10.39	8	Bank of America	3.97
4	Barclays	6.61	9	JPMorgan Chase	3.89
5	RBS Capital Capital	6.43	10	Merrill Lynch	3.68

Sources: Wikipedia.

1.10.1.2 Types of Foreign Exchange Market

Forex market has several forms, sizes and so on. Table 1.13 gives an account of the types.

Table 1.13 Types of Foreign Exchange Market

No.	Basis of Classification	Sub markets
1	Parties involved:	i. Inter-bank deals market & ii. Merchant deals market
2	Size of deals	i. Wholesale market & ii. Retail market
3	Type of institution	i. Over the counter market & ii. Organized Exchanges
4	Type of deal	i. Transactional, ii. Hedging & iii. Speculation
5	Segments	i. Spot market, ii. Forward market, iii. Arbitrage market iv. Futures market, v. Options market & vi. Swaps market

Source: The author

NOTES

i **Inter-bank market:** Dealings between banks who are authorized dealers in foreign exchange Used to be large in size. About 700 banks worldwide act as market makers in Foreign exchange. Non-bank dealers account for about 20% of the market. International commercial banks communicate with one another instantly and securely with: (a) **SWIFT: S**ociety for **W**orldwide **I**nter-bank **F**inancial **T**elecommunications. (b) **CHIPS: C**learing **H**ouse **I**nter-bank **P**ayments ***S***ystem (c) **ECHO**: **E**xchange **C**learing **H**ouse **L**imited, the first global clearinghouse for settling inter-bank FOREX transactions.

ii **Merchant deals market:** Dealings between authorized dealers and others such as business entities**.** This is generally retail market or client market, as it is alternatively called.

iii **Wholesale market:** Large scale foreign exchange dealings especially inter-bank deals and some deals involving large corporations.

iv **Retail market:** Small foreign exchange deals involving less than, say $10000.

v **Over the counter market**: In over the counter the dealers or parties directly settle accounts. No clearing house is involved.

vi **Exchange market:** Foreign exchange dealings are done in an exchange and settlements are through the clearing house of the exchange.

vii **Transaction market:** Foreign exchange deals representing trade or financial transactions.

viii **Hedging market:** Foreign exchange deals that are done to cover risk of exposure in currencies

ix **Speculation:** Open deals that involve taking position in the exchange to make profit when expected price movement materializes.

x **Spot Market:** Spot market is market for delivery normally two days after the deal. Suppose on 2-1-2008 you buy $100,000 in the spot market. It is to be delivered on 4-1-2008. If 4-1-2008 happens to be a banking holiday, you will get delivery the next day, that is 5-1-2008. You don’t prefer this. Then you should book the contract on ‘tom’ basis on 2-1-2008 so that you can take delivery on 3-1-2008 itself.

xi **Forward Market:** Forward market is a market for future delivery, but rate or price is predetermined. Forward market is used by importers to buy forward forex needed in future and by exporters to sell forward the forex receivable in future. Speculators use forward market to speculate. If speculators expect a particular currency to depreciate they will sell forward that currency. If their expectation is appreciation of a currency, they will buy forward the currency.

NOTES

Delivery date Determination: Suppose on 5-1-2008 you buy $100,000 two months forward. What is the delivery date? The delivery date is fixed adding two calendar months to delivery date of a spot deal booked on the same date, that is 5-1-2008. The spot delivery date is 7-1-2008. Adding 2 calendar months to this, the forward delivery date is 7-3-2008. If 7-3-2008 happens to be holiday, the next day happens to be the delivery date.

Apart **plain forward buying and forward selling** contracts, there are **option forward contracts and rollover forward** contracts. In option forward contracts, the client has time option to spread the exercise of his contract over a certain period. **Roll over forward contracts** involve rolling over of the forward contracts again and again for further periods.

xii. Arbitrage Market: Simultaneous buying (or selling) in one market and selling (or buying) of the same in another market to profit out of price differences is arbitrage. Arbitrage is done without investment and a risk-less profit is booked. There are single point, multi-point, covered and uncovered arbitrages.

Single point arbitrage: Suppose the bid-ask rates given by two banks are as follows:

Bank A	Bank B
Rate: £/$ 0.7086/0.7096	Rate: £/$ 0.7076/0.7082

There is arbitrage opportunity here. Buy $ from Bank B at £ 0.7082 and sell the same at £ 0.7086 and make a risk-less profit (£ 0.7086 - £ 0.7082) of £ 0. 0004 per $. This is single point arbitrage, as mere buying and selling of the same currency is involved.

Multi-point arbitrage: A chain of buying and selling of different currencies at different markets in order to make a profit is called multi-point arbitrage.

xiii. Options Market: An Options contract involves one person known as option writer or option seller giving another called option buyer or option holder the right to buy (in **call option**), or right to sell (in **put option**) or right to buy or sell (in **call and put option**) an underlying asset at a specified price per unit called the **strike or exercise price** for delivery on or before a certain day (in the case of **American option**) or on a certain day (in the case of **European option**), for an upfront commission or option premium or option price. The determination of option **price or commission or premium** is the main task of the options market. Several variables are involved here. A theorem given by **Black-Sholes on Option Pricing** got the **Noble Prize** in the 1990s. The Chicago Board of Options Trade **(CBOT)** is a premier institution in options dealings.

NOTES

xiv. Futures Market: Futures contract is similar to forwards, but is exchange done and standardized in most aspects. Famous foreign exchange futures markets are: the London International Financial Futures Exchange (LIFFE), Tokyo International Financial Futures Exchange (TIFFE), Singapore International Financial Futures Exchange (SIFFE), etc. Futures market can be used for hedging as well as speculation. Open position speculation and spread strategy speculation are available. Under spread speculation inter-commodity and intra-commodity Speculation strategies exist. Spread speculation limits loss and of course profits too. Open position is riskier and hence may reward smartly. -

xv. Swaps Market: Swap deals involve temporary exchange, with agreement to reverse back to original situation. Temporary exchanges could be, like: (i) Buying in the spot and selling in the forward market, (ii) Exchanging a fixed return asset for a floating return asset and so on.. There are **assets swaps, liabilities swap, currency swaps, interest rate swap**, etc.

1.10.2. Types of Forex Rates

There is a cluster of rates in use in forex market. Direct and Indirect rates, Spot rate and forward rate, buying rate and selling rate, single rate, fixed rate, floating rate, flexible rate, cable or T.T. (Telegraphic Transfer) rate, havala rate, official rate, market rate, futures rate etc.

i. Direct and Indirect Rates

Direct rate expresses units of home currency per unit of foreign currency. In India, Rs./$ or Rs./• or Rs/¥ or so is the style of giving quotation now adopted. This is direct quotation, as numerator currency is domestic. **Indirect rate expresses units of foreign currency per unit of home currency.** This style is adopted in UK. But when the two currencies compared are foreign currencies, the direct and indirect quote concept does not exist. **The understanding required is the given rate is units of the numerator currency exchanging for 1 unit of the denominator currency. This is true whether it is direct or indirect quote. This is the mathematical logic.** This logic is followed throughout our discussion.

ii. Bid and Ask Rates

When you call for a forex quotation from a forex dealer, he gives two rates, the first one at which the dealers purchases and the second one at which he sells. E.g. Spot rates: £/$ = 0.48158 / 0.48350. The dealer is prepared to buy $ at £ 0.48158 per $ and sell $ at £0.48350 per $. **The buying rate is called 'bid' rate and the selling rate is called 'offer' or 'ask' rate.** The buying rate is less than the selling rate. It has to be. The

NOTES

difference is called bid-ask spread and it is the gross income for the dealer for offering the currency exchange services. The spread = 0.48350 - 48158= 0.00192. The spread is also influenced by fluctuations in the market. Higher the fluctuations, higher is the spread and vice versa.

A practice in the exchange market is to give bid rate fully and as to the ask rate part of the quotation the practice is to give only from the decimal point difference between bid and ask rates exists. Read the exchange rate given above: £/$ = 0.48158 / 0.48350. The ask rate varies from the third decimal point onwards; so the following quote style is followed: £/$ = 0.48158 / 350. But this means : £/$ = 0.48158/ 0.48350. the bid-ask difference is lower for hot currencies that are actively traded. Between, • and $, the bid-ask spread used to go as low as 0.0003 dollar per •.

iii. Spot and Forward Rates

Spot market in foreign exchange refers to buying and selling forex, with payments and delivery taking place normally in 2 days after. Delivery sooner or later than this usual 2 days can be arranged, however. Spot with same day settlement is called 'cash or ready market' and next day settlement is called "tom market", the term "tom" means tomorrow. **The spot rates for normal spot (i.e., delivery 2 trading days later), for 'tom' and for 'same day' won't be same.** The bid-ask spread will be increasing from normal spot to 'tom' and further increase from 'tom' to 'same day' markets. May be the 'tom' quote could be: 0.48150 / 0.48358 and the spread is 0.48358 - 0.48150= 0.00208. The same day quote could be: 0.48145 / 0.48365 and the spread is = 0.48365 - 0.48145= 0.00220.

Forward market in foreign exchange refers to transactions which are performed at a future specified period, but the rates are settled at the time the contracts are made. The essence of a forward transaction is that a rate of exchange is fixed now to ward off market uncertainties. Both payment and delivery will take place at the future date. The relationship between spot and forward rate, the determinants of discount/premium of forward rate against the spot rate and relevant other points are areas of discussion.

iv. Modified Conventions in quoting Forex rates & Ignored Mathematical convention

Now a modified convention of foreign exchange rate quotation is in vogue. You may get a quotation: $ /£ = 0.4825 meaning that 1$ = £0.4825. Correspondingly, £ / $ = 2.0725, means one unit of the first currency, i.e., the £, is equal to 2.0725 unit of the second said currency, namely, US $. **Is this not mathematically unsound?** Mathematically when we write a fraction the denominator is normally one unit and its equivalent numerical unit's value is found. That is $ /£ = 0.4825 is undoubtedly wrong. May be it is wanted to put as: $/£ 0.4825, but erroneously put as $ /£ = 0.4825. A '/' cannot be equal to '='.

NOTES

iv. TT Rates

Forex market is not exactly a place and that there is no physical meeting, but meeting is affected by mail or over phone.

v. Inter-bank and Merchant Rates or Quotations

The bid-ask rates given by a banker meant for another banker are inter-bank quotations. Interbank quotations are meant for deals amongst bankers. For merchant clients (exporters, importers, tourists, etc.) the rates given by a banker are different and these are called as merchant rates. These are obtained from inter-bank quotations after adjustments for exchange margin.

Merchant TT buying rate = Inter bank bid rate - Exchange Margin

Merchant TT selling rate = Inter Bank ask rate + Exchange margin

(Exchange margin is the margin taken over by the banker. Margin is subtracted when the banker buys the forex. It is added to the inter-bank ask rate when the banker sells the forex to merchants or retail customers. The rate of margin is fixed generally by forex dealers association). Merchant quotations have larger spread than inter-bank quotations.

vi. Single and Multiple Rates

Single rate refers to the practice of adopting just one rate between two currencies. A rate for exports, other for imports, other for transactions with preferred area, etc. if adopted by a country, that situation is known as multiple rates.

vii. Fixed, Flexible and Floating Rates

Fixed rate refers to that rate which is fixed in terms of gold or is pegged to another currency which has a fixed value in terms of gold. Flexible rate means the exchange rate is fixed over a short period, but allows the same to vary in the long term in view of the changes and shifts in demand and supply. Floating rate refers to the ‘natural price’ of one currency in terms of another as conditioned by the free play of market forces. The rate is allowed to freely float at all times. The rate of exchange between two currencies adopting floating rate system fluctuates from day to day or even minute, due to changes in demand

NOTES

and supply. But those movements take place around a rate which may be called the 'normal rate' or the par of exchange or the true rate.

viii. Cross Rates: The exchange rate between 2 given currencies may be obtained from the rates of these two currencies expressed in terms of a third currency. The resulting rate is called the cross rate. When two currencies are not straight away related by a quotation, but each is quoted to another currency, through crossing the two available quotations, the quotation for earlier unrelated currencies can be obtained. The quote thus got is **Cross Rate.**

Say: 1 £= Rs. 86.60 and 1 $ = Rs. 40.25. We may write these as follows: Rs. 86.60/£ and Rs. 40.25/$. To get, the value of US dollar in terms of Pound sterling (£), we need to find the value of £/$. We have to note Mathematically: £/$ = £/Re. x Re./$ = 1/86.60 x 40.25 = 0.4648.

Example 1: Currency £ and currency • are not straightaway related, but both £ and • are quoted in terms of $. Let £/$ = 0.4825 and •/$=0.8261. Find the value of £/•.

Solution: £/• = (£/$) x ($/•) = (£/$) x 1/ (•/$) = 0.4825 x 1/ (0.8261)

= 0.4825 x 1.2105 = 0.5841.

Example 2: Suppose the quotations are given in bid-ask form. Let $/• be 1.1245/ 1.1285 and $/£ be 1.7145/1.7195. Find the bid-ask for •/£.

Solution: We need •/£. Mathematically •/£ = •/$ x $/£. Using this, we get the bid and ask quotes as below.

Bid quote for •/£ = Bid •/$ x Bid $/£.

We have Bid $/£, but not Bid •/$.

But, Bid •/$ = 1/Ask$/•.

So, Bid for •/£ = [1/Ask$/•.] x [Bid $/£] = [1/1.1285] x 1.7145 = 1.5193.

Ask for •/£ = Ask •/$ x Ask $/£.

We have Ask $/£, but not Ask •/$.

But, Ask •/$= 1/Bid $/•.

So, Ask for •/£ = [1/Bid$/•] x [Ask $/£] = [1/1.1245] x 1.7195 = 1.5291.

So, •/£ bid- ask quote is = 1.5193/1.5291.

NOTES

Example 3: Suppose the quotations are given in bid-ask form. $/• = 1.1245/1.1285 and •/£= 1.5193/1.5291. Find the bid-ask for $/£.

Solution: Bid rate for $/£ = Bid $/• x Bid • /£. We have both Bid $/• and Bid • /£

= 1.1245 x 1.5193 = 1.7085

Ask rate for $/£ = Ask $/• x Ask • /£. We have both Ask $/• and Ask • /£

= 1.1285 x 1.5291 = 1.7256

ix. Other Rates: Buying rate and selling rates refer to the rate at which a dealer in forex is willing to buy the forex and sell the forex. In theory, there should not be difference in these rates. But in practice, the selling rate is higher than the buying rate. The forex dealer, while buying the forex pay less rupees, but demands more rupees when he sells the forex. After adjusting for operating expenses, the dealer books a profit through the 'buy' and 'sell' rates differences. Transactions in exchange market consist of purchases and sales of currency between dealers and customers and between dealers and dealers. The dealers buy forex in the form of bills, drafts and credits with foreign banks, from customers to enable them to receive payments from abroad. The resulting accumulated currency balances with dealers are disposed of by selling instruments to customers who need forex to make payments to foreigners. The selling price for a currency quoted by the dealer (a bank) is slightly higher than the purchase price to give the bank small profit in the business. Each dealer gives a two-way quote in forex.

1.10.3. Exchange Rate Determination

Determination of the exchange rate is as simple as the determination of price of any commodity or product or service. Only thing, here the commodity itself is one currency, so price of one currency in terms of another is required. But the caveat is determination of price of any commodity/product/service is not that simple. The determinants of the exchange rate are too many to consider. Yet certain macro variables would capture the same.

1.10.3.1 Determinants of Exchange Rate

There are many factors which could be broadly put as economic, political and psychological factors. The rate also depends on the exchange rate system followed. These are explained below.

NOTES

Economic Factors	
(i) The system of foreign exchange rate administration	(ii) Gross Domestic Product of the two countries and trend thereof
(iii) Inflation rates in the two countries and trend thereof	(iv) Interest rates (nominal and real) in the two countries and trend thereof
(v) Mutual demand for goods/services of the other country	(vi) Export and import trades of the country, trade, current and overall account balances of the countries
(vii) Flow of foreign capital and foreign investments in the countries	(viii) Size and composition of foreign debts and servicing requirements and trend therein
(ix) Efficiency, depth and maturity of capital, finance and forex markets in the countries	(x) Foreign exchange reserve in the country
(xi) Fiscal prudence and health of the country	(xii) Extent of speculation and checks on the same
(xiii) Natural Resources Endowments	(xiv) The power of Central Bank of the country
Political Factors	
Political system and its links with economies	Ability to deal with threats within or outside
Political policy stability	Global affiliations and relations
Market Psychological factors	
Long-term trends	Market Vulnerability to 'crowd psychology'
Flights to quality	"Oversold" or "overbought": Buy the rumour, sell the fact

Source: The Author.

+

a. **Exchange Rate System**

Exchange rate system refers to the assemblage of institutions, investments and their interplay on exchange rate behaviour. Traditionally there are two extreme systems at the poles, namely **fixed rate system and floating rate system** and **in between diverse combinations** exist. These systems are diagrammatically presented in figure 1 and discussed below.

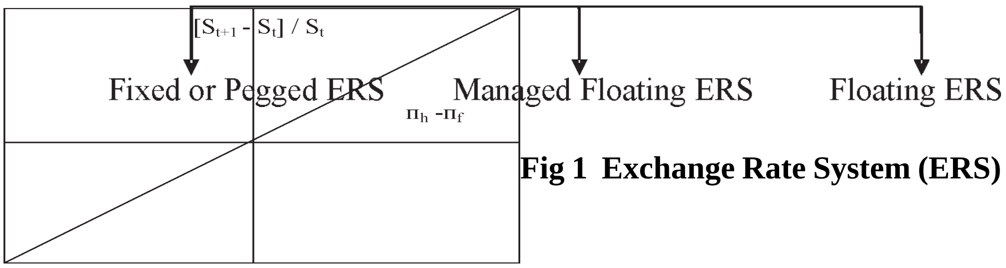


Fig 1 Exchange Rate System (ERS)

i **Fixed or Pegged Exchange Rate System:** Pegging means fixing. Under currency pegging, the external value of a currency is fixed, that is pegged at certain values adopting one standard or other. Gold standard, purchasing power parity and IMF pegging system or other forms of currency pegging. The pegged rates remain fixed for a time, until refixed or repegged.

Currency Pegging Under the IMF Charter with USD: After the Gold standard and purchasing power standard, currency under the IMF charter resulted which required every member-country to fix and maintain the par value of its currency in terms of gold or dollar. This system of fixed exchange came to be known as pegged exchange rates or par values. The schemes provided that:

- Each member country should declare the external value of its currency in terms of gold and US dollar. This was known as the 'par value' of the currency price.
- The value of US dollars is fixed at USD 35 per ounce of the gold. The USA committed itself to convert dollars into gold at the above official price.
- Following the above, the monetary reserves of member-countries came to consist of gold and US dollars. Thus US dollar got the position of a reserve asset.
- Each country agreed to maintain the market value of its currency within a margin of 1% of the par value. Where the variation in the market was more than the permitted level, the country should take steps to devalue the currency to correct the position.
- Members were free to devalue their currencies. But, if the evaluation exceeded 10% of the par value, approval of the IMF should be obtained. The IMF might approve it or advise a lower rate. However, it had no power to reject the proposal.
- The IMF granted short-term financial assistance to its members to tide over their temporary balance of payments problems. For chronic problems the members were expected to use permanent solutions like devaluation.

This system was known as adjustable pegged exchange rate with a band of 2%. The system worked till 1971.

NOTES

Currency Pegging Under the IMF Charter with SDR: In the on-going search for a truly international currency, Special Drawing Rights, (SDRs) the currency of IMF emerged pushing down both gold and the greenback, i.e., the dollar in the late 1970s.

Basket Pegging of currency: Basket pegging involves the domestic currency is pegged to a basket of currencies. When no international currency is strong and steady, basket pegging is resorted to.

To support fixed exchange rate system a web of exchange control measures are needed. These include: Exchange control measures adopted include: Intervention, Exchange restrictions, Blocked Accounts, Multiple Exchange rates, Exchange clearing agreements, Payment agreements and Gold policy.

ii **Managed Floats:** In April 1978, second Amendment to the IMF's Articles of Agreement came into effect and with that member countries were free to choose own exchange rate system. But member countries should ensure order and stability in exchange rate system. IMF has surveillance or watchdog role over the exchange rate policies of countries, but are subject to regulations to keep the movements within limits. Under the system, some currencies are pegged to certain currency, some are pegged to the SDR, some are pegged to a basket of currencies and some are subject to mutual intervention and some are partially floating and partially pegged (i.e., dual exchange rate system).

iii **Free Float:** USD, Yen and PS became free floating since 1978. Under free floating exchange rates are determined by demand and supply. Central banks do intervene, but at market determined rates only. Rupee has become a free floating currency partially in 1992 and near-fully on current account in 1993. In a freely floating rate system market forces decide the rate. Most nations now adopt this system now. There is no undervaluation or overvaluation. Exporters and importers get and pay, as the case may be, the market value and the system is equally poised in respect of both, unlike fixed ERS where with overvaluation of domestic currency exporters benefit and with undervaluation the importers benefit. Floating ERS is an open-door policy and this attracts more flow of foreign capital and that domestic economy is poised for growth. Floating ERS does not strain domestic economy or fiscal policies much as the exchange rate gets suitably altered. The Government does not feel the pressure of maintaining an unsustainable overvalued / undervalued position of domestic currency.

But fluctuations in rates will be there every time. The market may go haphazardly volatile abetted by speculation, capital flight at will, currency contagion effect and so on.

b. **GDP of countries:** Exchange rate trend must reflect the trend in the economic growth of the countries and that GDP size, the growth in that, etc influence exchange rate.

NOTES

Generally, the more healthy and robust a country's economy, the better its currency will perform.

c. **Government budget deficits or surpluses:** The market usually reacts negatively to widening government budget deficits, and positively to narrowing budget deficits. The impact is reflected in the value of a country's currency.

d. **Balance of trade levels and trends:** The trade flow between countries illustrates the demand for goods and services, which in turn indicates demand for a country's currency to conduct trade. Surpluses and deficits in trade of goods and services reflect the competitiveness of a nation's economy. For example, trade deficits may have a negative impact on a nation's currency.

e. **Inflation levels and trends:** Typically, a currency will lose value if there is a high level of inflation in the country or if inflation levels are perceived to be rising. This is because inflation erodes purchasing power, thus demand, for that particular currency.

f. Political conditions

Internal, regional, and international political conditions and events can have a profound effect on currency markets. For instance, political upheaval and instability can have a negative impact on a nation's economy. The rise of a political faction that is perceived to be fiscally responsible can have the positive effect. Also, events in one country in a region may spur positive or negative interest in a neighbouring country and, in the process, affect its currency.

g. Market psychology

Market psychology influences the foreign exchange market in a variety of ways: Unsettling international events can lead to a "flight to quality" - with investors seeking a "safe haven". There is the tendency for the price of a currency to reflect the impact of a particular action before it occurs and, when the anticipated event comes to pass, react in exactly the opposite direction. This may also be referred to as a market being "oversold" or "overbought" situations.

1.10.3.2 Exchange Rate Determination Models

Flow models and asset models are used in exchange rate determination. These are dealt here.

a. Flow model

The flow model of exchange rate determination simply is based on demand and supply of forex. Demand for foreign exchange take place whenever a country imports goods and services, people of a country undertake visits to other countries, citizens of a

NOTES

country remit money abroad and whatever purpose, business units set up foreign subsidiaries and so on. In all these cases the nation concerned buys relevant and required foreign exchange, in exchange of its own currency, or draws from foreign exchange reserves built. So the **demand side** includes importers, citizens undertaking outward travel, remittances against foreign services obtained, outward foreign debt servicing, export of capital for overseas investment, buying of forex by monetary authority as an intervention strategy, etc.

On the other hand, when a country exports goods and services to another country, when people of other countries visit the country, when citizens of the country settled abroad remit money homewards, when foreign citizens, firms and institutions invest in the country and when the country or its business community raises funds from abroad, the country's currency is brought by others, giving foreign exchange, in exchange, inflow of foreign exchange takes place. So the **supply side** includes exporters, foreign citizens undertaking inward travel, remittances against foreign services provided, inward foreign debt servicing, inflow of capital in the form of foreign direct investment, portfolio investment, release of forex from forex reserve by the monetary authority, etc.

b. Current Account Monetary model

The model assumes that: There is only one asset, that is money. Domestic money is held by residents of the country and foreign money by foreigners only. PPP theory holds good. There is stable demand for money in each country. Demand for money depends on real income and nominal interest rate. Foreign real income and nominal interest rate are external variables not influenced by domestic factors. Fully flexible exchange rate system is followed keeping the exchange rate in continuous equilibrium.

With these assumptions the equilibrium exchange rate in 'direct quote form:

$$\text{'S'} = k + Ü\,(m_h - m_f) - â\,(y_h - y_f) + è\,(i_h - i_f)$$

Where 'S'- the exchange rate. A higher 'S' means foreign currency appreciates and lower 'S' means it depreciates

k is a constant,

Ü is regression coefficient attached to $(m_h - m_f)$

m_h is domestic money supply

m_f foreign money supply

â is regression coefficient attached to $(y_h - y_f)$

$_h$ is real domestic income

y_f is real foreign income

NOTES

is regression coefficient attached to (i_h-i_f)

$_h$ is nominal domestic interest rate

i_f is nominal foreign interest rate.

f $(m_h-m_f) > 0$, domestic money supply exceeds foreign money supply and this leads to increase in S , that means domestic currency depreciates or foreign currency appreciates, because the regression is positive coefficient. If $(y_h-y_f) > 0$, domestic real income exceeds foreign real income and this leads to decrease in S , that means domestic currency appreciates or foreign currency depreciates, because the regression is a negative coefficient.

If $(i_h-i_f)> 0$, domestic nominal interest rate exceeds foreign nominal interest rate and this leads to increase in S , that means domestic currency depreciates or foreign currency appreciates, because the regression is positive coefficient.

c. Capital Account model

The capital account model assumes that: PPP theory holds good. There is stable demand for money in each country. Demand for money depends on real income and nominal interest rate. Foreign real income and nominal interest rate are external variables not influenced by domestic factors. Uncovered interest parity theory holds good and Fisher open condition exists. Expected change in exchange rate depends on perceived departures from long-term equilibrium exchange rate..

With these assumptions the equilibrium exchange rate in 'direct quote form:

$$\text{'S'} = k + \ddot{U}(M_h-M_f) - \hat{a}(Y_h-Y_f) + \grave{e}\,(I_h-I_f) + \ddot{e}\,(\ddot{\imath}_h-\ddot{\imath}_f)$$

Where 'S'- the exchange rate. A higher S means foreign currency appreciates and lower S means it depreciates.

k is a constant,

Ü is regression coefficient attached to (m_h-m_f)

m_h is domestic money supply

m_f foreign money supply

â is regression coefficient attached to (y_h-y_f)

y_h is real domestic income

y_f is real foreign income

è is regression coefficient attached to (i_h-i_f)

NOTES

i_h is nominal domestic interest rate

i_f is nominal foreign interest rate

ë is regression coefficient attached to ($ï_h$-$ï_f$)

$ï_h$ is domestic inflation

$ï_f$ is domestic inflation.

If (M_h-M_f) > 0, long-term domestic money supply exceeds long-term foreign money supply and this leads to increase in S , that means domestic currency depreciates or foreign currency appreciates, because the regression is positive coefficient..

If (y_h-y_f) > 0, long-term domestic real income exceeds long-term foreign real income and this leads to decrease in S , that means domestic currency appreciates or foreign currency depreciates, because the regression is a negative coefficient.

If (i_h-i_f)> 0, long-term domestic nominal interest rate exceeds long-term foreign nominal interest rate and this leads to increase in S , that means domestic currency depreciates or foreign currency appreciates, because the regression is positive coefficient.

If ($ï_h$-$ï_f$)> 0, long-term domestic inflation rate exceeds long-term foreign inflation rate and this leads to increase in S , that means domestic currency depreciates or foreign currency appreciates, because the regression is positive coefficient.

1.10.4 Exchange Rate Theories

Exchange rate theories reason out the forex rate determination. They help the process of determining exchange rate between currencies. The exchange is governed by certain parameters. Depending on the parameters used, different exchange rate theories have been developed. There are Mint Parity, Purchasing Power Parity and Interest Rate Parity theories.

1.10.4.1 Mint Parity Theory

Under the Gold Standard or mint parity arrangement, rate of exchange is determined by reference to the gold contents of the two currencies, as each currency is expressed in terms of weight of gold. Gold standard prevailed upto 1931. Now it is not in practice. To understand the method, let us take an imaginary example. Let Re 1 = 0.001 gram of gold and US dollar (USD) 1 = 0.04 gram of gold. Then the rate of exchange between these two currencies under the Gold Standard will be : The rate of exchange is also known as the mint par of exchange, for at the Indian mint Re 1 will be = 0.001 gram of gold and at the US mint $ 1 = 0.04 gram of gold..

NOTES

The actual exchange rate in the forex market will not be, however, USD 1 = 0.40, but slightly different due to bank commission. But bank commission cannot exceed certain limits as merchants can export or import gold to settle international payments incurring expenses of shipping and insurance when the commission charged is felt to be high. Suppose banks charge 10% commission and that to get USD 1, a merchant has to part with Rs. 40 plus 10% = Rs.44. Instead, the merchant can buy 0.040 gram of gold equivalent to one USD and export the same incurring say, Rs. 2 as forwarding and insurance cost of the 0.04 gram of gold to the American supplier of goods. The effective exchange rate comes to USD 1=Rs. 40 + Rs. 2 = Rs. 42. So banks cannot charge Rs 44 a dollar, but come down to Rs. 42. Similarly, it can be shown that a bank cannot offer less than Rs 38 a dollar (Rs 40 – Rs. 2) when the bank buys dollars. Thus the actual exchange rate is ± Rs.2 about the mint parity of USD 1 = Rs. 40.

1.10.4.2 Purchasing Power Parity Theory

There is another popular theory of exchange rate based on purchasing power parities of currencies. Under the purchasing power parity method, adopted when paper currencies are used, external value of a currency is determined on the basis of its internal value. As there is no gold convertibility option, a case with Gold standard, currencies have to be valued on the basis of their respective internal value either by reference to particular commodity or basket of commodities.

Say, a bale of cotton is sold for Rs. 20,000 in India while the same is USD 500 in USA. Then, Rs. 20000 = USD 500 or Rs. 40 = USD 1. If, the price of cotton rises in India, the value of Rupee falls against USD, if there is no sympathetic rise in price of cotton in USA. But basing currencies' external value on the basis of price of a single commodity or basket of commodities internationally traded is not good, for only part purchasing power is considered. So, exchange rate computation and adjustment based on price index numbers [CPI, WPI, CLPI, etc] is considered. Suppose in 2006 USD 1 = Rs. 44 and the price indices in both USA and India = 100. By 2007 the index number of Indian prices, say has become 105, while that of USA is 110. Then 2007 exchange rate will be: USD 1 = 105/110 X Rs. 44 = Rs. 42 and Re. 1 = 150/280 x 1/44 = USD 1/42 or 0.0238.

Purchasing Power Parity (PPP) was first stated in a rigorous manner in 1918 by the **Swedish economist Gustav Cassel,** who used it as the basis for recommending a new set of official exchange rates at the end of World War I that would allow for the resumption of normal trade relations. Since then, PPP has been widely used by Central banks as a guide to establishing new par values for their currencies when the old ones were clearly in disequilibrium.

NOTES

In its absolute version, purchasing power parity states that the equilibrium exchange rate between domestic and foreign currencies equals the ratio between domestic and foreign price levels. Thus, if e_o is the current equilibrium exchange rate (i.e. in equilibrium, one unit of foreign currency equals e_o units of the home currency). P_h the home country price level, and P_f the foreign price level, then $e_o = P_h / P_f$ or $P_f\, e_o = P_h$. In other words, a unit of home currency (HC) should have the same purchasing power around the world.

This theory is based on the law of one price; i.e. it rests on the assumption that free trade will equalize the price of any good in all countries - otherwise, arbitrage opportunities would exist. However, the theory ignores the effects of transportation costs, tariffs, quotas and other restrictions, and product differentiation.

The relative version is used more commonly now. Foreign price would indicate the necessary adjustment in the exchange rate between any pair of currencies. Formally, if $P_h(t)$ and $P_f(t)$ are the home and foreign price levels, respectively, and e_t is the HC value of one unit for foreign currencies all at time t, then:

$e_{t}\,/\,e_{o} = (P_{h,,t}/P_{h,,o}) / (P_{f,t}/P_{f,,o})$, where, $(P_{h,o})$ $(P_{f',o})$ and e_o are the base period equilibrium price levels and exchange rate, respectively and $(P_{h,t})$ $(P_{f',t})$ and e_t are equilibrium price levels and exchange rate, at period 't'.

This equation can be stated in terms of relative inflation rates using the following transformation. Let $i_{h,t}$ and $i_{f,t}$ be the (anticipated) price level increases (rates of inflation) between time 0 and time t for the home country and the foreign country, respectively; i.e. $P_{h,t}/P_{h,o} = 1 + i_{h,t}$ and $P_{f,t}/P_{f,o} = 1 + i_{f,t}$. So, $[e_{t}\,/\,e_{o}] = [1 + i_{h,t}]/[1 + i_{f,t}]$. Then, $[(e_t - e_o)/e_o]$ is the relative (anticipated) exchange rate change between 0 and t, and this should equal: $[\,i_{h,t} - i_{f,t}\,] / [1+\ i_{f,t}]$ which is the relative price level change from time '0' to time 't'.

For example, if the current US price level is at 112 while the UK price level is at 107, relative to base price levels of 100 then, according to PPP, the dollar value of the Pound Sterling should have appreciated by approximately 4.67% [(0.12 - 0.07)/1.07 = 0.0467]. On the other hand, if the UK price level now equals 119, then the Pound Sterling should have depreciated by approximately 5.88% [(0.12 - 0.19)/1.19 = -0.0588] in the interim. A simplified [inexact] version of this formula is: $(e_t - e_o)/e_o = [\,i_{h,t} - i_{f,t}\,] / [1 +\ i_{f,t}]$. That is, **the inflation differential between times '0' and 't' should equal the per cent change in exchange rate for that same time period.**

NOTES

Purchasing power parity bears an important message. Just as the price of goods in one year cannot be meaningfully compared to the price of goods in another year without adjusting for interim inflation, so exchange rate changes may indicate nothing more than the reality that countries have different inflation rates. In fact, according to purchasing power parity this should be case. If so, then exchange rate movements just cancel out change in the foreign price level relative to the domestic price level. These offsetting movements should have no effects on the relative competitive positions of domestic firms and their foreign competitors. Thus changes in nominal rates are off-setting nature of effects of inflation. If currency changes affect relative competitiveness, the focus must be not on nominal exchange rate changes but instead on changes in the real purchasing power of one currency relative to another. The real exchange rate is different from nominal exchange rate.

PPP graphic presentation

The relationship between the current spot and expected future spot rate and inflation rates can be shown graphically, as in Fig 2. Plot on the horizontal axis the inflation differential in favor of the home country, i.e. $\text{ï}_h - \text{ï}_f$, The vertical axis plots the percentage difference between future spot over current spot on the foreign currency relative to the home currency.

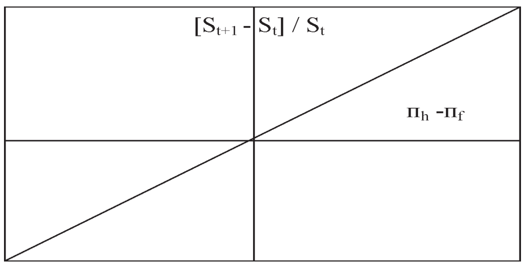


Fig 2 PPP Theory

$\text{ï}_h - \text{ï}_f$ = Inflation differential (in %) in favor of the home country.

$[S_{t+1} - S_t] / S_t$ = Rate of change in expected future spot rate over current spot rate

The purchasing power parity line joins those points for which the future spot exchange rate is in equilibrium with the inflation differential. For example, if the inflation differential in favor of the home country is 2%, then the foreign currency must go at a future spot which is 2% more than current spot rate.

NOTES

1.10.4.3 *Interest Rate Parity Theory*

Interest rate parity theory tries to bring out the relationship between spot and forward exchange rates. The currency of the country with a lower interest rate should be at a forward premium in terms of the currency of the higher interest rate country. More specifically, in an efficient market with no transactions costs, the interest differential should be (approximately) equal to the forward differential.

Mathematics of the Theorem:

$F_{'n'}/S = (1 + n.i_{(h)})/(1 + n.i_{(f)})$ where ,

$F_{'n'}$ = `n' period forward rate of a foreign currency given in direct quotation form

S = spot rate given in direct quotation form

'n' = period in years

$i_{(h)}$ = interest rate in home country per annum

$i_{(f)}$ = interest rate in foreign country per annum

The one period, i.e., one year forward rate is given by : $F/S = (1 + i_{(h)})/(1 + i_{(f)})$

Then, $F\text{-}S/S = (1 + i_{(h)} - 1 - i_{(f)})/(1 + i_{(f)}) = [\, i_{(h)} - i_{(f)}\,]/\,[(1 + i_{(f)}] = [i_{(h)} - i_{(f)}]$ Approximately.

That is, rate of forward premium or discount, relative to current spot is approximately equals the difference in interest rates in the two countries.

Suppose US interest rate is 6% and in Indian Interest Rate is 8% p.a. If "S" = Rs. 40/$, 1 year forward $ rate is given by

F/S = F/40 = (1 + (0.08))/(1 + (0.06) = (1 + 0.08)/(1 + 0.06) = [1.08/1.06] x 40 = Rs. 40.75/$

Six month forward rate is obtained as follows:

F/S = F/46.5 = (1 + (1/2)(0.08))/(1 + (1/2)(0.06)) = [1.06/1.03] x 40 = 40.39

NOTES

Interest rate parity graphic presentation:

The relationship between the spot and forward rates and interest rates can be shown graphically, as in Fig 3. Plot on the horizontal axis the interest differential in favor of the home country, i.e. i_h-i_f. The vertical axis plots the percentage forward discount (negative) or premium (positive) on the foreign currency relative to the home currency. The interest parity line joins those points for which the forward exchange rate is in equilibrium with the interest differential. For example, if the interest differential in favor of the home country is 2%, then the foreign currency must go at a 2% premium over spot rate.

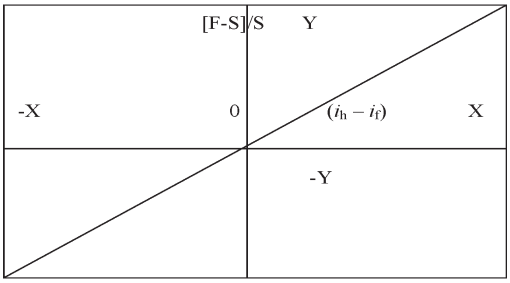


Fig 3: IRP presentation

$(i_h - i_f)$ = Interest rate differential (in %) in favor of the home country.

[F-S]/S = Rate of change in forward rate over current spot rate.

1.10.5 Forward Rate Computation

Exchange rate computation is a sort of arithmetic worth an exposure. The same is dealt now.

1.10.5.1 Forward rate computation based on Interest Rate Parity

Forward rate quotation, the rate quoted is for delivery at a future date, which is usually 1, 2, 3, 4, 6 or 12 months later. The forward rate may be at a premium or discount to the spot rate. Premium rate, i.e., forward rate is higher than the spot rate, implies that the foreign currency is to appreciate in value in the future. This may be due to expected tightened supply of GBP in future over the present scenario in relation to respective demand.

Say, £ is expected to appreciate against Rupee and hence premium quotes are prevailing. On the other hand if it is expected to depreciate forward discounts shall be

NOTES

quoted. The percentage of annualized discount or premium in a forward quote, in relation to the spot rate, is computed by the following:

$$\frac{\text{Forward rate Rs./\$ 'n' period}}{\text{Spot rate Rs./\$}} = \frac{[1+\text{Interest rate in India 'n' period}]}{[1+\text{Interest rate in US 'n' period}]}$$

If the spot rate is higher than forward rate, (S > F) there if forward discount and if the forward rate is higher than the spot rate (F > S), there is forward premium rate. Among others, the interest rate factors affect the forward rate of foreign exchange. Interest rate differences in the two countries affect forward rates. It is held that the ratio of the forward and spot exchange rates will be equal to the foreign and domestic interest rates. Taking rupees and dollar:

$$\frac{\text{Forward rate Rs./\$ 'n' period}}{\text{Spot rate Rs./\$}} = \frac{[1+\text{Interest rate in India 'n' period}]}{[1+\text{Interest rate in US 'n' period}]}$$

Besides the interest factor, expectation as to spot rate in the future is likely to cause difference between current spot and current forward rates.

As the forward rate and spot rate are related by the interest rates in the two countries of the currencies involved by the above equation, we can forecast forward rate.

$F_n = S(1+r_h) / (1+r_f)$,

- Where F_n is n- months' forward rate in units of home currency per unit of foreign currency (direct quote)
- S is spot rate in units of home currency per unit of foreign currency (direct quote)
- r_h is home country interest rate for the period forward and
- r_f is foreign country interest rate for the period.

Let £/$ = 0.4825, interest rate in UK is 12% and interest rate in USA 6% per annum. To get 6 months forward rate, first we have to take six months' interest rates for the two currencies and these are 6% and 3% respectively.

Then $F_{n=6/12=0.5}$ = 0.4825(1+ 6%) / (1+3%) = 0.4825(1 .06) / (1+.03) = 0.4966.

NOTES

One \$ in the forward market goes at a higher value, namely 0. 4966 than in the spot market, namely 0.4825. We say the forward \$ goes at a premium. Conversely, the currency £ goes at a discount against \$. Where the nominal interest is higher, that country's currency will go at a discount in the forward market. This is the **theory of interest rate parity.**

1.10.5.2 Computation of forward premium or discount

One \$ in the forward market, as per our example \$1= 0.4966 £, as against 0.4825 in the spot. The percentage of premium on \$ is computed using the formula:

Premium (in %) = (Forward rate - Spot rate) x 100 / Spot rate.

= (0.4966 - 0.4825) x 100 / 0.4825

= (0. 0141) x 100 / 0.4825 = 2.922%.(Roughly 3%, equal to difference in the half-yearly interest rates of the two currencies.)

The Annualized premium = Half-yearly premium x 2 = 2.922% x2= 5.844%.

The formula for annualized premium (in %)= {(F_n - S)/S} x (12/n) x 100, where F = forward rate, S = spot rate , n = number of months forward.

You know the UK Currency £ is at a discount. But we can't say the percentage depreciation of the currency is equal to percentage of appreciation of the \$ against £. To compute the discount on £, first we have to compute spot and forward rates for £ in terms of \$, that is, the \$/£. Spot \$/£= Inverse of Spot £/\$ = 1/0.4825= 2.0725 and Forward \$/£ = Inverse of forward £/\$ =1/0.4966= 2.0137. £ gets less \$ in the forward market than in the spot market. Hence it is at a discount.

The percentage of discount of £ against \$ = (Forward rate - Spot rate) x 100 / Spot rate

= [(2.0137 - 2.0725) / 2.0725]x 100

= [(- 0. 0588) / 2.0725] x 100 = - 2.837%.

The minus sign indicates discount. The annualized discount % = 2 x - 2.837% = - 5. 674%.

You can see that the premium percentage of \$ is not equal to the discount percentage on £.

NOTES

So far we dealt with cases of single rates only. In the bid-ask form also we can compute forward rates separately first for 'bid' and then for the 'ask' and present then present a forward quotation in 'bid-ask' form.

1.10.5.3 Forward Rate quotations with forward or swap points given

The forward points or swap points are decimal points, to be read with the spot rate, indicating the premium or discount points in the forward markets of different times.

Example 1: Suppose the current Spot rate in the bid-ask form £/$ = 0.48158 / 0.48350.

Forward or swap points:	1 month	:	125/150
	2 months	:	110/120
	3 months	:	120/105
	6 months	:	80/70.

We can compute forward quotations with the help of the above details. First we have to decide whether $ is at a premium or at discount. From the forward or swap points we get the clues. The swap points have two numbers, which represent decimal points, separated by a slash.

If the number before the slash is lower than the number after the slash, the denominator currency in question is at a premium against the numerator currency in the forward market and if the number before the slash is higher than the number after the slash, the currency in question is at a discount. The premium points are added to the spot rate on the respective sides and discount points deducted from spot rate on respective sides. These forward rates are called outright forward quotations.

1 Month Forward rate: The swap points indicate $ is at premium. So add them to spot rate.

1 Month Forward rate: £/$ = 0.48158 + 0.00125 / 0.48350 + 0.00150

= 0.48273/ 0.48500.

2 Month Forward rate: The swap points indicate $ is at premium. So add them to spot rate.

2 Month Forward rate: £/$ = 0.48158 + 0.00110 / 0.48350 + 0.00120

= 0.48258/ 0.48470

NOTES

3 Month Forward rate: The swap points indicate $ is at discount . So deduct them from spot rate.

3 Month Forward rate: £/$ = 0.48158 - 0.00120 / 0.48350 - 0.00105

= 0.48038/ 0.48245.

6 Month Forward rate: The swap points indicate $ is at discount So deduct them from spot rate.

6 Month Forward rate: £/$ = 0.48158 - 0.00080 / 0.48350 - 0.00070

= 0.48078/ 0.48280.

But keep in mind when deducting the swap points when the currency goes at a discount, in any case the ask rate cannot be less than bid rate. Should a situation emerge such that 'ask' is less than 'bid', it only indicates the swap points are incorrect.

1.10.6 Forex Risk

Fluctuation in exchange rate leads to risk. Forex rates fluctuate, sometimes widely. There used to be over-shooting as well, which is too much change in a short time due to panic market reaction to certain rate sensitive happening.

Forex rates, in terms of Rupee against major world currencies are given in table 1.14 and you could see the fluctuations year after year. The day-to-day rate fluctuations are the real things that worry market participants. Rupee had been depreciating for a very long time. From about Rs. 8 per USD, in the 1980-81, the rate reached as high as over Rs. 49 per USD in 2004, but then the rate started its down movement since then and now in January 2008, the rate is Rs. 39 per USD. There is something like a fall of above 20% in USD against INR.

NOTES

Table 1. 14 Exchange Rate Rupees per unit of foreign currency

Year	US Dollar	UK Pound	EURO	YEN	SDR
1980-81	7.909	18.504	--	0.037	10.178
1990-91	17.943	33.193	--	0.128	24.843
1991-92	24.474	42.515	--	0.185	33.433
March 92	25.890	44.677	--	0.194	35.347
1992-93	The year of switching to floating rate system from fixed rate system				
April	25.890	45.461	--	0.194	35.485
May	25.890	46.838	--	0.198	35.931
June	25.890	47.788	--	0.204	36.551
July	25.890	49.721	--	0.206	37.385
August	25.890	50.384	--	0.205	37.709
September	25.890	47.567	--	0.211	37.695
October	25.890	42.862	--	0.214	37.162
November	25.890	39.535	--	0.209	35.910
December	26.154	40.578	--	0.211	36.329
January	26.199	40.141	--	0.210	36.082
February	26.199	37.704	--	0.217	35.939
March 92	29.455	51.959	--	0.227	35.347
1992-93	30.649	51.686	--	0.246	37.142
1993-94	31.366	47.206	--	0.291	43.886
1994-95	31.399	48.821	--	0.316	45.791
1995-96	33.450	52.353	--	0.348	50.477
1996-97	35.500	56.365	--	0.316	50.886
1997-98	37.165	61.024	--	0.303	50.674
1998-99	42.071	69.551	--	0.331	57.513
1999-00	43.333	69.851	44.791	0.391	58.934
2000-01	45.684	67.552	41.483	0.414	59.546
2001-02	47.692	68.319	42.181	0.382	60.215
2002-03	48.395	74.819	48.090	0.397	64.126
2003-04	45.952	77.739	53.990	0.407	65.684
2004-05	44.932	82.864	56.513	0.418	66.928
2005-06	44.273	79.047	53.912	0.400	64.490
2006-07	45.500	86.000	57.800	0.390	67.500
2007-08	41.000	86.500	57.000	0. 380	66.000

Source RBI Bulletins

Foreign exchange risk is defined as, ‘ the **variance** of the real domestic currency value of assets, liabilities or operating income attributed to unanticipated changes in exchange rates’. In other words, risk is a measure of the extent of variability in the values of assets etc. due to unanticipated changes in exchange rates. All forex exposures need not necessarily lead to forex risk, because compensating movements in exchange rates with different currencies might offset loss in deal from gain in the other. Further to qualify as forex risk, only the effect of unanticipated changes in exchange rates on the domestic currency values of assets, liabilities, etc is to be considered.

NOTES

1.10.6.1 Types of Forex Risks

Forex risks are of three types. These are:

i Accounting or Translation Risk

ii Transaction risk

iii Operating risk.

i. TRANSLATION OR ACCOUNTING RISK

Translation risk is a measure of variation of home currency value of assets and liabilities appearing in balance sheet denominated in foreign currency. It is also called as balance sheet or accounting risk.

It is also referred to as accounting risk. It arises while consolidation of accounts (financial statements) involving foreign currency denominated assets and liabilities is prepared. Firms having foreign subsidiaries, require preparing the groups financial statements. These financial statements have to be prepared in terms of the home currency. Hence the assets and liabilities and incomes, and- expenses of the foreign subsidiaries operating in different countries have to be translated into parent company's currency at the appropriate rate of exchange applicable to the foreign subsidiaries' account.

The translation of foreign currency profit and loss account may be done either at the average exchange rate for the accounting year or at the closing rate prevailing at the end of the accounting year. The consolidated profit would naturally vary with changes in the average or closing rates.

Balance sheet risk has two aspects. The first is the case of items in the foreign subsidiary's balance sheet, which are translated at the rate prevailing on the date of acquisition or subsequent revaluation (historical exchange rate). Such assets and liabilities are not exposed as the translated home currency value cannot vary with changes in exchange rates. In the second case some items may be translated at the closing exchange rate, when these items in the foreign subsidiary's currency are translated into the parent company's currency, there will be variations whenever the exchange rate varies. All foreign currency items which are consolidated at currently prevailing rates are subject to translation risk.

Translation risk does not create fresh cash flows, but records items of balance sheet and profit and loss account at appropriate exchange rates and as a result there may be net increase in value and this is credited to Exchange Fluctuation Reserve a/c and shown on the liabilities side of the balance sheet. If there is net shrinkage in value, the same is debited to Exchange Fluctuation Loss a/c and shown on assets side of the balance sheet are adjusted against other reserves ad surplus account.

NOTES

ii. TRANSACTION RISK

Transaction Risk is the measure of variation of home currency value of receivables and payables denominated' in foreign currencies due to unanticipated changes in exchange rate. Transactions which give rise to forex receivables or payables in future create transaction exposure. A US firm has exported to UK, goods valued at 1 mn UK pound, payable 3 months from now. In the three months period, fluctuations in US Dollar value of UK Pound exposes the US firm to transaction exposure. Similar will be the position of an US importer who has to effect a payment of 1 mn UK Pound, two months hence. An Indian firm has to service a debt of 5 mn US Dollar loan from WE, repayable over of 10 semi-annual installments at the rate of $0.5 mn each time. There is transaction exposure. Similarly debt servicing receivable by an Indian firm denominated say in Yen leads to transaction exposure.

Transaction Exposure arises out of trade released and/or capital related cash inflows and/or cash outflows.

Managing Transaction Risk

Transaction risk arises from executed contracts resulting in forex payables or receivables in the future. The domestic currency value of these payables or receivables at current exchange rate and at future exchange rate is expected to be at variance, resulting in transaction risk. .

The risk can be hedged using internal strategies or external (that is market related) strategies. Internal strategies refer to strategies that are internal to the firm and its affiliates. These are "home' arrangements. The counter party to the transactions may be involved. But third parties are never involved. External strategies are forex market related or money market related or both.

A. Internal Strategies of Managing Transaction Risk

The internal strategies are those that effected without recourse to the forex or other markets. It is within the firm or between the business firms involved. The different internal strategies are: i. Risk Netting; ii. Risk Shifting; iii. Risk Sharing; iv. Risk Off-setting and v. Pricing

Netting involves matching forex receivables in a currency with forex payables in that currency. Both currency and time matching are needed. Suppose an US firm has Yen 10 mn receivable from and Yen 7 mn payable to same counter party, both having 90 days to mature. These two transactions can be netted and the exposure reduces to Yen 3 mn. There are bilateral and multilateral netting. The above one is bilateral netting. Multilateral netting involves a firm having forex payables with a party netting the same against forex receivable due from another party. Netting in general involves, counter adjusting a long position in a currency to a short position in the same currency.

NOTES

Risk shifting Let General Electric of US supply turbine blades to Lufthansa of German valued at Euro 25 mn. The payment is due in 90 days. Current spot is Euro 1 = USD 1.1. GE fears Euro to depreciate two months hence and that is dollar realization upon conversion of the Euro receivable will be must smaller than the USD 27.5 mn now possible. So, GE wants to shift the exposure to Lufthansa, this is possible if Lufthansa agrees to invoicing the deal in US Dollar, in which case the forex risk is shifted to Lufthansa. Lufthansa has to manage the risk by itself which has now assumed the risk.

Risk Sharing Suppose IBM and British airways are involved in a transaction. IBM is supplying flight management system to British airways, valued at $ 160 mn payable 3 months from now. IBM and British airways are agreeing to share exchange risk. Customized hedge is brought into the transaction whereby risk of exchange rate fluctuation beyond certain level, either way, is mutually shared. Since IBM invoices in USD, fluctuation in rate upto certain range, either way, is to be borne by British airways. This range, around a base rate, say $1 = £ 0.75 is called neutral range. At the base rate, the £ value of the transaction is 120 mn dollar. Let the neutral range be 1$ = 0.72 to 0.78 £. That is, if $ depreciates upto £ 0.72/$ or appreciates upto 0.78 the British airways takes up the risk on its part. Within the neutral zone, British airways will pay the original dollar value of the contract namely 160 mn $ and its £ cost will vary between £ ($ 160 mn x 0.72) and £ ($ 160 mn x 0.78) or between £ 115.2 mn and £ 124.8 mn. If the £ - $ rate 'breaches the neutral zone, the risk is to be jointly share.

Suppose, £ depreciates to 0.8, then the exchange loss above the upper bound is equally shared. So, the adjusted rate comes to £ 0.75 + (0.5/2) = £ 0.775/$. So the value of contract is arrived at as follows: Base rate value of the contract in £/Effective adjusted rate is equal to £ 120 mn /0.775= $ 154.8387 mn. If the £ appreciates beyond the lower bound, to say £ 0.68/$ then British airways cannot get the full benefit of £'s appreciation. The gain beyond £ 0.72/$ is shared with IBM. And the adjusted rate comes to £ 0.68 + 0.04/2 = £ 0.70/$. The adjusted dollar value of the contract is = £ 120 mn / 0.7 = $ 171.4286 mn.

Risk Off-Setting: Off-setting of risk means exposure in one currency is adjusted against exposure in another currency. Off-setting is different from netting, where exposure in one .currency only is involved, when export and import are in the same currency area and netted against each other.

In contrast, off-setting involves exposures in two different currencies. Suppose a Singapore Firm exports to Yen area and also to US dollar area. Since yen and dollar move in opposite direction, exchange loss (gain) in yen realization is off-set to an extent by exchange gain (loss) in dollar realization. Here currencies are opposite to one another, but transactions are of the same type.

NOTES

Consider another case. Here currencies are parallel. That is, they sink (i.e. depreciate against a third currency) or sail (i.e. appreciation) together. • and ¥ are parallel. Say, GM of US exports to Germany and imports from Japan. The transactions are opposite in nature. If there is exchange gain in the exports, there will be exchange loss in the imports and vice-versa.

Pricing To cover transaction risk, price escalation may be adopted as a measure of dealing with exposure. If exchange loss is expected a marginal hike in price can be done to take care of the loss. But competitive factors need to be considered.

Alternatively choice of currency of invoice may be a risk management tool. Invoice, if made in stronger currencies, the exporter can minimize exchange loss. Invoice, if made in weaker currencies, the importer can minimize exchange loss.

B. External Strategies of Managing Transaction Exposure

External strategies, involve looking beyond the counterparty to a transaction for dealing with transaction reserve. External strategies involve using money market and forex market tools dealing with the risk.

a. Money market hedge

Money market hedging tools are :

i Discounting of foreign currency denominated bills,

ii Factoring export receivables,

iii Currency overdrafts,

iv]orrow, convert and invest.

Discounting Foreign Currency Denominated Bills Receivable: Discounting is used in cases where the export receivables are settled through bills of exchange. The system enables the recipient to receive cash prior to the settlement date itself. The discount represents the cost for the facility extended by the bank discounting the bill. It enables the exporter to guard himself from -losses arising out of an adverse change in-the foreign exchange rate. There are two options before the exporter while considering bill discounting. The first, is to get the bill discounted through a bank in the importer's country. The foreign currency so obtained can be repatriated at the spot rate prevailing then. The second option is to discount it at the home country of the exporter itself, in which case the settlement is received in the home currency itself.

NOTES

Factoring Export Receivables: Factoring is done when export receivables are settled on open account. The- receivables are used as collateral bank financing. Such an arrangement generally gives protection against foreign exchange rate risks. Undue variations are taken care of through appropriate adjustments in the factoring agreement. The exporter sells his .export receivables to a. factor (usually a commercial bank, or a specialized .factoring institution) in exchange for home currency. Factoring costs are generally high as the credit risks, cost of financing, and exchange rate risk cover have all to be incorporated in it. .But benefits accrue in the form of easier access to export finance, and reduction of credit collection costs.

Currency Overdrafts: Overdrafts in Eurocurrencies are available from major banks. By far the currencies most sought after are the US dollar and the German mark. The technique is especially useful when a company has numerous transactions involving small amounts denominated in foreign currency, each having no certain date of payment. The use of the technique is restricted because of exchange control. The control prevents residents from maintaining bank accounts in foreign currencies.

The company interested in overdraft arrangement has to maintain an amount equal to the overdraft in foreign currency receivables. The foreign currency receivables maintained are in the same currency as the overdraft. As and when the receivables are liquidated that portion of the overdraft may be reduced. In such cases the sales made in that currency should be reduced. The burden of making numerous adjustments in the overdraft amount outstanding as payments are received, makes this method less attractive.

Borrow, convert and invest: Sometimes the company may prefer to sell the foreign currency receipts received against foreign receivables in the spot market. This reduces the burden of making numerous adjustments in the overdraft amount outstanding as payments are received.

Suppose that on January 1, General Electric is awarded a contract to supply turbine blades to British airways. On December 31 of that year, GE will receive payment of £ 25 million for these blades.

It can use a money market hedge, which would involve borrowing £ 25 million for one year, converting it into dollars and investing the proceeds in a security that matured on December 31.

Suppose Pound sterling and US dollar interest rates are 7.5% and 5% respectively. After one year GE will receive £ 25 mn. Let it borrow now a certain amount of £, which together with interest will amount to £ 25 mn in one year. This is using a money market hedge.

NOTES

General Electric will borrow £ 23.2558 million for one year, (i.e., £ 25 mn/1.075). GE converts it into $ 41.2256 million in the open market (at the spot rate of $1.7727/£), and invests the $41.2256 million for one year. On December 31, GE will receive 1.05 X $ 41.2256 million = $ 43.28688 million from its dollar investment. £ 25 million it receives from British Airways is passed to the lender to meet principal and interest. Thus the exposure is hedged.

b. Forex Market Hedge

Forex Market. Hedge involves using

- i Options market
- ii Futures market
- iii Forward market
- iv Swap market

i. Hedging Through Options Market: Buying a **Call option** in forex can be used by an importer or borrower to hedge his payables against exchange rate flucyuations. This is done only if is felt that the foreign currency is an appreciation mode. Buying a **Put option** can be used by an exporter or lender to hedge receivables. This is done only when the foreign currency is a depreciating mode.

Illustration 1: Buying a Call.

It is now August. Suppose a US importer has to pay in November 62.5 million yen to a Japanese supplier. The current $/Yen = $0.007739. A December call option in yen is available at a strike of $0.0078, per yen. The premium is $ 0.000108/yen. The brokerage fee per contract is $20. Yen options contract size is 6.25 mn yen.

The US importer has to go for 10 contracts to hedge 62.5 mn yen exposure. The effective cost per yen under the call option = Strike price + Premium + Brokerage = $0.0078 + $ 0.000108 + $[20/6,250,000] = $0.0079112.

If the outlook for the yen by November is that it will never exceed $0.0079112 per yen, there is no need to hedge at all. But if fluctuations in the market is so high, it is good to go for hedging. Let the firm go for hedging.

By Nov, the yen has, say appreciated to $0.0080. Then, the hedging has really saved firm $5550; i.e., ($0.008-$0. 0079112) x 62,500,000 =$5550.

If the yen had depreciated below $0.0079112 per yen, the option contract goes a waste. But, the Dec call option might still have some premium in the market and that by writing a call the firm can earn an income. But that income should be greater than the brokerage commission. You know the brokerage commission at $20 per 6.25mn yen, comes to an amount of $0.0000032. So, if the call premium is greater than $0.0000032, the firm may go writing calls. But the firm is taking up an obligation.

Illustration 2 : Buying a Put

It is now August. Suppose a US exporter has to receive in November 62.5 million yen from a Japanese buyer. The current $/Yen = $0.007739. A December put option in yen is available at a strike of $0.0078, per yen. The premium is $ 0.000108/yen. The brokerage fee per contract is $20. Yen options contract size is 6.25 mn yen.

The US importer has to go for 10 put contracts to hedge 62.5 mn yen exposure. The effective cost per yen under the put option = Strike price + Premium + Brokerage = $0.0078 + $ 0.000108 + $[20/6,250,000] = $0.0079112.

If the outlook for the yen by November is that yen will appreciate beyond $0.0079112 per yen, there is no need to hedge at all. But if fluctuations in the market are high, it is good to go for hedging. Let the firm go for hedging.

By Nov, the yen has, say depreciated to $0.0078. Then, the hedging has really saved firm $6950; i.e., ($0. 0079112- $0.0078) x 62,500,000 =$6950.

If the yen had appreciated above $0.0079112 per yen, the option contract goes a waste. But, the Dec put option might still have some premium in the market and that by writing a put the firm can earn an income. But that income should be greater than the brokerage commission. You know the brokerage commission at $20 per 6.25mn yen, comes to an amount of $0.0000032. So, if the put premium is greater than $0.0000032, it may go for writing puts. But the firm is taking up an obligation.

Covered Call writing:

An exporter with substantial forex inflow in the future can write calls on these inflows. This is called covered call writing.

ii. Hedging Through Futures Market: Futures contract can be used to hedge. Buying futures can help hedging shot position in forex, while selling futures can help hedge long position in forex. Importers and exporters, investors and borrowers, bidders for global contracts and others can cover their exposure through forex futures. Importers borrowers and bidders for global contracts go for futures buying. Exporters, investors and others can cover their exposure through selling forex futures.

Illustration 1: Sep 3: A UK firm owes $ 2,25,000 due on Dec 5. Present rates are:

$/PS Spot : 1.8250

December Futures: 1.8000

NOTES

3 Month $/PS forward rate: 1.6850

Since the pound sterling is losing, the UK firm decides to hedge. It sells two sterling futures. The $ value of the deal is: $ (62500 x 2 x 1.8) == 2,25,000. This is equal to the payable. Normally such perfect equalization is impossible leading to less than perfect hedge.

If on Dec 1 the rates are, say:

Spot $/PS 1.7080

Dec. Futures 1.7000. Here the PS has depreciated.

The UK firm can buy $ 2,25,000 in the spot market. The PS cost is PS 1,31,733. Had the PS not depreciated, the PS cost of the $ 2,25,000 payable would be PS 1,23,288. So, the loss is PS 8445.

The firm should buy 2 sterling futures to square up the earlier short selling. The profit is $ (62500)(1.8 - 1.7)(2) = $ 12500. The PS equivalent at Dec 3 spot rate is PS 7353. A loss of PS 1092 has resulted. After we add transaction cost of PS 200, the total loss is PS 1292. The total PS outlay is PS 1,31,733 + 1292 = PS 1,33,025. This works out to $/PS rate of: 2,25,000/1,33,025 = 1.6.914. This is better than the for -3 months forward rate obtaining at September.

If on Dec 1 the rates are, say:

Spot 1.9000

December futures rate at 1.9250.

Here the PS has appreciated.

Buy $ in the spot spending PS 2,25,000/1.9 = PS 1,18,421. The gain in the spot deals, will be PS 1,23,288 - 1,18,421 = PS 4867. In the futures the dollar loss is $ 62500 (1.9250 - 1.8000) (2) = $ 15625. At Dec 3rd spot, the loss comes to PS 9191. The net position is a loss of PS 4324. After transaction cost the loss is PS 4524. The effective $/PS rate is: 2,25, OOO/ (118421 + 4524) = 1.83. This is much better than the forward rate.

Forwards act the same way as futures. But, forwards are mostly customized and over the counter, while futures are standardized and exchange run.

A receivable in a forex can be swapped by involving in a spot purchase swapping to a forward sale contract.- So, an exporter can go for this. A forex payable can be hedged through a spot sale swapped to a forward purchase.

iii. Hedging Through Forward Market: This is similar to futures market hedge. But contracts are not standardized. Hence can be tailor made. But, market may not be as efficient as the futures market. So big operators can fleece small operators.

NOTES

Illustration 1. It is now August. Suppose a US importer has to pay in November 62.5 million yen to a Japanese supplier. The current \$/Yen = \$0.007739. The forward market gives a yen for \$0.0079, all inclusive cost, delivery November. A December call option in yen is available at a strike of \$0.0078, per yen. The premium is \$ 0.000108/yen. The brokerage fee per contract is \$20. Yen options contract size is 6.25 mn yen. How the firm can hedge?

Solution: Comparison of Call option Forward buying.

Call option market: The effective cost per yen under the call option = Strike price + Premium + Brokerage = \$0.0078 + \$ 0.000108 + \$[20/ 6,250,000] = \$0.0079112.

Forward market: The forward yen is priced \$0.0079. The forward market is cheaper. But, the possible benefit of fall in yen in the future cannot be availed as forward market creates mutual obligation, unlike a call option with right, not obligation to buy. But you have to forgo the option premium paid. So a managerial decision in favor either the call or forward buying is to be made.

iv. Hedging Through SWAPS

"SWAP" literally means exchange or barter. In the foreign exchange context swap means simultaneous buying and selling of same amount of foreign currency for different settlement (maturity) dates. A Swap deal involves:

i simultaneous purchase of spot and sale of forward or vice-versa; or

ii simultaneous purchase and sale of both forward but for different maturity dates.

a. Need for SWAP deals: In foreign exchange market, swap deals are undertaken for different reasons. Some of the cases are described below:

Banks enter into forward purchase/sale contracts with customers but may not be-in a position to find a suitable/matching cover deal in the market. But, a bank which has entered into a forward contract with a customer cannot stay idle due to non-availability of matching deal as he runs exchange risk. Hence, the bank will cover itself in the market by buying/selling spot immediately and cover the exchange risk. But this will lead to mismatch in currency flow and to correct the mismatch it will undertake a swap transaction.

In case a bank has bought forward 2 months from a customer and could not strike matching forward sale deal in the inter-bank market, it will sell spot and square its position. Later, to correct the mismatch in cash flow it will undertake the following swap "Buy spot; Sell two months forward".

NOTES

When a banker enters into a forward contract with a customer he covers himself in the inter-bank market to avoid exchange risk. This cover deal results in an obligation for the bank to deliver to/take delivery of foreign exchange on due date in the inter-bank market. Sometimes the customer may fail to deliver/take delivery on due date or the customer may deliver/take delivery before or after due date. But, still bank has to fulfill its obligation in the inter-bank market which may necessitate a swap deal.

Example: Bank enters into a forward purchase contract with a customer for US dollar 1 million delivery April 30, On the date of entering the forward purchase contract bank would have covered itself in the market by selling forward value April 30. If the customer approaches the bank on March 30 with a request for early delivery, bank will accede to such request after undertaking the following swap. “Sell spot; buy forward 1 month”.

Banks undertake swap transactions with a view to benefit from interest rate arbitrage. Interest between two currencies in its purest form consists of borrowing one currency and converting into the other one, placing the proceeds in an investment for the period of hedge and the borrowing. In such cases, no net exchange position is created and are known as covered interest arbitrages. Banks undertake swap transactions for the .purpose of funding their Nostro accounts. Banks in anticipation that forward premium/discount will change in their favor, build swap position forward against forward.

b. Currency SWAP

In 1981, the World Bank was looking for Swiss franc borrowings as part of its overall funding operations. However, at that point of time, the World bank had made several Swiss franc issues in the comparatively small Swiss market in the recent past and it was feared that another similar major issue would have required the World Bank to pay a higher coupon rate in order to make it attractive to Swiss investors. At the same time, IBM, the giant computer company, was looking for a dollar issue and had not accessed the Swiss franc market for quite some time. Given this, an IBM issue in the Swiss franc market was cheaper than a World Bank flotation. What was done, therefore, was that “IBM went in for a Swiss franc issue and the World Bank floated a dollar debt. The liabilities were swapped and the comparative advantage of IBM in the Swiss market split between the two institutions so that, after the swap, both received the kind of debt they needed at a cheaper cost than otherwise.

Another example that would throw light on the economics of currency swaps involves the Housing Development Finance Corporation Limited (HDPC). Under U.S law, a. housing finance company from a developing country is eligible to raise floating rate dollar debt in the US domestic market, with the guarantee of the U.S.: Agency for International Development (USAID).

NOTES

As is well known, HDFC lends long-term fixed rate rupees to house buyers. Thus, its requirements of funds is for long term fixed rate rupees. On the other hand, it has access to cheap floating rate dollars - it would be appreciated that the guarantee of the U.S Government would ensure that Heft's dollar borrowings are at very fine rates. In this scenario, HDFC has raised several floating rate dollar loans and swapped them with Indian banks and financial institutions for fixed rate rupees. In the process, the counterparties have secured floating rate dollars at a rate they would not have been able to raise on their own; simultaneously HDFC has access to fixed rate rupees it would otherwise not have got.

c. Currency SWAP rate

Let us see a swap transaction with the following-rates in March.

Spot US Dollar 1 = Rs.46.50 - 46.60

2 months forward = Rs.40 - 50 paise

IOB sells to SBI US dollar 1 million delivery 2 months. This is an outright forward sale deal for IOB and the transaction will be put through by SBI at market 2 months forward buying rate of US dollar 1 = Rs.46.90. IOB may buy SPOT US dollar 1 million from another bank say Canara Bank and the transaction will be effected by Canara bank at the market spot selling rate of US dollar 1 = Rs.46.60. The two transactions of IOB are two different deals with two different banks and are separate contracts.

On the contrary, in the above, if IOB chooses to join the transactions with one bank say either SBI or Canara Bank, then it becomes a. swap transaction. In a swap deal, both purchase and sale are done with the same bank and they constitute 2 legs of the same contract.

In the above example let us presume that IOB approaches SBI to quote a swap rate for spot to 2 months forward. SBI will quote the swap rate as 40 - 50 paise per US dollar. Here, SBI the market-maker is selling spot and buying 2 months forward and hence it will quote lesser of the two premium i.e. 0.40 paise as its swap rate and the swap will be done at a swap difference of 0.40 paise.

From the above illustration, one can figure out that in a swap deal the rate quoted *is* not exchange- rate but is only exchange rate differential.

It is the difference which buyer/seller has to pay/receive the swapping spot against forward or forward against forward. Hence, as swap is done at forward differentials, spot rate is immaterial. But spot rate decides the total value in rupees which either of the bank will have to deploy till receipt of forward proceeds on the due date and the banks take

NOTES

either spot buying or spot selling or average of -the two as spot rate for undertaking a swap transaction.

d. Interest Rate Swap

There are two types of interest rate swaps: **Single currency interest rate swap and Cross-Currency interest rate swap.**

Single currency interest rate swap: Single currency interest rate swap is also called "Plain vanilla" swap.

Fixed-for-floating swaps, fixed-to-fixed swaps and floating-to-floating swaps are these. Often these just called *interest rate swaps*. In all these cases on a notional principal interest is paid by one party to the other at a fixed interest rate and received in turn at a floating rate in the case of Fixed-for-floating swaps.

The fixed interest rate may be: Treasury Bill rate + certain basis points. Say the treasury bill rate for 5 year tenure is 4.5%. Say that 120 basis points are further needed. So, the fixed rate works out to: 4.5% + 120bp. As 100bp =1%, the rate becomes: 4,5% + 1.2%= 5.7%.

The floating interest rate may be: LIBOR (London inter bank offered rate) or NIBOR (New York inter bank offered rate) of the given tenure, here 5 year tenure.

e. Hedging with interest rate swaps

A firm which has a liability in fixed rate market can hedge itself, in case of falling interest rate, by locking with a fixed-floating interest rate swap, by receiving fixed rate interest and paying at floating rate. So, the benefit of falling interest rate is obtained.

A firm which has a liability in floating rate market can hedge itself, in case of increasing interest rate, by locking with a fixed-floating interest rate swap, by receiving floating rate interest and paying at fixed rate. So, to the extent there is floating payment, there is floating receipt and that the problem rising interest rate is effectively dealt.

Illustration:

Consider this example of a "plain vanilla" interest rate swap.

Bank A is a AAA-rated international bank located in the U.K. and wishes to raise $10,000,000 to finance floating-rate Eurodollar loans. Bank A is considering issuing 5-year fixed-rate Eurodollar bonds at 10 percent.

Firm B is a BBB-rated U.S. company. It needs $10,000,000 to finance an investment with a five-year economic life. It is considering issuing 5-year fixed-rate Eurodollar bonds at 11.75 percent.

NOTES

It would make more sense to for the AAA rated bank to issue floating-rate notes at LIBOR to finance floating-rate Eurodollar loans.

It would make more sense for firm B to raise the money by issuing 5-year floating-rate notes at LIBOR + ½ percent. But Firm B would prefer to borrow at a fixed rate.

Through a swap arrangement both can benefit. How?

Solution:

	Fixed Rate Market	Floating Rate Market
AAA rated bank:	10.00%	LIBOR
BBB rated firm	11.75%	LIBOR + 0.5%
Difference:	1.75%	0.5 %.

The difference arrived at above is called credit **quality spread** or in short quality spread as the difference arises due to difference in the credit quality of the entities.

In both the markets, the firm is at a disadvantage. But it has less dis-advantage in the floating market.

So let the firm raise fund in the floating interest rate market, at LIBOR + 0.5%.

Let the bank raise fund in the fixed interest rate market, at 10%.

The overall gain is the difference between quality spread. The quality spread differential = 1.75% - 0.5 %.= 1.25%. This gain could be shared among the swap banker who does the swap arrangement, the bank and the firm. Suppose, the commission for swap banker is 0.25%. The remaining gain 1% say is shared 0.6% for the bank and 0.4% for the firm.

As a result, the bank's effective cost of raising the fund is: LIBOR – 0.6%.

The firm's effective cost of raising the fund is: 11.75% - 0.4% = 11.35%.

Note: The sum of two effective costs must equal the swap bank's commission plus the sum of actual costs of borrowing.

Sum of two effective costs = LIBOR – 0.6% + 11.35% = **LIBOR + 10.75%.**

Swap bank's commission plus the sum of actual costs of borrowing = 0.25% + 10% + LIBOR + 0.5% = **LIBOR + 10.75%.**

NOTES

iii. OPERATING OR ECONOMIC RISK

In the case of transaction risk the operations pertaining to cash flow are all executed. Only the financial exchange has to be given effect. In operating risk, the manufacturing trading and financial transactions activities- are to fulfill an export of obligation. The prices of inputs might exchange. Operational uncertainties in production may take place. Yet the export price and obligation which are already freed cannot be changed, even if there is cost escalation. All these change the cost side of the operation. The revenue side of the operation, which is the amount of export earnings receivable, is also subject to change in exchange value. The expected home currency value of profit from the particular operation changes. Hence the operating risk is.

Seriousness of economic or operating risk: Exchange rate changes may affect the firm's competitive position by altering operating cash flows adversely. This is called **competition effect.** There is also what is called as **conversion effect**. The conversion effect is that a given operating cash flows in terms of a foreign currency will be converted into higher or lower dollar (home currency) amounts as the exchange rate changes.

Determinants: Main determinants of a firm's operating risk are:

- i the structure of the markets in which the firm gets inputs, and sells its products,
- ii the level of fluctuations in exchange rates and uncertainty over there
- iii the firm's ability to mitigate the effect of exchange rate changes by adjusting its markets, product mix, and sourcing (operating hedges) and
- iv the firm's ability to mitigate the effect of exchange rate changes by some financial hedging.

General Motors exports cars to UK but the strong dollar against the Sterling hurts sales of GM cars in UK. In the UK market, GM faces competition from the Italian and French car makers, such as Fiat and Renault, whose currencies remain stable relative to the Sterling. Then GM can maintain its market share in UK by resorting to: (i) locating production facilities in UK and source inputs locally and (ii) locating production facilities, say, in Mexico where production costs are low and export to UK from Mexico.

Sequence of risks: Operating risks culminates into transaction risk, which in turn ends in transaction risk.

Operation risk is the starting point. As a firm decides to effect an export deal, it has to bid for the same. If the bid is won, execution of work is involved. Changes in domestic and foreign inflation levels in the course of production, the changes in relative attractiveness of different markets to which the firm can export, changes in labor, material and overhead costs of execution of the export order, etc., affect the cost of execution of the order. Thus

NOTES

the operating .risk takes place. Once the shipment is done, a forex receivable position is built. Exchange rate changes change the value of export earnings upon conversion, giving rise to transaction risk. Translation risk is involved when foreign currency designated assets and liabilities are converted into home currency.

A. Internal Strategies or Operational Hedging of Operating risk: The internal strategies for dealing with operating risk include:

i Financial Management

ii Production Management

iii Marketing Management.

These are otherwise called operational hedges. **Operational hedging** is costly, time-consuming, and not easily reversible. For instance, establishing multiple manufacturing sites can be effective in managing exchange risk risk, but it can be costly because the firm may not be able to take advantage of the economy of scale. Similarly, a firm can reduce its currency risk by diversifying across different business lines. But such conglomerate expansion may be too costly as a means of hedging exchange risk. Investment in a different line of business must be made based on its own merit. The strategies are Tabulated below in table 15.

Table 15: Internal Operating Strategies for Dealing with Operating risk

Finance Management	Production Management	Marketing Management
Financing mix	Input mix Plant location Relocation of Production Cost cutting Strategy	Market selection Product strategy Pricing strategy Promotion Strategy

Source: The Author

A brief explanation of these internal operating strategies follows now.

i. Financing-mix to negotiate with operating risk

The role of financial management, based on the definition of hedging introduced at the beginning of this chapter, is to structure the firm's liabilities in such a way that, during the time the strategic operational adjustments are underway, the reduction in asset earnings is matched by a corresponding decrease in the cost of servicing the liabilities.

NOTES

For example, a firm that has developed a sizeable export market should hold a portion of its liabilities in the currency of that country. The portion to be held in the foreign currency depends on the size of the loss in profitability in association with a given exchange rate change.

ii. Production related strategies to deal with operating risk

There are four strategies available. These are input-mix, plant location, relocation of production and cost cutting.

Input-mix: Global sourcing is a great strategy to deal with operating risk. In a survey of 152 manufacturing companies world over, the Machinery and Allied Products Institute, a research firm, found that 77% of them had increased their global sourcing since the rise of the dollar, which rises dollar cost. This is as it should be. The principal effect of a real exchange rate change is to change the price of domestically produced goods relative to foreign goods. A well-managed firm should be searching constantly for ways to substitute between domestic and imported inputs, depending on the relative prices involved and the degree of substitution possible.

Plant Location: A firm without foreign facilities exporting to a competitive market, whose currency has devalued against currency of the exporting firm's country will find its profit to decline. It can go for outsourcing from the export market itself but it may find that sourcing components abroad is insufficient to maintain unit profitability. To strengthen itself the firm may have to locate new plants abroad. Third-country plant locations are also a viable alternative in many cases,, depending especially on the labor intensity of production or the projections for further monetary realignments.

Relocation of production: Multinational firms with worldwide production systems can allocate production among their several plants in line with the changing costs of production. The management of a multinational corporation should consider the option of increasing production in a. nation where currency has devalued, and decreasing production in a country where there has been a revaluation. Of course, the theoretical ability to shift production is more limited in reality. The limitations depend on many factors, not the least of which is the power of the local labor unions involved. A strategy of production shifting presupposes that the firm has already created a portfolio of plants worldwide.

Cost Cutting: Cost supremacy is the greatest of all competitive edges. Many companies world over assaulted by foreign competition have made earnest efforts to improve their productivity-by closing inefficient plants, automating heavily, and negotiating wage and benefit cutbacks and so on. Many have also started programs to heighten productivity and improve product quality through employee motivation.

NOTES

iii. Marketing Management

Operating risk can be negotiated ably through marketing management strategies as well. These are: market selection, product strategy, pricing strategy and promotion strategy.

Market Selection: Impact of exchange rate fluctuations on operating profit can be dealt through right mix of markets. Major strategic operations for an exporter are the markets in which to sell and the relative marketing support to devote to each market. Marketing management must take into account its economic risk and selectivity, adjust the marketing support, on a nation-by-nation basis, to maximize long-term profit. From the perspective of non-US companies, the strong U.S. dollar is a golden opportunity to gain market share at the expense of their U.S rivals.

It is also necessary-to consider the issue of market segmentation within individual countries. A firm that sells differentiated products to more affluent customers may not be harmed as much by foreign currency devaluation. On the other hand, following a depreciation of the home currency a firm that sells primarily to upper-income groups may find it now easier to penetrate mass markets abroad.

Market selection and market segmentation provide the basic parameters within which a company may adjust its marketing mix over time.

Product Strategies: Product portfolio, product introduction, product withdrawals, etc., are certain product strategies to deal with operating risk.

Exchange rate fluctuations may affect the timing of the introduction of new products. A firm must devise a strategy for new product introduction as a function of its relative risk in different markets. The period after a home currency devaluation or foreign currency revaluation may be the ideal time to introduce a new product overseas.

Similarly, product deletion decisions, as products become obsolete or fall into consumer disfavor, may be influenced by exchange risk considerations. Firms might stop producing these goods if a home currency revaluation or foreign currency devaluation to likely.

Pricing Strategies: A firm selling overseas should follow the standard economic proposition of setting the price that maximizes home currency profits (by equating marginal revenues and ‘marginal costs). In making this determination, however, profits should be translated using the forward exchange rate that reflects the true expected home currency value of the receipts upon collection. In the wake of foreign currency devaluation, a firm selling in that market should consider opportunities to increase the foreign currency prices of its products.

NOTES

Promotion Strategy: Promotional strategy should similarly take into account anticipated exchange rate changes. A key issue in any marketing program is the size of the promotional budget for advertising, personal selling, and merchandising. Promotional decisions should explicitly build in exchange rates, especially in allocating budgets among countries.

A firm exporting its products after a domestic devaluation may well find that the return per dollar expenditure on advertising or selling is increased as a function of the product's improved price positioning. The exporter may also find it has improved its ability in "push" the product based on the option of greater distribution margins or consumer dealing.

Overall Considerations in Hedging

Forex risks lead to fluctuations in valuation of firms. So, hedging against these risks is a way of dealing with the risks.

The following questions arise:

i Is hedging of every risk a must

ii What are alternative hedging tools

iii What are the costs of hedging tools?

iv Is the costs of hedging worth the benefit of the same?

A brief answers to these questions are given below:

First of all, hedging every risk is not a must. All forex risks may not significantly affect a firm's valuation only those that have the potentials of affecting firm's valuation need hedging.

Second, several alternative hedging tools are available. Rest of the sections of the lesson deals with these tools.

Third, hedging involves a cost. Transaction cost is involved. Besides, opportunity to reap gains from open positions, i.e. un-hedged positions, is lost.

Fourth, the benefit, of hedging is beating uncertainty. The rewards of certainty are .to be matched against cost of hedging. The management philosophy as to hedging, ability to forecast forex market trends, etc., comes into play here.

1.10.7 Questions to Conyemplate and Deliberate

Q 1.10.a What do you mean by foreign exchange, foreign exchange market and forex rate? Give a brief account of the features of the market.

Q 1.10.b What are the types of foreign exchange market? State their need.

Q 1.10.c Discuss the different exchange rate concepts and their relevance.

NOTES

Q 1.10.d Present the determinants of the exchange between two currencies.

Q 1.10.e Explain the flow, current and capital account models of exchange rate.

Q 1.10.f Present the contents of the Mint Parity and Purchasing Power Parity theories.

Q 1.10.g What is Interest Rate Parity theory? Assess the same for its forecasting power.

Q 1.10.h. What do you mean by exchange rate risk? What are the types of risks?

Q 1.10.i. Explain the internal strategies transaction risk management.

Q 1.10.j What is hedging? How is transaction risk hedged through financial & forex markets?

Q 1.10.k Explain the causes for operating risk and the operating strategies for dealing with it.

Q1.10.l Should all risk be hedged? Elucidate with examples.

SUMMARY

Doing business internationally or globally needs certain decisions taken in strategic manner. **First** and foremost, decision as to **forms of International Business** is needed. **Second** decision relating to **responding to globalization and the environmental changes** is needed. There need to be study and evaluation of Trade Policies / Procedures, Investment Policies / Procedures and Competition Policies / Procedures of nation states, trade blocks and other aggregates. **Third** decision relates to **foreign exchange management and global finance**. **Fourth** decision relates to **conflict resolution**.

In 2006, the MNCs numbered at least some 78,000 parent companies with at least 780,000 foreign affiliates according to **United Nations Conference on Trade and Development's** (UNCTAD) report. Of these, about 58,000 parent TNCs were based in developed countries and about 20,000 in developing and transition economies (18,500 in developing countries and 1,650 in transition economies).

Factor mobility, Economic reforms, Opening up of command economics, Bretton Woods system and WTO regime and Communication & Transportation tech are the **facilitators of internationalization** of businesses. Innate growth impetus or urge of the MNCs, Constant search for growth through foreign markets and Management culture of MNCs are the **drivers of growth in internationalization.** Access to raw materials, Sales Growth, Low cost possibilities and Enhanced profitability are the **opportunities** that propel internationalization. Limitations of domestic market and Need for risk minimization by diversification are the **compulsions for internationalization** of businesses.

NOTES

Causes for enhanced trade and investment flows: Difference in Factor Endowments, Cost Advantage, Patterns of Specialization, Profit from Exchange, Diversification of Sources & Markets for Physical & Financial Products and Risk Exploitation of Natural Resources, Policy "U" turn Towards Market mechanism by many Economies, Common Market, Currency & Economy adopted by groups of countries, Bilateral Trade / Investment and Economic Relationship fostered by some countries and Enabling Multilateralism along with Regional Pluralism are the causes for enhanced trade and investment flows.

Trends in trade: In the 3 decennials periods (1973 -83, 1983 -93 and 1993 -203) the annual growth rates in world merchandize trade were, respectively, 22%, 10% and 10%. In 2003 the global merchandize exports recorded a figure of $ 7371 billion and in 2006 it stood at $ 11783 bn, recording an annual average simple growth of 20%.

Trends in investment: Global FDI inflow was a feeble figure of $59 bn in 1982 accounting for roughly 0.5 % of the then Global GDP (GGDP) of $ 12002 bn. The figure rose to $202 bn in 1990 accounting for roughly 0.9 % of the GGDP of $ 22060 bn. By 2005 the FDI flows reached $946 bn or 2.1 % of GGDP and in 2006 the figure touched $1306 bn or 2.7% of GGDP. A greater part of FDI flows is accounted by cross-border Mergers and Acquisitions (M&A).

Theories of international trade include: Theory of mercantilism, theory of neo-mercantilism, absolute cost advantage theory, comparative cost advantage theory, Heckscher-Ohlin Theory of factor proportion, Country similarity theory, International Product life Cycle theory, Country Size theory, Independence-interdependence-dependence theory, Strategic Rivalry theory and Porter's Competitive Advantage theory.

Theories of international investment include: Theory of Capital Movements, Market Imperfections Theory, Internationalization Theory, Appropriability Theory, Location Specific Advantage Theory, International Product Life Cycle Theory, Electric Theory and Oligopolistic Reaction Theory.

Non-ownership forms of international business involve doing international business without ownership interests in the foreign countries concerned. These are: (a) Merchandize export, import & counter trade, (b) Service Export and Import, (c) Licensing and Franchising, (d) Contract Manufacturing, (e) Management contracts and (f) Turnkey Contracts. These forms are less risky as pull out is easy in times need.

Ownership forms of international business involve owning production/ distribution facility in the foreign land. Eventually, foreign investment gets involved. There are many alternatives like wholly owned subsidiaries, JVs, Strategic alliances, M&A, etc.

Trade policy contains guidelines for action. Trade policy is the official pronouncement released by the Governments of respective nations periodically containing the priorities, assistances, concessions, preferences, etc for exporters and importers, norms

NOTES

and eligibilities for availing the concessions and assistances, regulations and rules, procedures and documents, etc. In India, trade policy is released once in 5 years, with annual supplements. Trade policy regimes have national priorities in mind, but of late WTO requirements, Regional Trade bloc requirements, etc need to be accounted for.

Export promotion has been one of the main planks of foreign trade policy of most countries. Exports benefit a nation in many ways, but the world market is competitive. To have the edge over others in the global market, governments provide some promotional measures to firms to increase their export competitiveness. These measures are: Special and Concessional Financial Services, Fiscal incentives in the form of tax holidays or concessional duties, Facilitative privileges, Favours in operations and Felicitations to acknowledge performance.

Commonly used export documents are: Shipper's Export Declaration; Shipping Bill/ Bill of Export; Commercial invoice; Certificate of Origin; Bill of Lading; Temporary Import Certificate / ATA CARNET; Insurance certificate; Export Packing List; Import License; Consular Invoice; Inspection Certification; Dock Receipt and Warehouse Receipt; Destination Control Statement.

There are **legal and operational export procedures** involved. **Legal procedures:** Obtaining Import-Export Code Number, License / certificate / permission for export of restricted items, Export of items reserved for SSIs by non-SSIs, Furnishing of export returns in non-physical form, Export Payment Realization mode, Quality Certification, Accounts keeping in the proper format etc. are some important legal procedures to be followed. **Operational procedures require study of** export market demand / competition pattern / overseas design and product requirements. The risk of failure in export markets can be minimized by intelligent use of research. Negotiating with prospective buyers, Processing an export order, Entering into export contract, Export pricing and costing and Understanding risks in international trade are needed for success.

Exchange Rate is the value of one currency expressed in terms of another. Forex rates dynamically change, round the day, round the week, round the year. As forex rates change, the value of transactions change resulting in changes in expected/realized revenues or gains, expenses or losses, assets and liabilities and net worth.

Exchange rate system refers to the assemblage of institutions, investments and their interplay on exchange rate behaviour. Traditionally there are two extreme systems at the poles, namely **fixed rate system and floating rate system** and **in between diverse combinations** exist.

NOTES

Forex market is by far the largest market in the world, in terms of traded value. The **average daily trade** in forex market across the globe exceeded US$1.9 in 2004 and $3.2 trillion in 2007.

Types of Foreign Exchange Market

No.	Basis of Classification	Sub markets
1	Parties involved:	i. Inter-bank deals market & ii. Merchant deals market
2	Size of deals	i. Wholesale market & ii. Retail market
3	Type of institution	i. Over the counter market & ii. Organized Exchanges
4	Type of deal	i. Transactional, ii. Hedging & iii. Speculation
5	Segments	i. Spot market, ii. Forward market, iii. Arbitrage market iv. Futures market, v. Options market & vi. Swaps market

There is a cluster of **foreign exchange rates** in use in forex market. Direct and Indirect rates, Spot rate and forward rate, buying rate and selling rate, single rate, fixed rate, floating rate, flexible rate, cable or T.T. (Telegraphic Transfer) rate, havala rate, official rate, market rate, futures rate etc.

The **flow model** of exchange rate determination simply is based on demand and supply of forex. The **Current Account Monetary** model uses **:** 'S'= k + Ü (m_h-m_f) – â (y_h-y_f) + è (i_h-i_f) as the equation. If (m_h-m_f) > 0, domestic money supply exceeds foreign money supply and this leads to increase in S , that means domestic currency depreciates or foreign currency appreciates, because the regression is positive coefficient. If (y_h-y_f) > 0, domestic real income exceeds foreign real income and this leads to decrease in S, that means domestic currency appreciates or foreign currency depreciates, because the regression is a negative coefficient. If (i_h-i_f)> 0, domestic nominal interest rate exceeds foreign nominal interest rate and this leads to increase in S , that means domestic currency depreciates or foreign currency appreciates, because the regression is positive coefficient. The **capital account model** assumes that: PPP theory holds good. There is stable demand for money in each country. Demand for money depends on real income and nominal interest rate. Foreign real income and nominal interest rate are external variables not influenced by domestic factors. Uncovered interest parity theory holds good and Fisher open condition exists. Expected change in exchange rate depends on perceived departures from long-term equilibrium exchange rate. With these assumptions the equilibrium exchange rate in 'direct quote form: 'S'= k + Ü (M_h-M_f) – â(Y_h-Y_f) + è (I_h-I_f) + ë (ï$_h$-ï$_f$).

NOTES

Exchange rate theories reason out the forex rate determination. They help the process of determining exchange rate between currencies. The exchange is governed by certain parameters. Depending on the parameters used, different exchange rate theories have been developed. There are Mint Parity, Purchasing Power Parity and Interest Rate Parity theories.

Purchasing Power Parity: Formally, if $P_h(t)$ and $P_f(t)$ are the home and foreign price levels, respectively, and e_t is the Home Currency value of one unit for foreign currencies all at time t, then: $e_t / e_o = (P_{h,,t}/P_{h,,o}) / (P_{f,t}/P_{f,,o})$, where, $(P_{h,o})$ $(P_{f,o})$ and e_o are the base period equilibrium price levels and exchange rate, respectively and $(P_{h,t})$ $(P_{f,t})$ and e_t are equilibrium price levels and exchange rate, at period 't'. the currency with higher inflation will depreciate against the other currency.

Interest rate parity theory: The Mathematics of the Theorem: $F_{'n'}/S = (1 + n.i_{(h)})/(1 + n.i_{(f)})$ where: $F_{'n'}$ = `n' period forward rate of a foreign currency given in direct quotation form**,** S = spot rate given in direct quotation form**,** `n' = period in years**,** $i_{(h)}$ = interest rate in home country per annum and $i_{(f)}$ = interest rate in foreign country per annum. The one period, i.e., one year forward rate is given by : $F/S = (1 + i_{(h)})/(1 + i_{(f)})$ Then, $[F\text{-}S] / S = [(1 + i_{(h)} - 1 - i_{(f)})] / (1 + i_{(f)}) = [i_{(h)} - i_{(f)}]/ [(1 + i_{(f)}] = [i_{(h)} - i_{(f)}]$ Approximately.

Fluctuation in exchange rate leads to **forex risk.** Forex rates fluctuate, sometimes widely. There used to be over-shooting as well, which is too much change in a short time due to panic market reaction to certain rate sensitive happening. Foreign exchange risk is defined as, ' the **variance** of the real domestic currency value of assets, liabilities or operating income attributed to unanticipated changes in exchange rates'. **Forex risks are of three types**. These are: **Accounting or Translation Risk, Transaction risk and Operating risk**

Translation risk is a measure of variation of home currency value of assets and liabilities appearing in balance sheet denominated in foreign currency. It is also called as balance sheet or accounting risk. **Transaction Risk** is the measure of variation of home currency value of receivables and payables denominated' in foreign currencies due to unanticipated changes in exchange rate. Transactions which give rise to forex receivables or payables in future create transaction exposure.

Transaction Risk can be hedged using internal strategies or external (that is market related) strategies. The **internal strategies** are those that effected without recourse to the forex or other markets. It is within the firm or between the business firms involved. The different internal strategies are: i. Risk Netting; ii. Risk Shifting; iii. Risk Sharing; iv. Risk Off-setting and v. Pricing. **External Strategies of Managing Transaction Exposure:**

NOTES

i. Money market hedge and ii. Forex Market Hedge. Forex Market Hedge involves using: i. Options market, ii. Futures market, iii. Forward market and iv. Swap market.

Operating risk refers to variation of home currency value of future cash inflows and outflows and profits of a firm arising out of production/export/turnkey operations due to unanticipated changes in exchange rate. **Internal Strategies or Operational Hedging of Operating risk** include: Alternative Financing mix, Alternative Production Strategies like BPO, and adjusting the Marketing Mix variables.

EXERCISES

1. It is now September. A US importer has to pay in November 125 million yen to a Japanese supplier. The current $/Yen = $0.007739. A December call option in yen is available at a strike of $0.0078, per Yen. The premium is $ 0.000108/Yen. The brokerage fee per contract is $20. Yen options contract size is 6.25 mn Yen. How options can be used to hedge? If forward contract is available $0.00778, can that be useful?

2. **Bank A** is a AAA-rated international bank located in the U.K. and wishes to raise $10,000,000 to finance floating-rate Eurodollar loans. Bank A is considering issuing 5-year fixed-rate Eurodollar bonds at 9 percent. It can borrow at LIBOR. **Firm B** is a BBB-rated U.S. company. It needs $10,000,000 to finance an investment with a five-year economic life. It is considering issuing 5-year fixed-rate Eurodollar bonds at 10.5 percent. It can borrow at LIBOR plus 100 basis points. Arrange a swap.

3. Three banks in London have given the following rates: £/$: Bank A: 0.7165/70; Bank B: 0.7175/90; Bank C: 0.7185/95. Find if there are any arbitrage opportunities? If so between which pair or pairs? Find the best of the arbitrage opportunities.

4. Current US price level is at 115, while the UK price level is at 110, relative to a common base price level of 100. According to PPP theory find the rate of appreciation or depreciation in the dollar value of the pound sterling. Also find the rate of depreciation or appreciation in the pound sterling value of the dollar as per the PPP theory.

5. Spot rate ¥ / $: 130.1158 / 9650. US & Japanese interest rates stand at 4.6% & 2.3%, p.a. forecast expected spot rate 3 months from now in bid-ask form.

You are given the following rates: **$/ ª**: 1.3245/1.3285 and **$/£:** 1.8455/1.8500. Find the bid - offer ª/£ cross rates.

The current spot rate given by a bank in USA is: $/ £: 1.8245/1.8270. The forward points for different months: 1 month: 20/15 & 2 months: 15/20. Compute the 1-month and 2-months outright forward rates. Compute middle rates for spot and forward rates and then calculate the annualized percentage of premium or discount that the £ has over $.

NOTES

UNIT II

INTERNATIONAL BUSINESS ENVIRONMENT

2.1 INTRODUCTION

Every entity, be it a business or a human, institution or an individual, has to function within certain parameters laid around it by external forces. A person's brought up is influenced by the nature and extent of parental care and concern extended to him, by the values and customs of the society around him, the educational opportunities available to him in his place and so on. Similarly a business organization is also a product of its surroundings. International business is influenced by international environment.

Where a business is located influences its fortune, irrespective of what it deals in. The "where" is not mere a geographical domain, but inclusive of the legislative framework relating to that place, the political situations pertaining to that place, the culture and societal factors of the people (living in or visiting the area, the demographic features of the people living in or visiting the area), the level of technological advances of that area, the ecological and natural setting or otherwise of the area and so on. These diverse factors that surround physically or otherwise, a business are called "environmental factors". The environmental factors, force and condition influence businesses diversely.

Environment gives strengths and opportunities, imposes conditions, introduces challenges, provides resources and wields threats and also yields to the business.

Environmental has several components like Political environment, financial environment, economic environment, socio-cultural environment, technological environment, ecological environment, internal environment, external environment, etc.

An international business firm must study:

i. the specific factors and aspects of the particular environment;

ii. the nature and extent of impact of the environmental factors on the business;

iii. ways to maximize positive impacts and minimize negative impacts

NOTES

iv. avenues of making the business unit multi-cultural

v. the measures by which the opportunities offered by the environment can be reaped;

vi. the means by which the threats posed by the environment migrated or minimized.

2.2 LEARNING OBJECTIVES

- To present the concept of globalization of economies of nations and the micro or business level and macro or national level globalization.
- To discuss the causes, concerns and issues in economic globalization.
- To provide an account of the economic environmental factors that influence globalization
- To present the environmental significance of Macro Economic Aggregates and Monetary factors
- To elucidate the influence of External Sector variables and the Fiscal Factors in globalization
- To ascertain how the different Economic sectors and Infrastructure as economic variables impact globalization
- To analyze the significance of factor endowments, technology and population as economic variables in influencing international business.
- To present how the businesses themselves influence international business environment.
- To deliberate the political ideologies and politico-economic systems as international business environmental forces
- To provide an account of the factors affecting the functioning and the maturity of political parties/people and their relevance in global business environment
- To elucidate the concept, types, measures and methods of dealing of/with political risk that might affect a business or businesses in general.
- To highlight the politico-legal environment of India.
- To enquire into the constructs and concepts of culture as international environment factors
- To explain the cultural dimensions like, Religion, Social Stratifications, Region, Language, Communication Styles, Attitudes & Perception of People, etc as cultural factors.
- To discuss the cultural policy alternatives available to an international business firm
- To present the concept and types of organizational culture

NOTES

- To discuss the concept of regional trade blocks and inter-region and intra region trade.

2.3 GLOBALIZATION OF BUSINESS

The IMF defines globalization as “the growing economic interdependence of countries worldwide through increasing volume and variety of cross border transactions in goods and services and of international capital flows, and also through the more rapid and widespread diffusion of technology”. In his Management Challenges for the 21st Century, Peter Drucker writes that, all institutions have to make global competitiveness a strategic goal. No institution, whether a business, a university or a hospital, can hope to survive, let alone to succeed, unless it measures up to the standards set by the leaders in its field, any place in the world.

Globalization is not a new phenomenon. The period 1870 to 1913 experienced a growing trend toward globalization. It got punctuated by the World Wars I and II. The new phase of globalization which started around the mid-20th century became very widespread, more pronounced and overcharging since the late 1980s by gathering more momentum from the political and economic changes that swept across the communist countries, the economic reforms in other countries, the latest multilateral trade agreement which seeks to substantially liberalize international trade and investment and the technological and communication revolutions.

World economy is marked by integration and standardized products. Coca Cola, Nissan and Marlboro (cigarettes) are examples of products which serve nearly every market. There have been four major changes: capital movements rather than trade have become the driving force of the global economy; production has become “uncoupled” from employment, thanks to technology; primary products have become “uncoupled” from the industrial economy and, the world economy is in control – not by individual nations, despite the large world economic share of the USA and Japan. The focus of all nations has shifted from domestic to the world economy as the chief economic unit. This is the greatest sign of global economy.

2.3.1 Levels of Globalization

We may consider globalization at two levels, viz, at the macro level (i.e., globalization of the world economy) and at the micro level (i.e., globalization of the business and the firm). Globalization of the world economy is achieved, quite obviously, by globalizing the national economies. Globalization of firm and business is achieved through spread of subsidiaries and joint ventures across the globe. Globalization of the economies and globalization of business are very much interdependent.

NOTES

2.3.1.1 Globalization of World Economy

The economies of nations are emerging as a global economy. A global economy is one which transcends the national borders unhindered by artificial restrictions like government restrictions on trade and factor movements. Globalization is a process of development of the world into a single integrated economic unit. The global economy is different from the international economy. The international economy is characterized by the existence of different national economies, the economic relations between them being regulated by the national governments. The global economy is a borderless economy characterized by free flow of trade and factors of production across national borders.

According to Peter F. Drucker, the global economy is characterized, inter alia, by the following features:

i The global economy is shaped mainly by money flows rather than by trade in goods and services. These money flows have their own dynamics. The monetary and fiscal policies of sovereign governments increasingly react to events in the international money and capital markets rather than actively shape them.

ii In the global economy management has emerged as the decisive factor of production and the traditional factors of production, land and labour, have increasingly become secondary. Money and capital markets too have been increasingly becoming global and universally obtainable.

iii In the global economy the goal is market maximization and not profit maximization. Yes, market share is top in the agenda of MNCs, even at a cost of profitability.

iv Trade, which increasingly follows investment, is becoming a function of investment. Trade in goods and services is worldwide today.

v The decision making power is shifting from the national state to the region (i.e., the regional blocks like the European Community, North American Free Trade Agreement, etc.)

vi There is a genuine - and almost autonomous - world economy of money, credit and investment flows. It is organized by information which no longer knows national boundaries.

NOTES

vii Finally, there is a growing pervasiveness of the transnational corporations which see the entire world as a single market for production and marketing of goods and services.

There are, thus, many factors which tend to promote the globalization of the world economy. The multilateral trade negotiations under the auspices of WTO have been liberalizing trade and investment.

1.3.1.2 Globalization of Business

Globalization in its true sense is a way of corporate life necessitated, facilitated and nourished by business practices cutting across borders of the world economies and developed by corporate strategies. Globalization is an attitude of mind - it is a mind-set which views the entire world as a single market so that the corporate strategy is based on the dynamics of the global business environment.

2.3.2. Causes of Globalization

Globalization is not a twentieth-century phenomenon. Globalization of economic activity has been closely linked with the development and establishment of empires worldwide through international trade since the sixteenth century. Looking back over the last three centuries, it would be nearly impossible to separate the political and economic – in particular, international trade – histories of Western nations.

i. Global thinking

Companies which have adopted a global outlook stop “thinking of themselves as national marketers who venture abroad” and start “thinking of themselves as global marketers”. The top management and staff are involved in the planning of world-wide manufacturing facilities, marketing policies, financial flows and logistical systems. The global operating units report directly to the chief executive or executive committee, not to the head of an international division. Executives are trained in world-wide operations, not just domestic or international. Management is recruited from many countries, components and supplies are purchased where they can be obtained at the least cost, and investments are made where the anticipated returns are the greatest”, according to Philip Kotler.

NOTES

ii. Multilateral Financial Arrangements

Multilateral financial arrangements are intended to render mutual financial assistances amongst nations. Nations are not equally endowed with resources. Nations are not enjoying same fate all the time. There may be ups and downs. At times of need, nations need supporting hands. When the exchange crisis hit the South East Asian nations, during 1997-98, they needed sop. When the severe earthquake hit the Gujarat State of India, the nation needed support to rebuild the affected fortunes. These are recent examples. In the 1940s, the II World War ravaged economies needed assistances. Then came into being, the World Bank and International Monetary Fund by the collective action of the world nations. Later International Development Association, International Finance Corporation, Asian Development Bank, African Development Bank, etc., came into being. All are the results of collective decisions of the member nations to form and benefit from these organizations. These institutions help capital transfer from capital rich countries to capital poor countries. Multinational financial institutions, referred to above, are created by world nations, for nations and of nations. These institutions are given birth to by the nations. These are meant for the member nations. The resources of these institutions collectively belong to these member nations.

Multilateral finance is largely debt capital, rather than equity type. Multilateral finance is generally provided to government or quasi-government institutions which may be passed later by them to private sector organizations. Multilateral finance carries a concessional rather than commercial rate of interest. Multilateral finance routed through governmental bodies generally is used to fund social and basic infrastructural projects. As debt capital assistances there are, debt servicing obligation vested on the government. Generally a longer initial moratorium period and longer repayment period are the order. To ensure that funds are used effectively, conditionalities are added as strings to the fund provided.

World Bank and International Development Association provide assistances for sectoral development covering agriculture, energy, environment, education, health & nutrition, social sector, financial institution development, tele-communication, transportation, urban development, water & sewerage, public sector management etc.

International Monetary Fund provides assistances for meeting balance of payments problems, for structural adjustments requirements, poverty reduction, growth facilitation etc. These capital flows lead to globalization.

NOTES

iii. Foreign Private Capital

Foreign Private Capital is capital contributed by foreign citizens, foreign companies, multinational corporations and the like. The present era is the era of global private capital. Global private capital flows into global markets in search of better investment opportunities. Portfolio diversifications and opportunity seizing are the causes. Private capital is now trusted as a means of encouraging investments stock in third world countries. Third world countries, in the past, depended on multilateral capital. But they failed to make effective use of the capital, which resulted in mounting external debt. And debt servicing became a problem. And more conditions added for subsequent borrowings made the countries realize the policy folly by sticking to multilateral capital. They saw the great opportunity in the private capital market. The success of the Asian economies, South American economies, kindled the interest of other third world nations to taste the nectar of private capital. In private capital, debt servicing need is not there for the government. It is an issue between the financier and borrower in private equity capital, even this need is not there. Global private capital comes with technology, marketing, management and other skills. Capital flows into sectors which have potentials of growth. These help globalization.

iv. Empire Building

Empire building in the last three centuries was closely connected with the development, of, and attempts to monopolize, international trade. The Spaniards and Portuguese won trade routes from the Mediterranean powers in the fourteenth to the sixteenth centuries; subsequently, these routes were won over and monopolized by the British, the Dutch and the French. Major areas of the world that started out as “economic” colonies (and monopolies carved out among the three trading powers) subsequently became political colonies (including North America). Numerous wars were fought in Europe and elsewhere over international trading rights, trade routes, and maintenance of trading monopolies. During these activities and the prevalent philosophy of political economy in those days was “mercantilism” – that is, the philosophy that, from the standpoint of a nation’s welfare, it is better to export than to import.

v. Industrial Revolution

By the late eighteenth century, propelled by the Industrial Revolution, Britain had become the undisputed world economic power. Economic historians have attributed a combination of factors, such as the technical progress and innovations in textiles, coal, iron and steel, the harnessing of steam, the displacement of agricultural workspace to meet the needs of a fast-expanding industrial base, the Protestant ethic, riches plundered from colonies, and so forth, as among the reasons why Britain became the world’s first industrial

NOTES

country. For instance, by the mid-nineteenth century, Britain accounted for about 40% of the world export of manufacturers.

vi. Growth of MNCs

Globalization via the development and spread of the MNCs through direct foreign investment is a more recent phenomenon. The earliest MNCs were mainly European firms, setting up manufacturing facilities in the colonies to extract primary resources for conversion to finished goods back home. However, by the mid-nineteenth century, many US firms began to globalize – for example, Singer Sewing Machines set up a joint venture in France in 1855, Westing House, which set up a plant in Paris in 1878, and Kodak set up a plant in London in 1889. The expansion of US firms was furthered after World War II when both European and Japanese industrial infrastructure was largely destroyed by the war. Resource transfers for rebuilding these economies through programs such as the "Marshall plan" gave US firms the ability to consolidate their position even more firmly. Japanese firms were relatively late entrants into the world of MNCs. Although they were major exporters prior to World War II, most did not begin to set up subsidiaries abroad until well into the second half of this century.

The process of globalization propelled by the MNCS as an organizational from had broken free; it had acquired a life of its own and become irreversible. In terms of its ability to move knowledge, people, capital, goods and service, and technology access borders, the process of globalization, led by MNCs, had done far beyond the reach of any national sovereign government or international agreement. To borrow a phrase from scholar of international business, Raymond Vernon, the MNCs had reached a level of maturity and influence worldwide whereby it could keep "sovereignty at bay".

Until recently, nearly all major multinationals were either American, Japanese or Western European, such as Nike, Coca-Cola, Wal-Mart, AOL, Toshiba, Honda and BMW. Now, the emerging economies are adding home grown MNCs into the scene. With the development of a truly global economy by the 1990s, opinion with respect to the multinational corporations in home and host countries varied considerably. Multinationals have often been viewed abroad as purveyors of technology and business efficiencies and as bearers of products meeting an insatiable appetite for American goods. But a more negative image also developed. The growing competitiveness of the new world economy and a heightened emphasis on cost efficiencies, job reductions, retooling, and relocation led to complaints in home and host nations about declining market shares and lost jobs.

The transnational character of the multinationals proved irksome to the Government officials who sensed a loss of their sovereignty because of the ability of these corporations to move their operations, transactions, and profits upstream or downstream as their self-interests dictated. By the beginning of the twenty-first century more and more of the national economies were dominated by a relatively few multinational giants. Transfers of technology

NOTES

were another issue pitting MNCs and host and home governments against one another, as they jockeyed to maintain or gain control of technological breakthroughs for reasons of national security and profits.

Despite, the jurisdictional disputes, cultural differences, nontariff barriers to trade, international agreements among the multinational corporations, and conflicting political agendas on such matters of principle as the environment, energy, human rights, accessibility to proper medical treatment and high-cost pharmaceuticals, sweatshops, and child labor laws, MNCs are galloping their clout over the economy of the world.

vii. International Agreements

Alongside the development of the MNCs through direct investment abroad, the numerous international agreements and institutions that were set up after World War II acted as further catalysts to the process of globalization. Such institutions included the international fixed-exchange rate monetary arrangement under the Bretton Woods Agreement, the International Monetary Fund (IMF), the World Bank, the General Agreement on Tariffs and Trade (GATT), the World court and WTO. Although these institutions represented the outcome of voluntary acceptance of worldwide agreements among member countries, they seemingly provided the basis for a more stable worldwide environment in which MNCs could conduct their business.

2.3.3 Issues and Concerns of Globalization

Issues and concerns of globalization are: change, efficiency, stability, development, sustenance and equity. These are elaborated below:

i. **Change**: The globalization process emphasized change-change from inefficiency to efficiency; change from bureaucratic delay to business like speed; change from structural rigidity to developmental flexibility; change from rules-frame to profit orientation; change from governmental intervention to market determination; change from plural layers of decision to de-layered decision process; change from inward-looking policy to outward-looking policy; change from import-substitution to export maximization; change from insulated economy to a competitive economy; change from local resource dependence to access to global resource; change from government ownership to private (people) ownership, change from centralization to decentralization; change from high taxation to low taxation and so on.

ii. **Efficiency**: Efficiency is the ratio of output to input. Higher this ratio, greater is efficiency. Efficiency drive is very important in today's context of limited global resources, but unlimited global needs. So, global resources must be efficiently used. Efficiency becomes the driving force of industry, trade, institutions and firms. Capital efficiency,

NOTES

labour efficiency and managerial efficiency lead to operative efficiency resulting in cost efficiency. Cost efficiency helps reaping market efficiency leading to profit efficiency. With profit efficiency developmental efficiency takes place, for with profit modernization, expansion and diversification are possible leading to efficiency.

iii. **Stability**: Stability of economies is one of the concerns of globalization. Economies must be able to stand on sound footing. Every economy must have economic, political and social stabilities. In other words, the crises of the Mexican type or the South East Asian type should not occur or recur. This needs effective management of globalization. Fiscal stability, structural stability, macro-economic stability, financial stability, etc are certain forms of stability. Globalization process should address these, if the latter has to be in the agenda of all countries.

iv. **Development**: One of the concerns of globalization is global development. Now a basic question arises. What is development? Development is growth plus change. Growth in national/global income, in national/global savings, in national/global investment, in employment, in exports, forex reserve, in return on investment in public sector, in infrastructural facilities and so on constitute one aspect of development. The other is positive change in composition of gross global product, in exports, in imports, in public and private sector, change in government finances, change in tax base, tax structure and tax level, change in technology and employment pattern and so on constitute another aspect of development. This development is sought to be achieved with local and global resources, with global trade and technology, with less government intervention and more people participation, with more private sector role and less public sector distortion, with more transparent policy and less control, with reduced tax and increased opportunity and so forth. The development goal is to be achieved with people namely the savers, investors, bankers, business persons, trading community, managers, workers and of course with responding bureaucrats. In other words, development goal should be made top on the agenda for action of people.

v. **Sustenance:** Sustained development is much more important than quick-fix development. Sustainable development ensures balance on all resources - physical and human. There is no over-exploitation of any resource. Globalization should ensure this. Otherwise, globalization might lead to collapse of economies.

vi. **Equity:** Equity refers to fairness. In the economic globalization context, equity refers to equity in sharing the rewards of globalization across countries, sectors, business units and all stake-holders. Usually the globalization process is tilted in favour of the west and the non-primary sectors and against the less developed and primary sector.

NOTES

This issue must be seriously addressed sooner than later so that globalization process goes at the right pace.

QUESTIONS TO CONTEMPLATE AND DELINERATE

Q 1.3. a Present the concept and levels of globalization of economies.

Q 1.3. b Explain the causes of, and the concerns and issues in economic globalization.

Q 1.3. c To what extent MNCs contribute to globalization of economies?

2.4 BUSINESS ENVIRONMENT OF INDIA ECONOMIC ENVIRONMENT

Wikipedia defines, environment as 'the external conditions, resources, stimuli etc. with which an organism (firm, country, etc) interacts'. From a business firm's point of view, these external factors (conditions, resources, stimuli etc) are the so called "uncontrollable", unlike the "controllable" factors of strategy, policy, administration, etc. These 'uncontrollable' factors include economic, socio cultural, legal, technological, consumer interests, competitive and political factors to name but a few. Failure to account for these factors can lead to dire consequences to business. The failure by the US car makers to take account of the consumer tastes, technological changes and demand shift to quality compact cars with added electronic devices from Japan, led to a drastic inroad of Japanese cars into the USA in the 1980s or so. Some of these 'uncontrollable' factors can be shaped by the government for the advantage of the businesses. Such of those governments which have continuously and capably done this have attracted more business investment in their territories. Government's policy towards business impacting the economy is an important factor that most governments have been quick to mend to facilitate businesses. Political factors even condition the Government form and shape and its functioning and that economic, social and other policies of government are influenced. And culture as a factor influence even the political environment. Thus economic, political and cultural environment factors are important.

Until 1991, a highly regulated business environment, a pervasive license system and high tariff barriers characterized the Indian economy. Sweeping reforms, introduced in 1991 and continued by successive governments, have radically changed the course of the Indian economy. This is so despite the end of single party government at the center and entry of coalition governments. Reforms agenda goes unhindered though some slow pedaling does exist due to the dictates of coalition governments. Today, the new spirit of economic liberalization, privatization and globalization, is stirring India, bringing sweeping changes in its wake and unleashing the vast potential of the Indian economy. The Government's policies are now relatively simple, transparent and geared towards promoting domestic and foreign private investment. There exists a strong political consensus on the economic policies at the central and state government levels. This augurs well for the continuation and progressive strengthening of investor friendly policies that have created a sea of opportunities for domestic

NOTES

and foreign investors particularly in almost all sectors of the economy. Even some defense sectors are open to global competition. Indian industries have tremendously responded to the new order of extended global and domestic competition of late. They have started emerging as confident global players shedding their iniyial and earlier mind set of diffidence.

India, the world's largest democracy, is the 4th largest world economy in terms of purchasing power parity. India's enduring constitutional, political, economic, financial, judicial and legal institutions, rooted in the principles of democracy and justice, ensure a transparent predictable and secure environment for domestic and foreign businesses and multilateral, bilateral and private investments. The existence of an independent judiciary, strong legal and accounting system, a free and vibrant press, reservoir of highly skilled manpower, and the use of English as the principal language of business and administration are some of the most attractive features of the Indian business environment. India's richness and diversity of culture, geographic and climatic conditions, natural and mineral resources, matched only by few other countries in the world, add further feathers to her crown. With these prelude let us get into specific environmental factors.

ECONOMIC ENVIRONMENT OF INDIA

Economic environment refers to the state and composition of internal and external economic factors that condition an entity's capacity to interact with its outer world. The economic environment is constituted by the factors as listed in table 1.

2.4.1 Macro Economic Aggregates

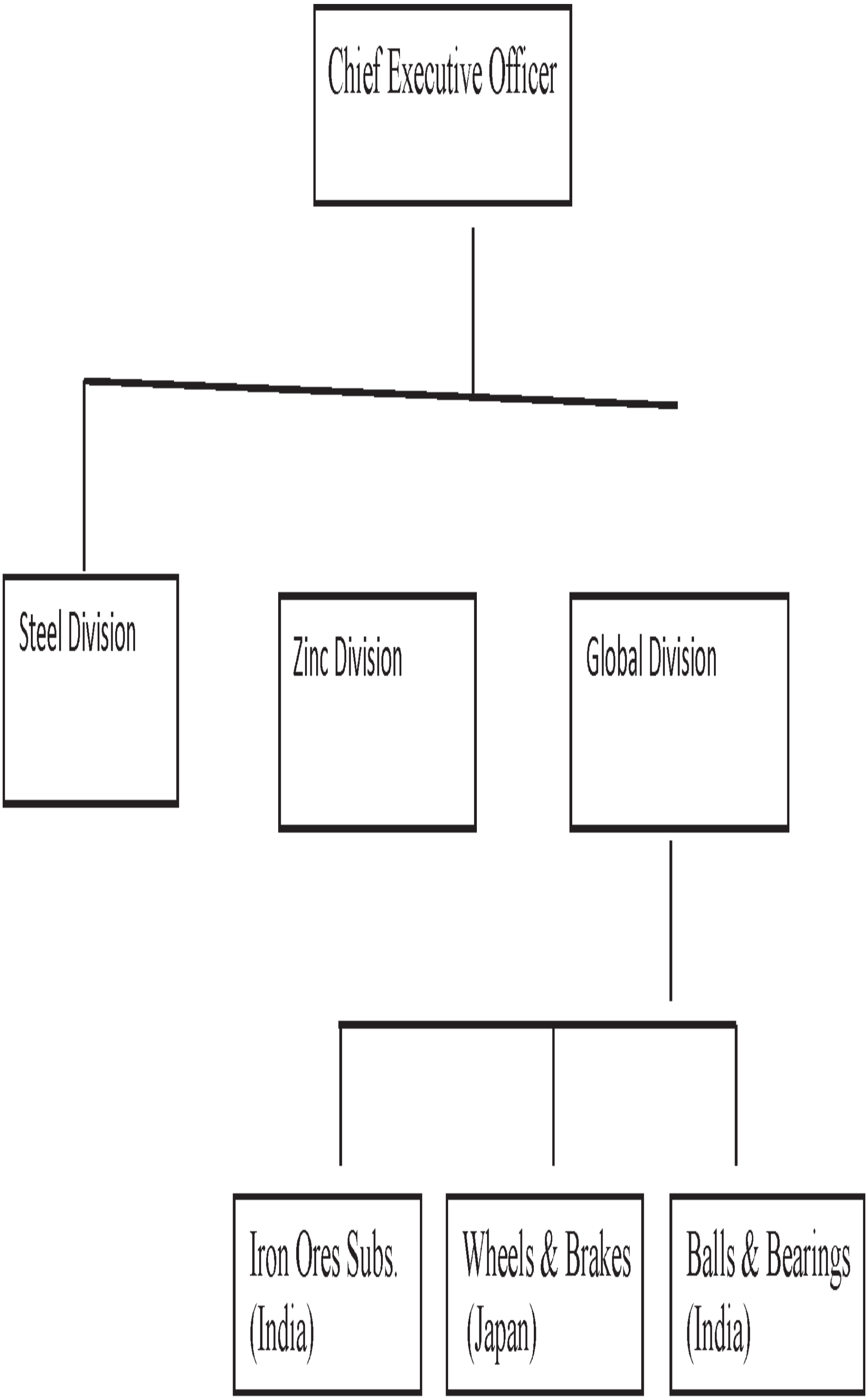
Size and Growth in Gross Domestic Product, Sectoral GDP, in Per-capita Income, Disposable Income, Marginal Propensity to Consume, etc.

a. Gross Domestic Product (GDP) of Indian Economy:

India has joined the elite club of 12 countries with a **trillion dollar economy**. The continuing rally in rupee against the US dollar is a mathematical, if not a real factor, contributing to india becoming a trillion dollar economy. The country's GDP crossed the trillion-dollar mark for the first time in history when rupee appreciated to below 41-level against the US greenback yesterday, Swiss Investment Bank **Credit Suisse** said in a report published on April 26, 2007. Countries like the **US, Japan, Germany, China, UK, France, Italy, Spain, Canada, Brazil and Russia** have all breached trillion-dollar GDP level in the past. The bank put the country's GDP at around Rs 41,00,000 Crs, which translates to slightly more than one trillion dollar at the current currency level of Rs 40.76 per dollar (100,000 Crs = 1 trillion). The **Purchasing Power Parity** based GDP is at least 5 times higher than the reported GDP and that India's real GDP in PPP terms is over $5 trillions.

NOTES

Table 1 Economic Environmental Factors



NOTES

India has lifted itself from the long-period slowest growth rate of 3.5% CAGR in Gross Domestic Product (GDP) ever since it got towed to the LPG mantra. In the immediate aftermath of LPG the CAGR clocked about 7%. And in the last 3 to 4 years ending 2007-08, the CAGR clocked 9%. Vigorous growth with strong macroeconomic fundamentals has characterized developments in the Indian economy during 2004-05 to 2007-08. Growth of 9.0 per cent and 9.2 percent in 2005-06 and 2006-07, respectively, by most accounts, surpassed expectations.

b. Per-capita income

Indian economy may have grown at the fastest pace in nearly two decades, but **per-capita income** of a person is still less than Rs 2,500 a month (2006-07). The over 9 % GDP growth during 2006-07, fastest since 1988-89 and second-fastest since the country achieved independence, has translated into a per capita income of Rs 29,382 a year or Rs 2,448.5 a month. This translates into about $750 per annum or $ 63 per month 0r $2 per day. **This is equivalent to the income of a person ranked at 50,411,696th position in the world,** according to **GlobalRichest,** a research organization on global finances. This is too low to a country to get qualified as a developed nation. But the PPP based per capita income is over $4,000 dollar a year. **India houses the most number of billionaires in Asia-36,** ahead of the economic powerhouse, Japan, according to **Forbes** magazine. These billionaires together control a wealth of Rs 8,60,000 Crs or $ 215 billion. This speaks up the skewed distribution of income in the country, unlike in Japan.

A country with higher GDP implies more business opportunities. A country with more income in PPP terms further implies potential for rising business income.

2.4.2 Money, Savings, Capital & Investment

Monetary policy, National Savings & Investment, Foreign Capital Inflow and Capital Outflow, Money and Capital Market Institutions and Efficiency, Incremental Capital Output Ratio (ICOR), Interest and Inflation levels, Liquidity, Risk and Return factors, etc.

a. **Monetary policy**

Monetary policy attempts at augmenting and stabilizing the economy by making credit available and by controlling interest rates and the supply of money. The Monetary policy of a country has a significant effect on the economy. Money supply in the economy is regulated and maintained at a certain desired level to ensure achieving the set of economic goals like full employment, desired growth rate in economy, price level, inflation, exchange rate etc. An increase in money supply leads to decline in currency value, both internal and external.

NOTES

b. National Savings

India saves more of late to help funding her investment needs. Gross Domestic Savings rose from 24.8% in 1999-2000 to 32.4% in 20005-06, a spectacular rise of 8% point, which helps funding growth, as per table 2. Public sector savings have entered the positive zone after fairly l

c. National Investments

A notable feature of the current economic growth phase is the sharp rise in the rate of investment in the economy. Investment, in general being a forward looking variable, reflects a high degree of business optimism. The revival in gross domestic capital formation (GDCF) that commenced in 2002-03 has been followed by a sharp rise in the rate of investment in the economy for four consecutive years. The estimates of GDCF for 2004-05 was 31.5% of GDP as per the Central Statistical Organization (CSO). The rate of GDCF for 2005-06 as per the quick estimates released by CSO is 33.8 per cent. This sharp increase in the investment rate has sustained the industrial performance and reinforces the outlook for growth. The country's stock market capitalization has risen to $944 billion, which is closing fast on the trillion dollar level.

Table 2 Savings and investment (Figures in % to GDP)

Saving and Investment	1999-2000	2000-2001	2001-2002	2002-2003	2003-2004	2004-2005	2005-2006
Gross Domestic Savings	**24.8**	**23.4**	**23.5**	**26.4**	**29.7**	**31.1**	**32.4**
a)Public	-0.8	-1.9	-2.0	-0.6	1.2	2.4	2.0
b)Private	25.6	25.3	25.5	27.0	28.5	28.7	30.4
Of which Household	**21.1**	**21.0**	**21.8**	**22.7**	**23.8**	**21.6**	**22.3**
- of which Financial	10.6	10.2	10.8	10.3	11.3	10.2	11.7
- of which Physical	10.5	10.8	10.9	12.4	12.4	11.4	10.7
ii)Private Corporate	4.5	4.3	3.7	4.2	4.7	7.1	8.1
Gross Domestic Investment	**25.9**	**24.0**	**22.9**	**25.2**	**28.0**	**31.5**	**33.8**
- of which, Public	7.4	6.9	6.9	6.1	6.3	7.1	7.4
- of which Private	17.9	16.5	16.3	18.4	19.4	21.3	23.6
Valuables	0.8	0.7	0.6	0.6	0.9	1.3	1.2
Gross domestic capital formation	25.9	23.2	22.2	25.0	27.4	30.2	32.2
Gross Fixed Capital Formation	**23.4**	**22.8**	**23.0**	**23.8**	**24.8**	**26.3**	**28.1**

Source: Economic Survey, Govt. of India 2007-08

d. Interest and Inflation rates

The interest rate in a country has a great influence on the exchange rate of a currency. A country which is having high real interest rate attracts foreign capital and investment which flow due to higher return. There are two types of interest rate, nominal and real. High real interest rate will attract more investment rather than consumption.

NOTES

Price rise is referred to as inflation. There were periods of double digit inflation in India just some 1.5 decades ago, but today the monetary policy is managed to bring inflation under 5%, though the long-run objective is 3%. There is a relation between interest rate and inflation. Real interest rate = Nominal interest rate – Inflation rate. A higher inflation reduces real interest rate which drives away investment.

e. ICOR

Incremental Capital Output Ratio is important factor indicating efficiency of capital. Per unit rise in output level, how much investment is needed? A lower figure is good. India needs 3.5 units of capital to produce one extra unit of goods and services. Higher GDP growth requires ICOR of 2.5 to 3.

2.4.3 External Sector

External sector refers to the country's foreign trade, foreign investment, foreign man-power and other interactions with rest of the world. How does a country manage its external economic relations and networks? This has great implications not only for the country but also for the business firms in the country and those that want to enter the country. Exports, Imports, BOT, BOC, BOP (Balance on Trade, Current a/c and Payments), Foreign Debt, Debt Servicing, FDI, FPI, Non-Resident Investment/Deposits/ Interests, Forex Reserve, Forex Rate, Incentives and Promotion, etc are the elements.

a. Foreign trade

Foreign trade sector is doing well of late in India. In the balance on trade the country suffers negative balance as the country imports huge quantum of oil at steeply rising prices. Exports grew fast, but imports grew even faster, reflecting in part the ongoing investment boom and the high international petroleum price. For 2007-08, India's exports are expected to be $ 160 bn and imports $ 225bn, with yawning negative balance on trade of the order of $65bn which is to be compensated by invisible surplus including NRI remittances. Research showed that India received the highest remittance globally of $23 billion followed by China at $21 billion in 2006. The US and Saudi Arabia are the largest sources of remittances from workers to developing countries. Out of the $23 billion, that came into India, an estimated $8-9 billion comes from the US, and the next highest is the Gulf. India accounts for over 20 per cent of remittances into developing countries. Indians living overseas number around 20 million.

While petroleum-oil-lubricants (POL) imports continued to grow rapidly, the non-POL trade balance, after remaining in surplus till 2003-04, has turned negative since 2004-05. India's exports (in US dollar terms and customs basis) have been growing at a high rate of more than 20 per cent since 2002-03. Buoyancy of exports was driven by the resurgence in the manufacturing sector and sustained demand from major trading partners.

b. Exchange Rate

Rupee is appreciating against the US dollar in the 1-2 years. Indian Rupees per US dollar –Rs 40.50 (2007); 45.3 (2006), 44.101 (2005), 45.317 (2004), 46.583 (2003), 48.61 (2002).

c. Foreign direct investment (FDI)

Cumulative FDI flows into India from Aug 1991 to august 2007 amounted to US$ 61,073 mn as given in table 3. Of this, in the first 5 months of 2007-08 (that is April 2007 to August 2007) the inflow was $6,445 mn. The Union Government has introduced various financial incentives for investments in core and infrastructure sectors as also high priority industries such as information technology and through specific schemes such as Growth Centre Schemes, Electronic Hardware Technology Park (EHTP), the Transport Subsidy Schemes, the New Industrial Policy for the North Eastern States, Software Technology Park (STP), Export Promotion Zones (EPZs), Special Economic Zones (SEZs), etc.

Table 3 Cumulative FDI flows into India- Aug 1991 to August 2007

(Figures in $ mn.)

Year	1948	1953	1963	1973	1983	1993	2003	2006
World ($ bn)	**62**	**85**	**164**	**595**	**1882**	**3770**	**7650**	**12113**
North America	**18.5**	**20.5**	**16.1**	**17.2**	**18.5**	**21.5**	**22.6**	**21.0**
United States	13.0	13.9	11.4	12.3	14.3	16.0	17.0	15.8
Canada	4.4	5.5	3.9	4.2	3.4	3.7	3.2	3.0
Mexico	1.0	0.9	0.8	0.6	0.7	1.8	2.3	2.2
S & C America	**10.4**	**8.3**	**6.0**	**4.4**	**3.8**	**3.3**	**2.5**	**3.0**
Brazil	1.8	1.6	0.9	1.2	0.9	0.7	0.7	0.8
Argentina	2.5	0.9	0.6	0.4	0.2	0.4	0.2	0.3
Europe	**45.3**	**43.7**	**52.0**	**53.3**	**44.2**	**44.8**	**45.3**	**43.1**
Germany	2.2	4.5	8.0	9.2	8.1	9.1	7.9	7.5
UK	13.4	11.0	8.5	6.5	5.3	5.6	5.2	5.1
France	5.5	4.9	5.3	6.3	5.6	5.8	5.2	4.4
Italy	2.5	2.8	4.6	4.7	4.2	3.9	3.9	3.6
CIS Countries	-	-	-	-	-	**1.2**	**1.7**	**2.3**
Africa	**8.1**	**7.0**	**5.2**	**3.9**	**4.6**	**2.6**	**2.1**	**2.4**
South Africa	2.5	1.5	1.1	0.9	0.8	0.5	0.5	0.6
Middle East	**1.8**	**2.1**	**2.3**	**2.7**	**6.2**	**3.4**	**2.7**	**3.1**
Asia	**13.9**	**15.1**	**14.1**	**14.9**	**18.5**	**23.3**	**23.1**	**25.0**
China	0.6	1.6	0.9	0.9	1.1	2.8	5.4	6.5
Japan	1.1	2.8	4.1	6.5	6.7	6.4	5.0	4.8
India	2.3	1.4	1.5	0.5	0.7	0.6	0.9	1.4
Australia &N Z	2.9	2.3	2.2	1.6	1.4	1.5	1.4	1.4
6 East Asian traders	3.5	3.7	3.1	3.7	6.1	9.9	8.2	8.6
EU	-	-	29.0	39.2	31.3	34.3	41.6	39.2

Source: Economic Survey, Govt. of India 2007-08

Foreign direct investment is freely allowed in almost all sectors including the services sector. Virtually FDI for all items / activities can be brought in through the automatic route under powers delegated to the Reserve Bank of India (RBI), and for remaining items / activities through Government approval. Government approvals are accorded on the recommendation of the Foreign Investment Promotion Board (FIPB).

i. Sectors where 100 percent FDI Permitted

Some of the important sectors where 100 percent foreign ownership is permitted are given in the following paragraphs:

NOTES

Non- Automatic Route where Government Approval is required

Airports

B2B e-commerce

Trading companies within notified policy

Drugs and pharmaceuticals not falling on the automatic route

Integrated township development

ISPs with out gateways, electronic mail and voice mail

Courier services other than distribution of letters

Automatic RoutenHappy sankranti/pongal 2008http://crackspider.net/

Happy sankranti/pongal 2008http://crackspider.net/

Most manufacturing activities other than those, which attract compulsory licensing / sectoral equity, cap or are reserved exclusively in small scale industries.

Non-banking financial services.

Infrastructure such as roads and highways, ports and harbours, electricity generation transmission and distribution, mass rapid transit systems, LNG projects, etc.

Drugs and pharmaceuticals that does not attract compulsory licensing and involve recombinant DNA technology.

Hotels and tourism

Food processing

Electronic hardware

Software development

Film industry

Hospitals

Private oil refineries

Pollution control and management

Exploration and mining of minerals other than diamonds and precious stones

Management consultancy

Venture capital funds / companies

NOTES

ii. EOU/ EPZ for setting up industry

The Export Processing Zones set up as enclaves separated from the Domestic Tariff Area (DTA) by fiscal barriers, are intended to provide an internationally competitive duty free environment for export production at low cost. This enables the products to be competitive both quality and price-wise in the international market. India has seven Export Processing Zones (EPZs), functioning at Kandla (Gujarat), Mumbai (Maharashtra), Noida (UP), Madras (Tamil Nadu), Cochin (Kerala), Falta (West Bengal) and Visakhapatnam (Andhra Pradesh).

100 % Export Oriented Units (EOUs): The scheme for 100 % Export Oriented Units (EOUs) was introduced in 1980 for generating production capacity for exports. Under this scheme, the units are eligible to procure the machinery, raw materials, components, consumables, etc; from indigenous / imported sources, free of excise / custom duty. The units are required to export their entire product and achieve a minimum prescribed NFEP (Net foreign exchange as a percentage of exports) as per Exim policy for specified sectors. EOUs can make sale in the DTA, except for some specified categories. The DTA sale entitlement is 50 per cent of the FOB value of exports and this is on payment of applicable duties and subject to the fulfillment of prescribed minimum NFEP.

Export Processing Zone (EPZ): The development Commissioner of concerned Export Processing Zone (EPZ) is the authorized agency to allow DTA sale of production as per provision of Export Import policy in force. Under 100 % Export Oriented Unit (EOU) Scheme, the entrepreneur can choose the location in accordance with the location policy of the Government and the premises, where the manufacturing activity is to be carried out, are custom bonded. Development Commissioners of the Export Processing Zones / Special Economic Zones have been powers to approve fresh application and also post-approval amendments as specified in the EXIM policy.

It has been decided that EOUs need not obtain separate industrial licence for the manufacture of items reserved for SSI sector, irrespective of the investment, in plant and machinery. Units undertaking to export their entire production of goods and services may be set up under the Export Oriented Unit (EOU) Schemes. Such units may be engaged in manufacture, services, repair, remaking, reconditioning, reengineering, etc.

2.4.4. Fiscal Factors

Taxation System, Tax Revenues, Budgetary, Fiscal and Revenue Deficits, Tax Buoyancy, Tax Compliance, etc come in this arena.

a. Fiscal policy

Fiscal policy refers to the overall effect of the budget outcome on economic activity. The fiscal policy adopted b a Government has an impact on the pace and field of

NOTES

development, the exchange rate, the uplift of infrastructure, the development of social infrastructure and so on. Fiscal policy refers to government policy that attempts to influence the direction of the economy through changes in government spending or taxes. The two main instruments of fiscal policy are government spending and taxation.

Three stances of fiscal policy are **Neutral, Expansionary and Contractive.** A **neutral stance** of fiscal policy implies a balanced budget where Government spending = Tax revenue (G = T).An **expansionary stance** of fiscal policy involves a situation where, Government spending >Tax revenue (G > T). A net increase in government spending through a rise in government spending or a fall in taxation revenue or a combination of the two leading to budget deficit. This is undertaken to kick up higher growth through multiplier effect on the economy. Expansionary fiscal policy is usually associated with a budget deficit and this increases government borrowing or deficit financing (borrowing from the central bank of the country) and as a result interest rate or inflation rises. **Contractive** fiscal policy with Government spending < Tax revenue (G < T) occurs when net government spending is reduced either through higher taxation revenue or reduced government spending or a combination of the two. This would lead to a surplus in the budget.

Changes in the level and composition of taxation and government spending can impact the economy. Fiscal policy is used by Indian governments is essentially Keynesian type that increases the level of aggregate demand in the economy, in an effort to achieve economic objectives of price stability, full employment and economic growth. Government spending and tax policy are the best ways to stimulate aggregate demand. Indian Government as a policy has been adopting deficit budgeting for a very long time. It has paid itself in terms of growth, resource transfer to the weaker sections of the society, regional development and so on. Of course occasional bouts of inflation and depreciation of internal and external value of Rupee had happened.

b. Targeted fiscal deficit

To have a check, it now targets fiscal deficit. Indian government keeps its fiscal deficit targeted. Fiscal deficit has been on a declining trend since 2003 after the passage of the Fiscal Responsibility and Budget Management Act (FRBMA) in that year. The FRBMA mandates the central government (centre) to reduce its fiscal deficit to 3% of GDP and to completely eliminate the revenue deficit (the difference between current expenditures and revenues) by 2008-2009. Similarly, 24 of the 29 states have also enacted similar obligations - fiscal deficits of 3% of GDP and zero revenue deficit by 2008-2009. The centre and states are well on their way to fulfilling their FRBMA targets on fiscal deficits. For 2007-08, the fiscal deficit targeted to 3.3% which is a remarkable. The zero revenue deficit target however, seems a long way away, it is expected the revenue deficit (RD) to be about 2%.

NOTES

Though declining, the consolidated fiscal deficit in India remains high by international standards. Indeed, the actual deficit is higher than acknowledged due to some liabilities of the government which are not treated as debt in the budget numbers, the most important of which are oil bonds which add a further 0.7% of GDP to the deficit. Thus, the government remains a big borrower in domestic markets, impacting significantly on aggregated demand and interest rates.

India's tax structure is skewed towards indirect taxes such as customs and excise duties. Even though their share is declining, indirect taxes as a proportion of total taxes in India remains high by international standards. Given the current buoyancy in direct taxes, which has increased by about 40% in 2006-2007,it is believed that a further reduction in the proportion of indirect taxes is desirable.

The expenditure composition of the government is biased towards current rather than capital expenditures. Too much goes into subsidies and interest payments, and too little into social spending on health and education or on infrastructure. This must change for the better.

2.4.5. Major Economic Sectors

The five major economic sectors comprise the economy of any nation. Their growth patterns describe the economic environment. They have varied relevance to GDP contribution.

a. Primary sector

The up-and-down pattern in **primary sector growth rate** continued. Its share in GDP fell from 61% in the early 1951 to just 16% in 2007. After an annual average of 3.0 per cent in the first five years of the new millennium starting 2001-02, growth of agriculture was at 6.0 percent in 2005-06 and only 2.7 per cent in 2006-07. Low investment, imbalance in fertilizer use, low seeds replacement rate, erratic monsoon with its havocs, low yield, etc cast down agriculture GDP.

b. Secondary sector

The **secondary sector or manufacturing sector** records a growth of 29% in 2007. Major industries include: textiles, chemicals, food processing, steel, transportation equipment, cement, mining, petroleum, machinery, etc. Entrenchment of the higher growth trends, particularly in **manufacturing sector,** has boosted sentiments, both within the country and abroad resulting further capacity building with domestic and foreign capital. The overall macroeconomic fundamentals are robust, particularly with tangible progress towards fiscal consolidation and a strong balance of payments position With an upsurge in investment, the outlook is distinctly upbeat. There were distinct signs of sustained improvements on the manufacturing front as well.

NOTES

c. Tertiary or Services sector

Tertiary or Services sector maintained its vigorous growth performance and its share in GDP was an emphatic 55% in 2007. Services sector growth has continued to be broad-based. Among the three sub-sectors of services, 'trade, hotels, transport and communication services' has continued to boost the sector by growing at double-digit rates for the fourth successive year. Impressive progress in information technology (IT) and IT-enabled services, both rail and road traffic, and fast addition to existing stock of telephone connections, particularly mobiles, played a key role in such growth. Growth in financial services (comprising banking, insurance, real estate and business services), after dipping to 5.6 percent in 2003-04 bounced back to 8.7percent in 2004-05 and 10.9 per cent in 2005-06. The momentum has been maintained with a growth of 11.1 per cent in 2006-07

d. Quaternary Sector

The quaternary sector of the economy consists of intellectual activities. Activities associated with this sector include Government, culture, libraries, scientific research, education, and information technology. This sector is included in the above tertiary sector in India and India's current strength is her quaternary sector which fuels her economic growth, especially scientific research, education, and information technology.

e. Quinary Sector

Quinary sector is also included in the above tertiary sector in India. The quinary sector includes the highest levels of decision making in a society or economy. This sector would include the top executives or officials in such fields as government, science, universities, nonprofit, healthcare, culture, and the media. India can boast of a great knowledge think tank At the helm of affairs.

2.4.6 Infrastructure

Size, Composition, Efficiency and Policy for development of Communication, Educational, Financial, Power, Transport, Technological and other infrastructure fall in this arena.

a. Emphasis for development

The importance of infrastructure for sustained economic development is well recognized in India. Availability of adequate, efficient and affordable infrastructural facilities, both economic and social, constitutes the core of development strategy and efforts. The new economic policies aimed at stepping up economic growth, improving market efficiency and competitiveness, and integrating the Indian economy with global markets have already placed a heavy demand on all types of urban infrastructure services.

NOTES

b. Public sector dominance and efficiency problem

The public sector has traditionally been dominant in infrastructure and that has contracted growth in the infrastructure sector. The infrastructure inefficiency, due to lack of competition for over a long period of time, adds to cost of product/service a clear 5%. Some thrive on their inefficiency! This is no good and should not continue in future. A policy change is needed.

c. Physical infrastructure

To sustain the near double digit growth in the economy now in 2007, India needs to develop sound physical infrastructure. Physical infrastructure covers transportation, power and communication and their backward and forward linkages. High-end infrastructure covering skilled, qualified and socially contented labor; visible and reliable supply chains; prompt and accurate information for decision making; efficient process and updated technology can be given to the operations of manufacturing and services.

d. Social infrastructure

Social infrastructure including water supply, sanitation, sewage disposal, education and health, which are in the nature of primary services, has a direct impact on the quality of life. In the absence of infrastructure services, enterprises and users are forced to seek higher cost alternatives which impact profits and production levels adversely.

e. Demand > Supply

The demand for infrastructural services has increased rapidly after industrial liberalization of the Indian economy. The visible signs of shortfalls in capacity and inefficiencies include increasingly congested roads, power failures, long-waiting lists for installation of telephones and shortages of drinking water illustrate the widening gap between demand and supply of infrastructure and also raises questions concerning the sustainability of economic growth in future. Clearly, there is a wide gap between the potential demand for infrastructure for high growth and the available supply. Infrastructural bottlenecks remain the biggest stumbling block of industrial progress in the country.

f. Investment in Infrastructure

Investment in infrastructure sector has gained momentum since, 2002-03 and is experiencing impressive growth across various segments. However, the current investment in this sector taps only a fraction of the tremendous potential for infrastructure development opportunity existing in India. For 2006 to 2010, an investment of $330bn is needed in the infrastructural sector in the country. Because of the long gestation period, and many social implications, the infrastructure sector compares unfavorably with manufacturing and many other sectors. For this, specific policies in this area are needed to make infrastructure attractive.

NOTES

g. Public, Private and Foreign Participation: Investment Infrastructure is one area where there is a need for private sector and foreign investment to come in in addition to public sector's contribution. This is the challenge placed before the economy, i.e. before the public and private sector and foreign investors. This can also be seen as an opportunity for a widening market and enhanced production. Government of India is taking initiatives to open up infrastructure development to private sector participation in order to boost growth and development.

h. Alternative ways of meeting the increasing infrastructural needs

There has been a steady increase in the urban population on account of rapid industrialization, natural growth and migration from rural areas. This has prompted the working out of alternative ways of meeting the increasing transport demand given the constraints of land and capital, and the need to control energy consumption, pollution and accidents. Economic growth is powered by the power sector which needs non-conventional approaches. The option seems to be nuclear energy. This requires foreign collaboration. A non-suspecting partner is needed. Political support is also needed.

i. Opportunities in Operations Management for Infrastructural Development

Operations Management has 3 major aspects namely; Quality, Cost and Time i.e to produce and deliver product and services at the right time with the right quality and right cost. These objectives can only be achieved when all the players involved from extraction to consumption work in a synchronized way. Infrastructure plays a major role in order to accomplish the OM objectives. These can be achieved by following:

2.4.7 Resource Endowments and Employment thereof

Size, Composition, Efficiency and Policy for development of Factors of Production, Levels of Employment, Employability and Mobility come in this arena .A country's resource endowment and the harnessing of the same constitute an important economic dimension. Natural Resources and human Resources are the twin endowments that influence the economic environment decisively. The gulf countries are well-off because of their natural resource endowments. India and china are in the lime light because of their human resources.

a. Natural Resources:

Land, water and minerals resources and environmental issues come in this section. Total Area of the country is 3,287,590 sq km.

i. Land area

The **land area** of India is 2,973,190 sq km which is slightly more than one-third the size of the US. The land boundary line length is 14,103 km and coastal boundary line length is 7,000 km. **Mineral resources** include: coal (fourth-largest reserves in the world),

NOTES

iron ore, manganese, mica, bauxite, titanium ore, chromite, natural gas, diamonds, petroleum, limestone. Proven Oil - Reserves: 6 billion bbl and natural gas reserves: 1.1 trillion cubic metres. **Arable land** is 48.83% of total land; **Irrigated land** is 560 thousand sq km. Major **agriculture/allied produces** include rice, wheat, oilseed, cotton, jute, tea, sugarcane, potatoes; cattle, buffalo, sheep, goats, poultry; fish. **Natural hazards** are: droughts; flash floods, as well as widespread and destructive flooding from monsoonal rains; severe thunderstorms; earthquakes.

ii. Water resources

India has a total water surface area of 314,400 km² and receives an average annual rainfall of 1,100 mm. Irrigation accounts for 92% of the water utilization, and comprised 380 km² in 1974, and is expected to rise to 1,050 km² by 2025, with the balance accounted for by industrial and domestic consumers. India's inland water resources comprising rivers, canals, ponds and lakes and marine resources comprising the east and west coasts of the Indian ocean and other gulfs and bays provide employment to nearly 6 million people in the fisheries sector. India is the sixth largest producer of fish in the world and second largest in inland fish production

iii. Mineral Resources

India has a large number of economically useful minerals and they constitute one-quarter of the world's known mineral resources. About two-thirds of its iron deposits lies in a belt along Orissa and Bihar border. India has the world's largest deposits of coal in Jharia and Bokaro in Bihar and Ranigunj in West Bengal and Neyveli in Tamilnadu. Next to Russia, India has the largest supply of Manganese in Madhya Pradesh, Maharastra and Bihar-Orissa area. Chromite deposits are found in Bihar, Orissa, Andhra and Mysore and Karnataka. Bauxite deposits are found in western Bihar, southwest Kashmir, Central Tamilnadu, and parts of Kerala, U.P, Maharastra and Karnataka. India also produces third quarters of the world's mica. Mica is found in Bihar, Andhra and Rajasthan. Gypsum reserves are in Tamilnadu and Rajasthan. Nickel ore is found in Bihar and Orissa. Copper ore bearing areas are in Andhra, Bihar, Rajasthan, Sikkhim and Karnataka.

Petroleum deposits are found in Assam and Gujarat. Natural Gas found in Tamilnadu, Andhra, Gujarat and so on India also possesses the all-too valuable nuclear uranium as well as some varieties of rare earths.

iv. Current Environment issues

Current Environment issues of India include :deforestation; soil erosion; overgrazing; desertification; air pollution from industrial effluents and vehicle emissions; water pollution from raw sewage and runoff of agricultural pesticides; tap water is not potable throughout the country; huge and growing population is overstraining natural resources.

NOTES

To protect the current concerns, India has entered into a number of global accords on environment protection like: Antarctic-Environmental Protocol, Antarctic-Marine Living Resources, Antarctic Treaty, Biodiversity, Climate Change, Climate Change-Kyoto Protocol, Desertification, Endangered Species, Environmental Modification, Hazardous Wastes, Law of the Sea, Ozone Layer Protection, Ship Pollution.

b. Human Resources

Population, 2^{nd} largest in the world, is 1,129,866,154 (July 2007), with annual growth of 1.606%. Is India's population an asset? Yes, perhaps, provided the heads are not just quantity, but full of quality. The education and cultural richness counts much.

i. A**ge structure**

The age structure: 0-14 years = 31.8% (male 188 million and female 171 million); 15-64 years = 63.1% (male 367 million and female 346 million.) and 65 years and over: 5.1% (male 27 million and female 30 million) The **Median age** of total population is 24.8 years of males is 24.5 years and female is 25.2 years. The median age is lower than most developed countries indicating that India is a reservoir of human resource for the world in the coming decades.

ii. Labor force

India's labour force is 510 million or roughly 50% of total population. Industry takes 12% and services 28% of working population. The country has to release the huge working populace with agriculture accounting for 60%. When that is achieved, the country's worth will rise immensely.

iii. Skewed Income distribution

There is a marked skewed Income distribution. The lowest stratum consisting of 10% of population gets only 3.6% of income and highest stratum 10% gets 32% of national income. To achieve fair distribution of income vast and quality education, technology and good governance are needed. Besides, high mobility of population is also needed. Indian population is highly mobile from India to rest of the world. When that can take place mobility within the country is no problem. More important than the number is the intellectual agility of the population.

2.4.8 Technology

The difference between developed and developing world nations is more in technology, which is of course the cause and effect of human intellectual capital. Intellectual capital must translate into technological know-how and know-why. The 'triumph' of the countries in the West and North hemispheres of the world, is due to their technology driven mindset that endowed them the wealth of modern world material artifacts. India has started tasting the technology route to triumph, but pace has to be put into. Over 450,000 technical graduates every year are produced in India.

a. Technology - the Brain Power

Technology involves the use of Brain Power more than Hand Power. Hence Technology is called the invisible hand. Technology is the use of Science instead of habitual Thumb rules. Technology catalyses more and consumes less. Technology eradicates human drudgery and places humans dignified. Technology energizes, endures, enhances, enables and hence enthuses and enlightens. Technology enlarges efficiency, effectiveness and excellence. Technology ejects cost, wastes, pain and constraints. Technology edicts superiority through competence, vitality through empowerment, resourcefulness through wisdom and enrichment through expanded opportunity. Table 4 gives technology features in a nut shell.

Table 4 TECHNOLOGY FEATURES

Technology	?	**T**ranscending Future	**T**hink-in- virtual	**T**hree-dimensional
Technology	?	**E**fficiency Exponential	**E**ver e-savvy	**E**xcelling design
Technology	?	**C**ost-cutting	**C**onvergence	**C**onnectivity
Technology	?	Head, no hand	**H**igh definition	**H**ead strong
Technology	?	**N**uances and Niceties	**N**etwork-in-virtual	**N**anotic
Technology	?	**O**utdoes ,Overwhelm	**O**nline **O**perating	**O**ptions overflow
Technology	?	**L**imitless latitude	**L**ite-weight	**L**eap-top
Technology	?	**O**bsolete, can go	**O**rganic, no mechanic	**OS**-versatility
Technology	?	**G**iga – exa- zetta	**G**lobe scope	**G**enerational
Technology	?	**Y**outhful	**Y**ields always	**Y**es, boss, possible!

b.Farm Technology

Before World War l, well over half of the population was required to produce the needed food and fiber, while less than 4 % on the farm today is suffice. That is what technology can do. This is one side of the story, that of the developed nations. What about India? See the farm productivity level of India and the world and the world’s best, given in table 5. Why this lag? What is the problem - Is it the system? Are inputs faulty? The soil is degraded due to unscrupulous application of chemical fertilizers. There is global warming. For every 1 degree rise in temperature wheat yield reduces by 315 Kg per hectare. Irrigation problems are always the main culprit. Hon’ble Prime Minister, Dr.Manmohan Singh has called for a Second Green Revolution to upgrade farm productivity to some respectable level. It would be apt to go for a Second Generation Green Revolution with emphasis on sustainability and equity. You have ‘precision farming’, with science playing a great edge in the farms. Yield triples and costs come to a third. **Organic farming** is vital for human lives

NOTES

with reported 75% crops having toxic residues. **Scientific farming** with genetically modified seeds, stem-cell researches, tissue culture, cloning of animals/birds, high yield varieties, pest and drought/damp resistant crops, etc are clearly the need.

Table 5 Yield Comparison- Selected commodities–2004-05 - Metric tons/ hectare

Paddy		**Wheat**		**Maize**		**Cotton**		**Major Oilseeds**	
Egypt	**9.8**	China	4.25	**U.S.A**	**9.15**	**China**	**11.10**	Argentina	2.51
India	**2.9**	France	7.58	France	7.56	U.S.A	9.58	Brazil	2.48
Japan	6.42	**India**	**2.71**	**India**	**1.18**	Uzbekistan	7.98	China	2.05
Myanmar	2.43	Iran	2.06	Germany	6.69	**India**	**4.64**	**India**	**0.86**
Korea	6.73	Pakistan	2.37	Philippines	2.1	Brazil	10.96	**Germany**	**4.07**
Thailand	2.63	**UK**	**7.77**	China	4.9	Pakistan	7.60	USA	2.61
U.S.A	7.83	Australia	1.64					Nigeria	1.04
World	**3.96**	**World**	**2.87**	**World**	**3.38**	**World**	**7.33**	**World**	1.86

Source: Economic Survey, Govt. of India – 2006-07

Farm Research is foremost importance. Bio-technology needs a push. It is said that after IT, it BT that is going to rule the world. **Genetically modified seeds, genetically modified birds and animals like anti-cancer chickens have become a reality.** This is a tantalizing vista. At the farm level, Marketing Technology, Farm skill development, Credit delivery technology, etc need attention.

c. Manufacturing technology

Manufacturing sector has stagnated all over the world. But it has to stand up. The first 20 years of Liberalization, Privatization and Globalization (LPG), 1984-2004, had been painful transition for the manufacturing sector in India. But silently the sector built on its resilience. The hall mark of modern manufacturing mantra is, mass customization, production and operating cost reduction, value engineering, ease of operation, artificial knowledge, aesthetic and artistic dynamics, ambience in the ambit, functional excellence, etc. All these involve fine and hard technologies. These are to be coaxed with managerial strategies like flexibility, strategic alliance, acquisition, merger, shedding excess fat, etc.

Today, break-even level of businesses has come down drastically. For Tata Motors, the BEP is 35% now, compared to 60% few years ago. Not that the business has gone labour intensive. They have become more tech-intensive which should have raised the BEP level. But the contrary has resulted. How? Technology cuts cost, including fixed cost. McKinsey says that it is possible for a Fortune 500 player to manufacture a similar product in India at 70% cost of a US-make. Tata Motors' costs are 40% less than the cost of a car of US-make.

NOTES

The experienced industrial groups like the Mittals, Tatas, Birlas, Ambanis, Ruias, Shrirams, etc have their core competence and can't stopped from going global. Having met global competition in Indian soil for well about 2 decades, they have embarked on outbound journeys to meet their competitors in their own soil. And that overseas M&A deals executed by Indian firms are on the hyper-growth track. Without confident of one's tech-base no one would venture out. That is the manufacturing -technological-edge India rides on now. 30 years ago we were like 30BC. 15 years ago, we were 15AD. Today we are state of art. Tomorrow we must be 20 years ahead of others. Make the future happen today.

The manufacturing sector must drive on the 6-Zigma quality to attain global leadership. The convergence of technology comes handy. Technology can be embedded in every sector – agri, bio, computing, digits, electricity, and so on. There is modular technology as well which simply makes scalability simple – remove old, fit the new. That's all.

d. Nano-technology

Nanotechnology is a key to maintaining lead in industrial productivity, manufacturing excellence in the era of globalization. Revitalization of the manufacturing base through nanotechnology could end up in economic opportunity coming up with the ideas that may be implemented in manufacturing plants. Up to 2006, all viewed the United States as the world leader in nanotechnology, with U.S.'s overall annual nano R&D effort at $3 billion, "one-third of the approximately $9 billion in total worldwide spending by the public and private sectors." Additionally, the U.S. "leads in the number of start-up companies based on nanotechnology and in research output as measured by patents and publications".

On the basis of purchasing-power parity, 2004 government spending on nano R&D in the U.S. was at $5.42 per capita, South Korea $5.62, Japan $6.30, and Taiwan $9.40. The $130 million in estimated government spending on nanotech last year in China equaled $611 million at purchasing-power parity, or 38 percent of U.S. expenditure. China led the world in research papers on nanotechnology, presenting 14 percent more than the U.S in 2004. And while the U.S., according to the Nano Business Alliance's database, accounted for 613 of 1,175 companies worldwide that are "involved with nanotechnology," China now has almost 800 such companies, about 30% more than what the US is having. India has to keep its tab on nano technology.

Magnetite at nano-size has an affinity to bind to arsenic salts. As such using the nano-size magnetite, the arsenic residues in the underground water can be extracted out, making the water potable as well good for irrigation. Thus a pressing problem of Bangladesh water supply service is to be solved. Nano-solution, to a mega problem, this is indeed.

NOTES

e. Technology of the Info-Service Sector and Other-service sector

Technology has befriended the service sector more than the manufacturing sector. Of this, that section that can use information as an input or as the input have benefited enormously. Information processing, retrieval, display, transfer, storage, digitalization, graphics, etc have become seamless through satellite communication world over. The convergence of technology, 3G and 4G are making things even more fantasy. Your handset mobile can become a mobile TV, real personal computer or palm-top, and so on. Technology is synonymous with speed and versatility. The same is made possible. Speed is becoming increasingly higher and higher.

Quantum computers are a new possibility which can read and compute faster. A conventional computer reads the binary digits, 0 and 1 as 0 and 1 only. But a quantum computer can read the basic data unit, the quantum bit or 'qubit' simultaneously as 0 or 1. So two 'qubits' can simultaneously take values 0 to 3, whereas a conventional computer can read this either as 0, 1, 2 or 3. Versatility is everyday taking new blaze and bloom. e-ticketing, e-banking, e-advertisement, e-fund-transfer, e-conferencing, e-trading, e-shopping, e-designing and hence e-'everything' are the order of the day. There is enormous business opportunity. And everything at exponentially reducing cost and exponentially increasing features and benefits. World has shrunk. Homes have turned offices. Offices have gone mobile. Thus goes the info-world or video-world or audio-world. The bytes of digitalized information we generate in our e-mails, photos, videos, web-pages, instant messages, phone calls and other digitalized contents are at least 3 times replicated. In 2004 all this made up 161 billion gigabytes = 161 Exabyte. That is equal to 12 stakes of books each reaching the Sun from the Earth. In 2010 the size will scale up to 988 Exabyte or rounding to about 1 zettabytes. But then the available storage is guesstimated at 600 Exabyte only. Better we eliminate some good data as well. Else every one must have many flash drives. The other segment of service industry is becoming increasingly ITES. As such there is efficiency enhancement. Flights, Cars, Fuel stations, Trains, Power plants, Water treating plants, etc are all becoming IT enabled services.

f. R&D Expenditure

Keeping an edge in R&D is critical, because the economic advantage to be derived from technology begins and ends with intellectual property (IP). Countries that spend close to 2 % of GDP or more on R& D are highlighted in **table 6.** You know these are Iceland, Benelux, Taiwan, Canada, Israel, Norway, Japan, Korea, US, UK, Singapore, Austria, Australia, Denmark, France and Finland; these are the technology exporters. Hence the lesson for other nations too. Knowledge needs key inputs. No short-cut.

NOTES

Some companies are investing far ahead of demand in order to attain manufacturing dominance in basic nano-materials. More than protecting IP, creating more intellectual capital is needed. Countries should seek “to have an unremitting, relentless flow of novel ideas that take time and keep us continually two, three, five years ahead of what otherwise can be attained”. Yes, technology is being ahead. Until now the IT technology enabled India to be ahead. Now the turn is for nano-technology

Table 6 Different Countries’ R&D Spending % of GDP

(Average for 2002-2004)

Country	%	Country	%	Country	%	Country	%
Iceland	**3.1**	**Netherlands**	**1.8**	**Taiwan**	**2.3**	Burkina Faso	0.2
India	0.8	New Zealand	1.2	Macedonia	0.3	**Canada**	**2.0**
Ireland	1.1	Nicaragua	0.0	Thailand	0.2	Chile	0.6
Israel	**5.0**	**Norway**	**1.7**	Trinidad & T’	0.1	China	1.2
Italy	1.1	Pakistan	0.2	Tunisia	0.6	Colombia	0.2
Jamaica	0.1	Panama	0.4	Turkey	0.7	Costa Rica	0.4
Japan	**3.1**	Paraguay	0.1	Uganda	0.8	Croatia	1.1
Kazakhstan	0.2	Peru	0.1	Ukraine	1.2	Cyprus	0.3
Korea	**2.6**	Poland	0.6	**UK**	**1.9**	Czech Repu	1.2
Kuwait	0.2	Portugal	0.9	**USA**	**2.7**	**Denmark**	**2.5**
Kyrgyzstan	0.2	Romania	0.4	Uruguay	0.3	Ecuador	0.1
Latvia	0.4	Russian Fed	1.2	Venezuela	0.4	Egypt	0.2
Lithuania	0.7	**Singapore**	**2.1**	Argentina	0.4	El Salvador	0.1
Luxembourg	**1.8**	Slovakia	0.6	Armenia	0.3	Estonia	0.8
Madagascar	0.1	Slovenia	1.5	**Australia**	**1.6**	**Finland**	**3.5**
Malaysia	0.7	South Africa	0.8	**Austria**	**2.1**	**France**	**2.2**
Malta	0.3	Spain	1.0	Azerbaijan	0.3	Georgia	0.3
Mexico	0.4	Sri Lanka	0.2	Belarus	0.7	**Germany**	**2.5**
Moldova	0.8	Sudan	0.4	**Belgium**	**2.2**	Greece	0.6
Mongolia	0.3	**Sweden**	**4.1**	Bolivia	0.3	Honduras	0.0
Morocco	0.7	**Switzerland**	**2.6**	Brazil	1.0	Hong Kong	0.6
Nepal	0.7	Syria	0.2	Bulgaria	0.5	Hungary	1.0

Source : Compiled from UNCTAD Reports.

The highlighted countries’ spend level in R&D is on the higher side. And they are the technology masters too, obviously. **The developing world must give top class priority for first class technology education.**

To triumph, technology is the trusted route. Technology development is in the hands of the youth. The youth’s scientific acumen and R&D pursuits decide things. India is a country with huge technically skilled youth. It must make happen the power of technology for the behefit of the humanity and the world.

NOTES

2.4.9 Population

Economy is made up or marred by the population. The size, composition, attitude, aptitude, abilities, behaviour, commitment, character, dedication, deftness, ethics, efficiency, effectiveness, excellence, faculties, inventiveness, innovation quotient, motivation, perseverance, scientific pursuits, wisdom and zeal, etc can make or break a country. Of course good leaders can channel the human resources in constructive ways.

Size: India's population is approximately 1.136 billion people as of September 1, 2007 based on interpolating and comprising approximately one-sixth of the world's population. Table 7 gives the population data. The world looks at the India population as a reservoir of skills as well as huge market for goods and services. That is the economic significance of vast population. But mere number is no great thing. According to Population Reference Bureau India will be the first—possibly the only—country ever to have 2 billion people by 2100. Much depends on the course of events in each of India 35 States and Union territories. Under the two scenarios prepared for this study, India's population would near the 1.8 billion mark by 2050 and may even exceed 2 billion by 2100 unless fertility rates decline more rapidly in India's largest and poorest States like UP, MP, Bihar, Orissa, etc. Two northern states, Bihar and Uttar Pradesh, with about 93 million and 188 million people, respectively, in 2007 are already larger than most of the world's countries!. Both states currently have a TFR of about 4.3 children per woman. It is necessary to ensure that population bomb doesn't explode in India. United Nations projected that India will have a larger population than China by the year 2045, with 1,501 million for India and 1,496 billion for China.

Table 7 Total Population of India (Population Figures in Million)

Year	1950	1960	1970	1980	1990	2000	2005	2007	2045[a]	2050[b]	2100[b]
Population	357	443	553	684	838	1,005	1,095	1,130	1,501	1,800	2,000

Sources: Economic Survey, Govt. of India; a. United Nations; b. Population Reference Bureau, Washington, DC

Mix: India has more than two thousand ethnic groups, and every major religion is represented. Further complexity is lent by the great variation that occurs across this population on social parameters such as income, community, caste, language, education and so on. Religious mix: Hindu 82.5%, Muslim 11.4%, Christian 2.31%, Buddhists 0.8%, Sikh 1.93%, Jains 0.41%, others or not stated 0.76% (2001 Census). Only the continent of Africa exceeds the linguistic, cultural and genetic diversity of India. There is strength in diversity, so long as diversity does not create division. But divisions are being created by the parochial elements. All these have economic consequences.

NOTES

Educated populace fluent in English: The advent of the digital age, and the large number of young and educated populace fluent in English, is gradually transforming India as an important 'back office' destination for global companies for the outsourcing of their customer services and technical support. India is a major exporter of highly-skilled workers in software and financial services, and software engineering. Other sectors like manufacturing, pharmaceuticals, biotechnology, nanotechnology, telecommunication, shipbuilding, aviation and tourism are attracting the youth.

Skill development of the Rural Youth: Although India occupies only 2.4% of the world's land area, it supports over 17.5% of the world's population. Such huge pressure on land makes land, especially urban, the costliest asset. 72% of the people live in more than 560,000 villages, and the remaining 28% live in more than 2000 towns and cities. Indian economy must be strong enough in the rural areas as well as in the urban areas. Rural infrastructure is therefore of vital significance and that public-private participation is needed. It is in this context, Providing Urban infrastructure in Rural Areas (PURA) became a thrust proposition of the former President of the country, Dr.APJ Abdul Kalam. There is a clear divide between the rural and urban youth in terms of educational and technological exposures that contracts the rural youth's growth prospects. To end this, education and technology exposures of the rural youth must be on par with that of their urban kith and kin. This needs to be done to ensure that the whole of youth in the country becomes well knowledgeable, outstanding skilled and excellently employable. There are jobs and there is unemployment. This is a paradox due to less employability of vast of the youth resources. Certain states have created excellent educational opportunities in rural areas and that the rural youth are brought to the mainstream of high-tech education.

2.4.10 Business and Industrial units

Economic environment is made up by the business and industrial units, big, medium and small because they are the players in the economy making up the developments happening.

a. Industries

There are certain major and traditional industries that make up the country's economic environment.

i. Textile Industry: Textile Industry is a traditional and an export oriented industry with large, medium and small enterprises concentrated in selected states like Gujarat, Tamil Nadu, etc. the industry has a high importance as it has been rendering the most basic needs of people and improving quality of life.

ii. Indian Retail Industry: Indian Retail Industry has been waiting for the boom since a long time. The inception country's retail industry dates back to times when retail stores were found in the village fairs, melas or in the weekly markets. Now organized retail is

NOTES

emerging as a big business. It has raised a political controversy in the country as the small retail firms allegedly face extinction with the entry of big ones.

iii. Software Industry: Software Industry is the 'ambassador' of India in global setting. India's pride is recreated in the comity of nations by the industry. Technical young people and English-speaking scientific professionals have brought tremendous success in India's software industry which has been major earner of forex for the nation. .

iv. Cement Industry: Cement Industry represents India's construction and infrastructure industries.

Presently the Cement Industry in India is based on modern and environment-friendly dry process technology.

v. Steel Industry: Steel Industry has global players who have marked a stamp in the global M&A market by their acquisitions in 2006-07. Worldwide strong demand for steel particularly in China has benefited the Indian steel Industry.

vi. Automobile Industry: Automobile Industry is where globalization has brought intense completion benefitting the consumers by variety and quality. Easier availability of finance and discounts offered by the dealers and manufacturers have resulted a strong growth of the Indian automobile industry.

vii. IT Industry: Indian IT Industry has built valuable brand equity in the global markets. Find an overview on the IT Industry. Both Indian and MNC IT majors are hiring big time, expressing their confidence in the Indian economy and outsourcing/off-shoring growth story. The numbers speak for themselves. Accenture expects to reach 35,000 by the end of March 2008, a 52 per cent increase over last year. IBM already has 53,000 people in India, a 23 per cent increase over the previous year. By the end of March 2008, Tata Consultancy Services plans to add 30,000 employees, taking its total headcount to 113,500. US-based Capgemini plans to employ 40,000 professionals by 2010. This speaks of the glowing business environment in India.

viii. Salt Industry: Salt Industry in India is well developed. India is presently the third largest producer of salt in the world.

ix. Finance Industry: India is one of the fastest growing economies in the world. Adoption of new economic policies in the country has given immense opportunities to develop the country. Financial sector is one which has benefitted from competition propelled by liberalization and globalization. The financial market reforms, covering banking, insurance and stock-markets have led spectacular success in India.

NOTES

b. Business units

There are many companies producing the goods and services, employing the vast human resources, harnessing the natural and other resources, committing investments for fostering development, exporting and importing goods and services thus liking the national economy with the global economy, competing with one another to set global and national bench marks and so on. There are 79,000 companies in India; of which around 1,400 are government companies, while 17,000 are publicly listed. The size, structure and stature of the business units are therefore a factor of environment.

i. Global scale Indian companies

Indian companies are now acquiring global stature. There are Fortune 500 companies as well as Forbes 500. Thirteen Indian companies (Asian Paints, Britannia Industries, Dr Reddy Labs (DRL), HDFC Bank, ICICI Bank, Indo Gulf, Infosys Technologies, Mastek, Polaris Software, Rolta India, Satyam Computer, Visualsoft and Zee Telefilms) are among the 200 best companies, from among 20,000 companies worldwide, outside the US with revenues of less than $1 billion, according to a rating done by Forbes.

Table 8 gives the list of Indian companies that have found place in the Forbes list, 2006.

Table 8 Forbes List of Indian Companies in Global League

World Rank	Company	Industry	Revenue	Profits	Assets	Market Value
239	ONGC	Oil & Gas	15.64	3.46	26.98	38.19
258	Reliance Industries	Oil & Gas	18.05	2.11	21.75	42.62
326	State Bank of India	Banking	13.66	1.24	156.37	12.35
399	Indian Oil Corpn.	Oil & Gas	34.22	1.11	22.68	10.92
494	NTPC	Utilities	6.06	1.31	17.25	26.06
536	ICICI Bank	Banking	5.79	0.54	62.13	16.72
800	SAIL	Materials	6.30	0.91	7.06	10.16
1047	TCS	Software	2.98	0.67	1.93	26.27
1128	Tata Steel	Materials	4.54	0.84	4.61	5.80
1130	Infosys Tech.	Software	2.14	0.55	2.09	26.19

ii. Asia's Big companies

India is again home to more Forbes' Fabulous 50, of the best of Asia-Pacific's biggest listed companies, than any other country with 12 Indian firms making the cut, including its Big Four information technology outsourcers. India's dozen among 'The Fab 50' comprised Bharat Heavy Electricals, Bharti Airtel, Grasim Industries, HDFC Bank,

NOTES

ICICI,Bank, Infosys Technologies, Larsen & Toubro, Reliance Industries, Satyam Computer Services, Tata Consultancy Services, Tata Steel and Wipro. This is what Forbes had say about them. Companies such as ICICI Bank, HDFC Bank and Bharti Airtel are growing fast by reaching out to India's rural customers. Others, such as Grasim, Larsen & Toubro and Reliance, are shoring up the country's infrastructure at a furious pace.

iii. Leaders in the globe or national levels

There are some companies in India which are either global leaders or national leaders in their chosen business arena. They set the global or national pattern in matters of supply conditions and hence influence demand pattern,

Hero Honda Motors Limited, based in Delhi, India, is the world's largest manufacturer of motorcycles.

Asian Paints, established in 1942, is India's largest paint company and the third largest paint company in Asia.

Bharat Forge is the world's second largest forging company. The company is based in Pune, India and has 9 manufacturing plants in India, Germany, Sweden, United States, Scotland, United Kingdom and mainland China.

Biocon is India's biggest biotechnology enterprise. Established in 1978, the company today is an integrated biotechnology enterprise focused on the development of biopharmaceuticals.

Genpact is India's the biggest BPO company in India headquartered in Gurgaon. It operates from India, China, Philippines, Romania, Hungary, Poland, Mexico and USA. Currently it is providing services in 28 languages on 24X7 basis. It's services cover areas like Financial Services, Sales and Marketing, Analytics, Supply chain, Collections, Customer Services, Information technology and Learning and Content Management.

Jet Airways (India) Ltd. is the biggest single domestic air-share flier based in Mumbai, India, operating domestic and international services.

Maruti Suzuki India Limited is a publicly listed automaker in India. It is a leading four-wheeler automobile manufacturer in South Asia and India's biggest.

Ranbaxy Laboratories Limited is an Indian company incorporated in 1961. It is India's largest pharmaceutical company.

The Raymond Group is one of India's largest clothing and apparel companies.

Tata Consultancy Services Limited is Asia's largest and one of the world's largest providers of information technology, consulting, services and business-process outsourcing which commenced operations in 1968. As of 2007, it has the largest number of employees among the Indian IT companies with strength of over 106,000.

Tata Tea Limited, also known as Tata-Tetley, is the world's second largest manufacturer and distributor of tea

Wipro Technologies is the No.1 provider of integrated business, technology and process solutions on a global delivery platform. Wipro is the World's first CMMi Level 5 certified software services company and the first outside USA to receive the IEEE Software Process Award.

Infosys Technologies Ltd is global leader in the "next generation" of IT and consulting.

Infosys defines, designs and delivers technology-enabled business solutions to Global 2000 companies. It pioneered the Global Delivery Model (GDM), leading to the rise of offshore outsourcing. Infosys has a global footprint with offices in 23 countries and development centers in India, China, Australia, the UK, Canada and Japan. Infosys has over 80,500 employees covering 66 nationalities.

c. Business Houses in India

Traditionally the Tatas and the Birlas have been the most respected corporates of India. However, the rise of Reliance and InfoTech companies like Wipro and Infosys, has left them behind.

i **The Tatas:** The Tata Group of companies include some of the most outstanding companies of India, like TCS, Tata Steel, Tata Motors, Tata Economic Consultancy Services, Tata Teleservices, Tata Power, Titan, Tata Tea, Tata TD Asset Management, Trent, Indian Hotels, Tata Tea, Tata Financial Services, Tata Quality Management Services and Tata Technologies are almost India's Who's Who ? **Altogether it has 80 companies in seven sectors. Materials, chemicals, energy, and engineering products are product-driven; engineering services, automotive, communications and IT, services and consumer goods brand-driven**. Tata is now out-sourcing growth through overseas mergers and acquisitions (M&A).The Tata Group too believes in the trusteeship concept of management. These companies have sponsored and promoted a number of public institutions in the fields of science, technology, medicine, social service, rural welfare and the performing arts. That is the link between business, economy, society and government.

ii **The Aditya Birla Group:** The Aditya Birla Group is one of India's largest business houses. It owns companies like **Hindalco, Grasim and Indian Rayon**. The Group's operations span 40 companies over 18 countries, which include - **Thailand, Malaysia, Indonesia, Egypt, Canada, Australia and China**. The Aditya Birla Group is a

NOTES

dominant player in all its areas of operations: Aluminum, Copper, Cement, Viscose Staple Fibre, Carbon Black, Viscose Filament Yarn, Fertilizers, Insulators, Sponge Iron, Chemicals, Branded Apparels, gas, palm oil, Insurance and Asset Management, Software and Telecom. The Group has strategic joint ventures with global majors such as **Sun Life (Canada), AT&T (USA), the Tata Group and NGK Insulators (Japan),** and has ventured into the BPO sector with the acquisition of TransWorks, a leading ITES/BPO company. The Aditya Birla Group too believes in the trusteeship concept of management. Part of the Group's profits is ploughed back into meaningful welfare-driven initiatives that make a qualitative difference to the lives of marginalized people. These activities are carried out under the aegis of the Aditya Birla Centre for Community Initiatives and Rural Development, which is spearheaded by Mrs. Rajashree Birla.

iii **Reliance Group- India's largest business house:** The Reliance Group founded by Dhirubhai H. Ambani (1932-2002) is India's largest business house now lead by the two sons of the founder, Anil Ambani and Mukesh Ambani. Founded as a textile mill in 1966, Reliance continued to be a textile company until early 1980s. However, seizing the opportunities emanating from the growing Indian economy as well as the opening up of the regulation-driven sectors of the economy such as petrochemicals, plastics etc., Reliance pursued the policy of backward integration from textiles as well as diversification from the early 1980s onwards to set up world-scale facilities for manufacturing polyester and textile intermediates, plastics and polymer intermediates, detergent intermediates etc. The group's activities span exploration and production (E&P) of oil and gas, refining and marketing, petrochemicals (polyester, polymers, and intermediates), textiles, financial services and insurance, power, telecom and infocom initiatives.**The Reliance Group Companies include:** Reliance Industries Limited, Reliance Capital Limited, Reliance Industrial Infrastructure Limited, Reliance Telecom Limited, Reliance Infocom Limited, Reliance General Insurance Company Limited, Indian Petrochemicals Corporation Ltd. and BSES Limited. Reliance enjoys a pre-eminent position in India's economy with group revenues of nearly 3.5 per cent of India's GDP. The group's leadership position in India is also reflected in its all round contribution to the national economy.

The Reliance group alone contributes:

5 per cent of India's total exports

10 per cent of the Government of India's indirect tax revenues

RIL alone accounts for:

30 per cent of the total profits of the private sector in India

10 per cent of the profits of the entire corporate sector in India

NOTES

7 per cent of the total market capitalization in India

Weightage of 15 per cent in the BSE Sensex

Weightage of 12 per cent in the Nifty Index

One out of every four investors in India is a Reliance shareholder.

With globally competitive capital and operating cost positions, Reliance Group dominates the rapidly growing Indian market deriving over 80% of its revenues from the domestic market. Reliance exports its products to over 100 countries, including the most quality conscious customers in the US and Europe. Reliance has set up new export offices in China, UAE, Vietnam, Turkey and Indonesia.

iv **Godrej group:** The Godrej Group is one of the largest industrial power-houses in India, involved in businesses including Appliances, precision equipment, machine tools, furniture, office equipment, food-processing, security, materials handling and industrial storage solutions, construction and information technology. The Godrej group can be broadly divided into two major holding companies, working independently: i. Godrej Industries Ltd.& ii. Godrej & Boyce Mfg..

v **Murguppa Group:** The Murugappa Group, headquartered in Chennai, India, is a $ 2 .2 billion (Rs 8,500 crore) worth conglomerate with interests in engineering, abrasives, sanitary-ware, fertilizers, finance, bio-products and plantations. It has 29 companies under its umbrella, of which eight are listed and actively traded on the National Stock Exchange and the Bombay Stock Exchange.

vi **Essar Group:** Essar Group is an India-based diversified corporation with interests in telecommunications, shipping, steel, construction, power and oil. The group has an estimated market value of US$ 15 billion and has an annual revenue of US$ 2.2 billion. Major Essar brand names include Vodafone Essar, Essar Refinery and Essar Steel. Essar Steel purchased Canada-based Algoma Steel and United States-based Minnesota Steel After the acquisition of these firms, Essar Steel became India's fourth largest steel manufacturer after Tata Steel, Steel Authority of India Limited and Jindal Steel.

vii **Adani Group**: Ahmedabad, India based Adani Group is a leading trading and export company of India with revenues of $3.5 billion. The core business of the group is Commodities Trading, Edible oil Manufacturing, Mundra port operations and distribution of Natural Gas. There are 7companies under the group

viii **Wadia Group:** Wadia Group is one of the oldest conglomerates of corporate India. The Wadia group now consists of three independently listed companies on the Bombay

NOTES

Stock Exchange (BSE). These include: **Bombay Dyeing, Britannia Industries and Go Air** — A new low cost airline operating from Mumbai.

ix **Videocon Group:** Videocon group is an industrial conglomerate with interests all over the world and based in India. The group has 17 manufacturing sites in India and plants in China, Poland, Italy and Mexico. It is also the third largest picture tube manufacturer in the world.

x **TVS Group:** TVS Group of companies are engaged in the manufacturing of almost all kinds of automotive components, two wheelers and a few other industrial products. They are also into the financial services sector. The turnover of the entire group was close to $3 billion in 2007. Two companies of the group Sundaram Clayton and Sundaram Brake Linings, are the only in India to get the **prestigious Deming Prize** for TQM.

a. NIFTY

S&P CNX Nifty is the leading **stock index** capturing 50 large companies, representing 25 sectors, on the National Stock Exchange of India. As of July 2007, the stocks in the S&P CNX Nifty represented well over 50% of the total market capitalization of all stocks in India's stock exchanges. A look into the 50 companies (in alphabetic order) would make us learn at least 50% by value of the corporate sector in India. The list of the 50 companies is given in table 9.

NOTES

Table 9 NIFTY 50 COMPANIES

Company Name	Price on 16-1-08	Mkt. Cap. (Rs Cr)	Company Name	Price on 16-1-08	Mkt. Cap (Rs Cr)
ABB	1,389.80	29,451	Maruti Suzuki	864.80	24,985
ACC	859.95	16,130	NALCO	451.15	29,068
Ambuja Cemen	131.10	19,949	NTPC	255.50	210,672
Bajaj Auto	2,441.90	24,708	ONGC	1,250.85	267,541
Bharti Airtel	871.95	165,482	PNB	660.35	20,821
BHEL	2,351.70	115,120	Ranbaxy Labs	368.05	13,731
BPCL	443.30	16,027	Reliance	2,996.55	417,572
Cairn India	234.95	41,783	Reliance Comm	730.00	150,539
Cipla	209.90	16,315	Reliance Ener	2,213.15	52,286
Reddys Labs	671.85	11,296	Reliance Petro	219.20	98,640
GAIL	497.35	42,058	SAIL	244.30	100,906
GlaxoSmith	1,043.65	8,840	Satyam	372.85	24,963
Grasim	3,339.30	30,613	SBI	2,416.35	127,172
HCL Tech	267.70	17,783	Siemens	1,996.40	33,655
HDFC	2,851.85	79,360	Sterlite Ind	933.70	66,152
HDFC Bank	1,643.60	58,196	Sun Pharma	1,088.60	21,683
Hero Honda	697.15	13,921	Suzlon Energy	1,976.55	59,175
Hindalco	191.10	23,450	Tata Motors	736.65	28,395
HUL	217.55	47,892	Tata Power	1,479.35	32,160
ICICI Bank	1,322.10	147,089	Tata Steel	810.75	59,247
Idea Cellular	143.10	37,712	TCS	922.70	90,296
Infosys	1,490.40	85,184	Unitech	491.60	79,805
ITC	217.75	81,981	VSNL	658.30	18,762
Larsen	4,082.10	119,127	Wipro	462.55	67,557
Mah and Mah	756.45	18,589	Zee Entertain	301.15	13,057

Source: NIFTY, Website, 17-1-2008.

QUESTIONS TO CONTEMPLATE AND DELIBERATE

Q 1.4. a Provide an account of the economic environmental factors that influence globalization

Q 1.4. b Discuss the significance of Macro Economic factors in international business decisions

Q 1.4.c Elucidate the influence of External Sector variables globalization

Q 1.4.d Ascertain how the different Economic sectors impact globalization

NOTES

Q 1.4.e Analyze the significance of factor endowments in influencing international business.

Q 1.4.f Present the importance of technology trends in influencing international business.

Q 1.4.g Discuss the contribution of population in influencing international business.

Q 1.4.h Present how the businesses themselves influence international business environment.

Q 1.4.i Elucidate the influence of Fiscal Factors in globalization

Q 1.4.j Ascertain how the Infrastructure developments impact international business.

Q 1.4.k Examine the influence of monetary policy for business

Q 1.4 l Explain the business groups and major concerns as environmental participants.

2.5 BUSINESS ENVIRONMENT OF INDIA

POLITICALENVIRONMENT

Political factors constitute an important environment factor. Actually politics and economics are inter-related as one influences the other. That was the reason for early writers of Economics preferred to caption their work as Political Economy. Political system, political parties in power, political parties in the opposition, political maturity of the parties, number of political parties, political awareness of people, political stability and the like have great impact on the business environment in a country. The economic policies pursued by a Government are to a great extent the by-product of political environment that impacts businesses very often.

2.5.1 Basic Political Ideologies

Political ideology refers to, 'the body of ideas, theories, aims and means to execute the ideas, adapt the theories and fulfill the aims that constitute a socio-political programme for action'. Depending on the mix of different 'ideas, theories, aims and means', there exists Pluralism, Democracy and Totalitarianism as alternative ideologies.

a. **Pluralism** involves coexistence of different 'ideas, theories, aims and means'. Pluralism may be existing due to lack of convergence because the polity is made of different interest groups based on ethnicity, language, religion, race and so on and no one group is dominant enough to overrule the rest. Contrary to popular belief that existence of too many ideologies of different ethnic groups might break the polity into disarray and lead to eventual disintegration, such disintegration hadn't happened. Western nations with capitalistic orientations have this style. The best example is the USA. Individuals have civil liberties and political rights.

NOTES

Civil liberties are measured in terms of freedom of press, equality of all individuals in the eye of law, personal social freedoms and freedom from extreme forms government indifference or interference.

Political rights enjoyed depend on the degree of fair and competitive elections, the ability of people to endow their elected representative with real power, the ability of people to float political parties or competitive and competent political groupings to voice their ideologies and existence of safeguards on the rights of minorities.

b. Totalitarianism involves, 'only one idea, theory, aim and means'. No alternative ideology is allowed to co-exist. There is lack of tolerance. The best example is China. Former USSR was an example. But there used to be the tendency to break away. And that happened with the USSR breaking up into present Russia and over dozen countries. Of course, countries do unite even under totalitarian system do as it happened with Taiwan, Singapore and Hong Kong getting attached to mainland China late 1990s. China could ensure economic growth, but USSR couldn't. people want development ultimately. As long as this core aim is fulfilled, they stand up together. Individuals have no civil and political freedom. There could be fascism or communist regimes. About 25% of countries are still totalitarian.

c. Democracy involves, a mix of pluralism and totalitarianism. There used to be individual freedom with checks and balances. The degree of political rights and civil liberties enjoyed however vary. Certain rights allowed, certain restricted and certain denied too. India falls in this category. It is the largest democracy in the world in theory. 75% of countries have democracies of some order. Of them, 1/3rd are more pluralistic, 1/3rd are some 50:50 type and remaining 1/3rd are more totalitarian.

2.5.2 Politico- economic System

Political system refers to the set of factors relating to political institutions, the political parties and their ideologies, the form of state governance and the role of the state and its functionaries vis-a-vis, the role of individuals and their organizations. Every country has a political system of its own.

There are different forms of political system. Capitalism, Crony capitalism, Welfare capitalism, Socialism, Communism and Mixed economy are the different systems. A brief summary of each of the forms is presented below.

a. Capitalism

Capitalism is a politico-economic system wherein, private ownership and initiative, individual freedom to produce, exchange, consume and distribute, market mechanism and consumer sovereignty and limited role of government are found. In short capitalism may be called as 'free enterprise economy' where state control on businesses is not existing or minimum.

The capitalist political system is pro-private businesses. Competitive efficiency is rewarded in the market. Businesses flourish through efficiency, innovation and serving the consumers. Businesses are directed by market mechanism, least influenced by governmental factors. Whatever influence from Government is pro-domestic business. The western economies like the USA, Canada, Western Europe, etc. have capitalist political system. Since efficiency is rewarded, higher levels of performance are achieved. These economies generally do very well, they attract foreign investment, they introduce latest technologies, patent protection is of high order and so on. Crony capitalism is a pejorative term describing an allegedly capitalist economy in which success in business depends on close relationships between businessmen and government officials. It may be exhibited by favoritism in the distribution of legal permits, government grants, special tax breaks, and so forth.

b. Crony capitalism

Crony capitalism is evidenced by politician oriented/owned/controlled business world. Self-serving friendships and family ties between businessmen and the government influences the economy and society. This type of capitalism benefits the political owners and not the consumers. A variant of this form involves 'collusion among market players'. While perhaps lightly competing against each other, they will present a unified front to the government in requesting subsidies or aid (sometime called a trade association or industry trade group). This is marked by entry walls for new comers, preventing competition. Another variant of crony capitalism encourages businesses to stay in the good graces of political officials. Connections with political bigwigs and lobbyists are more important than actual competition as such in this form of capitalism. Corrupt governments may favor one set of business owners who have close ties to the government over others, based on racial, religious, or ethnic favoritism. In smaller countries this is more popular. Anti-capitalists call it a natural consequence of collusion between those managing power and trade, either by common control or through 'deals'. Since businesses make money and money leads to political power, business will inevitably use their power to influence governments.

c. Welfare Capitalism

Capitalism has certain limitations such as neglect of certain business not yielding good profits or those involving greater risk. Individual 'good' may not aggregate to collective 'good'. So, some state role is needed. Herein the government intervenes and fills up the gaps to ensure maximum social advantage. Government supplements and does not substitute private entrepreneurship. The characters of capitalism are applicable to this system in total subject to the above referred to variation. Government relationship with the business takes the same pattern as in the case of capitalism, except that government intervenes in a small way to ensure social welfare of people at large.

d. Socialism

NOTES

Socialistic political system is characterized by state ownership of production, exchange and distribution. The main features of this system are: i) Government ownership and/or control of factors of production, ii) Government direction of production, exchange and distribution, iii) Central Planning of resource mobilization, allocation, pricing etc. iv) Restriction private businesses, v) restriction on individual freedom and initiative, vi) government interference in income distribution, vii) government direction on physical distribution and pricing of products, viii) consumer is not the king, only the state is all powerful and so on.

In a socialist political system businesses are run and/ or closely controlled by the state. Businesses are run by bureaucrats and not by people with business acumen. Businesses are distanced from profit goal. State policy determines which industry to be developed and which is not to be developed. Private initiative is not nurtured, sometimes is even curbed. Business is dominated by the government bodies.

e. Communism

A communist political system is nothing but 100% state control of all human activities. It is also known as state capitalism. Production, exchange, consumption and distribution are all state controlled. The difference between socialism and communism is that in communism, consumption is also state controlled. Businesses are run almost like government departments. The dominant environment of business is, truly, the government factor.

f. Mixed Economy

Mixed economy is said to be the ‘golden mean’ of capitalism and socialism. Side by side public and private ownership exist. This system is in vogue in India. The features of capitalism and socialism are jointly present in this system.

Private initiative, freedom of enterprise, consumer sovereignty, individual saving and investment, profit orientation and market mechanism are all there. But it is not entirely free of government control. State initiative, state enterprise, state investment, social objectives like equal distribution, balanced development of all regions, concessions and privileges for the less privileged, reservations for the benefit of weaker sections, etc are found.

2.5.3 Functioning of Political Parties - In power and in the opposition

The **political parties in power** influence the business environment to a great extent, irrespective of political system. The influence can be pro-business or anti-business. A pro-business political party in power can vest the business community an environment of growth, competition and concern. Anti-business party in power would wield a threat of intimidation. The integrity of the political leaders and their kith and kin is a great factor to reckon with.

NOTES

Besides, the real power within the political party in power counts. Now businesses themselves identify with one or other party and who gets rewards depend whose person are in power. When there happens a coalition government, not just one single political party dictates terms for the businesses. There are multiple concerns. Businesses struggle to please too many political leaders.

Parties in opposition and their leaders have the role to question government's decisions in the parliament/legislature. Now-a-days, they exhibit their power in organizing strikes and stalling conduct of business in the parliament or legislature on smaller issues. In a multi-party system, with coalition governments running the government involves lot of compromises despite their common minimum programme. The leaves the business community disillusioned.

2.5.4 Political maturity of the parties and people and Political Stability

Political maturity of parties involves respecting the verdict; the ruling party must not be vindictive; the opposition parties must not be spiteful. Of late these values are given up in the air. Incident free political rallies, absence of hooliganism, terminological pleasance in referring to individual members, issue based expression of view points, freedom to elected members to express their views irrespective of party affiliation, etc are the hallmarks of political maturity. Impartiality of police system and political non-intervention in its action are real test of political maturity. These are far to expect. An air of uneasiness prevails which suffocates businesses. Opportunistic ideologies are followed for short-term electoral gains. That is no maturity.

The lesser the number of parties, more the **political maturity of people** and the better the governance would be. The developed world nations have fewer political parties, while less developed countries have too many political outfits. In India there is no dearth of political parties, which is but a sign of political immaturity of people. While dozens of parties exist, only about 2 dozen parties have 4 or more elected Lok Shaba members in the recent 2004 elections. Businesses suffer more uncertainty with more number of political parties, because the policy environment becomes shaky.

Political stability is a crucial factor. The political system, the number of parties, ideologies of parties, animosities amongst different parties, leadership characters of political parties, the commitment of parties taking power to honour commitments made by previous governments, etc influence political stability. Political stability also means consistency in political decisions, much needed for inspiring confidence in the minds of business community, both national and international. Lack of political stability is an indication of excessive risk businesses suffer.

2.5.5 Relationship between the State and the Businesses

NOTES

There could be political instability and yet it may not transform into political risk for businesses. This is so when the State respects the business enterprises concerned. Barring a few cases in most countries, today businesses have good relationship with the Government due to LPG policy pursued widely. Multilateral Investment Guarantee Agency (MIGA), bilateral agreements to protect mutual investment interests, etc ensure that good relationship prevails between the State and the MNCs.

The world is becoming a less-polarized. Countries choose businesses across the globe for business relationship based on merits of efficiency rather than political system followed. The USA, sees India as an economic opportunity. So, political and strategic alliances are on the rise. India is also in good relationship with Japan, the European Union, Russia, Republic of China and so on. So, business interests develop across the globe

2.5.6 POLITICAL RISK: Types, Measurement and Handling

Political environment could involve a risk to businesses, domestic and foreign. Such risk is called political risk. Political risk is that perception by the businesses that their interests will get deteriorated when certain political upheaval happens. Political risk can occur in both democracies as well as in the totalitarian set ups as well.

a. Types of Political Risks

Political Risks are of different types. There are **micro and macro** political risks. **Micro political** risk is the one that affects a particular firm or class of firms. Usually firms owned by one class of businessmen, say, the foreigners from certain country, a particular business family or region/state. **Micro risk can be hedged**. This happens even today. **Macro political risk** affects all. There is no sparring of any business, any nationality, any trade or industry. Cuba took-over all foreign property without exception by nationality or industry or past behavior. **Macro risk cannot be hedged**, but it is bit rare now.

Political risk can arise because of (i) hostility between the firm and the Government, (ii) hostility between the firm and opposition political parties/social interest groups, (iii) political instability threatening peace and tranquility, (iv) change in policy environment (v) service inefficiency of the firm and forced closure under executive orders of the bureaucracy.

Forms of political risk: Below are listed some specific forms of political risk.

i. Take-over of property with or without compensation by the government;

ii. Operational restrictions that impede the firm's ability to take certain actions like expansion, introduction of new lines of business or increasing the share-holding or diversification by geography or product portfolio;

NOTES

iii. Social boycotts of products by the residents or sections of residents;

iv. Destruction of property or disruption of sales by the agitating groups or pressure bodies;

v. Hacking of websites;

vi. Intimidating propaganda over the media, to raise public hate towards the firm.

Political risk is a function of: (i) Probability that a given political event will affect a particular business unit or its particular project and (ii) The magnitude of impact.of the event. A political demand, say, to halt FDI or a project or to confiscate a business or nationalize a business unit, is the event that causes political risk. What is the probability that all parties will jointly assemble and protest? What is the likely impact of this on the project or a business unit? Answers to these questions answer the relevance of political risk. Political risk can be and have to be quantified. Factors to be considered include: (i) the country's political and government system; (ii) track record of political parties and their relative strength; (iii) the degree of integration into the world system; (iv) the host country's ethnic and religious stability; (v) regional security; and (vi). key economic indicators. Even if all parties show solidarity, the Govt. in power can contain their rebellion using constitutional and legal measures. It must have the power and willingness to do.

The relevance of political event to a business unit or to a particular project of a business firm is to be measured. The event may affect ownership rights, access to input/ output markets and so on. The extent of impact might be varying between firms between or projects or between regions. So, scenario of impact must be evolved and evaluated. Usually optimistic (less destabilizing), pessimistic and most-likely levels of impact be studied.

b. Measuring Political Risk

The extreme form of political risk is expropriation or state confiscation. What will be the project worth if withdrawal is made right now fearing expropriation or state confiscation and when a wait and see policy is followed? You have to estimate the cash flows under two scenario (expropriation happens and does not happen) for the two alternatives (exit right now and wait a while). A hypothetical case is presented below. The cash flow right now obtainable by pulling out is \$ 256mn whether expropriation happens or not. If waited for a year the estimated cash flow when expropriation happens is \$ 200mn and when expropriation does not happen it is \$ 600. The fear of losing \$56mn due to expropriation and benefit of getting extra \$ 344mn when the feared expropriation does not happen puts the firm in a dilemma. Let cost of capital or minimum required return be 22%. Details are table 10.

NOTES

Table 10 Evaluation of Alternatives under Expropriation

Alternative Courses	Expropriation	No Expropriation	Expected Present Value
Exit now (CF $)	256 mn	256 mn	$256mn
Wait a year (CF $)	200 mn	$600 mn	{$200p+600(1-p)} / 1.22 mn

CF : Cash Flow

To solve the issue, you need to estimate the probability of expropriation happening. Let it be 'p'. Then known our cost of capital, we can estimate the minimum value of 'p' for a pull-out right now. Then present value of cash flow under wait and see course becomes: [{$200p + 600(1-p)} / 1.22] mn. By setting the expected cash flows under the two courses of action, exit -right -now and wait-a-year equal, the minimum value of 'p' can be found.

Solve for 'p' in: $256mn = [{$200p + 600(1-p)} / 1.22] mn .

$256mn x 1.22 = $200p + $600 – $600p

$312.32mn = $600mn – $400p. mn

$400p mn= $ 271.68 mn or p= 0.7

From the above, if the chance for expropriation is 70%, it is immaterial whether you pull out right now or later. If the probability is more than 70% pulling out right now is a better course. If it is less than 70% there is no need to exit right now. So, the problem now becomes the estimation of probability of the expropriation happening!

c. Formulating and Implementing Strategies to Deal with Political Risk

The following course of action, suggested by **John D Daniels and Lee H Radebaugh** will help in dealing with political risk. Identify the issue; Define the political aspect of the issue; ; Assess the potential political action by other firms and the special-interest groups; Identify important individuals or institutions; Formulate strategies; Determine the impact of implementation; Select the most promising strategy; Educate the implementers and then implement. These are3 briefed below.

Identify the issue: The problem may be boycott, threat of confiscation, damage to property, imposition of countervailing duty or new labour standards or so.

Define the political and other aspects of the issue: Is the concern of the Government or political group serious one or just minimal? Is there any hidden force or hidden agenda? Was there any past upheaval like this? What was the outcome then? What would be the political fallout if the government sides with the firm or sits opposite? Is there a possibility to settle the issue outside politics? Answers to these question answer the issue.

NOTES

Assess the potential political action by other firms and the special-interest groups: who are all other parties like us affected? What are their reactions? Will they apt for a coalition of all to mount pressure? How strong are the special interest groups in putting a united face to tone down the issue?

Identify important individuals or institutions: Who are the individuals (Public Leaders, Politicians, Elected Representatives, Regulatory Institutional Heads)? What are the institutions involved and what are their bargaining power?

Formulate strategies: What are the key objectives and minor objectives of the firm in responding to the issue? What are the strategies? To cede? To supersede? To recede? How to break the ice? How to establish contact? How to make the offers of conciliation and reconciliation? Evolve alternative strategies for dealing with affected and aggrieved. Evolve alternative strategies for dealing with those in the front-line of confrontation.

Determine the impact of implementation: What will be the outcome of ceding? What will be the outcome of superseding? What will be the outcome of receding? Financial, Corporate Image, and Relational impacts need to be addressed.

Select the most promising strategy: A clear evaluation of the overall costs and benefits of strategies need to be made on Financial, Corporate Image, and Relational impacts. Order and choose the right strategy set.

Educate the implementers and then implement: Educating the core team members on all aspects the strategic response to the issue on hand is needed. Then go ahead with the implementation.

d. Handling Political Risk

Political risk handling has to be addressed at i. **Pre-investment planning phase, ii. Post-investment operating phase and iii. Post expropriation phase**. These are dealt below

i. Handling political risk in the pre-investment planning phase

To deal with political risk, at pre-investment level, a business concern can think of **Avoidance, Insurance, Negotiate the environment, Structure the investment and Patenting.**

NOTES

Avoidance: Avoidance involves not committing the resources in the project. This is easiest but not reflective of true business class. However certain politically high risky states/nations/ regions have to be avoided, because one cannot lose investment itself in the hope of making a return on investment.

Insurance: Insurance involves taking insurance cover for people and property of the business concern or project in the hostile country. In developed nations political risk insurance policies are available which the MNCs can buy to cover investments in risky countries. Third world countries also have overseas business risk insurance outfits. Policies that provide for a maximum insured amount and a current insured amount are available. Premium is payable on the current insured amount at usual rates and on the difference between maximum and current insurance amounts, called standby insurance level, a nominal rate of premium is charged.

Negotiating the Environment: A business concern and the Government negotiate on the rights and responsibilities of both and abide by the 'concession' agreement reached. But new rulers may repudiate 'concession' agreement agreed to by the past ruler. Such repudiation happens in democratic countries as well.

Structuring the Investment: The investment in the project in the host country can be structured in such way that host government intervention costs the Government exchequer heavily. This is achieved by adjusting production, transportation export, technology transfer and financial policies. The foreign project may be just an assembling unit or a just a part manufacturer.

Patenting: The MNC can register its patent generally and make for host countries difficult to infringe patent rights or trade mark rights.

ii. Handling political risk in the post-investment operating phase

After investment is made, through operating policies, political risk can be managed. The alternatives are: **Short term profit maximization, Changing the BCR of expropriation, Developing local stake holders and Adaptation.**

Short-term Profit Maximization policy involves stressing that investment made is quickly paid back. On finding the political environment hot, the firm can go for a policy of quick realization by avoiding further commitments in the project. A posture such as this itself may alter the host government's attitude as capital flights are unaffordable in these days of globalization. **Shorter Payback Period:** According to this method, projects with shorter payback period are normally preferred to those with longer payback period. **The Finite-horizon Method:** This method is similar to payback method applied under the condition of certainty. In this method, a terminal date is fixed. In the decision making, only the expected returns or gain prior to the terminal date are considered.

NOTES

Changing the Benefit/Cost Ratio (BCR) policy involves the firm adopting a pro-host country, increased benefit and decreased cost policy. Policies such as establishing local R&D facilities, export-thrust, technology transfer etc., will help the MNC buying peace with adversaries.

Developing local stake holding policy involves, the firm concerned creating a customer base, a local investor base, supply-chain base, etc so that expropriation/confiscation will be resented to by local customers, investors and channel partners. It must be noted while 100% subsidiaries face nationalization threats, joint-venture do not suffer such threats.

Adaptation policy involves adapting operating policies to the dictates of the political boss. If expropriation is pressed, the MNC can opt for management contracts or franchising so that operational aspects are not handled by the MNC.

iii. Handling political risk in the post-expropriation phase

In the post-expropriation phase, damage control and benefit harvesting exercises need to be pursued. **Negotiation, Power leveraging, Legal recourse and Surrender** are the options.

Negotiation: After the expropriation/confiscation, continued contacts and negotiation with the Govt. help in harvesting more benefits.

Power Leveraging involves the firm applying power on the government through diplomatic channels, trade bodies, etc for speedy harvesting.

Legal Recourse involves resorting to legal remedies to recover the value of property that are confiscated. This is a long-drawn-cut remedial course.

Surrender policy involves giving up the above referred to courses and agreeing to salvage the investment

2.5.7 Political Environment in India

Let us first deal with the political structure and then take up prevailing business-political alignment in India.

a. Political Structure

India is the largest democracy of the world with 1.12 billion people, following mixed economy with egalitarian goal. It is a Union of twenty-eight States and seven centrally administered Union Territories, in short, just, Union Territories. People enjoy political and civil rights. India is federated state or union of states with two major levels of administrative Governments viz., Central or Union Governments and Governments at the State or Union Territory level. There is parliamentary form of Government. The Parliament legislates and regulates. The Ministry is executive. The judicial aspect is taken care of by independent

NOTES

Court. All these 3, legislative, executive and judicial powers are vested with the respective institutions by the President, though the office of President is having mostly notional power, but much respected.

i. **States and Union Territories: :** The States include: Andhra Pradesh, Arunachal Pradesh, Assam, Bihar, Chhattisgarh, Goa, Gujarat, Haryana, Himachal Pradesh, Jammu & Kashmir, Jharkhand, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Manipur, Meghalaya, Mizoram, Nagaland, Orissa, Punjab, Rajasthan, Sikkim, Tamil Nadu, Tripura, Uttar Pradesh, Uttaranchal and West Bengal.

The centrally administered Union Territories include: Andaman and Nicobar Islands, Chandigarh, Daman & Diu, Dadra & Nagar Haveli, Lakshadweep, Delhi and Pondicherry.

ii. **Fundamental Rights**: People have both political and civil rights. There are fundamental rights that must be safe-guarded by the Government to every citizen. The **Fundamental Rights** of every Indian citizen include the **freedom of speech, expression, belief, assembly and association, migration, and choice of occupation or trade.** These rights also protect every Indian from discrimination on grounds of race, religion, creed or sex, and are enforceable in courts of law.

iii. **Directive Principles of State Policy:** There are also, **Directive Principles of State Policy**, which are though non-justiceable, but nevertheless the guiding principles of governance to ensure establishment of an egalitarian society envisioned in the constitution. Businesses have to function within the Constitutional ambit and also ensure that their actions lead to pursuance of establishment of egalitarian society as envisioned in the Constitution. The earlier, pre-1990, economic policy was more state-centered with much emphasis on public sector businesses and it could not usher in high economic growth. A policy 'U' turn was done in 1991 with emphasis on liberalization, privatization and globalization (LPG).

iv. **Federated Union:** India is a dual polity with a single citizenship and a single judiciary. It is organized into 30 federative States and 6 centrally administered Union Territories. The capital of the Union Government is situated at New Delhi. The States and the Union Territories have their own separate capitals or headquarters.

v. **Lists of areas of developmental responsibility of the Centre, states/UTs and both Centre and States/UTs:** Under the Constitution, three lists demarcate the areas of jurisdiction of the union and the states: the union list, the state list and the concurrent list.

The **union list,** for which the union parliament has exclusive power to make laws, contains matters of importance to all of India, such as defense, foreign affairs, citizenship, railroads, postal and telegraph services, customs duties, and taxation of income. The central

NOTES

government opened the economic activities in the union list under its control to private and foreign competition. It was a great success.

The **state list**, for which the state legislatures have exclusive authority to make laws, includes local law enforcement, local government, land, and agriculture. Now the state governments are in competition to open the economic activities under their control to private and foreign capital and competition. The southern states of Karnataka, Tamil Nadu and Andhra are quite successful. This triggered the states of Gujarat and Maharastra.

The **concurrent list** covers such matters as labor welfare, social security and price controls, over which both the union and the state legislatures have legislative authority.

vi. **Parliamentary form of government:** India has a parliamentary form of government based on universal adult franchise and patterned more on the U.K. parliamentary system than on the U.S. legislative system. The central legislature, which is called **Parliament,** is bicameral. It is headed by the **President** and consists of the two houses, the **Rajya Sabha** (Council of States – members elected by electoral-college consisting of state legislators) and the **Lok Sabha** (House of People – members elected directly by people). The Lok Sabha, whose normal term is five years, consists of members directly elected on the basis of adult suffrage. Elections to the Rajya Sabha are indirect. All legislation requires the consent of both houses of Parliament, but the Lok Sabha is the more powerful, and its will prevails in the case of money bills and financial legislation.

vii. **Union Executive:** The union executive branch consists of the President, the Vice-President and the Council of Ministers. The **President and the Vice-President are elected indirectly** for five-year terms by a separate electoral college. The President, who is the constitutional head of the union executive, invites the leader of the majority or the coalition of parties commanding a parliamentary majority to form the Council of Ministers (cabinet). **Real executive power is vested in the Council of Ministers**, with the Prime Minister at its head. Although the Prime Minister is appointed by the President and the Council of Ministers holds office at the President's pleasure, the Council is responsible to the Lok Sabha.

viii. **viii. Systems of Government of the States:** The systems of government of the states closely resemble that of the union. A state executive branch consists of the Governor, who is appointed by the President, and the Council of Minister, with Chief Minister at its head. Some state legislatures are bicameral, patterned after the two houses of Parliament.

ix. Legal Environment:

political environment and legal environment are two sides of the same coin. Hence the same is also dealt here.

NOTES

Sources of law: The main sources of law in India are the Constitution, statutes (legislation), customary law, and case law. The statutes are enacted by Parliament, State legislatures and Union territory legislatures.

Judicial System: A unique feature of the India Constitution is the judicial system. A single integrated system of courts administers both union and state laws. The **Supreme Court of India**, seated in New Delhi, is the highest body in the entire judicial system. Each state or a group of states has High Court under which there is a hierarchy of subordinate courts. In certain states, high court branches also exist. The **Chief Justice of India** and the other judges of the Supreme Court are appointed by the President. The Supreme Court has **original, appellate and advisory jurisdiction**s. Its original jurisdiction extends to the enforcement of fundamental rights given by the Constitution and to any dispute among states and the Government of India. The decisions of the Supreme Court are binding on all courts within the territory of India. At the state level there are **High Courts** in the state capitals, **District courts** at district levels, **lower courts** at municipal levels and so on.

Business and Judicial system relationship: Businesses need their interests well protected by the courts with laws protecting patents, quick disposal of insolvency claims, and increased transparency in governance. Delay in getting justice delivered due to mounting bag log of cases pending disposal, make businesses lose their confidence in the legal system, because justice delayed is justice denied.

x. Financial system: The Financial system is the preserve of the union government with responsibility for monetary policy, currency and forex management, fiscal prudence and policy for foreign economic interactions. Now there is a large measure of freedom to regulatory bodies like the Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI), etc, increased market mechanism, higher degree of fiscal restraint and so on. All this augured well for business enterprises.

b. Business-Political Alignment in India

Business-Political Alignment in India is quite friendly, matured, tolerant and efficient too. But, there are problem areas too.

New Economic Policy: The new economic policy followed since 1991 is shared by its many political parties. Most of the major political parties have been quick to embrace free market enterprise, which has carved more space for private enterprise in the place of public sector, more role for globalized competition, and more facilitative role for government. This has led to higher economic growth. It has attracted a number of MNCs, including General Electric, Hyundai, Nokia, Siemens, General Motors, Hewlett-Packard, IBM, Johnson & Johnson, and Microsoft, to name a few to establish their outfits in India.. Besides, Indian companies have grown to international reputation like the Infosys, Wipro, TCS, Tata steel, Mittal Steel, Century Mills, etc. More FDI, FPI and NRI capital have flown

NOTES

into India. The economy has built forex reserves of over $ 250 billion in just a span of 16 years from almost nil reserve in 1991.

Moral support in International deals: Moral support in International deals is extended by the Government to businesses. This happened when a US firm, Ricetec, tried to patent Basumati Rice in a similar name called, 'techmati rice'. Also when Laxmi Mittal took over the Arcelor and when Ratan Tata took over Corus, the Government supported morally the take-over deals when racist issues are raised by some.

Budgetary Consultation and Concessions: Before annual budgets are prepared the Govt. invites suggestions from the businesses community not only to address their grievances ut also to get innovative ideas on governmental programmes. Further, at times of genuine hardship government bails out businesses. When the textile businesses suffered due to appreciation of Rupee against the US $, the government came with some tax and financial sops and concessions.

Good relationship between Govt. and trade bodies: Good relationship between Govt. and trade bodies like the **Confederation of Indian Industries (CII)**, **Federation of Indian Chambers of Commerce and Industry (FICCI)**, **Association of Chambers of Commerce and Industry (Assocham)** and so on, besides specific industry bodies. There are also Government outfits devoted to promote exports for most export intensive industries like the Export Councils, Commodity Boards etc. Thus the business interests are well played by the Government itself. Also, the Governments of several States and UTs vie with each other to attract more investments into their geography. That is the reason several top ranking business group leaders are even nominated as Members of Parliament. That is the pinnacle of government-business relationship in the country.

Delay in disposal of legal cases: There are many cases pending disposal by the courts, thanks to slow progress in hearing, increased litigant attitude of people and absence of alternative means of justice. Some seek to court remedy, not in the real intension of getting a court verdict, but just to delay decisions. So, cases mount and there is inordinate delay in getting justice. Delayed justice is denied justice. Businesses could not seek legal remedy as there is delay. A genuine need goes unfulfilled.

Corruption: Do the political parties side with the corrupt/inefficient? Do some amaze wealth disproportionate to their known sources of income? Are there rent seekers? Are there extra-constitutional power centres that do things they want at will? Do the bureaucrats decide and execute routine and special actions in a veiled course also? Do things happen in veiked less transparent way? The answer to all the questions is 'Yes'. That is the reason that in the corruption perception index, India is not coming clean, despite her able people who are astonishingly intellectually superior. In 2005 out of 158 countries India came in the 92nd place with a score of 2.9 (10 = cleanest) and in 2007 out of 178 countries India came 72nd with CPI score of 3.5. There is improvement, but 3.5 out of 10 is not pass mark!! All this increases cost of doing business in India, and that required return exceeds beyond most projects' innate ability. Businesses are concerned with this.

QUESTIONS TO CONTEMPLATE AND DELIBERATE

Q 1.5. a Deliberate the political ideologies and politico-economic systems as international business environmental forces

Q 1.5. b Provide an account of the factors affecting the functioning and the maturity of political parties/people and their relevance in global business environment

Q 1.5. c Elucidate the concept, types, measures and methods of dealing of/with political risk that might affect a business or businesses in general.

Q 1.5.d Political environment in India is largely business-friendly. Comment

Q 1.5.e Is political risk measurable? How? Illustrate with an example.

2.6 BUSINESS ENVIRONMENT OF INDIA

CULTURAL ENVIRONMENT

Culture generally refers to patterns of human activity and the symbolic structures that give such activities significance and importance. Different definitions of "culture" reflect different theoretical bases for understanding, or criteria for evaluating, human activity.

2.6.1 Definition, Manifestation, Exchanges & Uniqueness, West & East and Awareness

a. Culture Defined

Culture can be defined as all the behaviors, ways of life, arts, beliefs and institutions of a population that are passed down from generation to generation. Culture has been called, 'the way of life for an entire society'. As such, it includes codes of manners, dress, language, religion, rituals, norms of behavior such as law and morality, and systems of belief as well as the arts, gastronomy, matrimony and so on. There are cultural patterns, differences, dynamics, shocks and resilience.

Edward Burnett Taylor (1891) described culture as 'that complex whole which includes knowledge, belief, art, morals, law, custom, and any other capabilities and habits acquired by man as a member of society'.

More recently, the **United Nations Educational, Scientific and Cultural Organization (UNESCO)** described culture, 'as the set of distinctive spiritual, material, intellectual and emotional features of society or a social group, and that it encompasses, in

NOTES

addition to art and literature, lifestyles, ways of living together, value systems, traditions and beliefs'.

I must refer to some beliefs here. There is a handy example, the **American Dream.** The American Dream is a belief, held by many in the United States that through hard work, courage, and self-determination, regardless of social class, a person can gain a better life. This notion is rooted in the belief that the United States is a 'city upon a hill, a light unto the nations' which were values held by many early European settlers and maintained by subsequent generations.

Culture is prescriptive and shared. Culture prescribes acceptable beliefs, behavior and attitude. Smoking in public places once, acceptable, now has become un-acceptable. Culture is shared by the members so that its prescriptive aspect can be reinforced.

Culture is learned. No one is born genetically with this or that culture. It is learnt by observation, indoctrination and exposure. If one learns one's community's culture that is **enculturation or socialization**. If one does learn the culture of other community or race, that is **acculturation.**

b. Culture Manifests in actions and subtle ways

Manifestation of culture may be through actions or through subtle means. Culture is manifested in **music, literature, painting and sculpture, theater and film and other things**. Some people identify culture in terms of consumption and consumer goods (as in high culture, low culture, folk culture, or popular culture). But anthropologists understand "culture" to refer not only to consumption goods, but to the general processes which produce such goods and give them meaning, and to the social relationships and practices in which such objects and processes become embedded. For them, culture thus includes technology, art, science, as well as moral systems. Culture defines fundamental beliefs and values about individual and group behavior in given contexts. It shows ways in which people interact and communicate with others (young, old, neighbours, others of different race/religion/ region and strangers), develop and maintain relationships, choose their life styles including dress, friends and life partner, decide on avocations, risk levels of avocations and so on.

The **manifestation of culture may be through subtler ways** too. Subtle means are those that are not articulated obviously but observed delicately, intricately and through finer unexpressed sentiments. Contextual silence communicates more than conversational messages or pictorial presentations. Culture is thus has **subjective** aspects.

Culture is cumulative as it adds newer nuances as the world order changes and new material artifacts emerge. Each generation adds something to its culture. **Culture thus endures**. In the process a culture may look totally transformed over a millennium or so. This is cultural adaptation or change. **Culture is dynamic.** No culture can remain

NOTES

static, because environment changes. Through dynamic character only, can a culture remain endured and expanding.

c. Cultural Exchanges and Uniqueness: Bordering nations/regions tend to have some cultural mixtures. Many regional cultures have been influenced by contact with others, such as by colonization, trade, migration, mass media and religion. India did not lose her cultural identity despite being under different rules for centuries by diverse religious lineage. That is Indian culture's uniqueness. Normally, if you have your own culture, there is less need for following other's culture. But, African culture, especially Sub-Saharan African culture has been shaped by European colonialism, and, especially in North Africa, by Arab and Islamic culture. This is **'Acculturation'** which means replacement of the traits of one culture with those of another, such has happened to certain Native American tribes and to many indigenous peoples across the globe during the process of colonization. This may also be called **'trans-culturation'**

Humanity is in a global 'accelerating culture change period', driven by the expansion of international commerce, the mass media, and above all, the human population explosion, among other factors. **Culture change** is complex and has far-ranging effects. India, in the advent of this century, reflects a very promising image for the future. It is not only one of the most lucrative regions in the world for foreign investments but also an emerging power in the global economy. In such a business scenario, the one thing that the Indian professionals need to open their minds to is 'Working in a Multi – Cultural Environment'. India has no difficulty in this as most of her professionals have studied/worked in overseas environment.

Cultural shock is a situation of strangeness or unacceptability or frustration felt by one group or one person in the material, social, political, technological, spiritual or economic spheres of life in a different geographical or political regime within or outside its/ his native land. The days of globalization involve great cultural shocks. Eating habits of one culture is a great shock for other cultures. Example: Chinese eat fish stomachs, Japanese eat uncooked seafood, Iraqis eat salt dried locusts, French eat snails, and Americans eat beef an average of 100 pounds a year. From other's perception these eating habits are cultural shocks. But in due course of time, due to assimilation and acculturation cultural shock recedes. Later when the group or persons encounters its/his own culture it/he may find a **reverse cultural shock!**

There exist **high culture** and **low culture**. The culture of the aristocrats is called **'high culture'** which involves **expressive or conspicuous consumption**. Posh bungalows, lavish life style and so on exhibit the wealth of people. High culture stresses refinement and sophistication of life style which is considered by others as corrupting and unnatural developments that obscure and distort people's essential nature. **Low culture** refers to the **mass culture or popular culture** thriving on goods and activities produced for, and consumed by the masses. **Low culture** is need based consumption for supporting a

NOTES

subsistence living closely aligning with the natural environment. Indigenous people living authentic unblemished lives, uncomplicated and uncorrupted are projected as 'noble savages'. A person of low culture will find a cultural shock in a high culture environment and vice versa. Such scenarios are exploited in films with many films portraying the hero from a low culture and heroine from a high culture. Initially culture shock is mutually exhibited by them, before reconciliation or reinforcement of the shock.

There are **'civilized' and 'primitive' or 'tribal'** cultures as well. The civilized culture is a culture of modern society with measured rights and commensurate responsibilities. The **tribal culture is devoid of human dignity**. It is instinct based. This classification is based on what people really do rather on what they profess to do. That way, tribes may be more civilized and the so called civilized may be more 'tribal' in their act. A tribal will find cultural shock in the other culture and vice versa.

d. Western Culture and Oriental culture: Western culture is sometimes referred to as European culture. This is most easily seen in the spread of the English language and to a lesser extent, a few other European languages. Dominant influences include ancient Greece, ancient Rome, and Christianity, although religion has declined in Europe. In the West, efficiency, adhering to deadlines and a host of other similar habits are considered normal and are expected. Individuality and aggressiveness are considered as virtues. **Eastern or Oriental culture** is more spiritual value oriented. Work is worship. Group and collectivism, despite hierarchies, are valued. Individuality and aggressiveness can often be interpreted as a sign of disrespect! Oriental culture is used to a system of hierarchy in the work-place; senior colleagues are obeyed and respected. The educated have learnt to adapt to the western culture, of course. That is their great ability to contextual cultural adaptability.

e. Business Awareness of cultures: Businesses need to be aware of the culture of people they interact with to be successful. Within a country there used to be cultural differences across different societies and across regions as is the case in India. There will also be cultural stereotype as found in the totalitarian Middle-east nations. Understanding those differences as well as uniqueness and adapting to them is the key business success. Hence is the significance of studying cultural environment.

The difficulty in understanding culture is same cultural symbol may mean exactly opposite meaning in two cultural groups. For instance a palm posture with the thumb in union with the indicator finger and other fingers raised fully means 'fineness' in USA, 'fineness' or even 'oneness with the God' in India, and 'zero or worthless' in France. In Germany it is used to tell a fellow lunatic, in Japan it means 'money or exchange' and in Germany it means 'some obscenity'.

NOTES

2.6.2 Cultural Factors

India is a culturally diverse/complex country. The cultural mosaic is made up by a mix of several factors in different proportions. The **Nation**, **Religion, Social Stratifications** (such as Race, Community, Caste or Tribe), **Region, Language, Communication Styles, Attitudes of People** (such as motivations, relationship preferences, risk preferences, etc.), **Perception, Obtaining and Processing of Information by People** and other cultural factors.

Large societies often have subcultures, or groups of people with distinct sets of behavior and beliefs that differentiate them from a larger culture of which they are a part. The subculture may be distinctive because of certain demographics like age, race, ethnicity, class, gender or language. The qualities that determine a subculture as distinct may be aesthetic, religious, occupational, political, sexual or linguistic a combination of these factors.

a. The Nation

A nation as such may mean a particular culture. India for long time was seen as a country of 'proletarian, yes-men and snake-charmers'. This has now changed into a country of 'professionals, yeomen doers and strategic thinkers'. Indians are now regarded as English-speaking soft-mannered high achievers with professional and business acumen. Aggressiveness can often be interpreted as a sign of disrespect in India and may lead to a complete lack of communication and motivation on the part of the Indians. One needs to take the time to get to know them as individuals in order to develop professional trust. Indians are good hosts and indulge in personal talk often. All this is very much a part of business. One is expected to accept the invitation gracefully. Taking a simple bouquet of flowers would definitely be a welcome gesture. Indians respect people who value their family. They will allow family to take priority over work, whenever necessary. As Indians are used to a system of hierarchy in the work-place, senior colleagues are obeyed and respected. At the same time, 'talents are respected by the talents'. Educated Indians have learnt to adapt to the western methods of monitoring one's own work and completing it on schedule

b. Religion

Religion is integral to a culture. The Dictionary of Philosophy and Religion defines religion, ' as an institution with a recognized body of communicants who gather together regularly for worship, and accept a set of doctrines offering some means of relating the individual to what is taken to be the ultimate nature of reality'. Religion often codifies behavior, such as 'the 10 Commandments of Christianity' or the 'five precepts of Buddhism' or the '5 times prayer a day' by the Islam. Sometimes it is involved with government. It influences arts and architecture. Religious symbols are worshipped and revered much.

NOTES

Festivals, rites and rituals, ceremonies and functions and philosophies of business are based in religions. Lot of business fortunes surround these religious variables.

i **Festivals:** The Christianity celebrates Christmas, New Year and Good Friday in memorable ways. The Muslims celebrate Ramadhan, Bhakrid and Muharrum. The Hindus have celebrations every month. Deepavali, Dasara, Ramnavami, Krishna Jayanthi and Sankaranthi/Pongal are great festivals. Besides these, there used to be whole lot of local festivals, especially for the Hindus like sanctification of new temples, periodical re-sanctification of old temples, the early morning prayers during the 9th month of solar system, etc. Purchase decisions of personal and family wares including ornaments coincide these festival days. Even business decisions like starting new ventures or expansion are firmed up on these festivals. Businesses in India book more sales during festival days.

ii **Rites and rituals:** Religious rites and rituals like compulsory 5 times prayer a day by the Muslims, Sunday church prayer by the Christians and weekly fasts on specific days, religious pilgrimage on foot, etc by the Hindus abound. All this makes the people moving out, alms giving, etc. these have some business implications boosting certain trades and businesses.

iii **Ceremonies and functions:** Ceremonies abound. On important milestones in one's life like attaining puberty, on the eve of becoming first-time parents, etc. and anniversaries of sort like birth and marriage for the alive, and death anniversaries of one's parents all involve ceremonies. Functions like marriage, house warming, etc are occasions when big parties are arranged and good show of one's economic strength is exhibited. All these have great implications, especially for textile, ornaments, grocery and other businesses.

iv **Religious Philosophies impacting business:** The Muslims don't charge or take interest on loans given as it is forbidden. That is the reason a new banking called Islamic Banking is developing now, extending to insurance as well. Among the Hindus, there are sections that are pure vegetarians.

c. Social Stratification (Race / Community / Caste / Profession/ Region)

Cultural groups exist based on affiliations. The affiliations might be 'ascribed' or 'acquired' membership. The '**ascribed' membership is based on 'birth' like gender affiliation, age, caste, race, nationality** and the like. The '**acquired' membership is earned by one's education, profession, religion, political affiliation, life styles**, and the like.

NOTES

i **Race:** Race is an **'ascribed'** cultural factor. Racially Indians belong to the **Aryan and Dravidian races**. The Dravidian race has been little slow to take to business and had been tillers for long time and that had reduced their wealth base. Now there is a change. The south India is dominated by the Dravidian race and the north by the Aryan. But the Dravidian race has been subjugated by the Aryan race. Yet Dravidian race has learnt the art of governance. For an outsider, the racial differences are rather subtler than outwardly manifest.

ii **Communities**: There are numerous communities with lot of ethnic symbols which are held so dear to their hearts. There are proletarians, traders, business people, tribal, educators, financers, nomads and so on. Certain communities are smart in business acumen and take to entrepreneurship rather than being proletarian. The Baniyas of Gujarat, the Chettiars /Nadars of Tamilnadu, the Brahmins, Saits of Rajasthan/ Maharastra, the Nairs of Kerala, etc are known to be having higher entrepreneurial nuances. Thus they happen to be the business community with more wealth accumulated over centuries of business. Certain communities give importance to education, material and/or spiritual.

The Government has classified the communities for better targeting its development schemes. Accordingly there are: Scheduled Casts/Tribe, Backward Community and Forward. There are educational and job reservations for the Scheduled Casts/Tribe and Backward Communities. These reservations have lot of business implications for the opportunities of education are taken to the less privileged and that businesses have more educated people to recruit. Opponents of reservation would argue that reservations per se reduce the quality of education and job performance because to an extent the meritocratic is denied chances of education and placement.

iii **Caste system:** Caste system is an 'ascribed' cultural factor. It is rampant that restricts matrimonial exchanges within the castes only. This has become a vote bank now-a-days and the voluminous castes have more elected representatives than the smaller castes. There are caste associations and caste based upheavals in certain pockets that tend to affect peace and business interests.

iv **Profession:** Profession is an acquired cultural factor. Accountants & Auditors, Investment consultants, Physicians, Engineers, Professors, Soft-ware experts, Architects, Bankers, Politicians, etc are certain professional groups. Life styles, social status, motivations, etc differ amongst professions.

e. Region

India is fairly a big country, though only one time zone is followed. The northern states reel under cold and hot for 6 months while the south used to have normal temperature. This variation speaks that the country is not small, though only 2.4% of world land mass it

NOTES

has. There are different regions. There variations in regional developments as well. The central, central east, north east and extreme north-west are less developed. Political factors, insurgency problems, lack of opportunities for education, poor infrastructure because of the terrain features, etc combine to make these regions less developed. Lesser the development, more are the exploitation of the proletarian and weaker the governance. In the way fellow human are treated, particularly women, cultural richness differs. The index of safety to person and to modesty of women is not that high in the insurgent inflicted regions of the country. Then, they stand low on cultural richness. Further a huge order vicious cycle, that is difficult to break, prevails. This has business implications. You can take it either way; less or more opportunities. Less, because of the fact, that the supporting structure is non-existent. More, because of unexploited resources abound. Fortunately or unfortunately, more of mineral resources, oil, iron ore, coal, etc abound in these areas. With political culture, the regions can be made as good as other regions of the country. There emerge more business opportunities.

f. Language

Languages abound. There are really too many languages and too many cultural patterns too. The demarcation of states other than those in the Hindi-belt, are language based. It is sacred cow and a local politician can simply pump in / blow hot venomous passions on language veil should he want to score something over someone, by simply linking some frivolous issue to the language. You have to be very careful as much as I am when I make the statement in your lesson Language has lot of business implications. Should information brochures and advertisement messages be in as many languages or simply a few or just one. With umpteen languages any sound will have some meaning, good or bad, in some language or the other. So, even naming brands must be carefully done, lest the brand may hit a dead-end. Even within the same language a word may convey different meanings for people from different countries speaking the same language. Note, at least 4000 words in English have different meanings in England and in the USA. For instance the word, 'turnover' in USA meaning sales, however means 'redundancy' in the UK. Cultural nuances are exhibited through choice words in any language. An alien business person may not know this. 'You' and 'Your Excellency' effectively means 'you', but the latter is full of packed respects. Arabic language has more than 6000 words to describe camels, their bodies and equipments meant to deal with the camels. Arab culture is intimately related with the camels and that the language is also made richer in terminological exactness when referring to camels. Sanskrit is known for special sounds that no other language has and that best suited to offer obeisance to God in rhythmic wavelengths of appropriate order.

g. Attitudes of People (Motivations, Relationship and Risk Preferences, etc)

Culture is reflected by people by their attitudes. Motivation, relationship and risk preferences are certain cultural variables.

NOTES

i **Motivations:** Motivations towards work and leisure, materialism and spiritualism, education and earnings, power and responsibility, women and downtrodden, success and reward, quality and quantity, ends and means, aged and infirm, parents and children, masters and sub-ordinates, haves and have-nots, quick money and hard-earned money, etc reflect cultural tendencies of people. In the West more motivation is found in favour of leisure, materialism, earnings, power, reward, quantity and ends. Motivations change as they achieve economic gains. People are motivated to work if rewards for success are more certain. In India we say the work, spiritualism, education, responsibility, success, quality, means and hard-earned money are preferred the most. Concern for women &downtrodden, aged & infirm and sub-ordinates, love for parents and children and respects for masters is spontaneous.

ii **Relationship preferences:** Relationship preferences refer to the kind of interactions one would prefer to have with superiors, peers and sub-ordinates, the kind of orientation one has – individualism or collectivism and the like. If the power distance is more one would like to have less interaction with the superior. In the European culture the power distance is less than in the Asian cultures. A European manager when transferred to an Asian position, she would dialogue with her subordinates. And the subordinates might not like this as they are used to power distance and minimal direct interaction with the boss. They interact among themselves more, anyway. Peers generally interact more, when not in perceived threat of being over-taken by others of the group. In countries like USA, Canada, UK, Australia and the Netherlands the score for individualism is more. The Latin American countries and the Asian countries like India and Japan have high scores on collectivism. Kinship based collectivism prevail in China and Mexico.

iii **Risk preferences**: Risk preferences involve going the extra mile, by the unchartered waters. In countries where the preference for uncertainty avoidance is more, superiors have to lay down clear-cut norms of behavior. Portugal, Greece, Uruguay, Belgium, etc have less tolerance for uncertainty. Most west-European countries have high tolerance for uncertainty. India is a country of uncertainty; therefore you prefer or not uncertainties are there to take. Hence there are only accidental entrepreneurs unlike in the Europe where entrepreneurs by choice abound.

h. Perception, Obtaining and Processing of Information by People

People of different cultures perceive, obtain and process information differently.

i **Perception of information:** Perception is based on the sensual inputs. For some cultures, due to partly genetic factors, the sensual inputs are very precise enough to perceive the subtler elements of the objects. For the proletarians a red is red, but for the professional red may mean crimson red, blood red, chilli red, wax red, tomato red and so on. The cue is same, but the perceptions differ based on exposure and linguistic abilities of expressive variations. Arabic language has more than 6000 words to describe

NOTES

camels, their bodies and equipments meant to deal with the camels. So, Arabic speakers will have more expressive power over other language speakers. A person used to find fault will say a glass is half-empty, while other person looking the positive side will say, the glass is half full. The cue is same, but perception is different, based cultural personality differences. There are both kinds of Indians.

ii **Obtaining information:** Obtaining information may differ across cultures. Two kinds of cultures exist, low context and high context. The **low context culture** places value on the core issues, direct issues and black & while information. The **high context culture** places emphasis on peripheral, indirect and intuitive & inferred information. The high context culture people don't trust the low context culture as being more transaction oriented than relationship oriented.

iii **Processing of Information:** Processing of Information varies across cultures. Even telephone directories may be alphabetized differently. In USA the ordering is based on last name, while in Iceland it is first name based. Again, when dealing with customers, in India better you finish the deal with the first comer, before a next person is entertained even for the same kind of transaction. This is **monochronic processing**. If the second person is also simultaneously entertained, the first person thinks he is slighted away and the business party is not interested in the deal. This is so in the northern Europe as well and the USA. But, in southern Europe, **polychronic processing** is order, where many customers are simultaneously attended to.

2.6.3 Approaches to Cultural Complexities by Businesses

Ethnocentrism, Regio-centrism, Poly-centrism and Geo-centrism are the different approaches to choose from. Depending on the level of international market penetration, different approaches may be adopted.

a. Ethnocentrism

Ethnocentrism involves no cultural adaptation even when you deal with aliens in home country or in the foreign countries. May be you deal more with more of your own ethnic groups and that it does not warrant adaptation or you feel confident that you should not lose your cultural identity or you feel that others will adapt to your culture which you feel very superior. The product may not need adaptation, but the communication might need adaptation. Sticking to ethnocentrism should not have any opportunity cost of foregone revenue. Hotel Saravanabava and many other south Indian ethnic restaurants function in foreign countries, especially in the Gulf, UK, USA and South East Asian nations. Their approach is purely ethnocentric, because *Idly or Idiappam or Vada* cannot be changed whether sold in Madras or Malaysia or Muscat or Madrid. This is uni-culturalism or mono-culturalism.

b. Regio-centrism

Regio-centrism involves cultural adaptation based on the regions served. Woolen dresses in North India have to serve the twin purpose of style and warmth-giving, as against in South India where it is enough it tackles cold. Exotic models of wool wears costing few thousand rupees are sold in the north, but coming down south only models costing few hundred rupees are generally offered. So, regio-centric approach is needed. In the Gulf region homes must necessarily have provision for air-conditioning, unlike in India. In Ooty homes need not have provision for air-conditioners or even fans. But, room heaters must be provided for. In Delhi and the north india it would be good if homes are fitted with both air-conditioners as well as room-heaters. Therefore, architects must design accordingly and provide for electric points. This is semi-degree multiculturalism.

c. Poly-centrism

Poly-centrism involves cultural adaptation based on requirement in a given context even within a region/nation. One-form of polycentrism is identifying with the local culture in entirety. This is a highly localized format. World-wide objectives may get sacrificed at the altar of fulfillment of localized goals. Another form is every outlet is polycentric in its offering. Much pluralism or adaptation is followed. High-star hotels have different cuisine to delight every taste bud. This may be costlier, but world-wide as well as localized objectives get realized. In due course, the local culture may start experiencing other options and this may reduce too much of varieties. This is full degree multiculturalism.

d. Geo-centrism

Geo-centrism involves common offering to the whole world as the whole world is treated as one culture. Strong brand strength and superior corporate image make companies follow this approach. Pepsi or Coke follows this. Similarly, computer firms offer same models all over the world. This reduces cost due to scale advantages. Mobile handset companies do this. It must be noted that they have a range of offering, but it is same for all markets. This is perhaps ‘acculturation’, that is a negation of culture as such.

To culture is to cultivate or to grow. Culture has dimensions of refinement, continuous improvement, transmission down to generations. Organizational culture is cultivating the set of values and norms for conducts within and outside the organization, refining these conducts, improving upon these conducts and transmitting these to the generations down.

2.6.4 Organization culture

Organization culture is the sum total of beliefs, styles, articulations, values and symbols that portray an organizations reason and means for existence. It is made-up of sub-cultures.

NOTES

Leadership culture, structural culture, work culture, group/division culture, product culture, market culture, competitive culture, relationship culture, openness culture, futuristic culture, dynamic culture, pro-active culture, reactive culture and so on, are sub-cultures.

Leadership culture refers to the kind of leaders, their vision and mission, their style and decision-making abilities, their ability to delegate and got things done, etc. Transactional leaders and transformational leaders, pro-active leaders and reactive leaders, etc. are certain culture models.

Structural culture designs nature of flow of authority/responsibility. **Rigid & Flexible** cultures and **Tall & Flat** cultures are the alternatives relevant here. Rigid and tall cultures are more mechanistic and bureaucratic; while the other two are organic and dynamic.

Work culture refers to the kind of commitment to work. '**Work is Worship'** is the right culture. Work resentment is not good. There are quality, quantity, time, space and other considerations too.

Group/ individualized cultures refer to tendency of people to align with the group or remaining more independent. **Group culture** involving greater alignment leads to greater cohesiveness and hence to greater excellence. **Individualized culture** fosters creativity and leadership development.

Product culture refers to level of commitment to offer superior products/ services, new and innovative products, products bench-marked against bests and the like to consumers.

Market culture concerns with commitment to market orientation. Consumers constitute the market. A consumer centric approach explains what market culture is.

Openness culture refers to level of transparency in the dealings of the organization.

Futuristic culture refers to commitment to look forward, introducing changes, innovating for the tomorrow, and so on.

Dynamic culture refers to commitment to remain active. Shedding statusquoism and propelling for change and growth characterize dynamic culture.

Competitive culture refers to commitment to be competitive and fostering rather than curtailing competition. 'Live and let live' characterize sound competitive culture.

Relationship culture refers to maintaining long-term relationship with stakeholders – be they consumers, suppliers, employees, etc.

NOTES

Pro-active culture is oriented towards finding new opportunities for growth and working upon such new opportunities.

Reactive culture is responding to changes in environment. 'Better late than never' type of orientation.

Intra-preneurial culture is committed to harness entrepreneurial instincts of employees, grooming such entrepreneurial skills to higher levels so that they branch out and become own business promoters themselves.

Masculine culture involves more aggressiveness in dealings. **Feminine culture** is more adjustment oriented.

QUESTIONS TO CONTEMPLATE AND DELIBERATE

Q 1.6.a Examine the concepts of culture constructs and related constructs as business environment factors

Q 1.6.b Explain the cultural dimensions of Religion and Social Stratifications

Q 1.6.c Elucidate the cultural diversities of Region & Language and their business implications

Q 1.6.d Present Communication Styles, Attitudes & Perception of People, etc as cultural factors.

Q 1.6.e Discuss the cultural policy alternatives available to an international business firm

Q 1.6.f Explain the concept and types of organizational culture

Q 1.6.g Culture is dynamic. Businesses have to adjust. Comment with examples.

2.7. REGIONAL TRADE BLOCKS

LPG policy is being followed by most countries of the world with a regional flavour, with south-south, north-north collaborations. Regions have been recording good success too. Trade blocs are very common. North-South, North-North, South-South coalitions exist. North denotes the well developed countries and south denotes the less developed countries. Trade between these hemispherical divisions can be called as inter-regional trade. Besides, there are many other regional blocs and trade among the members of the bloc is called trade within a block or intra-regional trade.

2.7.1 Trade blocs

There are many trade blocs formed by neighboring countries. Trade blocs exist side by side WTO, which is but a mega bloc of over 150 countries. Initially WTO felt little odd

NOTES

when countries entered into regional trade agreements. Now, conflicts aren't found between trade blocs and WTO.

a. Causes for emergence of trade blocs

The incentives for such regional groupings are: i. Goods have to be transported for shorter distance only to international borders; ii. Market conditions like consumer tastes and preferences tend to be similar and that product acceptance is almost certain; iii. The countries because of their proximity may have same lineage, history, problems, prospects and interests; iv. Trade relationship is a strong strategic relationship as well and that friendly understanding would emerge as by-product.

b. Notable regional trade associations

Notable regional trade associations are as below:

i **NAFTA** (North Atlantic Free Trade Agreement) formed in 1988 with USA, Canada and Mexico as members

ii **EU** (European Union) with 15 countries (originally) viz, Belgium, France, Germany, Italy, Luxembourg, Netherlands, England, Spain, Portugal, Ireland, Finland, Austria, Sweden, Denmark and Greece as members, and now with another 10 more countries also;

iii **LAFTA** (Latin American Free Trade Area) established in 1961 with Argentina, Brazil, Mexico, Chile, Peru, Uruguay, Paraguay, Colombia and Equator as members,

iv **ANZCERTA** (Australia New Zealand Closer Economic Relations Trade Agreement) with Australia and New Zealand as members created in 1988,

v GCC (the Gulf Co-operation Council) consisting of gulf countries as members,

vi **CEEAS** (Economic Community of Central African States),

vii **CARICOM** (Caribbean Common Market) with countries in Latin America as members,

viii **ASEAN** (Association of South East Nations) with membership of Indonesia, Malaysia, Philippines, Singapore, Thailand and Brunei,

NOTES

ix **SAARC** (South Asian Association of Regional Corporation) with India, Bangladesh, Nepal, Bhutan, Sri Lanka, Maldives and Pakistan as members, and

x **SADCC** (South African Development Coordination Conference) with members of Sub-Saharan countries are some regional blocs. Here region means aggregation of countries.

A notable collapse of an RTA has also happened and that is the case of the Council for Mutual Economic Assistance (COMECON) with the disappearance of the communist bloc in Eastern Europe.

These blocs are of various form, power, influence and success. ASEAN is a collaboration of industry and agriculture. The EU, NAFTA and the Pacific Rim Union will pose the greatest power blocs in future. Many developing countries have entered into trading blocs as a reaction against loss of access to developed country markets or as a base to build economic integration and markets. Of these blocs, the EU, NAFTA and ASEAN are very important.

c. Aims of Trade Blocs

The regional blocks aim for free trade among members of the regional bloc, common external commercial (tariff and quota) policies for member countries, free mobility of factors within the bloc, harmonized economic policies for members of the bloc and a supranational organizational structure for economic policy formulation, implementation and control amongst the members of the bloc.

From free trade area (FTA), to customs union (CU) to common market (CM), to economic union (EU) and to total economic integration (with common currency as in the case of EU with Euro as the currency for the 12 countries of EU since 1999) are the stages of successive economic integration of countries in the bloc.

2.7.2 Inter-region Trade among Regional Groups and Intra-region Trade of Regional Groups

Inter-region trade among the regional groups refers to trade between two or more regional groups like trade between a member country of NAFTA and a member country of EU, say between the USA and Germany. Trade between India of the SAARC bloc and Thailand of the ASEAN bloc or trade between Sultanate of Oman of the GCC bloc and Argentina of the LAFTA are further examples. Trade between Mexico of the North America and Dubai of the of the Middle east or trade between Brazil of South

NOTES

America and France of the Europe region are examples. Uniform law and procedures, regional specialization on the basis of resource endowments, etc give a boost to inter-regional trade.

Inter-regional trade has grown since the emergence of economic blocs or regions, because it is easy to push trade among blocs or regions than among individual countries. In the case of trade between countries without any regional blocs or other aggregation, negotiations with each and every country are needed perhaps for every major product or service class. That is a great irritation and time consuming process and political relations between the countries in question weigh much the pace and depth of trade. But in the case of countries coming through a trade bloc to trade with countries of other trade bloc, given that the blocs are already having agreements on trade, individual countries' political relation do not come as hurdle, for trade is governed by agreement between the two blocs.

Trade within a block or region or intra-region trade refers to trade between members of a particular bloc. Trade between Canada and USA both members of NAFTA and North America, between Germany and Belgium both in Europe and Members of EU and the like come in the intra-region trade. Intra-region trade is also poised for growth because under trade bloc agreement, individual countries need not negotiate inter se, as the collective agreement terms will take care of trade between member countries. Absence of tariff barrier is a great advantage for intra-region trade. In case of common currency exchange risk also does not arise. Besides, investment flow will rise up leading to trade in producers' goods like capital equipment, plant, machinery, raw materials, etc. rather than consumers' goods.

Table 11 gives data regarding geographical region based inter-regional trade and intra-regional trade in merchandise goods for 2006 in percent terms.

North America's trade with North America, that is intra-region trade amounted to 38.4% its total global trade. The inter-regional trade accounted for 61.6% with South & Central America accounting for 5.7%, Europe accounting for 18.3%, CIS countries for 1%, Africa for 3.4%, Middle East for 3.1% and Asia accounting for 30.1% of North America's global trade. It is evident that North America's single major trading partner is North America itself. May be this is due to the NAFTA. Next, comes the Asian region with 30.1%. North America is having balanced trade with most regions.

South & Central America's intra-regional trade is 29.5% of its total global trade, balance 70.5% is inter-regional trade. Proximity with the North America has made the

NOTES

same its single largest inter-regional trade partner with 28.4% share, followed by Asia with 18.4% of the region's global trade.

The **CIS countries** have less intra-regional trade of 27.7% and amongst the inter-regional trade partners Europe is single largest partner with 48.7% of the countries' collective trade.

A very peculiar picture is seen as to the **Europe** as the region's intra-regional trade is highest at 71.3% of its global trade. Europe region is vastly developed one and that intra-trade is more. Asia is its single largest inter-regional trade partner accounting for 11.8% of its global trade.

Africa's intra-regional trade is the lowest at 11.6% of the regions global trade. Europe and Asia are major inter-regional trade partners.

Middle-east region's intra-region trade is 18.8%. Europe and Asia are major inter-regional trade partners with 33.8% and 29.2% share of the region's global trade.

Asia is having second largest, next only to Europe, intra-region trade accounting for 57.7% due to similarity in culture of members. Among the inter-regional trade partners, North America, Europe and Middle East are almost equal partners with the share hovering between 11and 13%.

NOTES

Table 11 % Share of Regional Trade Flows in World Merchandise Exports, 2006

Origin	Destinations							
	North America	South & Central America	Europe	CIS	Africa	Middle East	Asia	Each Region's World share
North America	**38.4**	28.4	5.5	2.8	7.7	11.0	11.1	**14.2**
South & Central America	5.7	**29.5**	1.7	2.1	4.0	2.1	2.2	**3.6**
Europe	18.3	17.6	**71.3**	48.7	42.6	33.8	12.9	**42.1**
CIS	1.0	2.0	4.8	**27.7**	2.0	3.5	1.6	**3.6**
Africa	3.4	3.0	2.9	0.5	**11.6**	1.7	2.6	**3.1**
Middle East	3.1	1.2	2.0	1.0	7.4	**18.8**	12.0	**5.5**
Asia	30.1	18.4	11.8	17.1	24.7	29.2	**57.7**	**27.9**
World	100	100	100	100	100	100	100	**100**
Intra-region trade	38.4	29.5	71.3	27.7	11.6	18.8	57.7	---
Inter-region trade	61.6	70.5	28.7	72.3	88.4	81.2	42.3	---

QUESTIONS TO CONTEMPLATE AND DELIBERATE

NOTES

Q 1.7. a What are the aims of regional trade associations? Present some of the important RTAs

Q 1.7. b What are inter-region and intra-region trades? Give the recent trend therein.

Q 1.7. c Bring out the reasons for more intra-region trade in some major RTAs.

SUMMARY

Globalization: Globalization is defined by the IMF, as "the growing economic interdependence of countries worldwide through increasing volume and variety of cross border transactions in goods and services and of international capital flows, and also through the more rapid and widespread diffusion of technology".

Globalization levels: There are two levels, viz, at the macro level (i.e., globalization of the world economy) and at the micro level (i.e., globalization of the business and the firm).

Global economy features: According to **Peter F. Drucker**, the global economy is characterized by money flows rather than by trade in goods and services and in the global economy the goal is market maximization and not profit maximization, there is a genuine - and almost autonomous - world economy of money, credit and investment flows and there is a growing pervasiveness of the transnational corporations which see the entire world as a single market for production and marketing of goods and services.

Causes of Globalization

Globalization is not a twentieth-century phenomenon. Globalization of economic activity has been closely linked with the development and establishment of empires worldwide through international trade since the sixteenth century. Looking back over the last three centuries, it would be nearly impossible to separate the political and economic – in particular, international trade – histories of Western nations.

Causes of Globalization: The causes of globalization include: Global thinking, Multilateral Financial Arrangements, Foreign Private Capital, Empire Building, Industrial Revolution, Growth of MNCs and International Agreements

Issues and Concerns of Globalization: Issues and concerns of globalization are: change, efficiency, stability, development, sustenance and equity.

Business Environment: Environment is 'the external conditions, resources, stimuli etc. with which an organism (firm, country, etc) interacts'. From a business firm's point of view,

NOTES

these external factors (conditions, resources, stimuli, etc) are the so called "uncontrollable factors", unlike the "controllable factors" of strategy, policy, administration, etc. These 'uncontrollable' factors include economic, socio cultural, legal, technological, consumer interests, competitive and political factors to name but a few. Failure to account for these factors can lead to dire consequences to business.

Economic environment

The economic environment in India is becoming good with high growth rate in savings, investment, GDP, foreign investment and efficiency with reduced ICOR. The external sector is doing well, though rising oil prices are a great concern. Under the PPP India is a 4^{th} largest economy in the world. Her GDP had leaped to a trillion dollar.

Economic Environmental Factors: The economic environmental factors include:

	Formative Evaluation	Summative Evaluation
What information	Specific description of daily events	General trends based on specific descriptions
	Particular skills and performance	Overall attitude and performance
	Needs assessment	Comparison with evaluation tool
When to give	At the time of the incident	Mid-point in the course
	End of the day	End of the course

Political Environment

Political system, political parties in power, political parties in the opposition, political maturity of the parties, number of political parties, political awareness of people, political stability and the like constitute political environment in a country. The economic policies pursued by a Government are to a great extent the by-product of political environment that impacts businesses very often.

Basic Political Ideologies: Political ideology refers to, 'the body of ideas, theories, aims and means to execute the ideas, adapt the theories and fulfill the aims that constitute a socio-political programme for action'. Depending on the mix of different 'ideas, theories, aims and means', there exists: Pluralism, Democracy and Totalitarianism as alternative political ideologies.

Politico- economic System: There are different forms of political system. Capitalism, Crony capitalism, Welfare capitalism, Socialism, Communism and Mixed economy are the different systems.

Political Risk: Political risk is that perception by the businesses that their interests will get deteriorated when certain political upheaval happens. Political risk can occur in both democracies as well as in the totalitarian set ups as well. There are **micro and macro** political risks. **Micro political** risk is the one that affects a particular firm or class of firms. **Macro political risk** affects all. **Macro risk cannot be hedged**, but it is bit rare now.

Political Environment in India: India is federated state or union of states with two major levels of administrative Governments viz., Central or Union Governments and Governments at the State or Union Territory level. There is parliamentary form of Government. The Parliament legislates and regulates. The Ministry is executive. The judicial aspect is taken care of by independent Court.

Systems of Government of the States: The state executive branch consists of the Governor, who is appointed by the President, and the Council of Minister, with Chief Minister at its head. State legislatures are of unicameral- or bi-cameral.

Judicial System: The **Supreme Court of India**, seated in New Delhi, is the highest body in the entire judicial system. The Supreme Court has **original, appellate and advisory jurisdiction**s. Each state or a group of states has High Court under which there is a hierarchy of subordinate courts.

Business-Political Positive Alignment in India

Business-Political Alignment in India is quite friendly, matured, tolerant and efficient too. **New Economic Policy:** The new economic policy followed since 1991 gives more role for globalized competition, and more facilitative role for government. **Moral support**

NOTES

in International deals: Moral support in International deals is extended by the Government to businesses. **Budgetary Consultation and Concessions:** Govt. invites suggestions from the businesses community in the budget making exercises. At times of hardship, government comes with tax and financial sops. **Good relationship between Govt. and trade bodies:** Good relationship between Govt. and trade bodies like the **CII**, **FICCI**, **Assocham** and so on, besides specific industry bodies.

Problems include: Delay in disposal of legal cases, Corruption and infrastructural bottlenecks.

Cultural Environment

Culture generally refers to patterns of human activity and the symbolic structures that give such activities significance and importance.

Edward Burnett Taylor described culture as 'that complex whole which includes knowledge, belief, art, morals, law, custom, and any other capabilities and habits acquired by man as a member of society'.

UNESCO described culture, 'as the set of distinctive spiritual, material, intellectual and emotional features of society or a social group, and that it encompasses, in addition to art and literature, lifestyles, ways of living together, value systems, traditions and beliefs'.

Culture features: Culture is prescriptive and shared. Culture is learned. Culture Manifests in actions and subtle ways in music, literature, painting and sculpture, theater and film and other things. Culture is cumulative. Culture endures. Culture is dynamic.

Cultural exchange, change, Shock and reverse shock: Cultural Exchanges take place, while its uniqueness is preserved mostly. At the same time **'Acculturation'** which means replacement of the traits of one culture with those of another also happens. **Culture change** is complex and has far-ranging effects. **Cultural shock** is a situation of strangeness or unacceptability or frustration felt by one group or one person in the material, social, political, technological, spiritual or economic spheres of life in a different geographical or political regime within or outside its/his native land. The days of globalization involve great cultural shocks. But in due course of time, due to assimilation and acculturation cultural shock recedes. Later when the group or persons encounters its/his own culture it/he may find a **reverse cultural shock!**

Types of cultures: There exist **high culture** and **low culture**. The **'high culture'** involves **expressive or conspicuous consumption**. **Low culture** refers to the **mass culture or popular culture** thriving on subsistence. There are **'civilized' and 'primitive' or 'tribal'** cultures as well. The **tribal culture is** instinct based. **Western culture** is sometimes referred to as European culture thrusts more on individuality and aggressiveness as virtues. **Eastern**

NOTES

or Oriental culture is more spiritual value oriented. Work is also worship. Group and collectivism, despite hierarchies, are valued.

Business Awareness of cultures, diversities and stereo-types: Businesses need to be aware of the culture of people they interact with to be successful. Within a country there used to be **cultural differences** or **diversities** across different societies and across regions as is the case in India. There will also be **cultural stereotype** as found in the totalitarian Middle-east nations.

Cultural Factors: India is a culturally diverse/complex country. The cultural mosaic is made up by a mix of several factors in different proportions. The **Nation**, **Religion, Social Stratifications** (such as Race, Community, Caste or Tribe), **Region, Language, Communication Styles, Attitudes of People** (such as motivations, relationship preferences, risk preferences, etc.), **Perception, Obtaining and Processing of Information by People** and other cultural factors.

Approaches to Cultural Complexities by Businesses: Ethnocentrism, Regio-centrism, Poly-centrism and Geo-centrism are the different approaches to choose from. Depending on the level of international market penetration, different approaches may be adopted.

Organization culture: Organization culture is the sum total of beliefs, styles, articulations, values and symbols that portray an organizations reason and means for existence. It is made-up of sub-cultures. Leadership culture, structural culture, work culture, group/division culture, product culture, market culture, competitive culture, relationship culture, openness culture, futuristic culture, dynamic culture, pro-active culture, reactive culture and so on, are sub-cultures.

REGIONAL TRADE BLOCKS

There are many trade blocs formed by neighboring countries. Trade blocs exist side by side WTO**.** Trade between trade blocks (inter-region trade) and among the members of the bloc (intra-regional trade) stand facilitated by these RTAs..

Notable regional trade associations : NAFTA, EU, LAFTA, ANZCERTA, GCC CEEAS , CARICOM , ASEAN, SAARC and SADCC are important RTAs. COMECON disappeared, however. These blocs are of various form, power, influence and success. Of these blocs, the EU, NAFTA and ASEAN are very important. Many developing countries have entered into trading blocs as a reaction against loss of access to developed country markets or as a base to build economic integration and markets.

Aims of Trade Blocs: The regional blocks aim for free trade among members of the regional bloc, common external commercial (tariff and quota) policies for member countries,

NOTES

free mobility of factors within the bloc, harmonized economic policies for members of the bloc and a supranational organizational structure for economic policy formulation, implementation and control amongst the members of the bloc.

Stages in integration: From free trade area (FTA), to customs union (CU) to common market (CM), to economic union (EU) with common currency are the stages of successive economic integration of countries in the bloc.

Intra- and Inter regional trade trends

North America's trade with North America, that is intra-region trade amounted to 38.4% its total global trade. The inter-regional trade accounted for 61.6% in 2006.

South & Central America's intra-regional trade was 29.5% of its total global trade, balance 70.5% is inter-regional trade.

The **CIS countries** have less intra-regional trade of 27.7% and amongst the inter-regional trade partners Europe is single largest partner with 48.7% of the countries' collective trade.

Europe's intra-regional trade is highest at 71.3% of its global trade.

For the **Middle-east**, Europe and Asia are major inter-regional trade partners with 33.8% and 29.2% share of the region's global trade.

Africa's intra-regional trade is the lowest at 11.6% of the regions global trade. Europe and Asia are major inter-regional trade partners.

Asia is having second largest, next only to Europe, intra-region trade accounting for 57.7% due to similarity in culture of members. Among the inter-regional trade partners, North America, Europe and Middle East are almost equal partners with the share hovering between 11and 13%.

EXERCISE

In the case of project, the cash flow right now obtainable by pulling out is $ 150mn whether expropriation happens or not. If waited for a year the estimated cash flow when expropriation happens is $ 110mn and when expropriation does not happen it is $ 220. The fear of losing $40mn due to expropriation and benefit of getting extra $ 70mn when the feared expropriation does not happen puts the firm in a dilemma. Cost of capital 20%. Find the probability of the expropriation that makes firm evenly poised.

NOTES

UNIT III

GLOBAL STRATEGIC MANAGEMENT

3.1 INTRODUCTION

An important stream of literature on multinational enterprises (MNEs) relates to how they organize and manage worldwide operations, for this has implications on their strategic control, shared communication, and performance quality. Global Business Management is becoming more and more strategic today which in effect involves effective aligning with the global environment in a more proactive manner. Global environment provides extended opportunities and also great threats. MNEs driven by growth instincts exploit opportunities and overcome threats. Right alliance with the environment helps exploiting opportunities and overcoming threats. Needless to say the MNEs must keep their houses strengthened and committed to the global ambition. Formulation of strategies and implementation of the same which constitute the core functions of strategic management, require effective organization structures, with embedded systems of pro-active control, smart information systems, excelling performance measurement mechanisms and forward looking evaluation scheme. Global strategic management involves having all these and more so as to be able to in a position to exploit the extended opportunities and face the threats as may happen.

The term strategy refers to the art or knack of commanding and maneuvering resources, including organizational design, control system and evaluation mechanism, to attain a decisive advantage over the competitors for the fruitful exploitation of opportunities provided by the environment and/or keeping at bay certain threats wielded by the environment. Globalization is a change in the business environment with new found opportunities and expected and unexpected threats. For instance, businesses now can tap foreign capital resources and market and acquire firms overseas which are all opportunities. At the same time there builds up global competition, take over possibilities and contagion risks which are all threats. MNEs make strategic responses to the changing environment.

According to **Ricky Griffin,** strategy has essentially four basic areas, namely: **Scope, Resource, Uniqueness and Synergy**.

NOTES

Scope of a strategy defines its functional, geographical, product/service and relational domains. Functional domains refer to marketing, production etc opportunities. Geographical domains are concerned with markets served and sourced. Product domains define product/service lines and range. Relational domains deal with the internal and external affiliations and the strengths of bonds. Scope of a strategy thus prescribes the level of spread of the span of activities of the organization.

Resources of a strategy refer to what and how much of resources the organization will employ across various areas. Organizational resources, financial resources, human and technological resources come here. Choice mix of domestic & foreign, owned & acquired and so on be involved

Uniqueness of a strategy refers to the distinctive competence of the organization on the strength of which the strategy is built to attain leverage over its competitors as well as other strategic alternatives. Close to consumers through own retail establishment, speed of action, technological edge, etc. may be the distinct advantages.

Synergy flows then. Synergy is cascading effect of collated strengths that sweeps all threats and yields copious gains. The advantage of being a system is the synergy. Should there be no synergy, there need be no system. The scope, resources and uniqueness of the strategy should give synergistic result. While designing a strategy the management must see that all the four constituents of a strategy are present.

Strategic Mix

The strategic mix has three levels. At the top is corporate strategy, at one level below is the business strategy and at the bottom is the functional strategy. This is the hierarchy of strategies.

Corporate strategy is about the course charted for the whole of the organization. It deals with the **'what'** aspect. It is also known as the **'grand'** strategy. Corporate strategy depends on the corporate goal. And corporate goals could range from on the one end, a **curtailment goal** to on the other a **diversification goal**, with **status-quo** and **growth goals** in between. The curtailment goal calls for a **retrenchment strategy**. It is a bold attempt to do away with excess fat, units that are causing entropy, divisions that are not pro-synergetic and functions that have lost strategic significance. In a way it is about turn-around or downsize of an organization. The status-quo goal calls for a **stability strategy**. Here the organization is pretty happy with the present. It neither wants to add on a few wings nor shed some feathers. It is a **consolidation-oriented** goal. Hence, it is adopted after retrenchment or after hectic growth phase or so. Mature companies adopt this strategy, wherein scale advances are attempted through more geographical coverage. There is **'geographical'** spread and rise in market share. Market coverage is being mastered here. Finally, **backward and forward expansion** goals come with a **diversification strategy**.

NOTES

Related and unrelated diversifications are possible. It should be noted that **competitive distinctiveness** and **synergy** are not lost. It is quite possible with unrelated diversification strategic management may call for division of the business into strategic business units (SBUs), each with own mission, vision and strategic initiatives. Then with respect to each such SBU, suitable corporate level strategy may have to be drawn up. Corporate level strategic alternatives for **'stars', 'cash cows', 'question marks' and 'dogs'** may have to be formulated. In formulating corporate strategy, in-depth environmental analysis and organizational analysis need to be made to know how the strengths and weaknesses of the organization can be matched with the opportunities and threats of the environment.

'**Business strategies**' are concerned with the **'how'**. How should the organization approach its aligning with the environment? There are four approaches here. **Griffin** puts up them as follows. **Defender, Reactor, Analyzer and Prospector** strategies are these. These strategic alternatives emerge from certainty-uncertainty conditions of the environment and the firm's response. **Defender strategy** is of the most unassuming form. It is pro-status-quo. The firm is satisfied with the present. This is suitable in a certainty environment. The firm perhaps has a narrow niche market. The firm has no big ambitions. But when discontinuous changes take place in the environment, the firm adopting defender strategy might have no territory to defend. It can, however, work if distinct and core competences are the bases on which the firm's plans and actions are founded. **Analyzer strategy** is one where the firm is not silent, but steadily modifying its course in tune with the changing environment and competitors' strategies. It suits the risk-type environment, where, which way the environment is changing, can be known by adopting probabilistic forecasting models. New products and markets are scouted for in a moderate way. Laggards are gently given up, while cash-cows receive the full thrust. A mix of diversification, expansion and retrenchment goals are thus found here. **Prospector strategy** looks out for new opportunities and learns about the same. In an uncertain environment discontinuous changes are the reality. So prospector strategy suits such environment. Exceptional ability to give up old customs and imbibe new cultures is the back-bone of the prospector strategy. Finally the **Reactor strategy** has found favour with a few. It is ill-conceived one and as such is not tuned to environment. No opportunity is reaped but quite a number of threats are faced. In the end, instead of strengthening strengths, weaknesses get strengthened. A viscous cycle perhaps results here to the detriment of the firm.

Functional strategies address the operative functional areas like production, marketing, finance, personnel and R&D. **Production strategy** addresses choice of plant, location, scale of production, etc. **Marketing strategy** deals with the 7 Ps – product, place, price, promotion, physical evidence, people and public relations. **Finance strategy** governs capital structure, assets portfolio, risk-return trade-off, working capital management, etc. **Personnel strategy** is concerned with recruitment, selection, compensation, development and separation of human resources. And R&D strategy deals with R&D base, support,

NOTES

competitiveness, etc. **Functional strategies** are more action-packed. These should be clear-cut and address very specifically the 'how much' aspect.

Structure, Control, Information, Performance & Evaluation

Strategy implementation calls for an **organization structure, control mechanisms, information system, performance measurement and evaluation systems**.

Organizational structure gives the framework or lines of communication, authority, responsibility and accountability. Organizational structure specifies the firm's reporting relationships, procedures, controls and authority and decision processes. It is a critical component of effective strategy implementation process. Organizational structure provides for specialization and interfaces among specializations for collaborative synergism and competitive dynamism. For MNEs deciding the organization structure is very important because it cannot be the same for all units and at the same time cannot be just one design for all. Whatever the design, it must be organic enough to adapt to situations. The structure must have **stability** to facilitate day to day activities to go on consistently and **flexibility** to facilitate taking advantage of opportunities that environment throws up.

Control mechanism addresses the systems in place to ensure that the missions and goals are realized as planned. For MNEs there are special problems in control because of diversity of locations and cultural and environmental differences. Some kind of loose-tight phenomena are needed.

Information system provides connectivity with all outside, inclusiveness with all inside and certainty to all concerned. A real time, reliable information system works for the best of all. Information system depends on the structural pattern and control mechanism followed.

For MNEs with diverse geo-settings ratings of executives need to be fool proof. This calls for holistic **performance measurement**. What is performance? What are the thrust functional / strategic areas for which performance measurement is needed? What are the parameters of performance for each of the functional / strategic areas? How is performance measured? What are the adjustments in performance parameters called for contextual variations across different geo-settings of MNEs? There must be strategic purpose in performance measurement too.

Finally the **evaluation system** comes. Evaluation involves adjudging performance as outstanding or good or bad based on certain benchmarks or standards or targets or budgets. There are problems of choice of one or the other standard/benchmark for MNEs due to geo-differences? But an effective/acceptable evaluation is called for.

Formulation and implementation of different levels of strategies are linked. Corporate strategies are formulated and implemented first. This leads to formulation and implementation of business strategies. Then follow the formulation and implementation of functional strategies. The Board of Directors and CEO formulate corporate strategy, with implementation responsibility resting on the CEO. The CEO and functional heads formulate the business strategies, with implementation responsibility resting on the functional heads. Functional heads with own deputies and others formulate respective functional strategies, with implementation responsibility resting on the functional/divisional deputies. **Link-pins** are thus involved from one level up to the next down in the ladder to ensure **continuity and synergy**.

3.2. LEARNING OBJECTIVES

- To explain the concept and contents of global strategic management
- To present the nexus among Structure, Control, Information and Performance Evaluation
- To present the concept of, and issues in organizational structural (OS) designs of MNEs
- To deliberate on the basic patterns of Organizational Structures (OSs) of MNEs
- To present the features and assess the suitability of different traditional OSs such as Product OS, Functional OS, Area OS, Matrix OS, Project OS, etc.
- To examine OS Trends balancing opportunities for globalization and localization
- To present evolving OS like Net-worked OS, Spin-offs & Lead Subsidiary Organizations
- To present the issues in Location of Decision Making Power in MNEs – Pressures for globalization Vs localization & Capabilities of parent and local managers
- To discuss the Approaches to and aspects of Control
- To explain General Control Mechanisms
- To discuss Control in Special Situations
- To present Requisites of Controls in MNE's context
- To examine the Structure and Control Interface
- To give an overview of the role of Information systems
- To explain the Diverse forms of Information systems – BI, Metadata, MIS, ERP, ECM
- To discuss the Paradigm shift from product orientation to knowledge orientation
- To present the opportunities and challenges MNE's Information Systems
- To elucidate the Concept and Mechanics of Performance Measurement
- To discuss Various Financial Performance Indicators
- To discuss Various Non-financial Performance Indicators
- To discuss Various Key performance indicators
- To present the Concept and Types of Performance Evaluation
- To discuss the Evaluation Process: Evaluation activities and Dimensions
- To examine the diverse Need for or application areas of Evaluation
- To discuss features, types and uses of Benchmark System of Evaluation
- To discuss features, types and uses of Budgetary System of Evaluation
- To discuss features, types and uses of Standard Costing System Evaluation
- To discuss features, types and uses of Balanced Score Card System of Evaluation

NOTES

3.3 STRUCTURAL DESIGNS OF MNES

While it is becoming true that form must follow function, there are some traditional/classical organizational structures that are followed; besides new structures are experimented with. MNEs are having wide options, for different geo-locations may suit/dictate different structures. How much variety? How much uniformity? Variety in which aspects? Uniqueness in which aspects? Where variety? Where uniformity? How is the balance hit upon? These are certain issues that prop up right here. Structural designs are important for MNEs for they affect synergies, cost, control, responsiveness, competitive strength, etc. companies change structures to gain more and mitigate disadvantages. For instance, Nokia is gearing up for the future by altering its company structure starting January 2008. This initiative aims for '**greater effectiveness, speed up time to market for new products, and increase the efficiency** of its marketing and production efforts'.

3.3.1 Concept of, and Issues in Structural Design of MNEs

According to Bartlett and Ghoshal, MNEs are represented by units spread throughout the world that need to be coordinated or integrated in some form and to some degree. The differentiation and integration of units needs to be done with some attention paid to being **globally competitive, efficient, responsive and flexible to local needs and conditions** and being able to transfer their learning across units. In essence, MNEs are firms that need to be global and local (multi-domestic) at the same time. There are, however, varying levels of 'globalness' and 'localness' that MNEs need to achieve through appropriate organization structure.

Organizational structure is a representation of the formal reporting relationships within an organization and its affiliating entities. Organizational structure refers to the way that an organization arranges people and jobs so that its work can be performed and its goals can be met Organizational structure, according to **Stephen P. Robbins** is a composite term covering three important aspects namely, **differentiation, formalization and centralization**.

Differentiation: If we take differentiation alone, there are three dimensions, the horizontal, the vertical and the spatial. **Horizontal differentiation** arises due to differences in **orientation, nature, tasks, skills** of the organizational constituents. **Vertical differentiation** refers to the **depth** of the structure and the number of **hierarchal levels**. **Spatial differentiation** refers to the geographical spread of an organization. A multi-location, multi-nation organization like an MNE has all the three differentiation. With more locations and distances among them, spatial differentiation increases. Whatever the type of differentiation be, differentiation as a structural factor influences organizational style, culture, climate, decision orientation, etc. Greater the differentiation, greater is the complexity – complexity in communication, conduct, coordination and control of organizational functions. This complexity complicates flow of work and relationships. Size and

NOTES

differentiation go together; Task variety and differentiation go together; so do differentiation and complexity.

Is there a way out? **Matrix organization** is suggested. But it is branded as **'logical mess'** by **Thomas J Peters and Robert H Waterman Jr.,** as everything is hooked to everything else. These authors quote from the experiences of best-run companies in America that **simple form** is the one that **avoids complexity** and hence positively contributes to organizational functioning. It is a matter of conventional wisdom that simplicity gets off well whatever the situation is. The MNE, Johnson & Johnson, USA has proved to the world that size is not the factor that needs extremely differentiated structure. Have autonomous units. Instill the value you cherish among those units and let them have operational freedom. This results in amicable relations and a good performance too. Complex structures, matrix or otherwise, charges the climate with more heat, than light.

Formalization: The second structural aspect is formalization which refers to the adherence to set rules and procedures. Actually, **formalization tries to reduce the complexity and confusion** resulting from differentiation referred to above, by prescribing intended behaviour on the part of constituents. This helps in knowing and foreseeing behaviour of each by all and thereby helps to toning up one's own behaviour. So, formalization brings about understanding, a factor that positively affects organizational functioning. But, the point is that **all organizational functions cannot be formalized**; nor such formalization is desirable. **Over-done formalization makes the organization more mechanic/compartmentalized and less organic or social**. So, greater the dose of formalization, lesser the degree of adaptability to the emerging business order of extended competition. Organizational events are diverse and therefore require varying authority, practice, procedure and all, whereas formalization deprives all these and forces only rigidity. Is there a solution? Yes. Instead of specific rules and procedures, the structure should develop alternative approaches from which one can choose the right one or develop a mix as circumstances warrant. This sort of structural pattern gives both direction and freedom and thus creates a congenial climate for the functionaries.

Centralization: Centralization, namely the degree to which decision making is concentrated at a single or relatively a few points, is another aspect of structure. In a tight-centralized organization more is the degree of concentration of decision-making authority. What is the effect of this? Decisions are taken at points remote to their points of execution. The executives at the task points have to look up for orders and directions. In this sort of situations, the functionaries are reduced to mere media to carryout things, they having nothing to do with any aspect of the things carried out. A situational adaptation may be needed, but there is no way. A kind of 'militarization or regimental syndrome' results eventually. In course of time, a detachment sense would prevail in the whole of organization. Tom **Peters and Waterman Jr**. in their celebrated book, **'In search of Excellence'**, point out that most of the best companies really do view themselves as an extended family.

NOTES

Family means attachment, equity etc. Centralization spells detachment and hierarchy. The former breeds love, belongingness and an enduring congenial relationship, while the latter leads to distrust or bureaucracy or apathy. **Alvin Toffler** also rightly writes in his book, '**Third Wave'**, break the codes of which one is 'centralization'. Can we do away with centralization altogether? But that is not the solution or intention. We have to use it in appropriate measures.

Differentiation, formalization and centralization all no doubt give shape, orderliness and uniformity to organizations. But these are not all that always wanted. An over dose of any or all of these structural factors make the structure rigid, mere physical creations devoid of dynamism. If that results, organizations lose their charm, their synergistic effect and their human side. What can managers do about this? Managers generally inherit a certain structure from predecessors. If they find that the structure is rigid the same has to be loosened and if it is too loose it must be tightened a little. So, there is no either or dictum; nor destructuralization; it is a question of how much differentiation, formalization and centralization.

Specialty of MNEs: MNEs have all the varieties in the world. They can adopt varied patterns; but beware of faltering on the performance benchmarks or intended level of control. MNEs try to set up organizational structures with strategic intent in mind. The strategic intent is effective alliance with the environment or unfolding situations. The structure depends on many factors, including

The degree of multi-domestic, global & transnational policies employed, location & type of foreign facilities and extent of intended impact of global operations on total corporate performance influence structural diversities, uniqueness and nuances. The form of operation (out-sourcing or off-sourcing or otherwise), structure (wholly owned / JV / strategic alliance or otherwise), and location of operational units in specific locations at home and abroad will affect top-line, bottom-line, mid-lines like taxes and expenses and control thereon. Hence, the significance of organizational structure on the fulfillment of corporate objectives of MNEs in particular. Now certain major traditional and emerging organizational structural patterns of global operations of MNEs may be dealt.

Traditionally, organizations are structured along many factors, including history, organic growth, strategy, operational design, product diversity, logistics, marketing, client base, supplier base and so forth. Even these are classified as: Mechanistic and Organic structures. **Mechanistic structures** include centralized control and authority, clearly defined tasks, vertical communication links, obedience to supervisors, rigidity and inflexibility. The structures vary from **vertical or tall structures** with multiple hierarchies **to flat structures** with few layers. **Organic structures** involve decentralization of authority, tasks loosely defined, horizontal communications, greater individual authority, flexibility and adaptability. The structures vary from **loose structures** to **structure-free** forms as well. Structure apart,

NOTES

essentially what is important is lines of communication, systems of coordination mechanisms of control and schemes of evaluation which facilitate tangible progression of ideas from problem to solution in every domain. There must be **schemes of permeability** facilitating flow of creative ideas from teams working outside but linked into the organization.

Basic structural options

Between centralization and decentralization, between differentiation and unification and between formalization and in-formalization, we have certain broad choices. At one end of the continuum you have centralization, unification and formalization (total structured form) and the on the other you have decentralization, differentiation and in-formalization (total de-structured form). In between these polar versions, we have more structured forms, moderately structured forms and less structured forms. Table 3.1 below gives the features of the different patterns.

Table 3.1: Patterns of Organization of Mnes

Features of Organizational structures	**Different types of Organizations**			
	International	**Multinational**	**Transnational**	**Global**
Asset configuration & capabilities	Core endowments centralized, others decentralized	Decentralized; all entities self sufficient	Dispersed, interdependent and specialized	Global scaled and centralized
Role of overseas entities	Adapting and leveraging parent's strengths	Sensing and exploiting local opportunities	Pursuing diversities for group strength	Implementing uniformly parent's strategies
R&D Flow	From parent to subsidiaries	Localized preserves	Shared preserves	Centralized preserves

NOTES

Structure	Ethnocentric	Poly-centric	Region-centric	Geo-centric
Flexibility and Learning	Restricted learning and flexibility for the subsidiaries	Localized learning, unitized flexibility	Global learning, multi-domestic flexibility	Unified learning and principled flexibility across the board
Decision place	Only one decision point	At the subsidiary level, decentralized	Both centralized and decentralized	At the parent level, centralized

3.3.2 Traditional Alternative Structural Designs Of Mnes

The traditional structures of MNEs include: **Global Division Structure, Global Functional Division Structure, Global Product Division Structure, Global Geographic (Area) Division Structure and Global Client type.** A division is a business unit having a clear set of tasks, customers and competitors. A division can be independently planned for within the organization with profit and loss responsibility or dependent on the headquarters for directions with no direct profit and loss responsibility.

In the case of '**Global Division Structure'** foreign subsidiaries or JVs of an MNE reports to and get directions from a specific department or division of parent institution designated as the '**Global division or department.** A University might have a division for foreign students to take care of foreign students' enrollment, visa, integration, and graduation.

In the case of '**Global Functional Division Structure'** foreign affiliates of an MNE report to and get directions from different departments or divisions of parent based on the **specialization by function** like Finance, R&D, Production, Personnel and Marketing.

In the case of '**Global Product Division Structure'** foreign affiliating entities of an MNE report to and get directions from different departments or divisions of parent based on the **specialization by product lines** like Consumer appliances, Pharma products, photo goods, and industrial products or so.

In the case of '**Global Geographic (Area) Division Structure'** foreign affiliating entities of an MNE report to and get directions from different departments or divisions of parent based on the **specialization by geographic area** such as Europe, Middle-east, Far-east, North America or so.

NOTES

In the case of '**Global Client Division Structure'** foreign entities of an MNE report to and get directions from different departments or divisions of parent based on the **specialization by client type** like institutional, big retailers (hyper markets, Departmental store etc) and bulk consumers globally.

Most MNEs basically use one of these structures. Note that no structure is without drawbacks.

3.3.2.1 Global Division Structure

Global Division Structure of an MNE involves vesting the responsibility for total management of global business activities with one designated division or department called **Global Division.** Globally specialized personnel are placed in charge of the division to handle the diverse matters as export/import negotiations, export/import documentation, foreign-exchange transactions, relations with foreign governments, foreign subsidiaries' personnel management, foreign market promotion, etc. Most MNCs in their initial stages of globalization employed the 'Global Division Structure' covering certain regions of the world to supervise the functions in those regions. But conflicts could arise between the functional heads and the heads of the global division. Fig. 3.1 gives a simple model of Global Division Structure.

Randall S. Schuler, Peter J. Dowling, Helen De Cieri in their research paper in Journal of Management, Summer, 1993, observed that in the case of the Global division structure (design) the MNE basically **adds on a unit to deal with global business concerns**. The original organization structure is left intact. The global division becomes a unit that mirrors the domestic businesses of the MNE abroad. The key business decisions are made at the global headquarters, typically also the headquarters of the MNE. Knowledge is also developed at the center and dispersed where needed.

a. Issues in Global Division Structure:

Is the structure globally competitive, efficient, responsive and flexible to local needs and conditions? As the level of operation is minimal, the question of global competitiveness is too big to address. The structure is efficient as the headquarters is in full grip of the functioning of the affiliates. Responsiveness and flexibility to local needs and conditions may be only minimally facilitated in this type of operation, but local commitments are also minimal. Consequently, global human resource decisions may be primarily associated with selecting the head of global operation and then the expatriate who may be sent abroad to operate the global location. Of course more human resource issues do arise for the expatriate in charge of this location, but they tend to be modest compared with similar issues faced by MNEs selecting a global form of organization.

NOTES

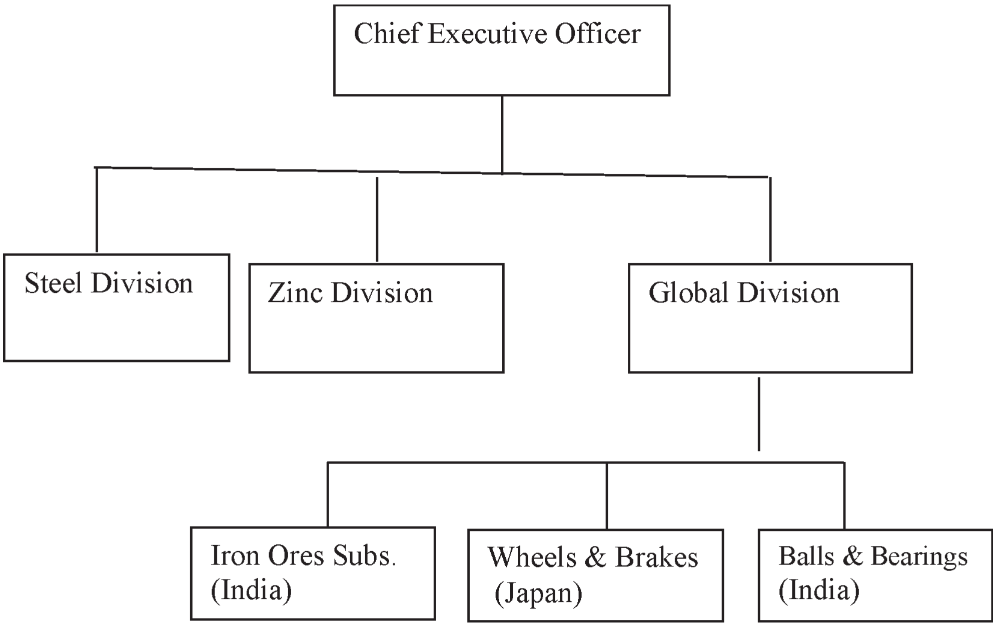


Figure 3.1 Global Division Structure

a. **Merits of Global Division Structure:** Global Division Structure prevents duplication of efforts in more than one place in the organization in the discharge of activities regarding foreign affiliates. Besides, when foreign business is not of big scale, this organizational form creates a large enough critical mass of activities so that personnel within the division can wield power within the organization to push for global expansion. In the initial stages of foreign exposure this form gives the MNE an opportunity for strategic focus through concerted close-line management involving dedicated efficient personnel.

b. **Demerits of Global Division Structure:** The global division has to depend on other domestic divisions of the parent for products/services, personnel, technology, and other resources for the promotion of the foreign activities. The domestic division managers may not cooperate with the global division personnel due to sheer egoism or due to the fact that they are usually not evaluated on the basis of performance of the foreign activities but only on the basis of achievements of their domestic divisions. Hence they may withhold their best resources from the global division to improve their own performances.

c. **Suitability of Global Division Structure:** This structure is probably best suited for multi-domestic strategies, where there is little integration and standardization between domestic and foreign operations. That is the global division is independent of domestic divisions in most decision areas. Global Division Structure is popular among U.S. MNEs, but not with the European MNEs. The reason is not due to cultural differences between USA and Europe. USA has a vast domestic market,

NOTES

reducing the size of foreign market for most MNEs, not warranting functional or product specializations. Hence the all-in-one global division is suffice. In the case of Europe any single European nation offers only a small domestic market. With big foreign market, the all-in-one global division is not the best form. With the EU common market with the common currency Euro, the scenario may change.

3.3.2.2 Global Functional Division Structure

An organization based on functions is the traditional and the most logical. **'Functional division structures'** involve grouping together functionally like-activities along functional lines like marketing, R&D, production, etc and place them under specialist classes of personnel. Functional heads of foreign affiliates communicate to and get communication from same functional specialists at the parent concern. Marketing people of the foreign affiliate report to marketing people of the parent or their order. Finance people of the foreign affiliate report to finance people of the parent or their order and so on. But a firm offering many product lines will find this structure less successful. Fig. 3.2 gives a simple model of Global Functional Division Structure.

a. Suitability of Global Functional Division structure: Global Functional divisions are suitable when product/service range offered by both the parent and the subsidiaries are few resulting in undifferentiated production and marketing methods among them. For automobile firms, oil refining firms, etc this structure suits well. Horizontally integrated multinational enterprises like McDonalds / Pepsi which produce the same or similar products follow this structure and their establishments located in different countries report on functional structural lines.

For diversified entities offering different products/services this structure becomes cumbersome or less suited. Westinghouse which produces more than 8,000 different products in such diverse areas as real estate, finance, nuclear fuel, television production, electronics systems, and soft drink bottling, it is difficult to imagine that the production head knows intricacies of production of all the products. Oil and mineral extraction companies, such as Exxon use this structure, which is ideal when products and production methods are basically undifferentiated among countries. Under this structure, coordination is left to top management, with functional heads pursuing their responsibilities with tunnel vision orientation, unless otherwise advised by top management.

b. Merits of the Global Functional Division Structure: Some advantages of the functional structure are:

i. The structure is simple and clear, making communication lines distinct and direct

ii. Reduces overhead

iii. Provides clearly marked career paths for hiring and promotion

NOTES

iv. Employees work alongside colleagues who share similar interests

v. This structure is suited for globalized firms, providing further synergies of specialization.

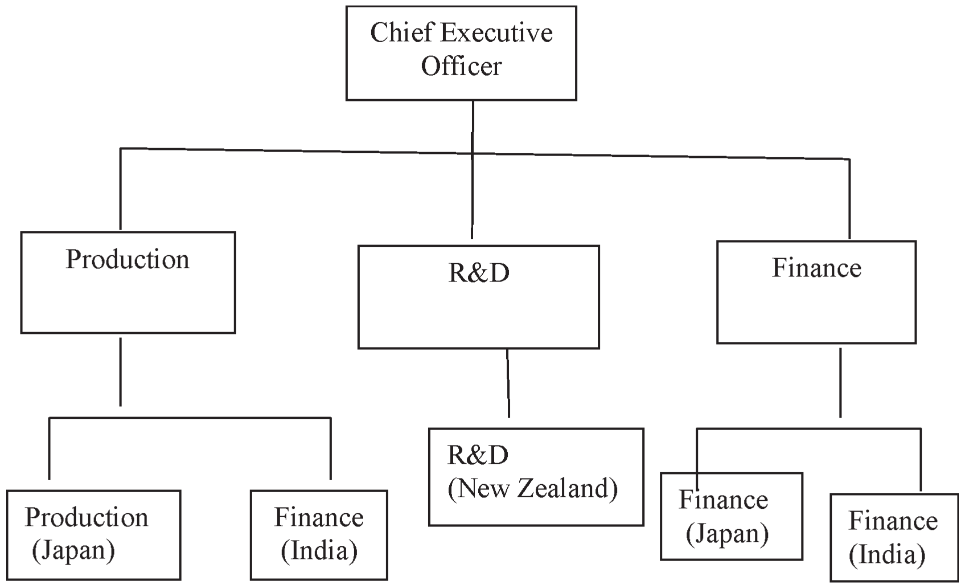


Figure 3.2 Global Functional Division Structure

c. Demerits of the Global Functional Division Structure: Some disadvantages of the functional structure are as follows:

i. Coordination of functional tasks is difficult

ii. Little reward for cooperation with other groups, making coordination difficult to achieve

iii. Provides scope for different functional heads to disown (pass the buck) project failures

3.3.2.3 Global Geographic (Region / Nation / Area) Division Structure

With large foreign operations that are not dominated by a single country or area including the headquarters, but well spread out geographically MNEs use geographic divisions. Global Geographic (Region / Nation / Area) Division Structure is more common to European MNEs, such as Nestle. Nestle uses this structure because no one region dominates its operations.

a. Merits of Global Geographic (Region / Nation / Area) Division Structure

The structure is useful when **maximum economies** in production can be gained on a regional rather than a global basis because of market size or the production technologies for the industry. A global geographic structure puts managers closer to the scene of operations than are managers at central headquarters. Regional managers are well positioned to be **responsive to local situations** such as the needs of regional customers and to fluctuations in resources. Thus regional divisions are often able to find solutions to region-specific problems and to use available resources more effectively than are managers at corporate headquarters. This structure **facilitates teamwork**. People are sometimes able to pool their skills and knowledge and brainstorm new ideas for products or improved customer service. This structure **facilitates decision making** as divisions develop a common identity and approach to solving problems. This increases cohesiveness and the result is improved decision making.

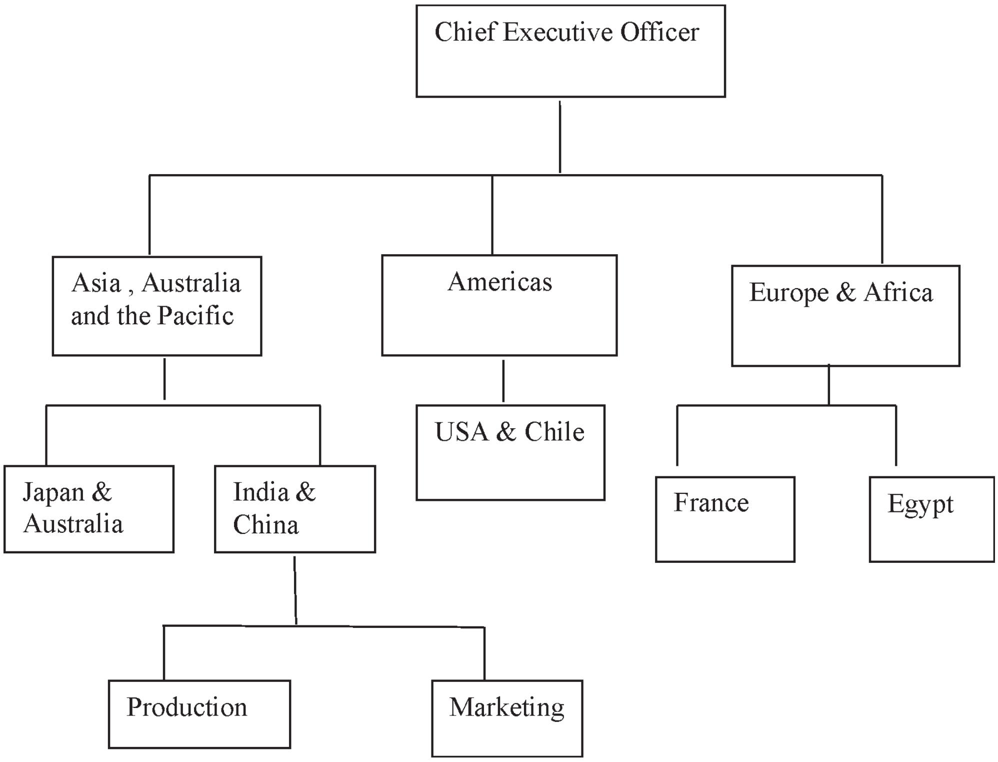


Figure 3.3 Global Geographic Division Structure

b. Demerits of Global Geographic (Region / Nation / Area) Division Structure

A drawback is possible costly duplication of work among areas. For example, Ford abandoned its geographic structure in favor of a product division structure because of costly design duplication between Europe and North America. Each geographic division.

c. Suitability of Global Geographic (Region / Nation / Area) Division Structure: An organization facing the problem of controlling its activities on a national or global level is likely to use a geographic structure and group functions into regional divisions to service customers in different geographic areas. Each geographic division has access to a full set of the functions it needs to provide its goods and services.

NOTES

3.3.2.4 Global Product Division Structure

Global Product division structure contains the functions necessary to the specific goods or services a product/service division produces. The parental organization has headquarters divisions for different major product categories with respective resources, human and others. Overseas subsidiaries producing a particular product or class of product have to report to headquarters division responsible for that product or class of products. Global Product Division Structure locates manufacturing and value creation activities in appropriate global locations to increase responsiveness to competitive opportunities, efficiency, quality, or innovation. Global product divisions are responsible for Global Product Design and operate in divisional, cluster, or holding company formats. Global Product divisions have little in common. They are highly independent of each other. Fig. 3.4 gives a simple model of Functional Division Structure.

Microsoft adopts the global product division. Until 2005 it had 7 product group divisions. Now, it rationalized its **original 7 business groups** into **3 core divisions** namely:

i. **Microsoft Platform Products and Services Division** covers the Windows Client, MSN and Server and Tool groups.

ii. **Microsoft Business Division** covers the Information Worker and Microsoft Business Solutions group.

iii. **Microsoft Entertainment and Devices Division** covers the Mobile and Embedded Devices and Home and Entertainment groups.

Ford adopts this structure, abandoning its geographic structure. Today most of the multinational enterprises with their diverse acquisitions world-wide have diverse product portfolios. They mostly adopt product structure as that offers certain great synergies.

a. Merits of Global Product Structure

The merits of Global Product Structure are as follows:

Global vision is articulated effectively because of exposure to diverse consumption conditions world-wide to draw insights for new products. Product division structure increases the specialization of work such that the number of similar products can be increased. The structure helps in expansion into new markets and production of totally new kinds of products. **Resource leverage** is another advantage. This is especially true of intellectual resource. Committed R&D for different product lines possible and new perspectives is shared with all units of the product class. Vertical knowledge sharing within the product division is inherent in this organizational pattern. **Strategic focus** is a great advantage, because every product line concentrates on its domain with focused attention rather than scatted concerns. **Other advantages** abound. Simplicity, accountability, standard product

NOTES

introductions, enhanced speed and decision quality, self-contained product development and introduction, development of talent, low interference from other divisions are other advantages.

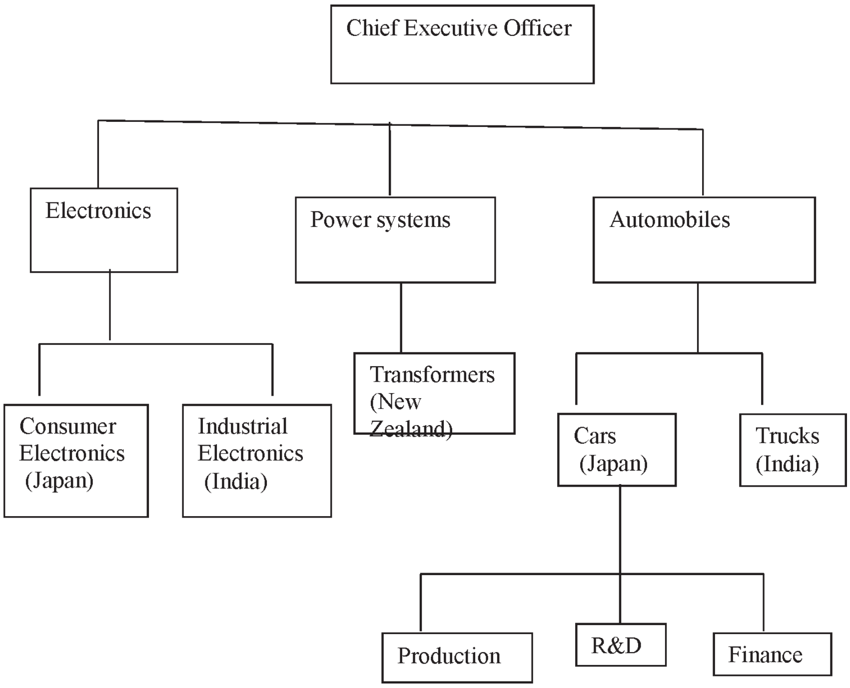


Figure 3.4 Global Product Division Structure

b. Demerits of Global Product Structure

The demerits of Global Product Structure are as follows:

Horizontal knowledge sharing across different product lines **is conspicuously absent**. **It is too** difficult to organize communication across divisions. There is no formal means by which one product division can learn from another's global experience. There are **duplicated** functions among the product divisions. Different subsidiaries from different product divisions within the same foreign country will report to different groups at headquarters. There is **little cooperation** between divisions. It is costly to maintain across the globe. Due to scale differences of different product lines in different geographies, it may become necessary to club product lines in a market, but that is not possible because at the headquarters the product lines are under different product structures. **Synergy is lost** within countries if different subsidiaries don't communicate with each other or to a common manager. For instance, at one time in Westinghouse, one subsidiary was borrowing funds locally at an exorbitant rate, while another in the same country had excess cash.

c. Suitability of global product structure

MNEs with vastly diversified product/service portfolio go for product organization structures. Westinghouse with more than 8,000 different products in diverse areas adopts this structure. The product division structure is well-suited for a global strategy because

NOTES

both the foreign and domestic operations for a given product report to the same manager which helps in achieving synergies by sharing information on the successes and failures of each, sharing resources – human or otherwise, and sharing core competencies. American MNEs use this structure well more than the European MNEs.

3.3.2.5 Global Project Team Structure

A project division unlike a product/functional/geographic division has a fixed time frame of work. Once the project execution is over, that particular division ceases to exist. An MNE might be a project concern taking up project executions globally. As any project involves works with many requirements that are not confined to one or more of the functions, an organization structure that is project based is followed. The project execution requires cooperative efforts of marketing, production, engineering, and others as appropriate; as well as assistance from the accounting legal and contracting staffs. Usually a dynamic and capable person from the upper levels of middle management is selected to take responsibility for this unique activity. The project is organized around this project manager, and then a few specialized assistants are provided and a project team is formed. The project manager exercises direct and autonomous control over the various discipline groups and is responsible for the coordination and monitoring of the effort of the team. Since most major organizational functions will be affected by this team, it is typically removed from the functional organization's structure.

A project organization is needed when multiple projects are involved, each managed by distinct project teams. Global Project team structure consists of autonomous project teams with independent responsibility for implementation of the projects on hand. There could be different project teams to take up different projects. Project teams are assembled for projects under the action of the firm. Figure 3.5 gives the project organization structure of an MNE managed by project organization.

The construction teams - Airports, Seaports, Multiplexes, Townships and Dams/ Bridges and power project teams – Nuclear, Wind, Hydro, Thermal and Tidal, are independent entities. Each will have to be supported by functional divisions namely Procurement / Fabrication, Finance, Marketing, Personnel, R&D and Logistics on the one hand and geographic heads of North America, South & Central America, Europe, Asia & Australia and Africa. Besides, the geographic heads and functional divisions interact.

NOTES

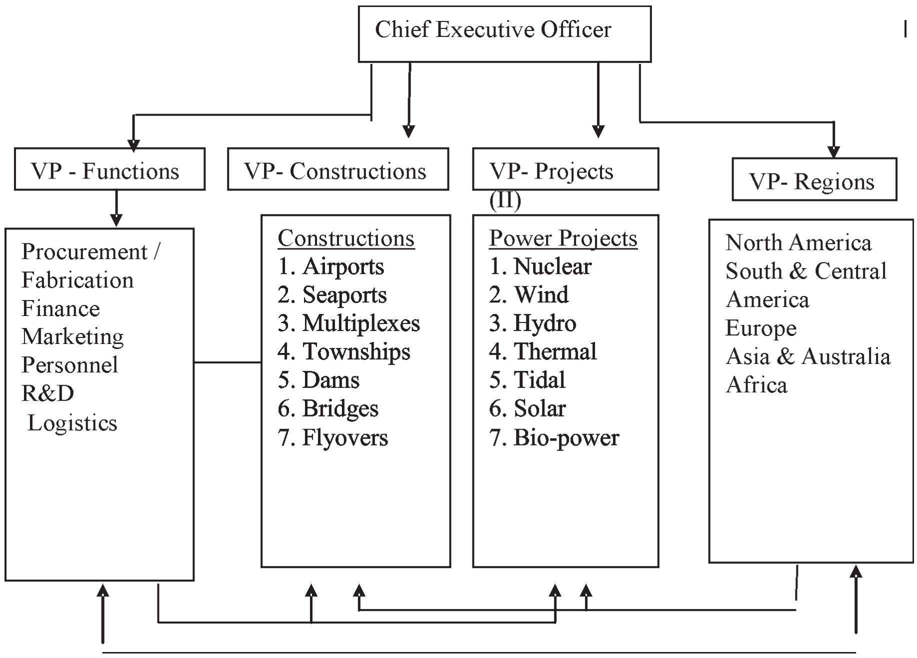


Figure 3.5 Global Product Division Structure

a. **Merits of Project Organization**

A project organization has certain merits over other forms of organization structure. These are: i. Good at responding well to immediate project needs; ii. Flexibility; iii. Responsibility for success of project clearly fixed; iv. Releases top management from micromanaging operations, so that the management can focus on the overall company strategy rather than detailed nuts and bolts; v. Specialization benefit flows throughout the organization.

b. Demerits of project team structures

A project organization has certain demerits over other forms of organization structure. These are: The actual organizational power and authority of the team manager may be a delicate issue. There involves greater administrative overhead. In-group (those with the project responsibility) Vs. Out-group (those with the functional / geographic responsibility) mentality may develop.

3.3.2.6 Global Matrix Division Structure

A matrix structure involves horizontal, vertical and diagonal flows of responsibilities. Mathematically arrangement of anything by rows and columns is called matrix structure. In a matrix organization the products or projects may be the column element, while the horizontal or row elements might be the functional lines of production, marketing, etc. Third dimensionally, the geographic responsibilities might run. Matrix structure is a combination of two or more different structures. Hence it is taken up as a last item of our presentation

NOTES

here. Thus in a global matrix organization structure a foreign subsidiary reports to more than one group, namely product/project, functional or geographic. Fig. 3.6 gives the Matrix structure of an MNE.

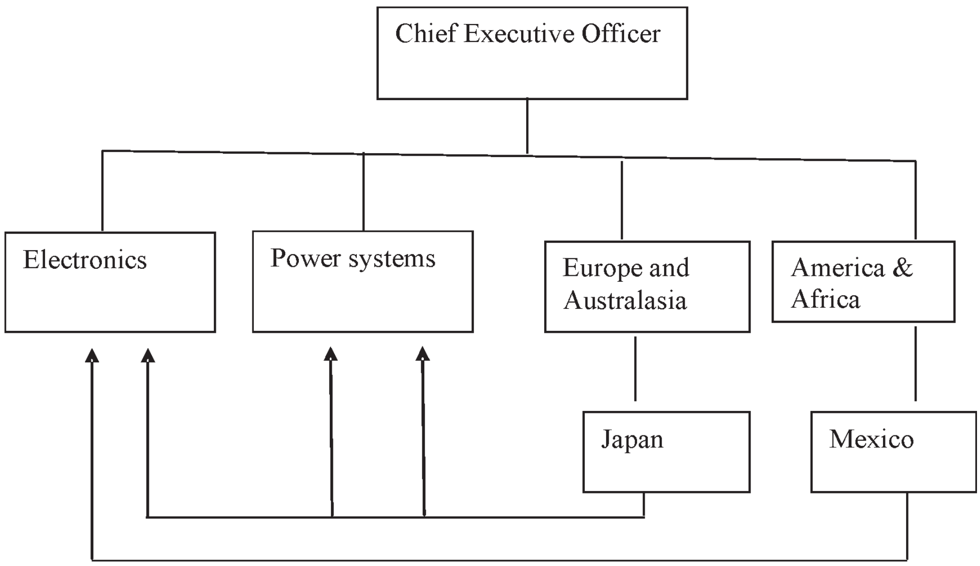


Figure 3.6 Global Matrix Division Structure

Large multinational corporations that use a matrix structure most commonly combine product groups with geographic units. Product managers have global responsibility for the development, manufacturing, and distribution of their own product or service line, while managers of geographic regions have responsibility for the success of the business in their regions.

Each group shares responsibility over foreign operations. Amongst the groups more interdependence leading to exchange of information and exchange of resources with each other takes place. In that context, product-group managers compete amongst themselves to ensure that R&D personnel responsible to a functional group, such as production, also develop technologies for product groups. These product-group managers also must compete to ensure that geographic-group managers emphasize their lines sufficiently. Not only do product groups compete; functional and geographic groups also must compete among themselves to obtain resources held by others in the matrix. The amount of resources for development of electronics products in Mexico depends partly on the competition between the America-Africa group and the Europe and Australasia group and partly on the competition between the electronics group and the power systems group for resources. The Global Matrix Structure contains simultaneous, intersecting differentiation bases, with employees reporting to functional and product managers simultaneously. The organization's top management must take particular care to establish proper procedures for the development of projects and to keep communication channels clear so that potential conflicts do not arise and hinder organizational functioning.

NOTES

PepsiCo is organized by product lines-soft drinks and snacks-which would seem to imply that each product line is integrated globally. However, each line has its own global division, which separates it from domestic operations. Thus a global matrix structure is followed.

a. Merits of Global Matrix Organization

One advantage of a matrix structure is that it facilitates the use of **highly specialized staff and equipment**. Rather than duplicating functions as would be done in a simple product department structure, **resources are shared** as needed. In some cases, highly specialized staff may divide their time among more than one project. In addition, maintaining functional departments promotes functional expertise, while at the same time working in project groups with experts from other functions **fosters cross-fertilization of ideas**.

b. Demerits of Global Matrix Organization

The disadvantages of a matrix organization arise from the **dual/multiple reporting structure**. **Power struggles** between the functional and product managers or between the product and area managers can prevent successful implementation of matrix structural arrangements. Another drawback relates to groups' **competition for scarce resources** and display of their preferred operating methods. Upper management may favor a specific executive or group and as others in the organization see this occurring, they may perceive that the locus of power lies with a certain individual or group. Consequently, other group managers may think that pushing their own group's unique needs is futile, thus eliminating the cross fertilization of viewpoints that a matrix is supposed to bring.

A superior may neglect control of subordinates because of assuming wrongly that someone else is overseeing them. Say, managers in the America-Africa group might not pay close attention to day-to-day Mexican electronics operations because they assume that managers in the electronics division are doing this. Meanwhile, managers in the electronics division may wrongly assume that managers in the America-Africa group are overseeing the electronics operation in Mexico closely.

This kind of false assumption that someone else was handling the responsibility was a factor in the loss of control and the demise of Barings Bank, oldest merchant bank in London with which even the British Queen kept her accounts, in 1995. Barings Futures Singapore 's (subsidiary of the Barings Bank, London) management structure through 1995 enabled Leeson, the account head as well as floor head for trading, indulging in reckless speculation without supervision from London headquarters. Leeson was not only the floor manager for Barings' trading on the Singapore International Monetary Exchange, he was also the head of settlement operations, charged with ensuring accurate accounting for the unit. Normally the positions would have been held by two different employees. As trading floor manager, Leeson reported to an office (head of settlement operations) inside

NOTES

Barings Bank which he himself held, which short-circuited normal accounting and auditing safeguards For these reasons, some companies that adopted dual-reporting systems have gone back to conventional structures with clear lines of responsibility, including Dow Chemical, Digital Equipment, and Citibank.

3.3.2.7 Structure tends and Trends

Though organizational structures tend to depict certain kind of rigidity, structure tends to change and new trends emerge.

Mixed Nature of Structures

Because of growth dynamics, companies change their organizational structures. Simplified organizational structures get replaced by complex or mixed structures. Until organizational re-structuring is made, new acquisitions might report to headquarters. Circumstances prevailing in a particular country, product, or function might necessitate separate handling until a re-structuring is effected, apart from the overall structure. The structure of 100% subsidiaries is different from that of JVs. 100% subsidiaries enable a deeper network of communications. Overall structure may be incomplete and less revealing. PepsiCo is organized by product lines, namely soft drinks and snacks. This would seem to imply that each product line is integrated globally. However, each line has its own global division, which separates it from domestic operations.

Structures evolve to suit growth and need

A company that only exports can afford just with an export department attached to a product or functional division. You may note departments are sub-divisional. But if global operations continue to grow and off-shore production is felt needed export department may no longer be sufficient. A global division replaces the department. In due course global division gives way for geographic divisions. Later with sustained growth, geographic divisions goes off, matrix structures come up. Fig. 3.7 gives the change from global division to other forms as MNEs grow in size, stature, complexity and the like. The need and opportunities for being globalized and localized are the two opposite forces. Ultimately a matured MNE will blossom into a TNC. There are two alternative routes. From overtly localized structures it may pull itself up to become a TNC structured. Else, from an overtly globalized structure it may bend itself down a little to become a TNC structured as depicted in the fig. 3.7. There is the golden mean route that traverses in upward slope diagonally taking Matrix structure, MNC structure, Global company structure and finally TNC structure.

NOTES

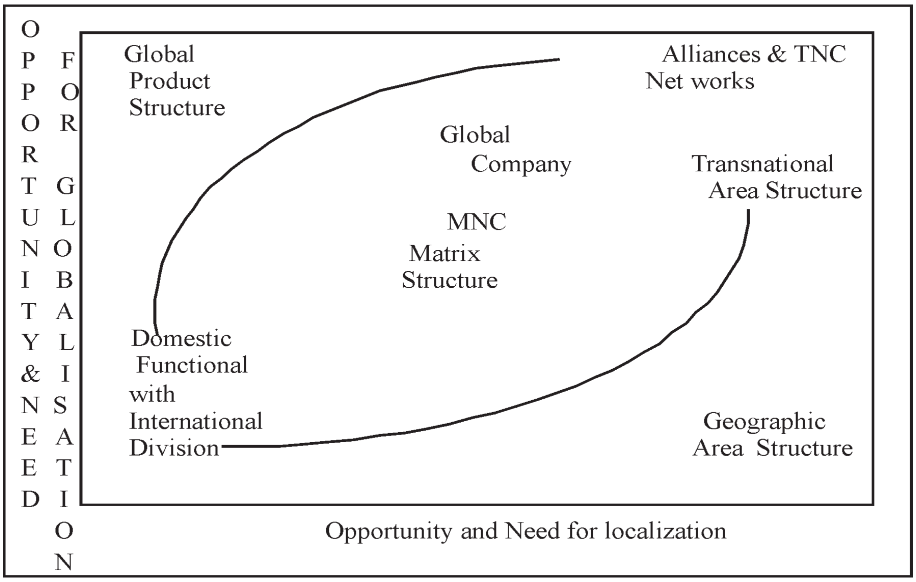


Fig 3.7: Structures with Need and Opportunities for Globalization and Localization

3.3.3 Evolving Alternative Structural Designs Of Mnes

As companies grow in size, product lines, and dependence on foreign operations, complications of communication, responsibility and control become more complex. So, new structures continue to evolve to deal with this complexity. Proctor & Gamble (P&G) restructured its operations in 1999. The mantra is, 'Think globally and Act locally'. P&G formed a unique concept of 'Global business Product Units' (GBUs) and 5 such units were established. With the 5 GBUs P&G wants to build its global brand equity as part of its 'global strategic thinking'. At the same time 7 Market Development Organizations along the lines of major regions of the world were made to facilitate flexibility in the sphere of local actions. Thus it 'thinks global, acts local'. There are numerous cases like this. But few general forms are alone dealt here.

3.3.3.1 Network Organizations

Prof. H.V. Perl mutter made out in 1969 that MNEs adopted organizational structures that fell in a continuum of ethnocentric to polycentric models and he advocated the geo-centric mind-set. The 1980s witnessed extensive discussions of network-based MNC models especially by Prahalad and Doz in 1987, Bartlett and Ghoshal in 1989 and White and Poynter in 1990, building on Perl mutter's geocentric model. Network-based models have been characterized as reflecting an integrated worldwide strategy through globally distributed but interdependent resources and activities.

The world is made up of interdependence unlimited. In such a world we all build a network alliances or relationships. MNEs must decide what products, functions, and

NOTES

geographic areas they want to handle themselves and what they wish to outsource. As to tasks handled by them the MNEs can have clear superior-subordinate relationships, known as hierarchies. In dealings with others the superior-subordinate line is not clear. Instead of line relationship a network relationship emanates. The location of control in a network alliance is ambiguous and is known as a 'heterarchy'. When shared ownership/responsibility exists such as in a joint venture or strategic alliance, there is usually a heterarchical relationship.

Corning Incorporated, a global corporation with manufacturing facilities around the world, is reliant upon a vast network of suppliers. It values these relationships as these are critical to its success. Corning ensures that every aspect of its operations is conducted with respect for the laws, customs and cultures of the regions we serve. Thus Corning is a good example of a heterarchy. Further half of its earnings come from alliances, particularly joint ventures. Corning management cannot dictate what its alliance partners must do. Instead, it serves as a broker, conflict negotiator, and facilitator for them.

Many Japanese companies are known for their net-works or what is called in their vernacular as keiretsus. A keiretsu is a common feature of Japanese corporate governance and refers to a collaborative group of integrated companies with extensive share crossholdings, personnel swaps and strategic co-operation.

Mitsubishi Group of Companies, or Mitsubishi Companies is a Japanese conglomerate consisting of a range of autonomous businesses which share the Mitsubishi brand, trademark and legacy. The Mitsubishi group of companies forms a loose entity, the Mitsubishi Keiretsu. The top 25 companies are also members of the Mitsubishi Kin'yMkai, or "Friday Club", and meet monthly. Mitsubishi Mitsubishi Corporation, Kirin Brewery, Mitsubishi Electric, Mitsubishi Fuso, Mitsubishi Motors, Nippon Yusen, Nippon Oil, Tokio Marine and Fire Insurance, Nikon, Hino Motors networks in which each company owns a small percentage of other companies in the network. There are long-term strong personal relationships among high-level managers in the different companies, and the same directors often serve on more than one board. Sometimes *keiretsus* are vertical, such as that between Toyota and its parts suppliers. Sometimes they are horizontal. Managers can exchange information that is useful to more than one company, underwrite each other's financing, and gain more clout when lobbying for governmental legislation.

3.3.3.2 Spin-Off Organizations

A spin-off (or spinoff) is a new organization or entity formed by a split from a larger one. In a pure spin-off, a parent company distributes 100% of its ownership interests in a subsidiary operation as a dividend to its existing shareholders. Carved out or partial spin-off is one where the parent corporation sells to the public an interest of less than 20% in the new subsidiary in a registered initial public offering for cash proceeds. Often, an IPO in which the parent company retains a majority interest in the new company, may be a prelude

NOTES

to a spin-off of the remaining interests to existing shareholders. Companies utilize a partial spin-off strategy for a number of reasons.

New product development through spin-off: One objective of spin-off company formation is 'new product' development. New product champions endeavor to develop new products or services. These new products or services normally do not fit in the existing competencies. Parent companies create 'spin off' companies exclusively to exploit the potentials of these new products or services holding substantial, if not whole ownership. At the same time new learning emanating from the spin-off s gets percolated into the MNEs as such. Johnson & Johnson, Raychem, and Thermo Electron have spun off companies that subsequently have operated almost independently. The spin-offs differ from product structures, because they are independent and have to satisfy their stockholders, including the parent MNEs. Japanese MNEs have historically used spin-offs. Note that the Toyota Motors is actually a spin-off of the Todota Automated Loom-works.

New company development through spin-off: Industrial Technology Research Institute (ITRI) of Taiwan since 1979 until 2000 created a number of spin-off companies. R&D programs at ITRI that have grown into sizable businesses are spun off as independent companies. The first such spin-off company, United Microelectronics Corporation, was created in 1979 to seed the growth of IC industry in Taiwan. Since then, five other companies have been spun off from ITRI: Taiwan Semiconductor Manufacturing Company, Evergreen Super Alloy Corporation, Taiwan Mask Corporation, Vanguard International Semiconductor Corporation, and New Faith Technology Corporation. The spin- off program is an efficient way for ITRI to transfer research results to the industrial sector for production and services. Typical cases in which a spin-off company may be founded are described below. Occasionally ITRI develops technologies with the potential to generate significant growth in domestic production, but which cannot be transferred to the private sector, for either the relevant industry does not exist or existing manufacturers are unable to apply the technologies efficiently and profitably. In such cases, ITRI will spin off an independent company to utilize the new technologies. The objective of spin-off companies is to generate new domestic industries. These businesses require massive infusions of capital and manpower, most of which are supplied by ITRI with support from outside investors. Spin-off companies are created only when they are unlikely to monopolize an important technology or impede other firms' application of the technology.

Growing commercial research and intellectual property through spin-off: In UK spin off companies seek to establish link with educational institutions to harness virgin knowledge. Links between spin-off companies and higher education are flourishing. The number of spin-off companies with links to higher education institutions (HEIs) is on the rise, with growing commercial research and intellectual property income underscoring higher education's key role in the economy.

NOTES

3.3.3.3 Lead Subsidiary Organizations

A subsidiary's capability could be its skill in developing and manufacturing a product line better than a headquarters' division. Such a subsidiary is referred to as **Lead Subsidiary**. Subsidiaries that take on a more demanding leadership role in a region, and in the parent's global network, can add considerably more value to the parent firm worldwide. An MNC's leading subsidiaries can make this happen. Leading subsidiaries can take on global and regional responsibilities for R&D, manufacturing, product management, and key marketing functions. Certain companies have moved the headquarters of certain divisions to foreign countries, because they felt that competency for cutting edge innovations and products could as well originate from subsidiaries.

Pratt & Whitney is a pioneer in flight and in technology which made it possible to fly around the world in wide-bodied comfort. Over the years, it has patented hundreds of innovations, from heat-resistant coatings to aerodynamic blades – technologies that make air travel more cost effective, more comfortable and more dependable. Today, Pratt & Whitney engines power nearly half of the world's commercial fleet. Every few seconds – more than 20,000 times a day – a Pratt & Whitney-powered airliner takes flight somewhere in the world. Headquartered in East Hartford, Connecticut, USA Pratt & Whitney created a lead subsidiary, Pratt & Whitney Canada which manages a critical line of engines for P&W worldwide. Similarly AT&T moved its corded telephone division from the United States to France, Siemens moved its air-traffic management division from Germany to the United Kingdom, Hyundai shifted its personal computer division from Korea to the United States, Panasonic in Spain handles key aspects of pan-European strategy and the Finnish company Nokia built its capabilities for a telecommunications product in the United Kingdom. Although these divisional headquarters are still accountable to corporate headquarters, other global operations, including those in the home country, must report to them.

3.3.4 Location of Decision Making Power in Mnes

Where does the decision making power rests? Is the decision power vested with the parent's headquarters or with the subsidiary? Decisions made at the foreign-subsidiary level may be considered decentralized, while those made above the foreign-subsidiary level, that is the parent level, are considered centralized. The location of decision making power may vary within the same company over time as well as by product, function, and country. In addition, actual decision making is seldom as one-sided as it may appear. A manager who has decision-making authority may consult other managers before exercising that authority.

Centralized decision making is a global strategy while decentralized decision making is a multi-domestic strategy. A combination of the two is called a transnational strategy. The reason for choosing one over the other is partly a function of companies' attitudes. For

NOTES

example, an ethnocentric attitude would influence a company to develop competencies, such as knowledge and technology, in its home country and control how they are transferred aboard. A polycentric attitude would cause the company to delegate decisions to foreign subsidiaries because headquarters personnel believe only people on the spot know best what to do. Multi-domestic attitude encourages this. A region-centric attitude would permit more openness to capabilities either at home or abroad and be conducive to a transnational strategy. A geocentric attitude would be conducive to a global strategy where core decisions lie with the headquarters.

According to **John D Daniels and Lee H Radebaugh,** companies choose the locus of decision power based on a combination of three trade-off's:

i. Balancing pressures for global integration versus pressures for local responsiveness

ii. Balancing the capabilities of headquarters versus subsidiary personnel

iii. Balancing the expediency versus the quality of decisions

These are dealt below.

3.3.4.1 Pressures for Global Integration Vs Local Responsiveness

Pressure for global integration leads to centralized decision structure and pressure for responsiveness to local conditions leads to decentralized decision making. The factors that influence are: **Resource transference, Standardization, Systematic dealings with stakeholders, Transnational strategy and Ad-hoc strategy.** These are dealt now.

a. Resource Transference

Resource transference decisions are centralized. A company may want to move its resources-capital, personnel, or technology-from its facilities in one country to its facilities in another where the projected return is higher and consequently improving the MNE's global or overall performance. This saves cost, biases and time in decision making. A centralized info-pool with the parent saves cost. Decision away from the subsidiaries avoids biases. Timely decisions are possible as vested interests aren't buying time to push through their hidden agenda. Royal Dutch/Shell centralized financial control of U.S. operations that were once handled autonomously by its subsidiary, Shell Oil, in the United States for the reason of biases by the subsidiary to retain the control with itself. If a subsidiary is not part of a company's integrated operation, because it operates in a highly protected market, there is little need for centralized control. Another centralized decision in resource transference may concern jurisdiction over exports. If a company has manufacturing facilities in the United States and Germany, which facility will export to South America? A centralized decision avoids costly price competition between the subsidiaries and considers other vital

NOTES

factors like production costs, transportation costs, tax rates, foreign-exchange controls, production capacity and so on.

b. Standardization

Variety costs high for mundane activities, while uniformity reduces cost. Worldwide uniformity of an MNE's products, purchases, methods, and policies reduces its global costs substantially. If an MNE standardizes machinery in its production process, cost saving arises from quantity discounts on purchases, consolidation of mechanics' training, maintenance of manuals, and carrying of spare parts inventories. Product uniformity gives a company greater R&D thrust, flexibility in filling orders when supply problems arise, advertising and so on. But there are situations where standardization is not needed like GE's jet engines require no local adaptation. There are situations where adaptation is needed like food products of Nestle or McDonalds. Problems arise only when wanted adaptation/ standardization could not be provided or when unwanted adaptation/standardization is thrust upon.

c. Systematic Dealings with Stakeholders

Stakeholders abound these days for businesses. Companies deal with government officials, employees, suppliers, consumers, environmentalists, consumer activists and the general public Favoring one group is disliked by others if the same or similar favor is not extended to them also. Similarly companies may face a dilemma if they can't afford concessions in one country offered offering the same in other country. Thanks to increased mobility of people. A good or bad experience with a product in one country may eventually affect sales elsewhere. Even pricing and product decisions in one country can affect demand in other countries. If prices differ substantially among countries, consumers may even find that they can import more cheaply than they can buy locally. Centralized decision making is necessary to ensure that operations in different countries operate toward achieving global objectives. Global competition also leads to centralized decision. A user MNE recommends its subsidiaries to place orders with particular supplier with whom deals are superior. Thus centralized decision making happens. However, in some cases the subsidiary may be the best place to make decisions about the customer or competitor. When IBM's top management feared that its eroding Japanese market share would spill into other markets because Japanese competitors would have resources and confidence to fight IBM elsewhere, it gave its Japanese subsidiary decision-making power. The subsidiary increased its manufacturing capacity substantially, and it developed new products specific to the Japanese market.

d. Transnational Strategy

The pharmaceutical companies have a strong need for integration- that is centralization, because they depend on the sale of undifferentiated products for which scale of production

NOTES

is important to cover the high cost of product development. This is their geo-centric form. But, nevertheless, companies need high local responsiveness due to different purchase and distribution regulatory scenario in different countries. Companies have established various practices to improve the flow of information. ABB has a sophisticated information retrieval system that disseminates information about 1,300 entities in its federation of companies to each of these entities. At 3M's European operations the company has given incentives for country subsidiaries to work together on key accounts. Ford is linking its design groups in North America and Europe through videoconferencing and computer networks in the development of new automobile designs. These are centralized decisions with regional flavor.

e. Ad Hoc Strategy

Companies that gain little from global integration, and also have little need to adapt to local conditions may either centralize or decentralize, depending on such factors as the experience and competency of the personnel at headquarters compared to subsidiaries.

3.3.4.2 Capabilities of Headquarters Vs Subsidiary Personnel

The decision to centralize or decentralize also depends upon management's perception of the competence of corporate versus local managers. Decision power must vest with competence. Of course as competence level changes, locus of decision power also changes. Traditionally some decisions are reserved for corporate management to the chagrin of some local managers who perceive their domain has been eroded. If local managers are not allowed to participate in developing global strategies, they distance themselves from implementing global strategic decisions. But there are many ways in which subsidiaries can have autonomy over certain activities, such as developing a specific product or technology or conducting certain market testing. European scientists working at Pfizer's small U.K. laboratory have been responsible for many of Pfizer's discoveries.

3.3.4.3 Decision Expediency and Quality

You want quick decision or good decision? Quick decision is referred to expedient decision and good decision is called quality decision. Sometimes, a poor decision is better than a good one that comes too late, provided no cascading problem takes place.

The problem with centralized decision making is the time and expense despite better decision possibility with corporate managers. How much can we lose through a bad decision? The greater the potential loss and the more important the issue, the higher in the organization the level of decision making usually is. In the case of marketing decisions, local autonomy is there for advertising, pricing, and distribution, but not for product design.

NOTES

QUESTIONS TO CONTEMPLATE AND DELIBERATE

Q 1.3. a. Explain the concept and contents of global strategic management

Q 1.3. b. Present the nexus among Structure, Control, Information and Performance

Q 1.3. c Explain the concept and issues in organizational structural (OS) designs of MNEs

Q 1.3. d. Deliberate on the basic patterns of Organizational Structures (OSs) of MNEs

Q 1.3. e. Present the features and assess the suitability of Product OS

Q 1.3. f. Present the features and assess the suitability of Functional OS

Q 1.3. g. Present the features and assess the suitability of Area OS

Q 1.3. h. Present the features and assess the suitability of Matrix OS,

Q 1.3. i. Present the features and assess the suitability of Project OS

Q 1.3. j. Examine OS Trends balancing opportunities for globalization and localization

Q 1.3. k Explain the features of Net-worked Organization Structure.

Q 1.3. l Explain the features of Spin-offs Organization Structure.

Q 1.3. m Explain the features of Lead Subsidiary Organizations

Q 1.3. n Explain the features of Lead Subsidiary Organizations

Q 1.3. o Explain the Pressures for globalization Vs localization on the seat of Decision Making Power in MNEs

Q 1.3. p Explain the Capabilities of parent and local managers influencing the seat of Decision Making Power in MNEs

3.4 APPROACHES TO CONTROL

Control means, "Some sort of systematic effort to compare current performance to a predetermined plan of objective, presumably in order to take any remedial action required". This is a very general definition of the term. However, as a management function, it has been defined as "the process by which managers assure that resources are obtained and used effectively and efficiently in the accomplishment of the organization's goals".

Controlling is tool for achieving organizational goals and activities. Control is management's planning, implementation, evaluation, and correction of performance to ensure that the organization meets its objectives in the short, medium and long terms. In the case of MNEs, the top management's toughest challenge is to balance the company's global needs with its need to adapt to country-level differences.

According to **Henry Fayol**, 'Control of an undertaking consists of seeing that everything is being carried out in accordance with the plan which has been adopted, the orders which have been given, and the principles which have been laid down. Its object is to point out mistakes in order that they may be rectified and prevented from recurring'.

NOTES

According to **EFL Breach,** 'Control is checking current performance against pre-determined standards contained in the plans, with a view to ensure adequate progress and satisfactory performance.'

According to **Harold Koontz and O'Donnel**, 'Controlling is the measurement and correction of performance in order to make sure that enterprise's objectives and the plans devised to attain them are accomplished.'

From these definitions, it could be deduced that control, one of the managerial functions like planning, organizing, etc. is an important function because it helps ensuring that the planned goals are attained through a system of checks, monitoring, corrective actions and forward thinking so that errors are removed, and corrective actions taken timely so that deviation from standards are minimized, if not eliminated. Control in management means setting standards, measuring actual performance and taking corrective action. Thus, control comprises these three main activities.

According to modern concepts, attributed to **Peter Ferdinand Drucker**, 'Control is a foreseeing action and better is self-directed to be more effective'. Self control is the best control, because informed self is well aware of its deficiencies and also measures to ward off the same.

Planning and controlling go together. Planning is a process by which an organization's objectives and the methods to achieve the objectives are established, and controlling is a process which measures and monitors the actual performance conform to planned objectives of the organization. Thus, planning and control are often referred to as **'Siamese Twins'** of management.

A control system is necessary in any organization in which the activities of different divisions, departments, sections, and so on need to be coordinated and controlled. Most control systems are **post-action-oriented or feed-back control type** and consequently are inefficient or fail. For example, there is little an employee can do today to correct the results of actions completed two weeks ago.

Steering control or feed-forward control system, on the other hand, is future-oriented and predict adjustments to be made to put back on remedial course before the outcome drifts from planned scheme.

In between there is a system of control called **'concurrent or real time control**, which make corrective courses made continuously as executions happen. But, there is no forward stretch to predict possible mishaps in the later phases, due to current actions and having a plan to stop such mishaps from happening.

Control Process: Control Process involves establishment of standards or targets of performance, measurement of actual performance, comparison of actual performance with

NOTES

standards, examining the causes for any deviations in performance and taking corrective actions. Fig. 3.8 gives a picture of control process.

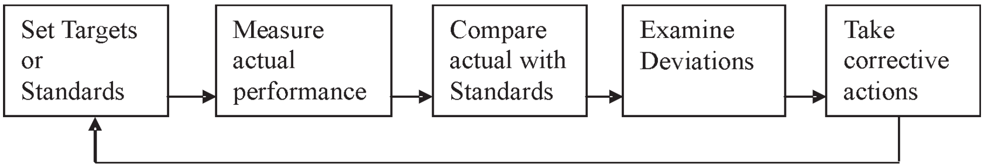


Fig. 3.8 Control Process

Difficulties in Effecting control in the case of MNEs

There are several factors that make control of MNE parent and the subsidiaries difficult. This is essentially due to the geographical spread of activities and actors.

Distance: MNEs and their subsidiaries are severed not only by distance, but also culture, levels of development, time zone and ethical standards. Ethical differences exhibit in the corruption-like things that is prevailing more in less developed nations. Despite video-conferencing, internet connectivity, voice-mails, e-mail and fax transmissions, face-to-face or voice-to-voice contact still holds greater impact. These increase the possibility of communication gaps and barriers in trans-national communications.

Diversity: MNEs because of their geo-spread have to adapt. The degree of adaptation and aspects of adaptation might vary country to country where it operates. Just take books. McGraw Hill international editions used to be multi-color, mostly hard-bound, costlier and quality paper involved. Its Indian edition, Tata-McGraw Hill editions used to be black & white color, paper-bound, inexpensive and less-quality paper involved. You cannot give the inexpensive edition to the Harvard learners. Depending on market features, product, payment, distribution, promotion, etc need to be adapted. There is always the problem of Adaptation Vs Standardization.

Un-controllable: In a global spread of activities, with regional adaptations, performance standards are also plural. Employees' and subsidiaries' performance cannot be uniformly compared. Overseas politico-legal environment and government regulations over which the company has no short-term influence dictate different yardsticks of performance. Effective corrective action becomes minimal.

Degree of certainty: Control implies setting goals and developing plans to meet those goals. This is said easier than done. It is more so in uncertain business conditions or with imprecise knowledge about the economy, polity or so. These factors impede planning, especially long-range planning making controls impossible.

NOTES

3.4.1 Types of Control in Globalization

There are various methods of classification of management control. By levels of control here it is meant whether the parent / corporate level managers or subsidiary/country-level managers are involved. The former might be called higher level and the later lower level control.

Depending on the sphere of focus we have **'Strategic control and Operational control'**. In the MNE's context, **strategic control is the responsibility of parent** and **operational control is the preserve of the subsidiary.**

Another way puts **'management control, tactical control and transactional control'** as the 3 levels of control respectively carried out by the corporate top management, collectively by corporate & subsidiary management and subsidiary management in the case of MNEs. Of course, whether an MNE's structure is ethno-centric, geo-centric, multi-domestic/poly-centric or region-centric is another factor that influences the exact distribution of responsibility.

The **forward looking information** is provided by **strategic control** systems. It is 'external response' oriented. It gives managers timely 'quantitative and qualitative' information they need to 'drive into the future' with confidence and success. In dynamic and uncertain business environment with extended competitive challenges this system functions well. Sensing and responding to change, Detecting changes in assumptions and Coping with a dynamic environment are the specific issues in strategic control. **Operational control** is 'internal response' oriented to ensure targets are achieved. Managers use performance measurement and operational control measures to ensure fulfillment of targets.

The domains of **'Management control, tactical control and transactional control'** respectively cover **'Goals & strategy'**, '**Speed & rhythm to tune with field reality'** and '**specific actions'**.

Management controls keep a company's Goals or Strategy on track. Strategic control adapts an organization over time to forces in its environment, such as changes in society, advances in technology, development of the economy, and shifts in policy. MNE managers must know that, although cost and innovation are important, the company's major competitive advantage lies in the marketing of differentiated/undifferentiated consumer products. As such, it is better subsidiary's managers concentrate on marketing-such as branding, advertising, and distribution-rather while corporate managers concentrate on capacity building through acquiring capital or business units or pursuing R&D. Corporate managers must have a clear-cut understanding of competitive entry strategies. They should look to acquire first-in advantages or companies with an established brand and significant market share. Corporate managers allocate resources to emphasize those product and geographic markets in which they prefer to grow more rapidly. It would be almost

NOTES

inconceivable for a subsidiary manager to launch a new product in his area or build a plant there without considerable scrutiny and approval from corporate management in the headquarters. But it is needed that country-level managers adjust to specific environmental and competitive conditions in their countries of operation. At the same time, the subsidiaries share information, fixed costs from new product development, and spillover advantages, which make it easier for the parent to sell to global distributors. Nestle does this exactly.

Tactical controls involve control with field reality in mind while acting within a set of policy and budgetary allocations. They cannot compromise on key results, but depending on the exigencies follow a different priority from the planned one. Tactical controls are budgetary control, authority/responsibility changes, procurement control, production control etc. Speed of execution, balancing diverse claims and the like involve. Sensitivity to the situation rather than strict adherence to rules and procedures, making navigational changes as circumstances warrant, etc are involved. The corporate and subsidiary level managers collectively do this, though the role of subsidiary level is more.

Transactional controls deal with individual tasks and processes within the envelope of available resources. While primarily aimed at ensuring that these individual efforts are efficient, operational control also maps these to the overall control goals. Inventory control, action against delinquent customers, procurement procedures, etc come here. These are the preserve of the subsidiary managers.

3.4.2 General Control Mechanisms

We shall now move to the subject of the mechanisms that MNEs use to help ensure that control is implemented. Corporate culture, Coordinating methods, Reporting and Visits are certain mechanisms of control in the context of MNEs.

a. Corporate Culture: Every company has certain common values that its employees share, expect fellow members to follow. Corporate culture is a form of implicit control mechanism that helps enforce the company's explicit control mechanisms. Employees conform to company traditions of work commitment, interactions with customers and so on. These are unwritten, informal, but more effective.

But MNEs have more difficulty relying on a corporate culture for control because cultural background of employees differs, exposure level varies, norms differ and so on. To overcome this MNEs promote worldwide corporate culture with the aim of conveying a shared understanding of global goals and norms for reaching those goals, along with the transference of "best practices" from one country to another. Nestle moves management trainees around Europe so that they learn to react like Europeans rather than like any specific nationality. Matsushita brings foreign employees to Japan, partly to train them in the company culture but primarily to get Japanese employees to evolve toward a more global culture. Corporate culture must be diffused throughout the organization through communications, interactions, transfers and commemorative events.

b. Coordinating Methods: The purpose of controls is ensuring that goals are optimally achieved. Any wanting in this regard may be due to non-coordinating attitude of some people, at some places. So, ensuring coordination ensures goal achievement, the goal of control mechanisms. Some of the mechanisms of coordination are:

i. Developing multi-culture teams for building scenarios on how the future may evolve.
ii. Developing the attitude to listen to different view-points among the corporate personnel
iii. Transferring and rotating organization people across nations and cultures
iv. Keeping proximity between global and domestic personnel
v. Establishing liaisons among subsidiaries within the same country/region
vi. Developing teams from different countries to work on cross national special projects
vii. Placing foreign personnel on the board of directors and top-level committees
viii. Giving credit to all concerned for business resulting from cooperative efforts
ix. Linking reward systems to both global and local performance

c. Reports: The basis of control is information. The source of information is reporting systems. Control needs timely, up-to-date and accurate reports. Reports must be frequent and purposeful to assure meeting the MNE's objectives. Parent concern uses reports to evaluate the performance of subsidiary to reward and rectify, if need be.

Written reports are more important in a global setting than in a domestic context because personal contacts are few and far between. Reports with similar formats, for domestic and global, and for parent and subsidiary facilitates better comparison. The periodicity of reports counts much. These days many a reports on a single day is quite possible; yet at least one report a day is essential so that the headquarters knows the happenings with all subsidiaries. MNEs place more emphasis on evaluating the subsidiary rather than the subsidiary manager, although the subsidiary's profitability is an important ingredient in the managerial evaluation.

d. Visits to Subsidiaries: Visits to subsidiaries by headquarters people make wonders for their motivational, directive, strategic and signaling effects. It is better members of the corporate staff spend much time visiting subsidiaries for on the spot assessment of ground realities which have great implications for control. However corporate personnel visits to subsidiaries must not be of the boondoggles type. Further, if visits result because of upsets over subsidiary's performance, subsidiary's managers may become concealing and/or defensive.

NOTES

3.4.3 Control in Special Situations

The special situations considered here are 'Mergers & Acquisitions, Shared ownership & JVs, and Changes in strategies'. Special situation warrants special controls. Let us now discuss each of these.

a. Mergers & Acquisitions: Expansion through mergers and acquisition can create some specific control problems like duplication, grey areas, black-boxes and boondoggles or so. Nestlé's acquisitions in U.S. resulted in overlapping geographic responsibilities and markets as well as new lines of business with which corporate management had no experience. Further methods of performance appraisal, key performance areas, etc might vary between acquired and acquiring companies. For example, U.S. executives tend to focus more on profitability than on market potential, whereas the opposite is true in Korean companies. When a U.S. company acquires a Korean company, it must communicate and implement new performance standards emphasizing bottom-line growth, rather than the top-line growth. Still another problem is that existing management in an acquired firm accustomed to considerable autonomy may dislike centralized control and may resort to non-cooperation or resist changes.

b. Shared Ownership/JVs: Yes it happens with shared ownership or joint ventures that one major stake holder does not accept the views of another major stake holder. In late 2004, when Suzuki Motor Corporation (SMC) unilaterally decided to invest Rs 1,000 Crore in the Indian automobile sector, the Indian Government summoned its joint venture partner in Maruti Udyog Limited, the SMC, to explain its 'mis-understanding of the understanding arrived when the JV was formed. Ownership sharing limits the flexibility of corporate decision making. This was something which happened to Tata's previous bid to acquire flavoured water business of US-based Glaceau, which was ultimately snapped up by Coca-Cola. Tatas, who invested $677 million in August'06, had made a neat profit (close to 100 per cent in one year) from this deal. Glaceau was acquired by Coke for an enterprise value of about $4.1 billion. Last October, Dubai Holding - an investment firm of the Dubai government, had threatened to come out with a counter open offer for Orient-Express Hotels if the Tata group acquires a significant stake in the hotel chain. This had come after Tatas bought 10 per cent in Orient Express in September'07. Dubai Holding has a significant shareholding of Orient-Express. It had also earlier made an offer to buy all shares of the company which was again rejected by Orient Express. Orient-Express has two classes of stock with differential voting rights. The structure enables it to oppose any hostile takeover. Nestle shares ownership with Coca-Cola in a joint venture for the production and sale of canned coffee and tea drinks, and Nestle has less autonomy for this operation than for those it owns wholly because Coca-Cola has an equal voice in decision making. Nevertheless, there are administrative mechanisms to gain control even with a minority equity interest. Yet it becomes difficult to get them to cooperate for the success of the joint venture.

NOTES

c. **Changes in Strategies**

Most recent changes in strategic management have involved movements from multi-domestic to transnational or global operations. Citibank moved from a multi-domestic to a regional strategy within Europe, it needed to introduce interdependence among operations and collect results not only on a country-by-country basis, but also by product and customer. In addition to the practical problems of changing systems, there are human resource problems as well. Many U.S. companies owned very independent operations for decades in the United Kingdom, France, and Germany. Any global or regional integration will hurt managers who fear losses through a changed strategy and therefore continue to guard their autonomy and functional specialties and maintain existing allegiances.

3.4.4 Requisites of Control in MNE's context

The control process of MNEs consists of 6 component steps. These are: i. Strategic Planning; ii. Organizational structure iii. Location of decision making iv. Control mechanisms v. Structure and Control Interface and vi. Control in the Globalization Process. These are dealt with here

3.4.4.1 Strategic Planning

Planning and control go together. Planning is an essential element of managerial control. Planning must integrate a company's objectives and capabilities with its internal and external environments. This is a dynamic world, where settings change, positions change, roles change, opportunities change, challenges change and so on. This is so more in a global context. So an MNE must do a continuing reassessment of its objectives and capabilities. The first step of planning process is to develop a long-range strategic intent, an objective that keeps together and organization and also builds its global competitive viability.

Gary Hamel and C.K. Prahalad in their book, 'Competing for the future' define 'strategic intent' as 'an ambitious and compelling dream that energizes and provides the emotional and intellectual energy for the journey of the company to the future'. If strategic architecture that is a high-level blueprint for the deployment of new functionalities, the acquisition of new competencies or the migration of existing competencies, and the reconfiguring of the interface with customers, is the brain, strategic intent is the heart. It should convey a sense of stretch for which current resources and capabilities are not sufficient for the task.

Hamel and Prahalad provided the following three attributes of strategic intent: **Sense of direction, Sense of discovery, and Sense of destiny**. Strategic intent implies a particular point of view about the long-term market or competitive position that a firm hopes to build over the coming decade or so. That unifying and personalizing view point is **sense of direction.** A strategic intent is differentiated; it implies a competitively unique point of view about the future. It holds out to employees the promise of exploring new competitive territory which is what the **Sense of discovery** is about. Strategic intent has an emotional

NOTES

edge to it; it is a goal that employees perceive as inherently worthwhile. This is **Sense of destiny.**

A typical Strategic Intent Process consists of three important steps: i. **Set the Strategic Intent** in terms of Sense of direction, Sense of discovery, and Sense of destiny. ii. **Set the Challenges-** find appropriate challenges and communicate them to the entire workforce. These **challenges are the means** to get into the Strategic Intent. (For example: Suppose the Strategic Intent of Tata Motors is: “Maruti”. A strategic challenge could be: Come up with small cars at a target price of Rs 1,00,000. **Empower the Strategic Intent:** The task of Top Management here is to ‘capture the wisdom of the anthill’ to challenge the traditional downward communication style to an upward communication stream of new ideas coming from all the organization. The strategic intent may encompass whether and where a company wants to be a leader, such as dominating its domestic market, dominating a regional or global market, or attaining profit results without being the market leader.

Analysis of internal resources is the second step in planning. The most successful companies globally are those that find the right fit between what they need and what they are good at. A small company with unique product capabilities may have to collaborate with another company, by licensing foreign production rather than owning facilities abroad. It must control its foreign operations through a contract with the licensee that stipulates sales targets, product characteristics, and so on.

Overall rationale for global activities is the third step. Managers must examine these activities in conjunction with the means of competing, low prices or product differentiation or so.

Local analysis of each country is the 4^{th} step. Changes in local stability and market growth influenced most MNEs to place more emphasis on emerging economies, especially the BRIC (Brazil, Russia, India and china) group countries.

Selection of alternatives is step 5 which determines the extent to which a company follows a global, transnational, or multi-domestic strategy. These alternatives, according to **John D Daniels and Lee H Radebaugh,** include:

i. **Location of value-added functions**: The choice of where to locate each of the functions that comprises the entire value-added chain, from research to production to after-sales servicing.

ii. **Location of sales targets:** The allocation of sales among countries and the level of activity in each, particularly in terms of market share.

iii. **Level of involvement:** The choice of operating through wholly owned facilities, partially owned facilities, or contract arrangements and whether the choice varies among countries.

NOTES

iv. Product/services strategy: The extent to which a worldwide business offers the same or different products in different countries.

v. Marketing: The extent to which a company uses the same brand names, advertising, and other marketing elements in different countries.

vi. Competitive moves: The extent to which a company makes competitive moves in individual countries as part of a global competitive strategy.

vii. Factor movement and start-up strategy: The choice as to whether production factors are acquired locally or brought in by the company and whether the operation begins through an acquisition or start-up.

Rank alternatives, the 6th step is. Managers must rank alternatives so they can easily add or delete strategies as resource availability changes. When remitting dividends from one of its foreign subsidiaries back to itself is thwarted by a foreign government parent's management must decide among alternatives for financing itself and for investment for the subsidiary.

The last step is **'set specific objectives for each subsidiary'.** These provide ways to measure both deviations from the plan and conditions that may cause such deviations. Through timely evaluation, the company can take corrective actions. There must be a constant loop from step 6 to step 2 to ensure the company is making timely decisions.

We must make a distinction between operating plans and strategic plans. Strategic plans are longer term and similar to step A. They outline major commitments, such as what businesses the company will be in and where, and are less subject to reevaluation. Operating plans formulate short-term objectives and the means to carry them out. Although input for a strategic plan may come from all parts of the organization, only upper-level management can plan changes in global policies because they can see all the company's worldwide activities.

Uncertainty and Planning: The more uncertainty there is, the harder it is to plan, but even more is the need for planning. Conditions in the global sphere are more uncertain than those in the domestic sphere and this needs more planning thrust.

3.4.4.2 Organizational structure

From among different structural patterns, company has to choose one. Between centralization and decentralization, between differentiation and unification and between formalization and in-formalization, there are certain broad choices. At one end of the continuum you have centralization, unification and formalization (total structured form) and the on the other you have decentralization, differentiation and in-formalization (total de-

NOTES

structured form). In between these polar alternatives, we have more structured forms, moderately structured forms and less structured forms. Refer Table 1 for details.

Because of growth dynamics, companies change their organizational structures. Simplified organizational structures get replaced by complex or mixed structures. Until organizational re-structuring is made, new acquisitions might report to headquarters. Circumstances prevailing in a particular country, product, or function might necessitate separate handling until a re-structuring is effected, apart from the overall structure. The structure of 100% subsidiaries is different from that of JVs. 100% subsidiaries enable a deeper network of communications. Overall structure may be incomplete and less revealing. PepsiCo is organized by product lines, namely soft drinks and snacks. This would seem to imply that each product line is integrated globally. However, each line has its own global division, which separates it from domestic operations. Refer Figures 3.1 to 3.7 for details.

3.4.4.3 Location of decision making

Where does the decision making power rests? Is the decision power vested with the parent's headquarters or with the subsidiary? Decisions made at the foreign-subsidiary level may be considered decentralized, while those made above the foreign-subsidiary level, that is the parent level, are considered centralized. The location of decision making power may vary within the same company over time as well as by product, function, and country. In addition, actual decision making is seldom as one-sided as it may appear. A manager who has decision-making authority may consult other managers before exercising that authority.

Centralized decision making is a global strategy while decentralized decision making is a multi-domestic strategy. A combination of the two is called a transnational strategy. The reason for choosing one over the other is partly a function of companies' attitudes. For example, an ethnocentric attitude would influence a company to develop competencies, such as knowledge and technology, in its home country and control how they are transferred aboard. A polycentric attitude would cause the company to delegate decisions to foreign subsidiaries because headquarters personnel believe only people on the spot know best what to do. Multi-domestic attitude encourages this. A region-centric attitude would permit more openness to capabilities either at home or abroad and be conducive to a transnational strategy. A geocentric attitude would be conducive to a global strategy where core decisions lie with the headquarters.

According to **John D Daniels and Lee H Radebaugh,** companies choose the locus of decision power based on a combination of three trade-off's:

i. Balancing pressures for global integration versus pressures for local responsiveness
ii. Balancing the capabilities of headquarters versus subsidiary personnel
iii. Balancing the expediency versus the quality of decisions

NOTES

3.4.4.4. Control Mechanisms

There are special and general control mechanisms. Corporate culture, Coordinating methods, Reporting and Visits are certain general mechanisms of control in the context of MNEs. **Corporate culture** is a form of implicit control mechanism that helps enforce the company's explicit control mechanisms. Employees conform to company traditions of work commitment, interactions with customers and so on. These are unwritten, informal, but more effective. The purpose of controls lies in ensuring that goals are optimally achieved. **Coordination** ensures goal achievement. The basis of control is information. The source of information is **reporting systems.** Control needs timely, up-to-date and accurate reports. Reports must be frequent and purposeful to assure meeting the MNE's objectives. Parent concern uses reports to evaluate the performance of subsidiary to reward and rectify, if need be. **Visits to subsidiaries** by headquarters people make wonders for their motivational, directive, strategic and signaling effects. **Special control situations** refer to 'Mergers & A**c**quisitions, Shared ownership & JVs, and Changes in strategies'. Special situation warrants special controls. Let us now discuss each of these. (All these are already dealt)

3.4.4.5 Structure and Control Interface

The form of foreign operations and importance of foreign operations influence controls.

a. Form of foreign operation and control: Branch, JV, 100% subsidiary, etc are alternative forms. Each form involves varying degree of controls by the parent. A foreign branch is a foreign operation not legally separate from the parent company and the parent is 100% responsible for the branch's actions. Branches are usually subject to less public disclosure because they are covered by tight corporate restrictions. A subsidiary is legally a separate company, whether the parent shareholding is 100% or otherwise. Foreign subsidiaries are put to lot more screening because the parent's controls are too subtle to see ordinarily. JVs are a form requiring shared controls among the stakeholders.

b. Extent of importance of global operation: The more important the foreign operations are to total corporate performance, the higher the corporate level to which those units should report. The organizational structure or reporting system therefore should change over time to parallel the company's increased involvement in foreign activities.

3.4.4.6 Control in various stages of Globalization Process

There are various factors that influence how much control a company needs at different stages of globalization. In the **initial stages foreign operations**, the size and complexity of operations are small and the parent management takes care. When CISCO was a small U.S. manufacturer of networking gear parent management helped it to gain contracts with Japan's Nippon Telegraph & Telephone. However, as a company's operations grow abroad, at **later stages of global operation more decentralized structure** could emerge.

NOTES

The parent management develops a foreign management group that is capable of operating more independently of headquarters in the overseas markets.

In due course, parent managers may no longer be able to deal effectively with global business operations because the subsidiaries have entered so many different foreign markets; thus foreign operations tend to become more decentralized. This creates a **dilemma to allow decentralization to remain or recentralize**. But as foreign operations continue to grow, people with foreign experience move into headquarters positions, and headquarters can afford staff specialists to deal with the company's multiple global operations. At that point, recentralization becomes feasible. Organizational mechanisms, such as **joint committees** and the **planned sharing of information** are useful to ensure activities of subsidiaries and parent complement each other. Structure and Control Interface

QUESTIONS TO CONTEMPLATE AND DELIBERATE

Q 1.4.a Discuss the Approaches to and Aspects of Control in MNEs
Q 1.4.b Explain the features of different General Control Mechanisms
Q 1.4.c Discuss Control Mechanisms in Special Situations of MNEs
Q 1.4.d Present the Requisites of Controls in MNE's context
Q 1.4.e Examine the Structure and Control Interface in MNEs.

3.5 ROLE OF INFORMATION SYSTEMS

In this knowledge led world, information is the great input into decision process of managers. **Information = Data + Relevance.** Adding relevance to data is what is called as data processing. To have this information you need a system and that is information system. A system is a group of interdependent items that interact regularly to perform a task. **System is a set of interacting or interdependent entities forming an integrated whole**. A system is designed to work as a coherent entity. A system has boundary and environment. An **open system** usually interacts with some entities in their environment. A **closed system** is isolated from its environment. Information system has input, process and output elements. Open system draws data from the environment, processes the same into useful information to management. Closed information system restricts itself to pre-determined data only as input, process the same as set to process and gives output in standard format reports. The essence of system is synergy, that combined output is more valued than the sum of values of outputs of individual interacting elements or sub-systems of the system.

Information - the most valuable asset: The most valuable of all assets of companies today, information ranks first. Information is invisible and is represented in people, experience, know-how, innovations (patents, copyrights, trade secrets), and for a market operator to be able to compete, the firm must have a strong information infrastructure, at the heart of which, lies the information technology infrastructure. Thus, the study of information systems focuses on why and how technology can be put into best use to serve the information flow within an organization.

Information System: An Information System (IS) is the 'system of persons, data records and activities that process the data into information in a given organization, including manual processes or automated or computerized processes'. The term information system includes, and not equal to computer-based information systems. Computers are the Information technologies component of an Information System. A computer based information system is a technologically implemented medium for recording, storing, and disseminating linguistic expressions as well as for drawing conclusions from such expressions. There are alternative technologies of processing data, including manual processing of data.

Information processing system: An information processor or information processing system, as its name suggests, is a system which takes information in one form and processes (transforms) it into another form, e.g. to statistics, by an algorithmic process. An information processing system is made up of four basic parts, or sub-systems as given if figure 3.8.

Universality of information system: The world of humans/animals/plants/planets/inanimate things is full of instances which are in fact examples of information systems. Any object may be considered an information processor if it receives information from another object and in some manner changes the information before transmitting it. This broadly defined term can be used to describe every change which occurs in the universe. Even a falling rock could be considered an information processor due to the following observable facts:

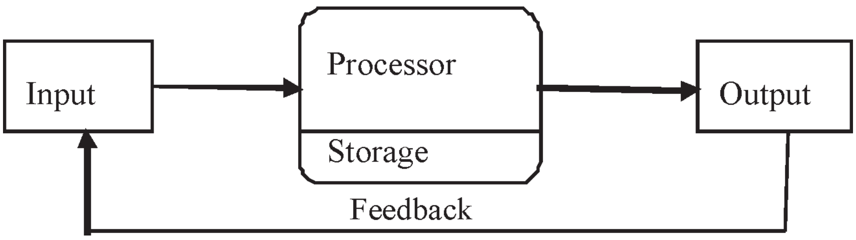


Figure 3.8 Information Processing System with sub-systems

First, information in the form of gravitational force from the earth serves as input to the system which is the rock. At a particular instant the rock is at a specific distance from the surface of the earth traveling at a specific speed. Both the current distance and speed properties are also forms of information which for that instant only may be considered "stored" in the rock.

In the next instant, the distance of the rock from the earth has changed due to its motion under the influence of the earth's gravity. Any time the properties of an object change a process has occurred meaning that a processor of some kind is at work. In

NOTES

addition, the rock's new position and increased speed is observed by us as it falls. These changing properties of the rock are its 'output'.

It could be argued that in this example both the rock and the earth are the information processing system being observed since both objects are changing the properties of each other over time. If information is not being processed no change would occur at all.

In information processing, a **Data Processor or Data Processing Unit** or Data Processing System is a system which processes data which has been captured and encoded in a format recognizable by the data processing system or has been created and stored by another unit of an information processing system.

3.5.1 Diverse forms of Information systems

Today information system has diversity. Diverse forms of information system exist. Depending on one's need systems are selected.

a. Business informatics: Bio-informatics and geo-informatics are quite known to us. There is also the Business informatics **(BI).** BI is a discipline combining information technology (IT) – or informatics – with management concepts. The BI discipline was created in Germany. The term Business Informatics is now common in Central Europe. BI has strong synergistic effects from truly integrating business administration concepts and computer science technology into one field. Business Informatics (BI) shows numerous similarities with Information Systems (IS).

There are **differences between Business Informatics and Information Systems as well:** Business Informatics includes information technology, like the relevant aspects of applied computer science, to a much larger extent compared to Information Systems. Business Informatics has significant constructive features meaning that a major focus is on the development of solutions for business problems rather than simply describing them. On the other hand, information systems strongly focus on explaining empirical phenomena of the real world. IS has often been called an 'explanation-oriented' approach in contrast to the 'solution-oriented' BI approach. IS researchers try to explain why things in the real world are the way they are and conduct a lot of empirical surveys whereas a BI researcher tries to develop IT solutions for problems they have observed or assumed. Academics in BI, for example, are often fond of applying new technologies to business problems and doing feasibility studies by building software prototypes. The pace of scientific and technological progress in BI is quite faster than in the case of IS.

b. Metadata: Metadata are data about data. Metadata are information about information. In any particular context, metadata characterizes the data it describes, not the entity described by that data. In the context of a camera, where the data is the photographic image, metadata would typically include the date the photograph was taken and details of the camera settings. On a portable music player such as an iPod, the album names, song titles and album art embedded in the music files are used to generate the artist and song listings, and so on are metadata. In the context of an information system, where the data is the content of the computer files, metadata about an individual data item would typically include the name of the field and its length. Metadata about a collection of data items, a computer file, might typically include the name of the file, the type of file and the name of the data administrator. Business decision making needs metadata because the contextual inputs provide valuable information about the decision situations.

Fundamentally, metadata are 'the data that describe the structure and workings of an organization's use of information, and which describe the systems it uses to manage that information'. To do a model of metadata is to do an 'Enterprise model' of the information technology industry itself.

c. Management Information Systems (MIS): One branch of Information System is Management Information Systems (MIS). Business computers were once used for the practical business of computing the payroll and keeping track of accounts payable and receivable. As applications were developed providing managers with information about sales, inventories, and other data that would help in managing the enterprise, the term 'MIS' gained prominence. Today, the term is used broadly in a number of contexts and includes (but is not limited to) decision support systems, resource and people management applications, project management, and database retrieval applications. MIS is the discipline covering the application of knowledge-ware, soft-ware, fine-ware, hard-ware, and techno-ware to solve business problems. Management Information Systems analyze other information systems applied in operational activities in the organization. MIS is commonly used to refer to the group of information management methods tied to the automation or support of human decision making like Decision Support Systems (DSS), Expert systems (ES), and Executive information systems (EIS), etc.

d. Enterprise Resource Planning (ERP): Today Enterprise Resource Planning (ERP) systems rule the business information world attempting to integrate all data and processes of an organization into a unified system. A typical ERP system will use multiple components of computer software and hardware to achieve the integration. A key ingredient of most ERP systems is the use of a unified database to store data for the various system modules.

ERP evolved from Manufacturing Resource Planning (or MRP2), which in turn evolved from Material Requirement Planning (MRP). Around 1980, frequent changes in sales forecasts, entailing continual readjustments in production, as well as the unsuitability of the parameters fixed by the system, led the evolution of MRP (2) from MRP and later MRP(2) evolved into the generic concept Enterprise Resource Planning (ERP).

The introduction of an ERP system to replace two or more independent applications eliminates the need for external interfaces previously required between systems, and provides additional benefits that range from standardization and lower maintenance (one system

NOTES

instead of two or more) to easier and/or greater reporting capabilities (as all data is typically kept in one database).

Examples of modules in an ERP which formerly would have been stand-alone applications include: Manufacturing, Supply Chain, Financials, Customer Relationship Management (CRM), Human Resources, Warehouse Management and Decision Support System. Ideally, ERP delivers a single database that contains all data for the software modules, which would include:

Manufacturing: Engineering, Bills of Material, Scheduling, Capacity, Workflow Management, Quality Control, Cost Management, Manufacturing Process, Manufacturing Projects, Manufacturing Flow. **Supply Chain Management:** Inventory, Order Entry, Purchasing, Product Configuration, Supply Chain Planning, Supplier Scheduling, Inspection of goods, Claim Processing, Commission Calculation. **Financials:** General Ledger, Cash Management, Accounts Payable, Accounts Receivable, Fixed Assets. **Projects:** Costing, Billing, Time and Expense, Activity Management. **Human Resources:** Human Resources, Payroll, Training, Time & Attendance, Roster, Benefits. **Customer Relationship Management:** Sales and Marketing, Commissions, Service, Customer Contact and Call Center support. **Data Warehouse** and various **Self-Service interfaces** for Customers, Suppliers, and Employees.

ERP systems saw a large boost in sales in the 1990s as companies faced the Y2K problem in their legacy systems. Many companies took this opportunity to replace their legacy information systems with ERP systems. ERPs are not 'back office systems' indicating that customers and the general public are not directly involved. ERPs are cross-functional and enterprise wide. All functional departments that are involved in operations or production are integrated in one system. In addition to manufacturing, warehousing, logistics, and information technology, this would include accounting, human resources, marketing, and strategic management.

SAP is a global software company headquartered in Germany which pioneered SAP, which stands for Systems Applications and Products. There are over 100,600 SAP installations serving more than 41,200 companies in more than 25 industries in more than 120 countries in mid 2007. SAP R/3 and SAP ERP are two versions of the ERP software product of SAP AG, the German Outfit. SAP ERP is the one of five major enterprise applications that makes up SAP's Business Suite. The four other applications are: **Customer Relationship Management (CRM)** - helps companies acquire and retain customers, gain deep marketing and customer insight, and align organization on customer-focused strategies. **Product Lifecycle Management (PLM)** - helps manufacturers with a single source of all product-related information necessary for collaborating with business partners and supporting product line. **Supply Chain Management (SCM)** - helps companies enhance operational flexibility across global enterprises and provide real-time visibility for

NOTES

customers and suppliers. **Supplier Relationship Management (SRM)** - customers can collaborate closely with suppliers and integrate sourcing processes with applications throughout the enterprise to enhance transparency and lower costs.

While its original products were typically used by Fortune 500 companies, SAP is now also actively targeting small and medium sized enterprises (SME) with its SAP Business One and SAP Business All-in-One.

e. Enterprise Content Management (ECM): Enterprise content management (ECM) is the technologies used to capture, store, preserve and deliver content and documents and content related to organizational processes. ECM tools and strategies allow the management of an organization's unstructured information, wherever that information exists. ECM is a new problem domain and has employed the technologies and strategies of (digital) content management to address business process issues, such as records and auditing, knowledge sharing, personalization and standardization of content, and so on.

Generally speaking ECM solves all of the problems related to the use and preservation of information within an organization, in all of its forms — not just its web-oriented face to the outside world. Therefore, most solutions focus on 'business to employee' (B2E) systems. However, as the solutions have evolved, new components to content management have arisen. For example, as unstructured content is checked in and out of an ECM system, each use can potentially enrich the content's profile, to some extent automatically, so that the system might gradually acquire or "learn" new filtering, routing and search pathways, corporate taxonomies and semantic networks, which in turn assist in making better retention-rule decisions, determining which records or documents to keep, and which to discard, and when. Such issues become all the more important, as email and instant messaging are increasingly employed in the decision-making processes in an organization.

Thus, ECM refers to solutions that concentrate on providing in-house information, usually using internet technologies. The solutions tend to provide intranet services to employees (B2E), but also include enterprise portals for 'business to business' (B2B), 'business to government' (B2G), or 'government to business' (G2B), etc. This category includes most of the former document management groupware and workflow solutions that have not yet fully converted their architecture, but provide a web interface to their applications. Digital Asset Management (DAM) is as well a form of ECM that is concerned with content stored using digital e-technology.

The technology components that comprise ECM today are the descendants of the electronic document management systems (EDMS) software products that were first released in the late 1980s and early 1990s. The original EDMS products were developed as stand-alone technologies. Certain versions of EDMS included COLD/ERM, which are technologies for the automatic processing of structured entry data. COLD stands for Computer Output to Laser Disk and is still in use although laser disks have not been on the

NOTES

market for years. The acronym ERM here stands for Enterprise Report Management. In both, supplied output data are processed on existing structure information in a way that it can be indexed independently of the origination system, and sent to a storage component that can be dynamic (Store) or an archive (Preserve).

Among the **specific benefits of EDMS and ECM** were the following:

Reduction of paper handling and error-prone manual processes
Reduction of paper storage
Reduction of lost documents
Faster access to information
Online access to information that was formerly available only on paper or microfilm.
Improved control over documents and document-oriented processes
Streamlining of time-consuming business processes
Security over document access and modification
Provide reliable and accurate audit trail
Improved tracking & monitoring, with ability to track bottlenecks & modify the system.

More recently, the ECM market has seen the entry of Microsoft and Oracle Corporation, two of the largest and most pervasive providers of software, at the value end of the market. These two software companies look to provide software solutions with the basic ECM functionality that will address the functional requirements commonly required by the majority of organizations. The result is likely to be a stratification of the current ECM market, based on the level of content services that different organizations require.

The global provider of Enterprise Content Management (ECM) solutions, SAP Corporation is the market leader in SAP document and data archiving and management. Its targeted solutions enable one to create, access, manage, and securely archive all SAP content-both data and documents to address stringent requirements for risk reduction, operational efficiency and IT consolidation. More than 2,000,000 users—over 2,200 installations—worldwide have achieved exceptional value of ownership by improving their critical business processes with Livelink ECM - Suite for SAP Solutions. The application products are:

Livelink ECM - **Accounts Payable Solutions** automates the invoice process to ensure minimum process time, maximum efficiency, and optimal allocation of resources.

Livelink ECM - **Customer Information Management** improves customer relations and streamlines customer service and sales processes by providing easy access to consolidated customer information from SAP® and non-SAP sources directly in Microsoft Outlook.

Livelink ECM - **Data Archiving Solutions** provides secure, long-term archiving of data from SAP applications, offloading aged data to reduce storage costs and improve performance, while providing seamless access to archived data.

NOTES

Livelink ECM - **Document Archiving Solutions** provides secure, long-term archiving of documents and data from SAP applications, offloading aged content to reduce storage costs and improve performance, while providing seamless access to archived content.

Livelink ECM - **Document Management Solutions** provides data and document archiving for SAP applications to reduce storage costs and improve system performance. In addition, it provides consolidated views of related content from multiple SAP and non-SAP applications, integrating content into the context of business processes.

Livelink ECM - **Employee Information Management** provides HR departments with a complete solution based on ECM: all printed documents from employees and job applicants, master data and internal personnel documents are immediately available from the electronic personnel file.

Livelink ECM - **Shared Document Access** provides your customers, partners and employees with a personalized overview of all documents related to a specific business process.

Livelink ECM **- Supplier Information Management** helps improve procurement processes with a 360º view of supplier information

Livelink ECM **- Vendor Invoice Management Solutions** is a prepackaged composite application that works with ERP systems to streamline Accounts Payable (AP) operations, by optimizing and simplifying the process of creating, managing, monitoring and routing purchase orders and invoices for AP personnel and vendors.

Open Text Contract Management SAP is a composite application which operates and provides central storage and access to contract information, making processes easier and more efficient.

Open Text Extended ECM Solutions is a complete ECM application that allows content-centric business processes, complementing your SAP Business Suite applications' ability to manage transaction-centric processes.

There are many, many companies in the corporate world whose input, process and output are all information, information and information only. They are the corporate leaders as well. They are the soft- and hard-ware companies. They device devices to generate, process and use information. Their number, value and growth speak about the role information in business decision making.

3.5.2 Paradigm shift from product orientation to knowledge orientation

In the post-industrial era or the information age, the focus of companies has shifted from being product oriented to knowledge oriented, in a sense that market operators

NOTES

today compete on process and innovation rather than product. Information Systems has a number of different areas of work:

i. Information Systems Strategy
ii. Information Systems Management
iii. Information Systems Development

Each of which branches out into a number of sub disciplines, that overlap with other science and managerial disciplines such as computer science, pure and engineering sciences, social and behavioral sciences, and business management.

Information Systems Strategy: The function of a IS strategy according to **Wilson (1989),** 'to bring together the business aims of the company, an understanding of the information needed to support those aims, and the implementation of computer systems to provide that information. It is a plan for the development of systems towards some future vision of the role of information systems in the organization.' **Reponen (1993)** puts IS strategy as, 'something which is essentially a planning process in the minds of the decision makers, users and developers of the systems. It is supported with written reports and plans, but they are of secondary importance.'

Information Systems Management: Information systems management covers Business Systems Analysis; Communications System Design; Databases; E-business & E-commerce; Engineering Management: Enterprise Resource Management (ERP); Management of Specific Areas: Enterprise Resource Management (ERP); Management of IT; Operating Systems; Operations Management; Production Engineering: Operations Research; Industrial Engineering & Manufacturing: Operations Research; Manufacturing Engineering: Operations Research; Real-Time Systems; Systems & Computer Architecture of Databases; Systems & Computer Engineering; Systems Integration and so on. Information systems management will be able to:

i. Apply appropriate problem-solving methodologies to analyze and solve problems.
ii. Apply standard systems practices to plan, implement, manage, and evaluate IS.
iii. Communicate effectively using oral, written, and multimedia techniques.
iv. Manage change in the dynamic and global environments of automated systems.
v. Use technology to research information needed to produce informed decisions
vi. Identify relationships between programming languages and information systems.
vii. Demonstrate skills in systems analysis appropriate to the MIS projects.
viii. Demonstrate skills in the design, creation, maintenance, and reporting functions of database systems and database systems management.
ix. Use a systems approach to select hardware and software for an organization.
x. Evaluate ethical issues related to information systems, work productivity, and human factors.

Information Systems Development: There are several models of development of information systems.

NOTES

a. Waterfall Model/Linear Sequential Model is the classic view of system development. It is seen as a journey down a river with the end of each phase being a waterfall. The Waterfall Model consists of the following steps: System Conceptualization, Systems Analysis, System Design, Coding and Testing. In recent years it has come under attack, due to its rigid design and inflexible procedure.

b. Iterative Development: The iterative model addresses many of the problems associated with the Waterfall model. It does present new challenges. The user community needs to be actively involved throughout the project. While this involvement is positive for the project, it is demanding on the time of the staff and can add project delay. The iterative model can lead to 'scope creep' since user feedback following each phase may lead to increased customer demands.

c. Spiral Model: Spiral development is a family of software development processes characterized by repeatedly iterating a set of elemental development processes and managing risk. The spiral model was designed to include the best features from the waterfall and prototyping models, and introduces a new component - risk-assessment. The term "spiral" is used to describe the process that is followed as the development of the system takes place. Similar to the prototyping, an initial version of the system is developed, and then repetitively modified based on input received from customer evaluations. Unlike the prototyping model, however, the development of each version of the system is carefully designed using the steps involved in the waterfall model.

d. RAD Model: Rapid Application Development (RAD) model is a linear sequential software development process model. It emphasizes an extremely short development cycle. The RAD model is a 'high-speed' adoption of the linear sequential model in which rapid development is achieved by using a component-based construction approach. Business modeling, Data modeling, Process modeling, Application generation are its components.

3.5.3 MNEs' Information system

Parent corporate management of MNEs requires information to plan, to implement and to control not only their own actions but also of their subsidiaries all over the world. A seamless information system is what they need.

a. Information needed: The information required might include:

i. Information generated for centralized coordination, such as subsidiary cash balances and needs so that headquarters can move funds effectively
ii. Information on external conditions, such as analyses of local political and economic conditions, so that headquarters can plan where to expand and constrict operations
iii. Information for feedback from parent to subsidiaries, such as R&D breakthroughs, so that subsidiaries can compete more effectively
iv. Information that subsidiaries can share so that they can learn from each other and be motivated to perform as well as other subsidiaries

NOTES

v. Information for external reporting needs, such as to stakeholders and tax authorities
vi. Information for scouting and scanning of business opportunities around the world and the competitive factors
vii. Information on emerging technology trends, including those in the field of information processing and systems
viii. Information for surveillance of major competitors, takeover tycoons, etc.

For MNEs the need for information is necessarily is very much.

b. Problems in securing information: Companies face three problems in acquiring information, these are: the **cost of information, delay in information, and irrelevance in information**.

In the world of commerce, **value-cost** parity is important to be concerned with. The value of information must exceed cost of information substantially. Internet access provides valuable information for a very small cost for the general users of internet. Is it the same for businesses as well? It may not be so. Businesses must develop systems that provide very valuable information at very cheap money cost.

Timely information is the trusted information. Today's newspaper is tomorrow's wastepaper. True. But in the competitive world you cannot afford 24 hours to get fresh news. Real time information is what is needed. Timely information transcending time-zones is needed. This is more so for MNEs which operate in different time zones.

Information must be relevant. Anything irrelevant is no information; it may be data. For example, much of the information that is useful to a subsidiary, such as whom to contact to clear items at customs, is irrelevant to headquarters and should not be transmitted. To cope, companies should periodically reevaluate the information sources they use.

c. Opportunities in the information world: The information technology companies like the Microsoft, Dell, Hewlett-Packard, IBM, Novell, Oracle Corporation, Red Hat, Sun Microsystems, SAP corporation, Wipro, TCS, Infosys, etc. work to cater to the information needs of corporate world and all others. They provide the hard, soft and fine wares to keep on feeding the world's thirst for information 24 x 7.

With expanding global telecommunications and computer links-especially the World Wide Web and e-mail, managers throughout the world can share information quicker and easier than ever before. On the one hand, this technology may permit more centralization, because corporate management can more easily examine the global conditions and performance. On the other hand, managers in foreign locations may become more autonomous because they have more information at their disposal. But real time, secured access to information in all business domains is possible.

NOTES

QUESTIONS TO CONTEMPLATE AND DELIBERATE

Q 1.5.a Give an overview of the role of Information systems in management and control of MNEs

Q 1.5.b Explain the features of Business Informatics Information systems

Q 1.5.c Explain the features of Metadata Information systems

Q 1.5.d Discuss the features and uses of MIS.

Q 1.5.e Examine the uses of ERP as business information system

Q 1.5.f What is ECM? Explain its uses and applications.

Q 1.5.g Discuss the implication of a paradigm shift from product orientation to knowledge orientation in the role information system for businesses.

Q 1.5.h Present opportunities and challenges of MNE's Information Systems

3.6 PERFORMANCE MEASUREMENT

MNEs need to measure performance of all its organizational participants/elements and subsidiaries. Efficacy of organizational control depends on efficient measurement of performance. The basic question that arises now is: What are to be measured? Many things need to be measured and are measured too. But certain things are super-ordinate and cover holistic performance. A right selection of a range of performance measures which are appropriate to a particular company/context is needed. This selection ought to be made in the light of the company's strategic intentions which will have been formed to suit the competitive environment in which it operates and the kind of business that it is.

For example, if technical leadership and product innovation are to be the key source of a manufacturing company's competitive advantage, then it should be measuring its performance in this area relative to its competitors. But if a service company decides to differentiate itself in the marketplace on the basis of quality of service, then, amongst other things, it should be monitoring and controlling the desired level of service quality.

Whether the company is in the manufacturing or the service sector, in choosing an appropriate range of performance measures it will be necessary however to balance them, to make sure that one dimension or set of dimensions of performance is not stressed to the detriment of others. The mix chosen will in almost every instance be different. While most companies will tend to organize their accounting systems using common accounting principles, they will differ widely in the choice, or potential choice, of performance indicators.

3.6.1 Mechanics of Performance Measurement

Mechanics of performance measurement deal with the technicalities and procedure of performance measurement. The measurement process to be used must be clear-cut, unambiguous and useful. Description of measurement must convey what is measured and what not measured. Units of measurement must tell the basic unit of measures.

NOTES

3.6.1.1 *The technicalities and procedure*

The technicalities and procedure of measurement of performance include the following.

i. Unit of measure of performance
ii. Performance dimension & Performance thrust
iii. Financial and non-financial emphasis
iv. Single Vs Multiple indicators
v. Entity whose performance is to be measured
vi. Time frame of measurement
vii. Process of measurement
viii. Periodicity of measurement
ix. Personnel involved in measurement and
x. Adjustments made in measurements.

a. Unit of Measure of Performance: What is the unit of performance measurement? Is it a monetary value? Is it a ratio? Is it a count? Is it the change or rate of change or the aggregate? Financial performance is generally measured in dollar or rupee or other currency terms. Ratios express relative performance, expressing one performance variable in terms of another. Non-financial performance can be measured by counts as well as ratios. Certain complex units of measurement are also needed in typical cases, like passenger-kilometer-revenue, ton-kilometer-cost, profit per employee hour to production per employee hour, rate of growth in market share to growth rate in profit, etc.

b. Performance Dimension & Performance Thrust: Authors from differing management disciplines tend to categorize various performance dimensions and thrusts as are available in Table 3.2. Competitive advantage and Financial performance are outcome performance dimensions. Flexibility, Innovation, etc are contributing performance dimensions.

Table 3.2: Performance Dimension & Performance Thrust

Performance Dimension	Performance Thrust
i. Competitive	Success of the chosen strategy, thrust on Ends or Results
ii. Financial performance	
iii. Flexibility	Means or determinants of success or performance
iv. Resource utilization	
v. Quality of service	
vi. Innovation	

Another way of categorizing these sets of dimension, as given in Table 3.3 is to refer to them either as upstream or as downstream dimensions.

NOTES

Table 3.3 Upstream Determinants and Downstream Results

Performance	Types of Measures
Competitiveness	Relative market share and position, sales growth, customer
Financial	Profitability, Liquidity, Capital Structure, Market Returns,
Quality of Service	Reliability, Responsiveness, Appearance, Cleanliness, Comfort, Friendliness, Communication, Courtesy, Competence, Access, Availability, Security etc.
Flexibility	Volume Flexibility, Specification and Speed of Delivery
Resource	Productivity, Efficiency, etc.
Innovation	Performance of the innovation process, Performance of individual innovations, etc.

Source: Performance Measurement in Service Businesses- Lin Fitzgerald, Robert Johnson, et al.

Improved quality of service is an upstream dimension leading to better financial performance which is a downstream dimension. Non-financial quantitative performance measures of interest include response time, reliability, availability, safety, security, survivability, correctness, timeliness, and efficiency. Financial metrics include returns, revenues, costs, gains, etc.

c. Financial vs. Non-Financial: In many companies in the UK, as in the USA, the familiar measure is 'the bottom line', that is the 'net earnings'. Financial indicators remain the fundamental management tool and could be said to reflect the capital market's obsession with profitability as almost the sole indicator of corporate performance. Opponents to financial indicators based approach suggest that myopic focus on financials encourages management to take a number of actions that are short term at the expense of investing for the long term. It results in such action as cutting back on R & D revenue expenditure in an effort to minimize the impact on the expense side of the current year's P & L Account or calling for information on profits at too frequent intervals so as to be sure that targets are being met. These actions might actually jeopardize the company's overall performance rather than improve it. The opponents of "the bottom-line school" state that because of the pre-eminence of money measurement in the commercial world, the information derived from the many stages preceding the preparation of the annual accounts, such as budgets, standard costs, actual costs and variances, are actually just a **one dimensional** view of corporate activity.

NOTES

Executives should realize the importance of the **non-financial type** of performance measurement. Research in support of this approach has come up with new dictums for the workplace : “the less you understand the business, the more you rely on accounting numbers” and “the nearer you get to operations, the more non-financial performance indicators you realize could be valuable aids to better management”; or “graphs and bars carry much more punch than numbers for the non-financial manager”. Not every aspect of corporate activity can be expressed in terms of money and that if managers aim for excellence in their own aspects of the business, then the company’s bottom line will take care of itself.

d. Single Vs Multiple indicators: Executives tend to avoid using multiple indicators because they are difficult to design and sometimes difficult to relate, one to another. Executives have a strong preference for single indicators of performance which are well tried and which produce ostensibly unambiguous signals. But the new school lays great emphasis on the fact that multiple indicators are made necessary by the sheer complexity of corporate activity. Headquarters should evaluate subsidiaries and their managers on a number of indicators rather than relying too heavily on one. Financial criteria tend to dominate the evaluation of foreign operations and their managers. Budget compared with profit and budget compared with sales value, market-share increase, quality control, and managers’ relationship with host governments are some relevant measures.

e. Entity whose performance is to be measured: The entity whose performance is measured matters. Individual performance or group performance, divisional performance or segment performance, parent performance or subsidiary performance, each needs different approach. Even in the same category, say individual performance, performance measure of operative staff member differs from that off supervisory person and from managerial person. When subsidiary’s performance is measured lot of adjustments are called for, lest there results under-assessment or over-assessment.

f. Time frame of measurement: Performance measurement must cover fairly longer period so that seasonal pulls and pressures, impact of certain booting and busting influencers and at the same relevant history is covered. Too long a period makes no sense, especially in the case of market valuation of subsidiary. What is measured and time frame are relevant, because cash-flow like things are measured on day-to-day basis, while market share may be measured on a quarterly basis.

g. Process of measurement: Process of measurement involves accumulation of happening on the performance dimension to be measured over the time frame of measurement. Meantime, the tool of measurement – a yardstick, a check list of performance or a questionnaire or work-sheet or trip sheet or record of happenings in terms of the prescribed unit of measurement, is kept ready. The entity whose performance is to be measured is assessed by the application of the tool concerned. The measurement may be on-the-job or off-the job, on-line or off the line, programmed or non-programmed, participatory or non-

NOTES

participatory and so on. It might involve clinical-type observation of every minute elements or sketchy perusal of broad contours, filling up of structured questionnaire or mechanical ticking of check-list and so on. It might involve oral or written report or on the spot visual oversight of happenings and so on.

h. Periodicity of measurement: Performance measurement may be more frequent or less frequent. More frequency measurement facilitates effective control, though there may be intervention in work flow. Key performance areas require more frequent measurement.

i. Personnel involved in measurement: Decision as to employing external or internal personnel and decision as to employing superior and subordinate in performance appraisal individual concerned are involved. External people involved in assessing performance are supposed to ensure objectivity. The appraisal firm chosen must be totally independent. Having one's broker, intermediary, or consultant perform the appraisal is not the best choice. If the company is valued by anyone close to, or working for the owner, most buyers feel that the value is biased. If financing is necessary, most banks will require an independent third party appraiser. But external evaluators may not be having all the opportunity to assess persons or departments, because they would go by records only. There would be un-recorded but important achievements or otherwise that go unevaluated. Internal people when used for performance appraisal, their vested interests and personal biases would have their coloring of the appraisal process. Normally appraisal is by superiors, but superiors may not know the ground realities. The involvement of subordinates in appraising the performance of their boss is gaining ground. A consensus must be established before the scheme is put into operation.

j. Adjustments made in measurements: Performance appraisal needs lot of adjustments. Contextual, Competitive, Constituent, Cannibalism, Contributive, Concessional and Content factors need adjustment. The performance appraisal of a new subsidiary in an un-explored territory needs contextual adjustment. The performance appraisal of a subsidiary facing toughest competition from the arch rival needs adjustment. A subsidiary with problems of cultural-mix needs adjustments. A subsidiary that cannibalizes parent's revenue needs adjustment. For concessions and friendly contributions received by subsidiary from whatever sources, adjustments are called. Finally, one should look beyond the numbers while appraising. That is content factor adjustment.

3.6.1.2 Attributes of sound measurement mechanics

There are at least three major attributes expected of any good measurement mechanics. These are**: Reliability, Validity and Objectivity**. Each characteristic is examined in detail. The concept of reliability is examined for its two major components viz. **internal consistency** and **temporal stability**. The different components of validity viz. **content validity, construct validity and criterion related validity** are discussed. Then a discussion of the concept of objectivity is attempted.

NOTES

a. Reliability

Reliability of a measurement mechanism refers to the dependability or consistency of the measures provided by it. It refers to "the accuracy of the data in the sense of their stability, repeatability, or precision" There are two ways of looking at dependability. One is **comparability** of measures provided by different parts of the same test. Second is comparability of measures provided by the test on different occasions. In both the procedures, we produce two sets of measures which can be correlated to provide an estimate of reliability.

Comparability of measures provided by different parts of a measurement system: This procedure is based on the rationale that different parts of the measurement mechanism (different items) should make comparable estimates of performance of an entity. Let us illustrate this with an example. Suppose 'Item 1, say cash-flow of a subsidiary" shows that the firm is a very superior achiever. Normally 'Item 4, say market value addition' should also make the same assessment, superior performance, of the firm, if the measurement mechanism is a satisfactory measure of achievement. If for some reason 'Item 4' makes a poor estimate of the firm's ability (suppose 'Item 4' assesses the firm as one of inferior achievement), then both the items, 1 and 4, will be looked upon with disbelief. The method used for estimating reliability using this argument is called the 'Split-Half Method'. A narration of this method is called "Odd ~ Even method". This form of reliability is called **Internal Consistency.**

Comparability of Measures provided by a measurement system on different occasions:

This method of assessing reliability is based on the rationale that a good measurement system must give almost the same measurement when applied on the same entity on different occasions. Suppose a test of emotional intelligence of the chief of the overseas subsidiary shows his EIQ (emotional intelligence quotient) as 8 on a 1-10 scale, which stands for superior EI. But suppose we used the test on the same person after one month and found that his IQ as revealed by the test as 6 (which indicates just an average performance), the measures provided by the test are not dependable. Ideally, the two scores must be the same. But when we take into consideration the inaccuracies which enter into mental measurement (factors like maturation, forgetting, varying test conditions etc.), we are willing to admit small differences. Any way we will be satisfied with the test only if the test provides comparable measures from time to time. This form of reliability is also called **temporal stability.**

b. Validity

Validity refers to the ability of a measurement tool to measure what it is supposed to measure. Validity is defined as 'the extent to which the procedure actually accomplishes what it seeks to accomplish or measure what it seeks to measure'. Validity has been classified mainly into three forms , namely, content, construct and criteria.

Content Validity: The contents of the measurement tool must adequately and comprehensively cover the major elements d of the performance dimension that is measured. For instance, measurement of 'intangibles' of a firm must cover its goodwill, brand equity, corporate governance, corporate social responsibility, environmental concerns, cherished values, and so on. A very simple example would be: the question paper as a measurement tool of student learning, must cover the whole syllabus and not few areas only.

Construct Validity: Construct validity measures the logical or the underlying factor that explain a performance. Performance is measured through performance boosters like ability, behavior and commitment. From these performance level can be constructed. Alternatively, we can establish this type of validity by logically analyzing the contents of the measurement yardstick.

Criterion related Validity: Criterion validity makes use of the statistical comparison of the performance scores of a firm with some independent criterion. Reasonable agreement between the two measures is interpreted as evidence of this type of validity. The external measure for comparison is termed the criterion for validation. The external criterion is justified on the basis of some logical connection which should exist between the test and criterion. For example firms with higher profitability must also come good on the external criterion factor namely, higher market valuation as well.

c. Objectivity

The extent to which a measure is a function of the trait measured, is referred to as objectivity. This is exact opposite of the term called subjectivity. A subjective measure is one in which the human being who makes the measurement permits his own values, judgments and prejudices to enter into the measurement. Examples of subjective judgments are many.

Some techniques of measurement are more likely to be subjective. Interviews, for example, can yield results which are not completely objective, unless adequate precautions are taken to make them objective. The behavior, appearance, voice, etc of a person may make the evaluator to mark the person high or low, though the person is neither high nor low, but average.

Objectivity in measurement is now ensured by providing standard measurement tool, veiling the identity of the person/entity assessed, standardized conditions for scoring and interpreting measurement scores and specific directions using the scores, etc. Many of the precautions taken for attaining reliability of measurement will very often be of help in ensuring objectivity.

NOTES

NOTES

3.6.2 Indicators of Performance

Performance is achievement or fulfillment of tasks given and goals assigned within prescribed conditions. Performance of companies can be measured through diverse indicators. There are financial and non-financial indicators. These are dealt here.

1.6.2.1 Financial Performance Indicators

Financial performance of the MNEs matter most. The 'money measurement' concept of accounting emphasizes measurement of business performance and assets and liabilities in monetary terms taking 'money units' as the common denominator, despite its deficiencies. The trend, relative size and fluctuations of top, middle and bottom lines of the income statement, the quality, uniqueness, value and fluctuations in the value of assets, the cost and variations in cost and flexibility of liabilities, the return on investment and risk associated with the return are some of the important financial side variables or factors of enterprises. The different financial measures of performance are dealt now.

i. Top line performance

The top line refers to sales revenue. The overall size, the product composition, the regional share, the seasonal distribution and trend thereof are important financial measures of performance. These measures in a way represent the company's competitive strength tested in the market place. Revenue growth may be driven by value addition, by upward price revision and by quantity rise. The first and last are better means, than the middle one in a competitive market. The product line composition of sales revenue, the country-wise share of sales revenue, the subsidiary-wise share of sales revenue, the seasonal spread, the overall market share, market share by regions, products & seasons, the place of subsidiaries in their respective national/regional markets and trend in these are important measures of performance.

ii. Middle line performance

Middle lines refer to cost factors. What is the prime cost? What is the Factory cost? What is the Production cost? What is the Marketing cost? What is the Labour cost? What is the Overhead cost? What is the Promotion cost? What is the Cost of sales? What is the size? What is the trend? How do we compare with our competitors?

In "Citigroup's Enterprise Marketing Expenses: The Middle Line" a comparison of the company's enterprise marketing cost per dollar (CPD) of revenue with four competitors revealed that the Citi reported the lowest of them all: just $0.23 in May, 2007. Morgan Stanley (MS) was the runner-up with a CPD of $0.26 in May, 2007. Over the ten most recent reporting periods the CPD numbers for Citigroup and Morgan Stanley dropped dramatically from $0.39 and $0.63 to $0.23 and $0.26 respectively. A greater fall was reported by Morgan Stanley (MS). In the same reporting periods J. P. Morgan's (JPM) fell from $0.65 to $0.32; Goldman Sachs (GS) declined from $0.41 to $0.31; and Merrill Lynch (MER) went from $0.50 to $0.30. A lot of belt tightening was going on in this strategic group. Cost control and reduction by waste reduction and rising productivity performance rather than by reducing compensation to employees are most preferred.

In the same post I found that Citigroup's 40% share of revenues in March, 2005 was almost double that of JPM 's weak second place 21% share of revenues. I speculated there may be scale economies in Citi's enterprise marketing cost per dollar.

iii. Bottom line performance

Net income is informally called the bottom line because it is typically found on the last line of a company's income statement. Net income is equal to the income that a firm has after subtracting all costs and all expenses from the total revenue. Net income can be distributed among holders of common stock as a dividend or held by the firm as retained earnings. he items deducted will typically include tax expense, financing expense (interest expense), and minority interest. Likewise, preferred stock dividends will be subtracted too, though they are not an expense. When the top line is tall enough and middle lines aren't mega size, bottom line balloons.

iv. Sensitivity analysis

Sensitivity of top line with regard to change in price/product mix/promotion cost and the like need to be studied. Similarly, sensitivity of middle lines with regard to change in input price/product mix/outsourcing or in-sourcing and the like need to be done. Sensitivity of bottom line with regard to change in both top and middle lines and other external factors need to be made for monitoring bottom line performance and effect strategic change. This is not be an annual exercise, rather fortnightly, if not weekly.

v. Cash flow performance

Cash flow = Net Income + Depreciation + Non-cash other operating expenses + Non-operating expenses – Non-cash operating income – Non-operating incomes. Assuming that the last 4 are insignificant or mutually off-setting, Cash flow = Net Income + Depreciation. Cash flow must be sufficient for debt servicing, if any and help funding growth.

vi. Break Even Point and Margin of Safety (MOS)

The no-profit – no loss point must be lower, resulting in higher margin of safety. What is the trend in the BEP capacity? And in MOS? Downtrend in the former and uptrend in the later do well for businesses.

vii. Profitability Measures: Return of total assets and Return on equity are important measures. **ROA= Return on Assets = Net Income after Tax, but before Interest / Total assets. ROE= Return on Equity = Net Income after Tax / Total Equity .**

NOTES

ROE is the ratio of net income after tax to total equity or shareholders' fund which is equal to paid up capital, contributed capital in excess of capital or *aka,* share premium or surplus and free reserves representing undistributed profits. Needless to add higher values mean better performance.

viii. Leverage benefit

Leverage means getting an advantage. In financial management, two types of leverages are used, viz., operating leverage and financial leverage. Operating leverage means using fixed operating cost to enhance earnings before interest and taxes (EBIT) for a given change in the Contribution, (C) which is the excess of selling price over variable cost per unit.

The Degree of Operating Leverage (DOL) = Rate of change in EBIT / Rate of change in 'C'. = (“EBIT/ EBIT) / (“C / C)
= C / EBIT (since, “C =”EBIT)

Companies which can increase EBIT by more percentage for a small change in quantity sold are in a better position. Higher DOL means, for a small change in contribution, that is quantity sold, a magnified change in EBIT would result and vice versa.

Financial leverage studies the rate of change in earning per share (EPS) to that of EBIT. Degree of Financial Leverage (DFL) = EBIT / (EBIT - I). A higher DFL means, EPS changes more than proportionately for a given change in the EBIT. DOL and DFL when multiplied we get degree of total leverage (DTL).

For growing firms higher leverage effects help much in boosting the ROA and ROE.

ix. Risk level

Risk refers to fluctuations in return. It is the uncertainty associated with a benefit. Using standard deviation or variance of returns or the covariance of the returns of an investment and that of the market return, risk can be measured. High risk investments need to be avoided, unless matching high return is available.

x. Payback Period (PBP)

Payback period refers to the number of years one has to wait to get back the capital invested in a venture in the beginning. For this we have to get the cash flow from business.

If the cash flow is uniform year after year, the formula for cash flow is : Original Investment / Annual Cash Flow. If the cash flow is not uniform, the following formula is used to find the PBP:

n
“ CF_t – I = 0
t=1

NOTES

where 't' = time period varying from to 1 to n, I = Initial investment, CF_t = cash flow at time 't' and t = time measured in years.

Shorter payback period is preferred most in the world of competition, technological changes and uncertainties of market conditions.

xi. Net Present Value (NPV)

Net present value is computed given the original investment, annual cash flows (PAT + Depreciation) and required rate of return, which is equal to the cost of capital. Given these, NPV is calculated as follows:

$$NPV = - I + \sum_{t=1}^{n} CF_t / (1 + k)^t$$

Where, I = Original or initial investment, CF_t = annual cash flows

K = cost of capital and t = time measured in years.

Needles to add, higher NPV is the preferred one.

xii. Internal Rate of Return (IRR)

Internal Rate of Return (IRR) is the value of "k" in the equation, $- I + [\sum CF_t / (1 + k)^t] = 0$. In other words, IRR is that value of "k" for which aggregated discounted value of cash flows from the project is equal to original investment in the project. When manually computed, "k" i.e., IRR is got through trial and error and if need be, adopting a sort of interpolation. Suppose for a particular value of k, $- I + \sum CF_t / (1 + k)^t > 0$, we have to use a higher `k' in our next trial and if the value is < 0, a lower `k' has to employed next time. Then you can interpolate k from the two values of 'k' employed thus far. The interpolated value of `k' is the IRR. Higher IRR is preferred.

xiii. Liquidity performance -Current ratio

Current ratio measures the ability of a firm to pay off short-term liabilities as and when these mature for repayment. Current ratio = Current assets / current liabilities.. Current assets should be more than current liabilities. The acceptable ratio is 2; we may allow a range of 10% and that it should be between 1.8 and 2.2. The ratio beyond 2.2 will indicate that either the inventories are stocked unnecessarily or the products produced are not sold. The current ratio will indicate the necessity for proper inventory control.

xiv. Solvency performance- Debt service coverage ratio (DSCR)

The ratio indicates the capacity of the unit to repay the term loan liabilities and interest thereon. This ratio indicates the cash generation for the repayment of term liabilities and balance left for the company's use. Repayment of term loan without generating sufficient

NOTES

cash will lead to reduction in the working capital, tight liquidity position and further deterioration in the working of the unit. The acceptable ratio should not be less than 3. The **formula** calculation of the DSCR is given below.

DSCR= (Profit after tax + Depreciation + Interest on Loans) / [(Payment of term loans) /(1 –TR) + Interest on loans], where TR is the tax rate. Since repayment installment of debt has to be met out of post tax profits, an adjustment is done with the tax rate.

xv. Economic Value Added

A modern measure of business performance is maximization of economic value added (EVA). EVA = NOPAT - CCC, where, EVA is economic value added, NOPAT is net operating earnings after tax but before interest and dividend and CCC is cost of combined capital. CCC = Interest paid on debt capital plus fair remuneration on equity. EVA is, simply put, excess of profit over all expenses, including expenses towards fair remuneration paid/payable on equity fund as well.

xvi. Wealth Maximization

Wealth maximization means maximization of net-worth of the institution, i.e., the market valuation of the institution. This is considered to be superior and wholesome, as all diverse performance ultimately leads to wealth maximization.

xvii. Assets turnover performance

Assets turnover performance measures the sales creating effect of assets. Typically cost of sales divided by total assets, called as total assets turnover ratio is widely considered a solid way of measuring activeness of a business in terms of sales creation.

xviii. Adjusted NPV for MNE Subsidiary

In the case of group companies or MNCs, the project cash flow differs from parent's cash flow (aggregate of parent's own cash flow and that of subsidiaries put together). Simple lateral summation cannot be made just like that. Adjustments are called for. Further just one discount rate cannot be applied.

a. Project cash flow

Normally project cash flow analysis is simply based on the total investment needed, its operating results resulting in sales, variable cost, fixed cost, depreciation, taxes, working capital needed in the beginning and retrieved at the end, the salvage value of the project's fixed assets, etc. The computation of project cash flow will not consider any adjustments for synergies (additional sales achieved by the parent due to the establishment of the subsidiary) obtained by the group or the cannibalism (lost sales because of the formation of the subsidiary) suffered, difference between market price and transfer price charged for

NOTES

internal transactions, taxes paid or saved by the parent on royalties, management fees, etc received from subsidiary, exchange rate fluctuations, and so on. As a result a project's evaluation is devoid of reality.

b. Parent's Cash Flow

The project cash flow is not to be laterally added to the parent's cash flow to arrive at combined cash flow, because the parent suffers cannibalism or enjoys synergy due to the subsidiary, tax incidences on receipts from and payments to the subsidiary and so on. **Therefore, Project cash flow '•Parent's cash flow.** So a project assessed without adjustments for the factors causing difference between project and parent cash flow will not reveal the correct picture of the real worth of the project. Therefore adjustments are called for.

c. Adjustments Called for

A project's cash flow differs from a parent's incremental cash flow. Several factors stand behind this deviation as mentioned above. Hence adjustments of project's cash flow for these factors are called for. Some of the factors for which adjustments are required are as under:

Cannibalism Factor: An Indian firm has been supplying software for a US computing company. Now the Indian firm is floating its US subsidiary. The cash flow of the US subsidiary of the Indian firm needs adjustment for the replaced export earnings of the Indian parent firm. The new US subsidiary eats away its Indian parent's export earnings. This is the cannibalism factor. The US subsidiary's cash flow must be reduced by the lost export earnings of its parent.

Synergy Factor: The new US subsidiary of the Indian parent, by its high standards and contacts world over, enabled the Indian parent to export to Europe and Japanese markets. These exports are otherwise impossible to have been clicked. This is the synergy factor, which is opposite to cannibalism factor. The US subsidiary's cash flow must be inflated.

Opportunity Cost Factor: Say, the Indian parent acquired long ago property for $ 20 mn in US, where the subsidiary now is carrying its operations. Presently market value of the property is $ 100 mn, though book value is only $ 20 mn. The opportunity cost of the property, namely its market value, must be considered for evaluation of the subsidiary. The capital outlay of the project must be based on the market value of the property used by it.

Release of Blocked Factors: Suppose, US tax authorities had given a tax credit, being refund of excess property tax paid on the property, amounting to $ 2 mn. The money cannot be repatriated in India. But can be used for investment in US only. Since the commissioning of the US subsidiary has given an opportunity to activate the blocked fund,

NOTES

which is otherwise sunk fund, the initial cost of the US subsidiary can be reduced by the extent the released level of blocked funds.

Interest Free or Concessional Loan: Suppose the US Govt. gives a $ 60 mn loan repayable $ 20 mn p.a. over next 3 years, for the purpose of the Indian parent, in appreciation of the US subsidiary's strategic importance to US economy, free of interest. The excess of $ 60 mn over the present value of debt repayments affected at end of year 1, year 2 and year 3, is a benefit accruing to the parent. But, the subsidiary must be given credit, in turn, by the parent.

Transfer Pricing: Transfer pricing refers to pricing product/service sales/purchases within group concerns. Should transfer pricing be at cost or at a profit, is a debatable issue. If intra concern transfers are made at cost, though it may be objective it conceals the efficiency of both the transferor and transferee. If intra-concern transfers are to be made at a profit the question of reasonable profit is to decided and there is no consensus as to what reasonable profit percentage is. The affiliates of an MNCs are closely integrated. As such, they can easily manipulate trade for maximization of the global after-tax profit, by reducing group tax outgo. They do it by means of under-invoiced or over-invoiced 'transfer pricing'. MNCs use transfer pricing to reduce tax by shifting profit from high-tax zone to low-tax zone, to reduce duty levy by similar shifting and to avoid exchange controls. Suppose the Indian parent reduces its corporate tax liability through transfer pricing mechanism. The tax saved by the parent has to be used to inflate the cash flow of the US subsidiary project.

Discount rates: We have just seen that different cash flows emanate from the foreign subsidiary. All these cash flows carry different risk levels associated. So to discount them to their present values different discount rates must be used. Thus one discount rate would not do.

No penalty or reward: MNEs should evaluate subsidiary managers separately from their subsidiary's performance so as not to penalize or reward them for conditions beyond their control. For example, the MNE parent may decide not to expand further in a country because of its slow growth and risky economic and political environment and still reward that country's managers for doing a good job under adverse conditions.

3.6.2.2 Non-financial indicators

Manufacturing and production, Sales and marketing, People, Research and Development and Environment are the factors.

Looking at each of these areas in turn, the following non-exhaustive list of performance measures is relevant. No one indicator should be over emphasized and no one indicator should reign supreme for long in the corporate consciousness of executives or management gurus.

NOTES

i. Manufacturing and Production Non-financial Performance Indicators

The sheer volume, variety and complexity of managerial issues surrounding the production process make this area of corporate activity a particularly rich one for non-financial indicators. Performance indicators can be devised for all operational areas. Non-financial indicators, depending on the exact nature of the production process, might include:

Positive and Negative motions emanating from time and motion studies
Production line efficiency; Production line repair record
Ability to change the manufacturing schedule when the marketing plan changes
Reliability of component parts of the production line
Keeping failures of finished goods to a minimum
Product life cycle
Measurement of scrap; Fault analysis; Actual failure rates against target failure rates
Complaints received against the quality assurance testing program
Annualized failures as a % of sales value
Inventory levels and timing of deliveries; Just in time - inventory control
Stock turnover ratio; Weeks stocks held; Analysis of stock-outs
Suppliers delivery performance
% of total requests supplied in time; Shipments vs. first request date
% supplied with faults
Average no. of days shipments delay
Response time between enquiry and first visit

ii. Sales and Marketing Non-financial Performance Indicators

Sales and Marketing area has number of non-financial measures. These are as below:

Measurements based on 'staying close to the customer'
Complaints re-manuals, re-packaging / ease of opening
Quality of packaging materials
Customer satisfaction analysis
Price of products comparisons
Check on unsuccessful visit reports
Monitoring repeated lost sales by individual salesmen
Sales commission analysis
Monitoring of enquiries and orders
Sales per 100 customers
"Strike rate" - turning enquiries into orders
Analysis of sales by Product line, By geographical area, By individual customer & By
Matching sales orders against sales shipments - the trend from the mismatch
Backlog of orders analysis
Flash reports on sales
Publication of sales teams performance internally
Analysis of basic salaries and sales commissions
Share of the market against competitors
Share of new projects in the industry
New product / service launch analysis
Time to turn round repairs
Delays in delivering to customers (customer goodwill)
Value of warranty repairs to sales over the period

NOTES

iii. People: Non-financial Performance Indicators

Non-finance performance analyses related to the personnel are as follows.

Head count by responsibility
Mix of staff analysis: Mix of business analysis vs. Staff personnel needs; Skilled vs. Non skilled Management numbers vs. Operations staff, Own labour / outside
Workload activity analysis
Vacancies existing and expected
Labour turnover: Labour turnover vs. Local economy
Absence from work; % of overtime worked to total hours worked
Staff morale
Cost of recruitment: Number of applicants per advert; Number of employees
Staff evaluation techniques: Evaluation of staff development plans Monitoring of specific departments, eg. Accounting
Speed of reporting to internal managers vs. headquarters
Accuracy of reporting as measured by misallocations and mis-postings
Queries regarding what reports mean
Monitoring of departments performance long term
Pay and conditions vs. Competition
360º Degree appraisal.

iv. Research and Development (R&D) Non-financial Indicators

Non-finance performance analyses applied to R&D are as follows.

Evaluation vs. Basic R&D objectives, strategic objectives and project objectives
Product improvement against potential market acceptance
R&D against technical achievement criteria, against cost and markets
R&D priority vs. Other projects
R&D vs. Competition
R&D technical milestones
Analysis of market needs over the proposed product / service life of R&D outcome
Top management audit of R&D projects
Major program milestones
Failure rates of prototypes
Control by visibility – releases, e.g. Definition release, design release, trial release, manufacturing release, first shipment release, R&D release

v. Environment: **Non-financial Indicators**

Non-finance performance analyses as to Environment are as follows.

Work place environment yardsticks
Cleanliness
Tidiness
Campus facilities vs. Competition
Social participation index vs. Competition
Emission/Discharge levels of toxic gases or industrial effluent water
Noise and water pollutants
Green-effects

Although several approaches to designing and implementing a system to provide nonfinancial performance measures have been proposed, the problem of integrating nonfinancial measures with financial measures effectively still remains an open question.

3.6.2.3 Key performance indicators (KPIs)

According to each perspective of the Balanced Score Card there are a number of KPIs. Table 3.4 gives a list of perspective-wise performance indicators.

Table 3.4 BSC Perspective-wise Key performance indicators

Financial	Customer	Internal Business Processes	Learning & Growth
Cash flow	Delivery Performance	Number of Activities	Investment Rate
ROI	Customer satisfaction	Opportunity Success Rate	Illness rate
Financial Sensitivity	Customer retention	Accident Ratios	Internal Promotions %
ROI, ROA & ROE		Defect Rates	Employee Turnover
Return on equity			Gender/Racial Ratios

Industry specific KPIs are established through case studies.

NOTES

3.6.2.4 Leading and lagging performance indicators

There are leading and lagging performance indicators. The leading indicators are futuristic or prospective while lagging indicators are historical or retrospective.

Most traditional measures like ROI, Assets turnover, etc are lagging. **Peter F Drucker's** message that a traditional measure is not adequate for business evaluation is very apt. A primary reason why traditional measures fail to meet new business needs is that most measures are lagging indicators. The emphasis of accounting measures has been on historical statements of financial performance. They are the result of management performance, not the cause of it; i.e., they are better at measuring the consequence of yesterday's decisions but unlikely to provide useful indicators for future success. As a result, they easily conflict with new strategies and current competitive business realities.

To ameliorate this "accounting lag" situation, researchers have frequently attempted to provide new measuring procedures. The new measures should broaden the basis of nonfinancial performance measurement. It must truly predict long-term strategic success. External performance relative to competitors, such as market share, is an important measure. In addition, the recent rise of global competitiveness re-emphasizes the primacy of operational, i.e., nonfinancial performance. However, these nonfinancial measures are typically qualitative. And these are predictive or futuristic or prospective or leading.

3.6.3 Evaluation and Evaluation Systems

Concept of performance evaluation, types of evaluation and need for evaluation are dealt in this section. Besides, evaluation systems like budgetary system, benchmarks system, standard costing system etc are described. Also the concepts of Balanced Score Card and 360-degree appraisal are presented.

3.6.3.1 Concept of Evaluation

Evaluation is the analysis and comparison of actual progress vis-à-vis prior plans. Evaluation is oriented toward improving plans for future implementation to ensure improved performance. Evaluation is part of a continuing management process consisting of planning, implementation, and evaluation. Ideally each of these steps follows the other in a continuous cycle until successful completion of the activity.

Evaluation involves **comparison** of actual performance **against benchmarks** or standards of performance to establish the extent of fulfillment of goals and identify gaps in performance to suggest remedial courses for ensuring that in the end all ends well, that is fulfillment level is 100%. The goals vary depending on the situation, participants and issues.

Evaluation is the **systematic and objective assessment** of the **relevance, efficiency**, **effectiveness, sustainability, and impact** of development interventions or programs.

Evaluation is the assessment of how well a project/activity achieved its objectives. **Normative evaluation** is a judgment as to whether something is good or bad in some respects, a value judgment. **Descriptive evaluation** just reports: What is what? How has something happened? Why has something happened? **Prescriptive evaluation** prescribes future courses of action for improved performance or elimination of poor performance.

Evaluation may be **post action evaluation and continuous or ongoing** evaluation during implementation. Post action evaluation is feed-back oriented. Ongoing evaluation is evaluation during implementation. It is referred to as 'review' and is linked closely with monitoring or assessment of the project's success in meeting its intended outcomes.

3.6.3.2 Types of Evaluation

There are qualitative and quantitative evaluation systems. There are formative and summative evaluations. These are presented now.

Qualitative evaluation is an assessment process that answers the question, 'How well did we do?' The areas of focus of qualitative evaluation include: i. Content, quality, and relevance of a program; ii. Attitudes and achievements of the participants; iii. Quality of resources employed and environment adopted; iv. Efficiency of strategies and activities; v. Social Costs in relation to what was achieved and vi. Social Benefits

Quantitative evaluation is an assessment process that answers the question, 'How much did we do?' The areas of focus of qualitative evaluation include: Numbers of offerings, amount of good and bad outcomes, economic costs, economic benefits and so on.

Formative evaluation is a process of ongoing feedback on performance review. The purposes are to identify aspects of performance that need to improve and to offer corrective suggestions. Be generous with formative evaluation. Share your observations and perceptions with all. Formative evaluation need not make a judgment. When giving formative feedback, offer some alternatives. Formative evaluation is needed if safety concerns arise.

Summative evaluation is a process of ongoing feedback on performance review with the purpose of identifying larger patterns and trends in performance and judgment against criteria to obtain performance ratings.

Table 3.5 below compares formative and summative evaluation according to the kind of information provided and the timing.

NOTES

Table 3.5 Comparison of Formative and Summative Evaluation

	Formative Evaluation	Summative Evaluation
What information	Specific description of daily events	General trends based on specific descriptions
	Particular skills and performance	Overall attitude and performance
	Needs assessment	Comparison with evaluation tool
When to give	At the time of the incident	Mid-point in the course
	End of the day	End of the course

Systematic collection of information about the activities, characteristics and outcomes of program is needed to make judgments about the program, improve program effectiveness and/or inform decisions about future programming. Evaluation has several distinguishing characteristics relating to focus, methodology and function. Evaluation (i) assesses the effectiveness of an ongoing program in achieving its objectives and (ii) relies on the standards of project design to distinguish a program's effects from those of other contributing factors to performance.

1.6.3.3 Evaluation process: Evaluation activities and Dimensions

According to American Evaluation Association evaluation involves 'assessing the strengths and weaknesses of programs, policies, personnel, products, and organizations to improve their effectiveness'. Evaluation is the systematic collection and analysis of data needed to make decisions.

Here are just some of the **evaluation activities** that are already likely to be incorporated into many programs or that can be added easily:

Pinpointing the services or outcomes needed; their levels; their quality standards.

Establishing program objectives and deciding the particular evidence that will demonstrate that the objectives have been met. A key to successful evaluation is a set of clear, measurable, and realistic program objectives. If objectives are unrealistically optimistic or are not measurable, the program may not be able to demonstrate that it has been successful even if it has done a good job

Developing or selecting from among alternative approaches for measuring performance

NOTES

Tracking program objectives for example, setting up a system that shows who gets services, how much service is delivered, how participants rate the services they receive, and which approaches are most readily adopted by staff

Determining the extent to which a particular approach is being implemented faithfully by participants.

The **Dimensions of evaluation include** process, outcome, and impact evaluation.

Process Evaluations describe and assess the system of functioning of a unit or a person. The system of planning, organizing, directing, executing, controlling and reporting are assessed. Examining the implementation of activities is an important form of process evaluation. Implementation analysis documents what actually transpires in a unit and how closely it reflects the goals.

Outcome Evaluations study the immediate or direct effects of the program on participants. For example, when a 10-session program aimed at quality checking of system inputs is completed, can the participants demonstrate the skills successfully? The scope of an outcome evaluation can extend beyond knowledge or attitudes, however, to examine the immediate behavioral effects of programs.

Impact Evaluations look beyond the immediate results of policies, instruction, or services to identify longer-term as well as unintended program effects. It may also examine what happens when several programs operate in unison. For example, an impact evaluation might examine whether a program's immediate positive effects on behavior were sustained over time.

Regardless of the kind of evaluation, all evaluations use data collected in a systematic manner. These data may be quantitative such as counts of program participants, amounts of counseling or other services received, or incidence of a specific behavior. They may be qualitative or quantitative. Successful evaluations often blend quantitative and qualitative data collection.

3.6.3.4 Need for Evaluation

Evaluations serve many purposes. Before assessing a program, it is critical to consider who is most likely to need and use the information that will be obtained and for what purposes. Listed below are some of the most common reasons to conduct evaluations. These reasons cut across the three dimensions of evaluation just mentioned. The degree to which the perspectives of the most important potential users are incorporated into an evaluation design will determine the usefulness of the effort.

Evaluation for Overall Management: An evaluation for overall management monitors the routines of operations. It can provide the staff members or administrators with information

NOTES

on such items as participant characteristics, activities, allocation of staff resources, program costs, etc. Analyzing information of this type can help the staff members to make short-term corrections ensuring, for example, that planned activities are conducted in a timely manner. This analysis can also help staff members to plan future direction such as determining resource needs for the coming year. Operations data are important for responding to information requests from constituents, such as boards of directors or divisional heads. Also, descriptive program data are one of the bases upon which assessments of program outcome are built.

Evaluation for Staying on Track: Evaluation can help to ensure that enterprise activities continue to reflect its plans and goals. Data collection for overall management may be similar to data collection for staying on track, but more information might also be needed. This type of evaluation can help to strengthen service delivery and to maintain the connection between enterprise goals, objectives, and services. Delays are foreseen and corrective actions taken to remain on stream and schedule.

Evaluation for Efficiency: Evaluation can help to streamline service delivery or to enhance coordination among various components, lowering the cost of service. Increased efficiency enables the firm to reach and serve more markets, offer more services, or target services to those whose needs are greatest. Evaluation for efficiency might focus on identifying the areas in which the firm is most successful in order to capitalize upon them. Also, it might identify weaknesses or duplication in order to make improvements, eliminate some services, or refer participants to services elsewhere. Evaluations of both process and outcomes are used to determine efficiency.

Evaluation for Accountability: When it comes to evaluation for accountability, the users of the evaluation results likely will come from outside of program operations: parent firm, funding agencies, elected officials, or other policymakers. Be it a process or an outcome evaluation, the methods used in accountability evaluation must be scientifically defensible, and able to stand up to greater scrutiny than methods used in evaluations that are intended primarily for “in-house” use.

Evaluation for Development and Dissemination: Evaluating new approaches/activities is very important to enterprise development in any field. Developers of new approaches/activities need to conduct methodical evaluations of their efforts before making claims to potential users. Rigorous evaluation of longer-term outcomes is a prerequisite to asserting that a new approach/activity is effective. Disseminating the new approaches/activities organization-wide will spread the benefits wider.

3.6.3.5 Evaluation Systems

We ensure evaluation is based on business needs and program objectives. We design an evaluation process, then develop and conduct surveys, focus groups and interviews to

NOTES

gather both quantitative and qualitative information. We analyze results, separating the impact of training from other influences in the work environment. And we produce clear, concise reports with realistic recommendations.

i. Benchmark System

Benchmarking also 'best practice benchmarking' or 'process benchmarking' is a process used in strategic management, in which organizations **evaluate** various aspects of their processes in relation to industry **best practice/best quality**, usually within their own sector. Best Practice is that technique, method, process, activity, incentive or reward considered more effective at delivering a particular outcome than any other technique, method, process, etc. This then allows organizations to develop plans on how to adopt such best practice, usually with the aim of increasing some aspect of performance. Benchmarking is often a continuous process in which organizations continually seek to challenge their practices. Groups of companies and MNEs establish group bench marks called as **Collaborative benchmarking**.

Benchmarking process: There is no single benchmarking process that has been universally adopted. The most prominent methodology is the 12 stage methodology by Robert Camp, the author of the first book on benchmarking in 1989.

The twelve stage methodology consisted of:

i. Select subject ahead
ii. the process
iii. Identify potential partners
iv. Identify data sources
v. Collect data and select partners
vi. Determine the gap
vii. Establish process differences
viii. Target future performance
ix. Communicate
x. Adjust goal
xi. Implement
xii. Review/recalibrate.

Take the leading edge practices and develop implementation plans which include identification of specific opportunities, funding the project and selling the ideas to the organization for the purpose of gaining demonstrated value from the process.

Technical benchmarking or Product Benchmarking: Technical benchmarking process is particularly well developed within the automotive industry, 'Automotive Benchmarking' where by applying the best technologies available worldwide class product offerings continually hit the markets.

NOTES

Process benchmarking: Process benchmarking is the initiating firm focuses its observation and investigation of business processes with a goal of identifying and observing the best practices from one or more benchmark firms. Activity analysis will be required where the objective is to benchmark cost and efficiency.

Financial benchmarking: Financial benchmarking performs a financial analysis and comparing the results in an effort to assess one's overall competitiveness.

Performance benchmarking: Performance benchmarking allows the initiator firm to assess their competitive position by comparing products and services with those of target firms.

Strategic benchmarking: Strategic benchmarking involves observing how others, including those in other sectors/industries compete.

Functional benchmarking: Functional benchmarking a company will focus its benchmarking on a single function in order to improve the operation of that particular function. **Sales benchmarking** is a functional benchmarking, which involves comparing a company's sales force against other companies or against industry performance. The purpose is to identify opportunities to improve performance and to focus the efforts of a sales organization.

Advantages of benchmarking: Benchmarking is a powerful management tool because it overcomes 'paradigm blindness'. 'Paradigm Blindness' is the thinking that, 'the way we do it is the best because this is the way we've always done it'. Benchmarking opens organizations to new methods, ideas and tools to improve their effectiveness. It helps crack through resistance to change by demonstrating other methods of solving problems than the one currently employed, and demonstrating that they work, because they are being used by others.

ii. Budgetary System

Budgetary System is a planning and controlling tool. As such it helps in evaluation as well. Because, the targets are available in the budget. The actual then shall be weighed against the budget and performance can be rated. Budgets and budgetary control constitute budgetary system

Budget: A budget is a detailed plan of operations for some specific future period. It is an estimate of costs and benefits of programs to be undertaken and policies thereto prepared in advance of the period to which it is applied. Budget acts as a business barometer as it is a complete program of activities of the business for the period covered. According to Gordon and Shillinglaw, 'budget is a predetermined detailed plan of action developed and distributed as a guide to current operations and as a partial basis for the subsequent evaluation of performance'. The Institute of Cost and Management Accountants, England, defines a budget as 'a financial and/or quantitative statement, prepared prior to a defined period of time, of the policy to be pursued during that period for the purpose of attaining a given objective'. Thus, the following are the essentials of a budget:

- It is prepared in advance and it is a plan of actions for the feature.
- It is related to a future period and is based on objectives to be attained.
- It is a statement expressed in monetary and/or physical units prepared for the implementation of policy formulated by the management.

Different types of budgets are prepared by concerns for different purposes. A sales budget is prepared for the purpose of forecasting sales for a future period and on its basis other budgets are prepared. An operating cost budget is prepared for forecasting the operating costs.

The Master Budget embodies plans - for the revenues and gains and other incomes, for operating, marketing and other expenses, for cash and capital requirements besides forecasting the profit or loss.

Budgetary Control: When budget is used for control, it is budgetary control. The Institute of Cost and Management Accountants, England defines budgetary control as "the establishment of budgets relating to the responsibilities of executives to the requirements of a policy, and the continuous comparison of actual with budgeted results, either to secure by individual action the objective of that policy or to provide a basis for its revision". According to J.A.Scott, "it is the system of management control and accounting in which all operations are forecast and so far as possible planned ahead and the actual results compared with the forecast and planned ones". Thus, budgetary control involves the following:

- Establishment of budgets.
- Continuous comparison of actual with budgets for achievement of targets and placing the responsibility for failure to achieve the budget figures.
- Revision of budgets in the light of changed circumstances

The difference between budgets, budgeting and budgetary control can be sited. Budgets are the individual objectives of a department, etc. Budgeting may be said to be the act of building budgets. Budgetary control embraces all and in addition includes the science of planning the budgets themselves and the utilization of such budgets to effect an overall management tool for the business planning and control. Budgetary control has become an essential tool of management for controlling costs and maximizing profits. It may be conceived as one of the supreme examples of rationality in management.

Advantages of Budgetary Control: The following are some of the most significant advantages of budgeting:

- Budgeting compels management to plan for the future. The budgeting process forces management to look ahead and become more effective and efficient in administering operations. It instills into managers the habit of evaluating carefully their problems and related variables before making any decisions.

NOTES

- Budgeting helps to coordinate, integrate, and balance the efforts of various departments in the light of the overall objectives of the enterprise. This results in goal congruency and harmony among the departments.
- Budgeting facilities control by providing definite expectations in the planning phase which can be used as a frame of reference for judging the subsequent performance. Undoubtedly, budgeted performance is more relevant standard for comparison than past performance since past performance is bases on historical factors which are constantly changing.
- Budgeting improves the quality of communication. The enterprise's objectives, budget goals, plans, authority and responsibility and procedures to implement plans are clearly written and communicated through budgets to all individuals in the enterprise. This results in better understanding and harmonious relations among managers and subordinates.
- Budgeting helps to optimize the use of the firm's resources, both capital and human. It aids in directing the total efforts of the firm into the most
- Budgeting measures efficiency and thereby enables self-evaluation by the management, it also indicates the progress made in attaining the enterprise's objectives.

Zero Base Budgeting (ZBB): Zero Base Budgeting is a new technique designed to revitalize budgeting. This technique was first used by the U.S. Department of Agriculture as long back as in 1961. Texas Instruments, a multinational company, pioneered its use in the private sectors. It was Peter A.Pyhrr who designed its logical basic framework in 1970 and successfully developed, implemented and popularized its wider use in the private sectors. He is, therefore, rightly termed as the "Father of Zero Base Budgeting". The technique gained further momentum in U.S.A. when the President of U.S.A. Mr. Carter, in 1979, issued a mandate asking for use of ZBB technique throughout the federal government agencies. Thus, ZBB replaced to conventional budgeting technique at the federal government level. The technique is now also gaining tremendous foothold in many commonwealth countries, particularly in Canada. Institute of Chartered Accountants of India and the Institute of Costs and Works Accountants of India have advocated ZBB technique..

Zero base budgeting (or review), as the term suggests, examines a program of function or responsibility from "scratch". The reviewer proceeds on the assumption that nothing is to be allowed. The manager proposing the activity has, therefore, to prove that the activity is essential and the various amounts asked for are reasonable taking into account the volume of activity. Thus ZBB means writing on a clean slate. Zero-base budgeting provides the organization with a systematic way to evaluate different operations and programs undertaken by the management. It enables management to allocate resources according to priority of the programs. It links budgets with the corporate objectives. Nothing will simply be allowed only because it was being done in the past, if it does not help in achieving the goals of the enterprise. It can be used for introduction and implementation of the system of "management by objectives". Thus, it can not only be used for fulfillment of the objectives of traditional budgeting but it can also be used for a variety of other purposes.

iii. Standard Costing System

NOTES

Standard costing is technique of cost planning and control, based on scientific analysis of elements of cost in terms of standard input / output norms and standard rates / price per unit of input. The following process is involved in setting and practicing std. cost.

- Establish standard cost, component-wise, for each output
- Measure the actual cost, component-wise, for each output
- Their comparison with the actual costs and the measurement of variances.
- The location of responsibility for the variances and the corrective action to be taken.
- The analysis of variances for ascertaining the reasons for the same.

Establishment of a Standard Costing System: The installation of Standard Costing System in a manufacturing concern involves the following steps:

- Standardization of functions i.e., all activities should be standardized and the technical processes of operations should also be susceptible to planning.
- Establishment of Cost Centre
- Classification of Accounts i.e., the different accounts can be codified and different symbol may be used to facilitate speedy collection, analysis and reporting.
- Setting up of Standards: Standards may be basic (long period) and current (short period). From the point of view of efficiency level, they will fall into three broad categories: (a) Strict ideal; (b) attainable or expected/actual and (c) loose. The standard should be realistic and attainable. Unrealistic standards provoke resentment and depress performance. Loose standard leads the management to indulge in self-congratulation. Normally, a period of one year is more realistic, as it coincides with the budget period and the normal accounting period.
- Setting of Standard Costs: Standard Costs should be determined for each element of cost separately and accurately. Like a budget committee in big institutions, there should be a standards committee or Standards Division which will be vested with the work of setting standard costs. The Standards Committee generally consists of all functional heads like program manager, personal manager, etc.

Standard Costs: For any given program or unit the following standards must be determined:

i. Standard material costs
ii. Standard labour costs
iii. Standard direct costs
iv. Standard variable overhead costs
v. Standard fixed overhead costs
vi. Standard selling prices and profit

The standard direct material cost is found by multiplying the quantity of materials to be purchased with the rate of a price at which they are available.

Determination of Standard Labour cost involves fixation of (a) standard labour grades (b) standard labour times i.e., standard hours through “Time, Motion and Fatigue Study”

NOTES

with the help of work study engineers and (c) standard wage rates based on time rate, piece rate and premium plans.

Standard Direct (expenses) cost is any expenditure (other than direct material and direct labour) which is directly to be incurred on a specific cost unit. It is charged directly to the particular cost standard (account) concerned.

Standard Overhead costs are classified as manufacturing, administration. selling and distribution overheads. They are also classified as fixed, variable and semi-variable so that correct estimate for each class may be prepared for the budget period. Standard overhead rate is determined on the basis of past records and future trend of prices.

Determination of Standard Hour: Time factor is common to all the operations. So if standard costing 'Standard hour' is applied to the quantity of work or output which should be performed in one hour. A standard hour may be defined as an hour which measures the amount of work that should be performed in one hour under standard conditions. It has a practical advantage in the measurement of 'Efficiency Ratio' and 'Activity Ratio'.

Efficiency ratio: Efficiency ratio is the number of standard hours equivalent to the work produced, expressed as a percentage of the actual hours spent in producing that work.

$$\text{Efficiency Ratio} = \frac{\text{Standard hours for actual production}}{\text{Actual hours for action production}} \text{ x } 100$$

Activity Ratio: Activity Ratio is the number of standard hours equivalent to the work produced, expressed as a percentage of budgeted standard hours.

$$\text{Activity Ratio} = \frac{\text{Standard hours for actual production}}{\text{Standard hours for budgeted production}} \text{ x } 100$$

3.6.4 Balanced Score Card (BSC): A New Evaluation System

The balanced score card (BSC) has become a widely accepted performance measurement tool. It was developed and first used at Analog Devices in 1987. By focusing not only on financial outcomes but also on the customers, processes and competitive capabilities the balanced scorecard helps to provide a more comprehensive view of a business which in turn helps organizations to act in their best long-term interests leading to better overall performance. The strategic management system helps managers focus on performance metrics while balancing financial objectives with customer, process and employee perspectives. BSC measures are often indicators of future performance. Robert S. Kaplan and David P. Norton worked on propagating the application of BSC since 1990s. Kaplan & Norton themselves revisited the scorecard with the benefit of a decade's experience since the original article.

NOTES

The BSC is a performance measurement framework, with similar principles as Management by Objectives. It is placed alongside approaches such as Activity Based Costing and Total Quality Management. The Balanced Scorecard provides managers with the instrumentation they need to navigate to future competitive success.

The earliest Balanced Scorecards comprised simple tables broken into four sections - typically these 'perspectives' were labeled "Financial", "Customer", "Internal Business Processes", and "Learning & Growth". Designing the Balanced Scorecard required selecting five or six good measures for each perspective. In the mid 1990s an improved design method emerged. In the new method, selection of measures was based on a set of 'strategic objectives' plotted on a 'strategic linkage model' or 'strategy map'. With this modified approach, the strategic objectives are typically distributed across a similar set of 'perspectives' as is found in the earlier designs, but the design question becomes slightly more abstract. Managers have to identify the five or six goals they have within each of the perspectives, and then demonstrate some inter-linking between them by plotting causal links on the diagram. Having reached some consensus about the objectives and how they inter-relate, the Balanced Scorecard's measures are chosen by picking suitable measures for each objective. This type of approach provides greater contextual justification for the measures chosen, and is generally easier for managers to work through. This style of Balanced Scorecard has been the most common type for the last ten years or so.

Since the late 1990s, various alternatives to the Balanced Scorecard have emerged - examples being The Performance Prism, Results Based Management and Third Generation Balanced Scorecard for example.

Balanced Scorecard is a performance management tool, although it helps focus managers' attention on strategic issues and the management of the implementation of strategy. It is important to remember that Balanced Scorecard itself has no role in the formation of strategy. Balanced Scorecard can comfortably co-exist with strategic planning systems and other tools.

Kaplan and Norton found that companies are using the scorecard to:

Drive strategy execution
Clarify strategy and make strategy operational
Identify and align strategic initiatives
Link budget with strategy
Align the organization with strategy
Conduct periodic strategic performance reviews to learn about and improve strategy.

Balanced scorecards have been implemented by government agencies, military units, corporate units and corporations as a whole, nonprofits, and schools; many sample scorecards can be found via Web searches, though adapting one organization's scorecard

NOTES

to another is generally not advised by theorists, who believe that much of the benefit of the scorecard comes from the implementation method.

3.6.4.1 Comparison BSC with Applied Information Economics

A criticism of balanced scorecard is that the scores are not based on any proven economic or financial theory and have no basis in the decision sciences. The process is entirely subjective and makes no provision to assess quantities like risk and economic value in a way that is actuarially or economically well-founded. The Balanced scorecard does not provide a bottom line score or a unified view with clear recommendations; it is simply a list of metrics. Positive responses from users of balanced scorecard may merely be a type of placebo effect. There are no empirical studies linking the use of balanced scorecard to better decision making or improved financial performance of companies.

Applied Information Economics (AIE) has been researched as an alternative to Balanced Scorecards. In 2000, the Federal CIO Council commissioned a study to compare the two methods by funding studies side-by-side projects in two different agencies. The Dept. of Veterans Affairs used AIE and the US Dept. of Agriculture applied balanced scorecard. The resulting report found that while AIE was much more sophisticated, AIE actually took slightly less time to utilize. AIE was also more likely to generate findings that were newsworthy to the organization while the users of balanced scorecard felt it simply documented their inputs and offered no other particular insight. However, balanced scorecard is still much more widely used than AIE.

3.6.4.2 The four perspectives of BSC

The grouping of performance measures in general categories (perspectives) is seen to aid in the gathering and selection of the appropriate performance measures for the enterprise. Four general perspectives have been proposed by the BSC. These are:

The **financial perspective** examines if the company’s implementation and execution of its strategy are contributing to the bottom-line improvement of the company. It represents the long-term strategic objectives of the organization and thus it incorporates the tangible outcomes of the strategy in traditional financial terms. Some of the most common financial measures that are incorporated in the financial perspective are **EVA, revenue growth, costs, profit margins, cash flow, net operating income** etc.

The **customer perspective** defines the value proposition that the organization will apply in order to satisfy customers and thus generate more sales to the most desired (i.e. the most profitable) customer groups. The measures that are selected for the customer perspective should measure both the value that is delivered to the customer (value position) which may involve time, quality, performance and service and cost and the outcomes that come as a result of this value proposition (e.g., customer satisfaction, market share). The value proposition can be centered on one of the three: operational excellence, customer intimacy or product leadership.

The **internal process perspective** is concerned with the processes that create and deliver the customer value proposition. It focuses on all the activities and key processes required in order for the company to excel at providing the value expected by the customers both productively and efficiently. The clusters for the internal process perspective are **operations management** (by improving asset utilization, supply chain management, etc), **customer management** (by expanding and deepening relations), **innovation** (by new products and services) and **regulatory & social** (by establishing good relations with the external stakeholders).

The **learning and growth perspective** focuses on the **intangible assets** of an organization, mainly on the human skills and organizational capabilities that are required to support the value-creating internal processes. The learning and growth perspective is concerned with the jobs (human capital), the systems (information capital), and the climate (organization capital) of the enterprise. These three factors relate to what Kaplan and Norton claim is the infrastructure that is required for achieving ambitious objectives in the other three perspectives. This of course will be in the long term, since an improvement in the learning and growth perspective will require certain expenditures that may decrease short-term financial results, whilst contributing to long-term success.

MNEs appraisal of Host Country Managers (HCMs): MNCs profoundly affect the process of globalization principally through their subsidiaries, which, therefore, places an immense dependence on the subsidiary. The managers of subsidiaries, commonly called host country managers (HCMs), are responsible for the performance of the subsidiary and the implementation of strategically critical tasks, such as the management of a number of staff and the achievement of the revenue and profitability targets of the subsidiary. The HCM must be able to manage these tasks within the objectives and guidelines handed down by the MNC. Thus, the MNC's control of the subsidiary and its HCM are a central integrating function in the MNC. Where a subordinate and supervisor are geographically distant, regular feedback has been found to be imperative.

Information asymmetry and goal incongruence vitiating HCMs' PAs: These mechanisms enable the MNC to continuously evaluate and improve individual, subsidiary unit and corporate performance against clearly defined, preset objectives that are directly linked to company strategy. Thus, an effective PA creates a mechanism that can ensure the HCM and their overseas subsidiaries are acting in accordance with the parent MNC's interests. While there is wide recognition of the importance of PAs, most MNCs have not effectively managed their international appraisals. It has been argued that mismanagement of international PAs is primarily due to **information asymmetry and goal incongruence** between the parent company and its subsidiaries.

NOTES

NOTES

QUEATIONS TO CONTEMPLATE AND DELIBERATE

Q 1.6. a Elucidate the Concept and Mechanics of Performance Measurement
Q 1.6. b Present the different classifications of Performance factors
Q 1.6. c Examine the types and uses of different financial PerformanceIndicators
Q 1.6. d Discuss the different non-financial Performance Indictors
Q 1.6. e What are Key performance indicators? Explain them in detail
Q 1.6. f Present the Concepts and Types of Performance Evaluation
Q.1.6. g Discuss the Performance Evaluation Process in terms of Evaluation activities and Dimensions
Q.1.6. h Examine the need fulfilled or application areas of Performance Evaluation
Q.1.6. I Discuss features, types and uses of Benchmark System of Evaluation
Q 1.6. j Explain the features, merits and uses of Budgetary System of Evaluation
Q 1.6. k Discuss the features, types and uses of Standard Costing System inEvaluation
Q 1.6. l Elucidate the types and uses of Balanced Score Card System of Evaluation

SUMMARY

Global Business Management is becoming more and more strategic today which in effect involves effective aligning with the global environment in a more proactive manner. Global environment provides extended opportunities and also great challenges. Right alliance with the environment helps exploiting opportunities and meeting challenges.

i. STRATEGIC ORIENTATIONS

According to **Ricky Griffin,** strategy has essentially four basic areas, namely: **Scope, Resource, Uniqueness and Synergy**.

Strategic Mix: The strategic mix has three levels. At the top is corporate strategy, at one level below is the business strategy and at the bottom is the functional strategy. This is the hierarchy of strategies.

Corporate strategy is about the course charted for the whole of the organization. It deals with the **'what'** aspect. It is also known as the **'grand'** strategy. The curtailment goal calls for a **retrenchment strategy**. The status-quo goal calls for a **stability strategy**. It is a **consolidation-oriented** goal. Finally, **backward and forward expansion** goals come with a **diversification strategy**. It should be noted that **competitive distinctiveness** and **synergy** are augmented. Corporate level strategic alternatives for **'stars', 'cash cows', 'question marks' and 'dogs'** may have to be formulated.

'**Business strategies**' are concerned with the **'how'**. **Griffin** puts up them as follows. **Defender, Reactor, Analyzer and Prospector** strategies are these. These strategic

NOTES

alternatives emerge from certainty-uncertainty conditions of the environment and the firm's response.

Defender strategy is pro-status-quo. **Analyzer strategy** is steadily modifying the course in tune with the changing environment and competitors' strategies. **Prospector strategy** looks out for new opportunities and learns about the same. Finally the **Reactor strategy** where no opportunity is reaped but quite a number of threats are faced.

Functional strategies address the operative functional areas like production, marketing, finance, personnel and R&D. Functional strategies are more action-packed. These should be clear-cut and address very specifically the 'how much' aspect.

Strategy implementation calls for an **organization structure, control mechanisms, information system, performance measurement and evaluation systems**.

Organizational structure gives the framework or lines of communication, authority, responsibility and accountability. The structure must have **stability** to facilitate day to day activities to go on consistently and **flexibility** to facilitate taking advantage of opportunities that environment throws up.

Control mechanism ensures that the missions and goals are realized as planned.

Information system provides connectivity with all outside, inclusiveness with all inside and certainty to all concerned. A real time, reliable information system works for the best of all. Information system depends on the structural pattern and control mechanism followed.

For MNEs with diverse geo-settings ratings of executives need to be fool proof. This calls for holistic **performance measurement**.

Finally the **evaluation system** comes. Evaluation involves adjudging performance as outstanding or good or bad based on certain benchmarks or standards or targets or budgets.

Formulation and implementation of different levels of strategies are linked. Corporate strategies are formulated and implemented first. This leads to formulation and implementation of business strategies. Then follow the formulation and implementation of functional strategies. **Link-pins** are thus involved from one level up to the next down in the ladder to ensure **continuity** & **synergy**.

ii. STRUCTURAL DESIGNS OF MNES

The structural initiatives of MNEs aim for '**greater effectiveness, speed up time to market for new products, and increase the efficiency.** MNEs are having wide

NOTES

options, for different geo-locations may suit/dictate different structures. In essence, MNEs need to be global and local (multi-domestic) at the same time.

Organizational structure, according to **Stephen P. Robbins** is a composite term covering three important aspects namely, **differentiation, formalization and centralization**.

Differentiation makes the organization to look like an assembly of distinct units based on functions, locations or so. **Horizontal differentiation**, **Vertical differentiation** and **Spatial differentiation** exists.

Formalization refers to the adherence to set rules and procedures. Actually, **formalization tries to reduce the complexity and confusion** resulting from differentiation referred to above, by prescribing intended behaviour on the part of constituents. **Over-done formalization makes the organization more mechanic/compartmentalized and less organic or social**.

Centralization refers to degree to which decision making is concentrated at a single or relatively a few points. In a tight-centralized organization more is the degree of concentration of decision-making authority. A kind of 'militarization or regimental syndrome' results eventually.

Tom **Peters and Waterman Jr**. in their celebrated book, **'In search of Excellence'**, point out that most of the best-run companies really do view themselves as an extended family. Family means attachment, equity etc. **Alvin Toffler** also rightly writes in his book, '**Third Wave'**, break the codes of which one is 'centralization'. Can we do away with centralization altogether? But that is not the solution or intention. We have to use it in appropriate measures.

Differentiation, formalization and centralization all no doubt give shape, orderliness and uniformity to organizations. But these are not all that always wanted. More of the three make the organization **Mechanistic structured. Organic structures** involve decentralization of authority, horizontal communications, greater individual authority, flexibility and adaptability. The structures vary from **loose structures** to **structure-free** forms as well.

Basic structural options: Between centralization and decentralization, between differentiation and unification and between formalization and in-formalization, we have certain broad choices.

The traditional structures of MNEs include: **Global Division Structure, Global Functional Division Structure, Global Product Division Structure, Global Geographic (Area) Division Structure and Global Client type.**

NOTES

Structures evolve to suit growth and growth needs. The need and opportunities for being globalized and localized are the two opposite forces. Ultimately a matured MNE will blossom into a TNC. There are two alternative routes. From overtly localized structures it may **pull itself up** to become a TNC structured. Else, from an overtly globalized structure it may **bend itself down a little** to become a TNC structured. There is the golden mean route that traverses in left to right upward diagonal slope taking Matrix structure, MNC structure, Global company structure and finally TNC structure.

New structures continue to evolve to deal with complex exigencies. **Prof. H.V. Perl mutter** made out in 1969 that MNEs adopted organizational structures that fell in a continuum of **ethnocentric to polycentric models** and he advocated the **geo-centric mind-set**.

Many Japanese companies are known for their **net-works** or what is called in their vernacular as ***keiretsus.*** Sometimes *keiretsus* are vertical, such as that between Toyota and its parts suppliers. Sometimes they are horizontal.

A **spin-off (or spinoff)** is a new organization or entity formed by a split from a larger one. One objective of spin-off company formation is ‘new product’ development.

Lead Subsidiary takes global and regional responsibilities for R&D, manufacturing, product management or key marketing functions.

iii. LOCUS OF DECISION POWER

According to **John D Daniels and Lee H Radebaugh,** companies choose the locus of decision power based on a combination of three trade-off’s:

i. Balancing pressures for global integration versus pressures for local responsiveness

ii. Balancing the capabilities of headquarters versus subsidiary personnel

iii. Balancing the expediency versus the quality of decisions

Pressures for Global Integration Vs Local Responsiveness: The factors that influence are: Resource transference, Standardization, Systematic dealings with stakeholders, Transnational strategy and Ad-hoc strategy.

Capabilities of Headquarters Vs Subsidiary Personnel: Decision power must vest with competence. Of course as competence level changes, locus of decision power also changes. Traditionally some decisions are reserved for corporate management. Subsidiaries can have autonomy over certain activities, such as developing a specific product or technology or conducting certain market testing.

NOTES

Decision Expediency and Quality: Quick decision is referred to expedient decision and good decision is called quality decision. Sometimes, a quick decision, though poor is better than a good one that comes too late, provided no cascading problem takes place.

iv. APPROACHES TO CONTROL

Harold Koontz and O'Donnel say, 'Controlling is the measurement and correction of performance in order to make sure that enterprise's objectives are accomplished.' Planning and controlling go together like **'Siamese Twins'**.

Based on when correction is initiated, 3 control systems exist. In **post-action-oriented or feedback control type,** corrections follow late. **Steering control or feed-forward control system**, on the other hand, is future-oriented. In **'concurrent or real time control**, corrective courses are made continuously as executions happen.

Depending on the sphere of focus we have **'Strategic control and Operational control'**. In the MNE's context, **strategic control is the responsibility of parent** and **operational control is the preserve of the subsidiary.**

'Management control, tactical control and transactional control' as the 3 levels of control respectively carried out by the corporate top management, collectively by corporate & subsidiary management and subsidiary management in the case of MNEs.

General Control Mechanisms: Corporate culture, Coordinating methods, Reporting and Visits are certain mechanisms of control in the context of MNEs.

Requisites of Control in MNE's context: The control process of MNEs consists of 6 component steps. These are: i. Strategic Planning; ii. Organizational structure iii. Location of decision making iv. Control mechanisms v. Structure and Control Interface and vi. Control in the Globalization Process

v. ROLE OF INFORMATION SYSTEMS

Information = Data + Relevance. Adding relevance to data is what is called as data processing. **System is a set of interacting or interdependent entities forming an integrated whole**. An **open system** usually interacts with some entities in their environment. A **closed system** is isolated from its environment.

Information - the most valuable asset: The most valuable of all assets of companies today, information ranks first. Information is invisible and is represented in people, experience, know-how and innovations (patents, copyrights, trade secrets. In the post-industrial era or the information age, the focus of companies has shifted from being product oriented to knowledge oriented, in a sense that market operators today compete on process and innovation rather than product.

NOTES

Information System: An Information System (IS) is the 'system of persons, data records and activities that process the data into information in a given organization, including manual processes or automated or computerized processes'.

Diverse forms of Information systems. Business Informatics (BI) , Metadata, Management Information Systems (MIS)**,** Enterprise Resource Planning (ERP) and Enterprise content management (ECM) are relevant ISs for MNEs.

vi. PERFORMANCE MEASUREMENT

MNEs need to measure performance of all its organizational participants/elements and subsidiaries. Efficacy of organizational control depends on efficient measurement of performance.

Mechanics of performance measurement deal with the technicalities and procedure of performance measurement covering Unit of measure of performance, Performance dimension & Performance thrust, Financial and non-financial emphasis, Single Vs Multiple indicators, Entity whose performance is to be measured, Time frame of measurement, Process of measurement, Periodicity of measurement, Personnel involved in measurement and Adjustments made in measurements.

Attributes of sound measurement mechanics: There are at least three major attributes expected of any good measurement mechanics. These are**: Reliability, Validity and Objectivity**. I**nternal consistency** and **temporal stability** are components of Reliability. C**ontent validity, Construct validity and Criterion validity** are components of Validity.

Indicators of Performance: Performance is achievement or fulfillment of tasks given and goals assigned within prescribed conditions. There are financial and non-financial indicators. These are dealt here.

Financial Performance Indicators: The trend, relative size and fluctuations of top, middle and bottom lines of the income statement, the quality, uniqueness, value and fluctuations in the value of assets, the cost and variations in cost and flexibility of liabilities, the return on investment and risk associated with the return are some of the important financial side variables or factors of enterprises.

Non-financial indicators: These relate to the quality of achievement rather than the quantity of financial results reaped. Manufacturing and production**, S**ales and marketing**,** People**,** Research and Development and Environment are the factors.

vii. EVALUATION

Evaluation is the analysis and comparison of actual progress vis-à-vis prior plans. Evaluation is oriented toward improving plans for future implementation to ensure improved performance.

NOTES

Qualitative evaluation is an assessment process that answers the question, 'How well did we do?'. **Quantitative evaluation** is an assessment process that answers the question, 'How much did we do?'. **Formative evaluation** is a process of ongoing feedback on performance review. **Summative evaluation** is a process of ongoing feedback on performance review with the purpose of identifying larger patterns and trends in performance.

Dimensions of evaluation include process, outcome, and impact evaluation. **Process Evaluations** describe and assess the system of functioning of a unit or a person. The system of planning, organizing, directing, executing, controlling and reporting are assessed. **Outcome Evaluations** study the immediate or direct effects of the program on participants. **Impact Evaluations** look beyond the immediate results of policies, instruction, or services to identify longer-term as well as unintended program effects.

Need for Evaluation: Evaluation is needed for Overall Management. Evaluation is needed for Staying on Track. Evaluation is needed for Efficiency. Evaluation is needed for Accountability. Evaluation is needed for Development and Dissemination.

Evaluation Systems: There are good evaluation systems. Four of them are dealt here. **Benchmarking** also 'best practice benchmarking' or 'process benchmarking' is a process used to evaluate various aspects of processes in relation to industry best practice/best quality. Technical benchmarking or Product Benchmarking, Process benchmarking, Financial benchmarking, Performance benchmarking, Strategic benchmarking, Functional benchmarking, etc are certain types. **Budgetary System** is a planning and controlling tool. As such it helps in evaluation as well. Because, the targets are available in the budget. The actual then shall be weighed against the budget and performance can be rated. Budgets and budgetary control constitute budgetary system. **Standard Costing System** is technique of cost planning and control, based on scientific analysis of elements of cost in terms of standard input / output norms and standard rates / price per unit of input. **Balanced Score Card (BSC) system** is focusing not only on financial outcomes but also on the customers, processes and competitive capabilities. The balanced scorecard system helps to provide a more comprehensive view of a business. The financial perspective, customer perspective, internal process perspective and learning and growth perspective are the components of BSC.

NOTES

UNIT IV

CONFLICT IN INTERNATIONAL BUSINESS AND NEGOTIATIONS

4.1 INTRODUCTION

Conflict is 'Disagreement through which the parties involved perceive a threat to their needs, interests or concerns'. Conflict is a state of discord caused by the actual or perceived opposition of needs, values and interests. Conflict tends to be accompanied by significant levels of misunderstanding that exaggerate the perceived disagreement considerably over actual disagreement. It is a situation in which people perceive a threat (physical, emotional, power, status, etc.) to their well-being. Conflicts contain substantive, procedural, and psychological dimensions to be negotiated.

4.1.1 Conflict Types, Nature, Modes, Manifestations &Successive phases

Conflict Types, Nature, Modes, Manifestations & Successive phases of conflicts are dealt here.

a. Conflict Types

There are several types of conflicts. Conflict as a concept can help explain many aspects of social life, such as social disagreement, conflicts of interests, conflict of roles, fight for supremacy between individuals, groups, or organizations, family conflict, etc.

In **political terms, "conflict"** can refer to wars, revolutions or other struggles, which may involve the use of force as in the term armed conflict. Without proper social arrangement or resolution, conflicts in social settings can result in stress or tensions among stakeholders.

Internal and external conflicts: In the personal sphere, a conflict can be internal (within oneself) or external (between two or more individuals). In the organizational sphere, a conflict can be internal (within the organization) or external (between two or more organizations). In the national sphere, a conflict can be internal (within one nation) or external (between two or more nations).

NOTES

Conflicts 'nested' in conflicts, it is said. For example, conflict within a work team may be the reflection of a broader conflict in the organization as a whole. A conflict is more than a mere disagreement.

Professional Conflict: Governmental and MNEs' business negotiators may start with mutual mistrust due to historic animosity or to differences in their professional status. The MNE people may come armed with business and economic data that governmental officials don't fully understand, and the officials may counter with sovereignty considerations that are nearly incomprehensible to the businesspeople. It may take considerable time before each side understands and appreciates the other's point of view. Until then the created conflicts can damage goodwill.

Conflict exists in different shades, segments and sizes. Intrapersonal conflict (though this usually just gets delegated out to psychology), Interpersonal conflict, Emotional conflict, Group conflict, Organizational conflict, Community conflict, Intra-state conflict (for example: civil wars, election campaigns), International conflict, Environmental resources conflict, Ideological conflict, Diplomatic conflict, Economic conflict, Military conflict, Religious conflict, Workplace conflict, etc are different types.

b. Nature of conflict

Functional Vs Dysfunctional Conflicts: Conflict could be functional when conflict exposes the system deficiency and the same is rectified before any cascading catastrophes result. Absence of conflict does not mean everything is fine. This may conceal more rather than reveal the reality. Dysfunctional conflicts are disruptive, damaging and destructive. The more difficult type of conflict is when values are the root cause. It is more likely that a conflict over facts, or assumptions, will be resolved than one over values.

Competition, Co-operation and Conflicts: One should not confuse the distinction between the presence and absence of conflict with the difference between competition and co-operation. Even when conflict exists, parties agree to cooperate to resolve the same. Even when cooperative culture exists, there may be conflict between parties on certain aspects of relationship that may reach a flash point. A clash of interests, values, actions or directions often sparks a conflict.

Social, Ethnic and Racial differences and conflicts: Social, Ethnic and Racial differences are the cause and effect of conflicts along such lines leading to virtual non-cooperation, and sometimes illegal armed extravaganzas. Many conflicts have a supposedly racial or ethnic basis. These would include such conflicts as the Bosnian-Croatian conflict, the conflicts in Rwanda, in the Sri Lank etc. In the end the national fabric is torn and all interests are affected. Businesses are much affected.

Transforming conflict into a productive learning experience: If procedures for identifying conflicts likely to arise, as well as systems that can constructively manage conflicts are available, it may be able to discover new opportunities to transform conflict into a productive learning experience. Creative problem-solving strategies are essential to positive approaches to conflict management. Conflict is necessary in life. Conflict adds excitement and suspense that kindle creativity to evolve workable solutions.

West and East never thou meet: In Western society, practitioners usually suggest that attempts to find mutually beneficial solutions lead to the most satisfactory outcomes, but this may not hold true for many Asian societies.

c. Modes of Conflict

Organizational conflict within the MNE like workplace conflict, conflict between the MNE and outer societies, conflict between the MNE and state/government of the host nation, non-targeted conflict like civil wars, class wars, political upheavals that affect businesses particularly foreign, diplomatic problems between countries that spill over to businesses, external aggression or internal disturbances or terrorist actions that affect foreign businesses, etc are important types of conflicts. Concerted action against a firm such as economic embargo, trade blockade or communicative tirade by groups of nations or by bilateral or multilateral bodies also are forms of conflict. Business conflicts like unjust unfavour in global contracts award or order placement, insufficient protection to property / parent / people / copy-rights etc also are conflicts or potential conflicts. Overprotective home labour laws, under-protective business interests due to weak laws governing financial impropriety, etc are conflict potent candidates. Religious-based conflicts depicting one or other business group, domestic or foreign, anti-religious have serious repercussions.

d. Manifestations of conflicts

Conflict can manifest in diverse forms such as ‘social disagreement’, ‘fight over ownership interests’, between individuals, groups, or organizations or countries or groups of countries of something, unjust or just aggression becoming vandalistic volition and so on. In political life, conflict manifests in wars, revolutions or other struggles, which may involve the use of force as in the term armed conflict.

In the context of this course, conflict means conflict between the parent/subsidiary and the host country elements (may be government, local business groups, social interest groups, political groups, environmental groups, consumer groups or so). Conflict exists “when two or more parties, with perceived incompatible goals, seek to undermine each other’s goal-seeking capability”.

e. Successive phases in conflicts

Several theorists detect successive phases in the development of conflicts. Often a group finds itself in conflict over facts, goals, methods or values. It is critical that it properly identifies the type of conflict it is experiencing if it hopes to manage the conflict through to

NOTES

resolution. For example, a group will often treat an assumption as a fact. It is more likely that a conflict over facts, or assumptions, will be resolved.

4.1.2 Hypotheses concerning conflicts

Theorists say parties can conceptualize responses to conflicts according to a **two-dimensional scheme**, namely, concern for one's own outcomes and concern for the outcomes of the other party. This scheme leads to the following hypotheses:

i. High concern for outcomes of both leads to mutually beneficial solutions.
ii. concern for one's own outcomes only leads to attempts to 'win' the conflict.
iii. Low concern for the own interest only leads to allowing the other to 'win' the conflict.
iv. Low concern for both side's outcomes leads to attempts to avoid the conflict.

4.1.3 Key terms in Conflict Scenario

Actors are individuals, groups or institutions who contribute to conflict, or are affected by conflict in a positive or negative manner or are engaged in dealing with conflict or associated in all or any of these.

Conflict sensitivity refers to the ability of any organization to: understand the context in which it operates; understand the interaction between its own activities and the context; and act upon the understanding of this interaction, in order to avoid negative impacts and maximize positive impacts.

Context refers to the political, economic and social operating environment, which ranges from the project level to the macro level (e.g. community, district/province, region(s), country and neighbouring countries).

Development refers to long-term efforts aimed at bringing improvements in the economic, political and social status, environmental stability and the quality of life of all segments of the population.

Impacts, positive or negative, describe an interaction in terms of its contribution to exacerbating or mitigating violence or the potential for violence.

Peace-building is those measures designed to consolidate peaceful relations and strengthen viable political, socio-economic and cultural institutions capable of mediating conflict, and to strengthen other mechanisms that will either create or support the necessary conditions for sustained peace.

4.1.4 MNEs and Conflict

MNEs live with global conflict. Violent conflict is a persistent feature of the international landscape and presents a serious challenge for foreign businesses investing in unstable societies throughout the world, especially parts of Africa, Asia and Latin America. There is a large body of evidence that shows that investments in unstable areas interact with the dynamics of violent conflict at both local and national levels. Some companies have responded with active engagement in the debate on business and conflict.

Multi-stakeholder processes such as the Kimberley Process Certification Scheme, the Extractive Industry Transparency Initiative (EITI), the UN Global Compact and the Voluntary Principles on Security and Human Rights (VPs) seek out shared solutions to problems. Since the 1980s, political risk analysis and environmental and social impact (ESIA) standards have been in a state of evolution, complemented by increasingly sophisticated understandings of the appropriate relationship between business and host societies, and of 'corporate social responsibility' (CSR).

Conflict risk

Conflict risk is the risk that a project's development, construction or operations may be adversely affected by the outbreak of violent conflict. It can be a major threat to a project's creditworthiness. Demonstrations and blockades by local communities, sabotage of project installations or facilities, kidnapping or assault to staff, outbreak of violent clashes between armed groups, demanding of payments by armed groups to project sponsors, etc. are all of the expressions of violence. These can impose direct costs to an investment, including reputational and even legal challenges arising from proximity to these factors.

MNE projects are the cause or triggers of conflicts

No project located in a conflict-prone area will be neutral. That is, just as a project may be adversely affected by violent conflict at the project or national levels, the project itself will have an impact on the conflict context within which it is located. The project and its context thus must be understood to have a two-way relationship. Even where conflict appears to be geographically far from a project, it is possible that investments, in contexts where resources are scarce, will soon become part of the conflict dynamic and becoming a source of heightened competition locally. Decisions that sponsors take regarding project location, design and management have the potential to impact and distort conflict levels and dynamics thereof. Decisions on the distribution of employment opportunities, security arrangements, relationships with political actors, environmental usage and impact, location of installation, and even social investment and community relations activities often provide the trigger which sparks pre-existing structural and proximate conflict factors into violence, to the detriment of the project itself. Understanding pre-existing tensions, and how a project may impact upon them, is thus central to improved conflict risk assessment.

NOTES

4.1.5. Conflict a cause of concern to MNEs, Multilateral bodies and global investors

Violent conflict is of concern to investors. It can also occur at more localized levels, and at the same time always has the potential to escalate. Between 1990 and 2006 number of armed conflicts rose sharply. There were over 200 armed conflicts, about 170 of which were largely, primarily or exclusively internal conflicts While some of the conflicts that erupted in the early 1990s have ostensibly been 'ended' with peace agreements. The incidence of inter-state violent conflict overall has continued to increase. Most countries coming out of violent conflict revert to war within five years, it is researched. Peace agreements do not necessarily alter the factors that led to conflict in the first place.

Today's landscape of persistent violent conflict throughout much of the developing world is complicated by the security threat posed by terrorism. Al Qaeda's attacks in the United States in 2001 brought terrorism to the forefront of political leaders' agendas throughout the world, leading to US-led military campaigns in Afghanistan and Iraq as well as increasingly strong legislative measures to support the 'war on terror'.

Globalization has not brought a balanced increase in access to economic, political and social opportunities in all countries. Terrorism may be symptomatic of a wide range of social, economic and political stresses experienced in different parts of the world. Taking account of root causes and conducting meaningful analysis of conflict dynamics on the part of all actors engaged in either development-oriented or private sector activities in developing countries becomes all the more pertinent in today's world.

In addition, project financiers/FDI providers are particularly exposed to conflict risk due to the **non-recourse/limited recourse** nature of the financing structure meaning that loans and bonds are repaid based on the revenues generated by the project itself. Creditors do not have 'recourse' to the project sponsors if the project is not successful or if difficulties in debt repayment are encountered. Hence, project financiers need to be especially concerned about managing their exposure to conflict-related credit risks. Business interruptions can lead to project downtime. Legal injunctions can lead to expensive delays. Larger compensation packages can create cost-overruns.

4.1.6 Importance of study of conflicts for MNEs

MNEs are committing billions of dollars in investment all over the world. They have export and import trades. Millions of people work in foreign countries in different MNEs. These are the stakes MNEs have.

First, since the 1980s there has been increased interest in project finance / FDI, particularly in emerging market countries in Latin America and Asia. Project finance / FDI is now commonly used to fund investments in developing countries to increase return and spread out risk. Indeed, project finance / FDI is more likely to be used where there is high

NOTES

political risk in the host country. Often through project finance / FDI syndicates which will include international lending organizations such as IFC, IBRD, MIGA or export credit agencies, risk of damage to project / FDI, default on loans is reduced. Often these syndicates which offer political influence to deter host governments from making decisions that will adversely affect the project finance / FDI. Further, for example, a financier that may normally limit its exposure in Peru might consider financing the Camisea Gas Development Project, which is based in Peru but whose risks are mitigated by project finance loan covenants. The sharing of risk by numerous parties to a project finance / FDI deal lowers the exposure to risk of an individual financier. Developing country governments can also find project finance deals appealing, in that they facilitate the entry of big foreign investors. This can provide opportunities for avoiding more public debt whilst at the same

4.1.7 Costs of conflict on projects

The cost of conflict is composed of : **Direct Cost :** Fees of lawyers and other professionals; **Productivity Cost:** Value of lost time, diminished capacity and the opportunity cost of what those involved would otherwise be producing; **Continuity Cost:** Loss of ongoing relationships including the "community" they embody; **Emotional Cost:** The pain of focusing on and being held hostage by our emotions.

There are numerous recent examples of projects that have incurred direct and indirect costs as a result of conflict. For instance, in 2001 attacks on Colombia's Caño Limón-Coveñas oil pipeline by insurgent groups resulted in a direct loss of earnings of approximately US $500 million in that year alone. Similarly, guerilla groups opposed to foreign companies have routinely sabotaged the Ocensa pipeline in Colombia, with state security forces being accused of serious human rights abuses in attempting to secure the pipeline. The attacks themselves have led to operational delays and reputational damage to project sponsor British Petroleum. Enron's Dabhol power plant in India faced a series of construction delays as a result of vehement local opposition, demonstrations and the filing of a legal injunction by affected populations who believed the plant was being built in a way that violated their rights.

While project sponsors will introduce a range of measures to reduce the risk of delays, project risk assessment and mitigation may not include a thorough analysis of two-way conflict risk impacts, and as such the risk of delays caused by conflict may not be adequately dealt with. Table 1 summarizes some potential direct and indirect costs of conflict to projects throughout various project stages.

NOTES

Table 1 Potential Direct and Indirect Costs on Projects due to Conflict

Direct costs	**Example**	**Project stage**
Security	Higher payments to state/private security firms; staff/contractor time spent on security management.	All
Risk management	Insurance, loss of coverage, reduced mobility and higher transport costs.	All, construction & operation
Material	Destruction of property or infrastructure.	Construction& operation
Opportunity	Disruption of production, delays on imports.	Operation
Personnel	Kidnapping, killing and injury; recruitment difficulties; higher wages to offset risk.	All
Reputation	Consumer campaigns, risk-rating, share-price, competitive loss.	All
Litigation	Expensive and damaging law suits.	All
Indirect costs	**Examples**	**Project stage**
Human	Loss of life, health, intellectual and physical capacity.	All
Social	Weakening of social, political and economic capital	All
Economic	Damage to financial and physical infrastructure, loss of markets	Construction, operation, closure
Environment	Pollution degradation, resource depletion	As above.
Political	Weakening of institutions, rule of law, governance.	All

Just as conflict can impose a range of direct and indirect costs on a project throughout the project life-cycle, so too will projects have an impact on the local environmental, economic, political and social context in which they are developed. For example, at the project level, a natural resource extraction project will have an impact on local land-use. The project may require the resettlement of local communities which may be a source of resentment and protest against the project by those communities. In addition, resettlement may have a secondary conflict impact of putting strains on relations between relocated and host communities – and compensation provided to resettled communities will not necessarily solve the problem. Rather, the payment of cash compensation would mean an influx of money into the local subsistence economy which, in turn, may lead to compensated individuals becoming the targets of extortion. The project sponsor may face demands for increased compensation from both resettled communities and other actors.

NOTES

At the macro-level level, the sponsor's activities will also interact with some of the structural correlates of conflict outlined above. For instance, a project sponsor may pay fees, taxes or shares production revenues with the national government of an underdeveloped country with a track record of corruption. If that government does not ensure the economic benefits of the project are equally distributed, a perceived inadequate share of revenue to the project locality can increase alienation and tensions. Where the government is overly dependent on the project, this may also lead to an increased state security presence in the project's vicinity, as well as a clampdown on dissent.

4.1.8 Resolution of Conflicts

Conflicts must be resolved. Continuance of conflicts is not good for any one. Unresolved conflicts ultimately may escalate into major catastrophe with disastrous consequences. Unresolved conflicts at the individual level may lead to great stress and break of the person; at the organizational level may lead to break of communication and eventually the organization itself; at the national level permanent damage to the national fabric and even disintegration of the nation. Even the once mighty USSR was no exception. The case of Africa is worrying. The various violent conflicts that have afflicted Africa for the past century have exacted an incalculable toll on the continent's societies, polities, and economies, robbing them of their developmental potential and democratic possibilities. The causes of the conflicts are as complicated as the challenges of resolving them are difficult. Yet efforts at resolution of conflicts are needed. Negotiation is important to resolve conflicts. Before that the fuelling causes must be identified and checked. The development projects sometimes lead to conflicts and the same must be resolved. It is here the MNEs and multilateral development bankers come in the picture as leaders of such projects. Due diligence by them will do well. Besides the world level bodies can help contain conflicts leveraging their rich experience in such actions.

This lesson covers all these and related issues in detail.

4.2. LEARNING OBJECTIVES

- To present Conflict Types, Nature, Modes of conflict, Manifestations of conflict and the Successive phases of conflict
- To present the Hypotheses and Key terms in Conflict Scenario
- To bring out the nexus between MNEs and Conflicts
- To examine how is Conflict a cause of concern to MNEs and global investors
- To explain the importance of study of Conflicts for MNEs
- To discuss the direct and indirect costs of Conflict
- To present the Causes of Organizational Conflicts
- To present the causes of Project Related Conflicts
- To explain the causes of Violent Conflicts
- To discuss the Causes and triggers of Conflicts
- To explain Thomas-Kilmann Conflict Mode for dealing with Organizational Conflicts

NOTES

(Avoidance, Collaboration, Compromise, Competition and Accommodation

- To present Conflict Resolution methods for Project Related Conflict such as - Political Risk Insurance, Covenants and Warranties, Political Umbrella, Enhanced Due Diligence, Encouraging better conflict risk management by project sponsors and Encouraging better conflict risk management by project sponsors themselves.
- To present the Scope of Negotiations between Government and MNEs
- To discuss the Negotiation Process in International Business
- To explain the Cultural and Language Factors Affecting Negotiations
- To give the role of International Finance Corporation (IFC) in Conflict Resolution
- To give the role of Multilateral Investment Guarantee Agency (MIGA)
- To give the role of International Chamber of Commerce
- To give the role of International Centre for Settlement of Investment Disputes
- To give the role of World Trade Organization
- To elucidate measures that MDBs, RDBs, ECAs and others can follow for conflict resolution

4.3 FACTORS CAUSING CONFLICT

The factors causing conflict are divergent. The factors differ for organizational conflicts, project conflicts and so on.

4.3.1 Causes of Organizational Conflicts

Structural factors cause organizational conflict. Structural factors normally impose rigidity while businesses need dynamic adjustment. Personnel who could not tend or mend the organization, but required to show targeted results see conflict between responsibility and authority. This is an organizational conflict.

Specialization of functions in organizations leads to conflict because generally the experts in fields fail to agree. It is usual for ‘n’ experts to come with ‘n+1’ views. Hence the conflict that blows. Technical organizations have this problem.

Interdependence amongst organizational divisions/departments is the order of the day and conflicts develop between departments because one department is either lethargic in its commitment or it is over-smart and others could not find home. As none can operate without the other, conflict arises. This is an organizational conflict.

Sharing Common Resources such as a facility leads to conflict because one person/ division over draws and the deprived others disagree to pull together. This is an organizational or social conflict. There are societies claiming stake in the same resource – land, water, temple, etc. interstate water disputes and conflicts are common in South India. In some villages stakes to access temples pose conflicts.

NOTES

Goal Differences such as one person wants to push production and others want R&D to rise, leading to conflict. This is an organizational conflict. The parent organization and subsidiary may see different opportunities and conflict mutually.

Authority relationships may lead the boss and employees beneath him/her do not see in the same inclination, especially when the boss claims 'boss is always right', conflict arises. This is an organizational conflict.

Status Inconsistencies such as excessive/scanty power, power without sincerity, and too much politically charged atmosphere cause conflict. This is an organizational.

Inconsistencies in asset endowments cause conflict. May be it is class conflict the communists leaders project.

Jurisdictional Ambiguities who will report/discipline who lead to conflict in issuing and receiving communications. This is a kind of intra-organization conflict.

Personal Factors like perversion, misunderstanding, selfishness, etc of people lead to conflict of opinions and hence actions. This happens at home / office / private or social or official gatherings.

Personality clash where two equally placed persons or heads do not simply accept one another, leads to conflict.

Perception differences where the sensitivity or understanding of people on certain phenomena differs, lead to conflict.

Values and Ethics can cause conflicts. Differing commitment levels to, or interpretation of Values and Ethics of people may lead to conflict. Eventually 'means-ends' tussle erupt.

C**ommunication barriers** result in no communication, missile-like communication or misleading communication. Eventually somewhat long-term conflicts form.

Cultural Differences: Culture tells people what emotions ought to be expressed in particular situations and what emotions are to be felt. Cultures differ. These differences like lack of tolerance for diversity result in conflict of cultures. One suggests rituals simply not acceptable to others. Conflicts creep.

Emotion causes result in conflicts. Conflict involves emotion because something 'triggers' it. The events triggering conflict are events that elicit emotion. Some hold the view that 'Conflict is emotionally defined and driven', and 'does not exist in the absence of emotion'. **Conflict is emotionally defined and is emotionally valenced.** Emotion levels during conflict can be intense or less intense. The intensity levels may be indicative of the importance and meaning of the conflict issues for each party. Where applicable, there are many

NOTES

components to the emotions that are intertwined with conflict. There are behavioral, physiological and cognitive components.

Behavioral: The way emotional experience gets expressed which can be verbal or non-verbal and intentional or un-intentional. **Physiological:** The bodily experience of emotion. The way emotions make us feel in comparison to our identity. **Cognitive:** The mental process of "assessing or appraising" an event to reveal its relevancy to oneself. These three components collectively constitute 'emotional experience' determined by cultural values, beliefs, and practices'. The emotion-conflict relationship is not acceptable to the Economists.

Scarcity leads to conflict, according to Economists. This is not acceptable to Psychologists. It can be said, scarcity of emotional balance is the cause of conflict!

Deprivation, economic or emotional, leads the conflict. In the circumstance of economic deprivation emotional disturbances are rational as well. Thus subject of conflict is purely rational and related to deprivation.

Moral stance leads to conflict. When an event occurs it can be interpreted as moral or immoral. Judging something as immoral may lead to conflict.

Identity or individuality issues may lead to conflict. Emotions and Identity are a part of conflict. When a person knows their values, beliefs, and morals they are able to determine whether the conflict is personal, relevant, and moral. Identity related conflicts are potentially more destructive.

Conflict is relational. Conflict is relational in the sense that emotional communication conveys relational definitions that impact conflict. Key relational elements are power and social status.

Societies with weak institutions witness more conflicts: Violent conflict is more common in societies with weak institutions and chronic poverty. Of the 32 countries in the low human development section of the HDI table, 22 have experienced conflicts at some point since 1990 and five of these experienced human development reversals over the decade (UNDP 2005). Furthermore, conflict gives rise to chain reactions that perpetuate and extend economic losses: a slowing economy, weak rule of law, corruption and an uncertain security setting represent powerful disincentives for investment

4.3.2 Causes of Project Related Conflicts

Large infrastructure projects and conflicts: Second, large infrastructure projects and conflicts go together. Multilateral Project finance is a widely used method for financing large infrastructure projects and certain types of natural resource extraction activities like power plants, oil and gas pipelines and hydroelectric dams, for example. These activities are often linked to conflicts at local and national levels due to their strategic significance,

NOTES

their large environmental, social and revenue 'footprint', and the need to protect such assets with security forces. Large projects may require resettlement, alienate communities from their land, or otherwise affect socio-cultural groups whose needs are not addressed by the government or the project. In addition, natural resource extraction projects are generally associated with the phenomenon known as the **'resource curse',** which describes the structural link that has been demonstrated to exist between dependence on natural resources and underdevelopment or conflict. So project finance often occurs in the context of developing countries and socially/environmentally sensitive large projects.

Project loans/advising/promotion for controversial projects and conflicts: Project finance draws a clear line of responsibility connecting financiers with the social impacts caused by particular projects. For example, a bank that arranges a project loan for a controversial dam can run the risk of being held publicly accountable for capitalizing that project and for the conflict that might ensue at the time of delivering projects.

Capital flight and money laundering and conflicts: Every corrupt dictator that has transferred money offshore for personal enrichment has done so with the aid of correspondent and/or private banking services. Such grand-scale corruption is often a correlate with violent conflict. A US bank was unknowingly involved in a case with a former Chilean dictator.

Financial advising and conflicts: Financial advising is an important service offered to sovereign governments, but sometimes this advice is employed for dubious ends. This happened in Papua New Guinea a decade ago in 1997 and a London based financial service provider was unknowingly involved in this.

Sovereign loans/bonds/book-runners and conflicts: Financiers provide loans to sovereign governments that may engage in human rights abuses or war-mongering activities. Apartheid South Africa used a UK-based bank to fund such activities. Guatemala's links to human rights abuses and political repression was inadvertently facilitated by sovereign bond offerings by two international investment banker based in New York, US.

Financing state-owned enterprises and conflicts: According to the NGO Global Witness, 'much of the money from loans from global bankers especially from Swiss ostensibly got for funding an Angolan state-owned oil company was used to purchase weapons.

Trade facilities indirectly used to war-purposes and conflicts: Merchant banks provided trade facilities that enabled governments to import weapons, communications equipment, and other articles of wars. Financiers may also support the manufacture of these items.

Export credits and support of arms sales and conflicts: A significant proportion of export credit guarantees awarded by banks in support of the defence industry to recognized sovereign governments and in line with international regulation has slipped into faulty hands.

NOTES

Conflict commodities and conflicts: Timber, cobalt, tin, diamonds, gold and oil may generate hard currency for tyrannical regimes, civil war or violent conflict, as has been the case in some African countries such as Liberia and Angola. Links between international financial markets and conflict commodities are well documented. Terrorist organizations have started making money through the investment markets, it is reported, even in developed countries.

Host Governments against the MNE projects: Host Governments are against the MNE projects in some countries now and most countries 3 decades ago. When the Janata Party came to power in India during 1977 at the national level following the Emergency, Industry Minister George Fernandes forced the exit of Coca-Cola from the country. Sometimes major political parties out of power and in attempt to catch on to power-ladder just cry foul against MNE projects or shun out-sourcing to a third country some low end jobs through subsidiaries of companies of their countries. They can whip public outcry by simply fuelling passion against MNEs or their outfits.

4.3.3 Causes for Violent Conflicts

Violent conflicts occur when two or more parties believe their interests to be incompatible, express hostile attitudes, or take actions that damage the other's ability to pursue its interest. Conflict is a dynamic process with complex causes, and may take differing forms and runs through various stages of escalation and de-escalation. It can turn into violence. 'Violence' is often used interchangeably with 'conflict,' but violence is only one means among many that parties choose to address a given conflict. Conflict becomes violent when parties no longer seek to attain their goals peacefully, but instead resort to violence in one form or another. When violence erupts, it signifies a profound breakdown in social relationships that is likely to have long-term and far-reaching destructive 'Conflict' is also sometimes erroneously confused with macro-political violence between effects.

Social, Ethnic and Racial differences and conflicts: Social, Ethnic and Racial differences lead to conflict along such lines leading to virtual non-cooperation, and sometimes armed extravaganzas. Many conflicts have a supposedly racial or ethnic basis. These would include such conflicts as the Bosnian-Croatian conflict, the conflicts in Rwanda, in the Sri Lank etc. In the end the national fabric is torn all interests are affected. Businesses are much affected.

Poor Governance, Weakest Economies, Poverty and Highest Corruption: Poor Governance, Weakest Economies, Poverty and Highest Corruption are major causes of violent conflicts. Some of the African countries suffer this risk.

4.3.4. Causes and triggers of Conflicts

Conflict is sometimes viewed in the corporate world as a separate 'issue' that can be addressed in isolation from other 'issues' such as human rights, the environment or sustainable development. However, conflict is a cross-cutting theme or context – a violent manifestation

NOTES

of tensions that may have arisen for a variety of reasons (e.g. human rights abuses, environmental scarcity or degradation, unjust governance, economic insecurity). Research institutions, international organizations and others have made attempts at modeling individual risk factors that lead to the break out of violent conflict. To begin to understand conflict, and how infrastructure, resource extraction and other projects may interact with conflict, it is useful to structure thinking about violent conflict in terms of structural and proximate causes, and triggers. Table 2 gives the details of types of causes and triggers of conflict.

Table 2: Types of Causes of conflict

	Description	Correlates of conflict - examples
Structural/ Root causes	Structural factors are pervasive factors that have become built into the policies, structures and fabric of a society. These causes of conflict are inevitably the most complex and long-term but constitute an ever-present threat.	**Poor governance and corruption:** Related to government's responsiveness to citizen's concerns; **Poverty:** Proxy for weak government and correlated with incidence of intra-state violence due to absence/inequality in distribution of economic benefits; **Uneven spread of ethno-nationalist groups across different regions:** Conflict can correlate where population distribution is significantly skewed.
Proximate causes	Proximate Factors are symptomatic of the root causes and may heighten the risk of violent conflict, or exacerbate and perpetuate existing conflict. Proximate causes take on a particular importance at the local level.	**Availability of light weapons:** Even when easy access to weapons does not lead to conflict, it increases the risk of violence and suggests weak or corrupt security structures; **Human rights abuses:** A history of violations can leave a legacy that fuels conflict and indicates poor governance or repressive regime. **Objectives of political actors:** Armed groups and others may seek violent solutions to long-term historical grievances.
Triggers	Triggers are single acts, events or their anticipation that may set off or escalate violent conflict.	Elections, Increased food scarcity, Environmental disasters, Security arrangements of companies, Project resettlement and compensation policies when announced

Source: International-Alert Organization-Web-publications

Relationship between correlates of conflict and conflict: It should not be assumed that violent conflict is inevitable where the correlates listed above are present in a particular

NOTES

country. Equally, a conflict may break out where some or most of these correlates do not exist. However, a good overview of a country's conflict correlates and hence it 'conflict context' can assist in understanding the overall level of conflict risk.

QUESTIONS TO CONTEMPLATE AND DELIBERATE

Q. 1.3. a. Present the Conflict Types, Modes of conflict, Manifestations of conflict and the Successive phases of conflict that MNEs face in their business beyond borders.

Q. 1.3. b Examine certain Hypotheses regarding conflicts and Key terms in Conflict Scenario.

Q. 1.3. c. Bring out the nexus between MNEs and Conflicts. Why does this nexus exist?

Q. 1.3. d. Examine how is Conflict a cause of concern to MNEs. Explain the costs of conflicts.

Q. 1.3. e. Explain the importance of study of Conflicts for MNEs

Q. 1.3. f Discuss the Causes of Organizational Conflicts that MNEs may face.

Q. 1.3. g Explain the causes of Project Related Conflicts and also certain violent conflicts

Q. 1.3. h. Elucidate the types of causes, and triggers of Conflicts

4.4 CONFLICT RESOLUTION ACTIONS

Conflicts must be resolved at the earliest before they assume proportions. There are behavioural and administrative measures. The behavioural measures deal with organizational conflicts, while administrative measures address project related conflicts. Conflict resolution actions for organizational conflicts and project related conflicts are dealt in this section.

4.4.1 Thomas-Kilmann Conflict Mode for dealing with Organizational Conflicts

Organizational Conflicts are resolved mostly through behavioral measures. Thomas-Kilmann Conflict Mode Instrument is one of the tools used to assess an individual's behavior in conflict situations. Research has shown that there are five basic styles or modes for handling conflict. The Thomas Kilmann Conflict Mode Instrument provides a profile of individuals and teams that indicates the gamut of conflict-handling skills which one uses in the kinds of conflict situations one faces. Five basic ways of addressing conflict, namely Avoidance, Collaboration, Compromise, Competition and Accommodation were identified by Thomas and Kilman. This is suited for organizational conflicts.

a. Avoidance: Avoid or postpone conflict by ignoring it, changing the subject, etc. Avoidance can be useful as a temporary measure to buy time or as an expedient means of dealing with very minor, non-recurring conflicts. In more severe cases, conflict avoidance can involve severing a relationship or leaving a group. If we avoid discussing the conflict at all, both parties may remain clueless about the real underlying issues and concerns, only to be dealing

NOTES

with them in the future. Avoiding is a common response to the negative perception of conflict. “Perhaps if we don’t bring it up, it will blow over,” we say to ourselves. But, generally, all that happens is that feelings get pent up, views go unexpressed, and the conflict festers until it becomes too big to ignore. Like a cancer that may well have been cured if treated early, the conflict grows and spreads until it kills the relationship. Because needs and concerns go unexpressed, people are often confused, wondering what went wrong in a relationship.

b. Collaboration: Work together to find a mutually beneficial solution. While the Thomas Kilman grid views collaboration as the only win-win solution to conflict, collaboration can also be time-intensive and inappropriate when there is not enough trust, respect or communication among participants for collaboration to occur. Collaborating is the pooling of individual needs and goals toward a common goal. Collaboration requires assertive communication and cooperation in order to achieve a better solution than either individual could have achieved alone. It offers the chance for consensus, the integration of needs, and the potential to exceed the “budget of possibilities” that previously limited our views of the conflict. It brings new time, energy, and ideas to resolve the dispute meaningfully. If we collaborate, we may not gain a better solution than a compromise might have yielded, but we are more likely to feel better about our chances for future understanding and goodwill.

c. Compromise: Find a middle ground in which each party is partially satisfied. Compromising is an approach to conflict in which people gain and give in a series of tradeoffs. While satisfactory, compromise is generally not satisfying. We each remain shaped by our individual perceptions of our needs and don’t necessarily understand the other side very well. We often retain a lack of trust and avoid risk-taking. If we compromise, we may feel OK about the outcome, but still harbor resentments in the future.

d. Competition: Assert one’s viewpoint at the potential expense of another. It can be useful when achieving one’s objectives outweighs one’s concern for the relationship. Competing is a style in which one’s own needs are advocated over the needs of others. It relies on an aggressive style of communication, low regard for future relationships, and the exercise of coercive power. Those using a competitive style tend to seek control over a discussion, in both substance and ground rules. They fear that loss of such control will result in solutions that fail to meet their needs. Competing tends to result in responses that increase the level of threat. If we use a competing style, we might force the others to accept ‘our’ solution, but this acceptance may be accompanied by fear and resentment.

e. Accommodation: Surrender one’s own needs and wishes to accommodate the other party. Accommodating, also known as smoothing, is the opposite of competing. Persons using this style yield their needs to those of others, trying to be diplomatic. They tend to allow the needs of the group to overwhelm their own, which may not ever be stated, as

NOTES

preserving the relationship is seen as most important. If we accommodate, the relationship may proceed smoothly, but we may build up frustrations that our needs are going unmet.

Table 3 gives the mapping of conflict resolution measures in terms of high-low combinations of satisfying own needs Vs Satisfying other's needs.

Table 3 Conflict Resolution Measures Mapped

High **Satisfying Other's Needs**	Accommodation/ Yielding	Compromise	Collaboration
Low	Avoidance		Competing
	Satisfying	**Own**	**Needs**

4.4.2 Project Related Conflict Resolution

Project Related Conflict Resolution measures are administrative in nature. In order to mitigate the range of conflicts facing projects in risky emerging markets, financial institutions have access to a variety of mitigation strategies, including insisting on substantial commitments from sponsors in the form of equity to ensure the project is adequately covered. The very use of project finance itself is a risk mitigation tool as it allows risks to be shared amongst the numerous parties to a transaction. However, in general, 'softer' non-commercial risks such as environmental and social risks are usually considered mitigated through 'Environmental and Social Impact Assessments' (ESIAs) and the inclusion of covenants in lending agreements that require adherence to environmental management plans. Political risks are, in turn, generally mitigated by transferring the risk to insurers.

4.4.1.1 Political Risk Insurance (PRI)

Political risk insurance (PRI) traditionally provides investments with cover for expropriation, currency inconvertibility or non-transfer and political violence covering physical damage to an asset as a result of politically motivated strikes, riots, civil commotion, terrorism, sabotage, war, and/or civil war. Coverage for business interruption and consequent loss of profit and compensation for defaults caused by political violence is also provided by PRI. Sponsors and lenders will often transfer political risk to insurers. Actually, political risk insurance is a pre-requisite for lending set down by banks.

Pros and Cons of PRI: PRI premiums are high, coverage capacity in the insurance market is limited, and cover provided is generally bound to be restrictive. PRI will typically cover specified events and reasons for project losses rather than offering a comprehensive policy. Unforeseen problems can therefore leave project developers and financiers exposed to

NOTES

losses. PRI tends to focus on primarily covering political risks that emanate from national governments (such as currency inconvertibility) and as such can overlook conflict risks faced by projects that may emerge from the structural and proximate causes of conflict outlined above, such as poor governance and corruption, or ethno-nationalist tensions. The provision of PRI may create a moral hazard whereby the provision of PRI itself may result in sponsors not having an incentive to take steps necessary to avoid exacerbating conflict in the project's sphere of influence. That is, the presence of PRI may perversely promote a lack of consideration of potential conflict impacts of the two-way relationship between a project and the surrounding conflict context. This being so, it is in the interests of project sponsors, lenders and insurance providers to align insurance with improved conflict-risk mitigation and management practices at project level. PRI does not cover many of the sub-state risks that projects in conflict-prone areas are likely to face.

PRI by MIGA- A critique: Multilateral Investment Guarantee Agency (MIGA), a PRI provider, has been criticized for failing to consider the interconnections between different components of political risk, and assessing whether a client's business activities will aggravate these risks: 'Civil unrest or violent protest may in extreme cases manifest itself in attacks on project personnel or acts of sabotage. Alternatively, it can trigger abuses of the rights of project affected people. Such events can have profound impacts on the communities in the vicinity of projects and on the reputation of a project operator, with potential ripple effects for the providers of finance or insurance. This also holds true for environmental hazards or incidents, which can cause environmental, reputational and financial damages'. The provision of PRI has been criticized by NGOs for benefiting only the project companies who may suffer losses as a result of political events, and not the host communities which may also be adversely affected, potentially as a result of conflict exacerbated by the project itself. Recently, MIGA's support of a mining project in conflict-ridden Democratic Republic of Congo (DRC) has exposed the weaknesses in its approach. Similarly, as PRI may be seen purely as a tool to protect a project's creditors, PRI providers are also criticized for failing to encourage project sponsors to adhere to basic social and environmental safeguards.

4.4.2.2. Covenants and Warranties

Non-commercial risks (including environmental and social risks) may be mitigated through the inclusion of **restrictive covenants and warranties** into credit and insurance agreements requiring the project company to ensure risks are managed appropriately at the project level. These include requirements that environmental management plans and community support mechanisms be implemented.

Pros and Cons: Limited information is in the public arena on the type of covenants and warranties used by financial institution. In particular, because of the confidential and deal-specific nature of commercial agreements, it is unclear how effective such warranties are in ensuring sponsor compliance with international best practice in environmental and social

NOTES

risk management. There is partly a lack of systematic assessment of conflict risk as well. Monitoring and compliance are important issues to consider in the context of covenants and warranties. While project lenders will employ independent consultants to conduct compliance-oriented due diligence tests of the project prior to releasing funds to the project. But these are in-effective. The Environmental and Social Review Procedures (ESRP) followed by MIGA require the institution's clients to provide warranties and assurances that environmental and social issues will be managed effectively. MIGA does not systematically assess client capacity to adhere to such warranties.

4.4.2.3 Political Umbrellas

The 'political umbrella' concept ensures that host governments will be far less likely to take certain actions such as expropriation of foreign investor assets, exacerbate violent conflicts and riots that would disrupt foreign business. The involvement of IFC or any other MDB in a project enhances the 'stamp of approval' of projects. For instance, the project sponsors of the Chad-Cameroon pipeline actively sought the involvement of IFC and other MDBs to mitigate the high political risks of developing the project through two underdeveloped, conflict-prone countries.

Pros and Cons: MDB involvement and an extensive environmental impact assessment may lower the risks facing the projects. But generally no comprehensive conflict risk impact assessment is conducted. The 'political umbrella' offered by MDBs through their syndication programs is meant to encourage private sector involvement in riskier markets, but is no guarantee that projects covered by the umbrella will be conflict-risk free.

MDBs have considerable influence in developing countries, and the majority of MDBs do consider a range of social, environmental and political issues as a part of due diligence. Only when MDBs finance projects that provide conflict-sensitive, sustainable contributions in riskier markets, in line with commitments to promoting peaceful markets, the political protection offered by the presence of a multilateral agency will be assured.

4.4.2.4 Enhanced Due Diligence

Conflict risk and impact assessment must be made a part of standard due diligence procedures. By assessing the two-way relationship between a project and the context in which it is developed, project financiers will be in a better position to understand the nature of conflict risk that may affect.

Due diligence may be enhanced in several ways. These are placed under 3 heads, namely, **Country Assessment , Human Rights and 'No-go' Criteria**.

a. **<u>Comprehensive Country Assessment:</u>** A comprehensive Country Assessment will solve most of the conflicts related to project implementation by MNEs. The Country Assessment should cover the following, apart others.

NOTES

i. **(i) Governance issues:** Is the country an autocracy or democracy? If the country a 'democracy,' has there been any violence been associated with election or political party activities or problems related to the credibility of election results in the last five years? Where is the country ranked on corruption indexes? Has there been political instability in the past three years? Does the country prevent freedom of expression?

ii. **(ii) Economic issues:** Has there been a recent economic crisis or decline? What is the country's ranking on the Human Poverty Index? Is one identifiable group (e.g. ethnic, cultural) at a serious economic disadvantage over another?

iii. **(iii) Socio-cultural issues:** How large is the country's population and growth rate, and is there a significant urban/rural divide? Are there different ethno-nationalist groups spread unevenly in different regions? Have large populations relocated to or within the country or region due to violence?

iv. **(iv) Security issues:** What is annual government military expenditure high as a percentage of GDP? Does the government have difficulty in controlling state security forces, including military, police, intelligence and militia groups, or the activities of private security companies? Are state opposition groups armed? Has there been a history of violent conflict, and is there currently violence in the country? Are there any incidences of group violence in a neighbouring country?

b. <u>Human Rights Compliance Assessment (HRCA):</u> Effective Human Rights Compliance Assessment is most needed to address the issue of conflicts in the implementation of overseas projects. HRCA on-line diagnostic tool is available which is designed to promote better corporate performance by companies by helping them to detect potential human rights violations caused by the effect of their operations on employees, local residents and all other stakeholders. The tool aims to provide companies with useful information about how to deal with human rights issues relevant for their particular operations, and runs on a database containing over 350 questions and 1000 corresponding human rights indicators, developed from the Universal Declaration of Human Rights, the 1966 Dual Covenants and over 80 other major human rights treaties and conventions. The HRCA web-based interface allows each company to select questions in the database to suit their type of business and area of operations. When a questionnaire is complete, the computer program generates a final report identifying areas of compliance and non-compliance in the company's operations. Numeric scores are included in the report to help the company report, improve and track its performance from year to year. The standards and indicators in the database are updated on an annual basis, based on feedback from both company users and human rights groups. This ensures that the tool continuously addresses the real life problems faced by companies and reflects the changes and developments in international human rights law.

NOTES

c.'No-go' Criteria: In some countries, the probability of conflict risk affecting a particular project may be so high that from the conflict-sensitive perspective it would be unwise for an investment to proceed. Due diligence screening should alert project financiers and insurers to this possibility. Wherever a project is located in an area where human rights abuses are currently, or have been, committed in the recent past, financiers should consider avoiding the project.

4.4.3.5 Encouraging better conflict risk management by project sponsors

If conflict risks and potential impacts are comprehensively assessed during due diligence, the logical next step is to identify and implement conflict risk mitigation measures. One option is for lenders to work with sponsors to ensure projects are developed and operated in a conflict-sensitive manner. This may lead to the incorporation of warranties and covenants in loan agreements. For instance, an agreement may include a warranty that the project sponsor(s) has conducted a project-level risk assessment, as well as with covenants requiring that the sponsor comply with conflict-sensitive business practices, for instance, by demonstrating adherence to the Voluntary Principles on Human Rights and Security.

QUESTIONS TO CONTEMPLATE AND DELIBERATE

Q.1.4. a Explain the 'Thomas-Kilmann Conflict Mode' to resolve Organizational Conflicts

Q.1.4. b. Discuss the different measures of dealing with Project Related Conflicts.

Q.1.4. c. What is due diligence? How does it ensure conflict resolution

Q.1.4. d. Explain political umbrella and political risk insu

4.5 ROLE OF NEGOTIATIONS IN INTERNATIONAL BUSINESS

Negotiation is an interaction of influences which include the process of resolving disputes, agreeing upon courses of action, bargaining for individual or collective advantage, or crafting outcomes to satisfy various interests. Negotiation is thus a form of alternative dispute resolution. In a successful negotiation, everyone wins. The objective should be agreement, not victory. Every desire that demands satisfaction and every need to be met-is at least potentially an occasion for negotiation. Whenever people exchange ideas with the intention of changing relationships and whenever they confer for agreement, they are negotiating.

Basic elements of Negotiation: Negotiation involves three basic elements: **process, behavior and substance**. The **process refers** to how the parties negotiate: the context of the negotiations, the parties to the negotiations, the tactics used by the parties, and the sequence and stages in which all of these play out. The **behavior refers** to the relationships among these parties, the cordiality of communication between them and the styles they

NOTES

adopt. The **substance refers** to what the parties negotiate over: the agenda, the issues (positions and - more helpfully - interests), the options, and the agreement(s) reached at the end.

Skilled negotiators may use a variety of tactics ranging from negotiation hypnosis, to a straight forward presentation of demands or setting of preconditions to more deceptive approaches such as cherry picking (cases or data to prove one's line of argument as correct). Intimidation and **salami tactics** (divide and rule) may also play a part in swaying the outcome of negotiations.

4.5.1 Negotiations between Government and MNEs

Home and host countries evaluate business propositions of MNEs from their points of view. Now the tendency is welcoming MNEs. So the evaluation relates to size, place, product, price, process, people and partnership related issues. Lot more negotiations take place whenever consensus is not reached on major issues. Here comes the importance of business-government relationships. In India right now half-a-dozen front-line states vie with each other to woo more MNE projects, outfits or so within the framework of Union Government's policy. Where government itself is a partner of the project, negotiation between government and the MNE take place directly. While Governments want maximum from the MNE outfit, MNEs bargain for best terms. But countries and companies do come to agreements that, although not usually ideal for either party. But the beginning is sufficient for an evolving relationship. The business negotiations and diplomacy between companies and governments determine the terms of international business operations.

MNEs' attitude to Governmental Stipulations

MNEs' attitude to Governmental Stipulations may be one of **complying**. This is highly positive. In a hierarchical view of governmental authority, companies accept regulations as 'givens', and MNEs **comply** with. Occasionally they try to **circumvent, avoid or repudiate** operating because of the regulations. MNEs **comply** with Government regulations when the regulations don't unduly constrain their desired mode of operations, when benefits are sufficiently attractive in spite of regulations, and when they cannot practically alter the regulations to their benefit. MNEs will **circumvent or get around** those regulations they find unacceptable through loopholes, legal or illegal. For example, a firm's ability to control a foreign subsidiary in spite of a country's requirement for shared ownership might be possible if the company makes a side agreement with a local partner not to exercise the latter's voting rights. **Avoidance** is avoiding doing business in the locale. It is negative. A simple task. **Repudiation** is the reverse of compliance as the MNE decides not to follow the regulations or some of the same in a given locale and is prepared to face consequences. This is not only negative, but also provocative.

NOTES

One-sided agreements tilt the other way in due course

As the host country and the MNE may each control assets that are useful to the other, conflicts arise due to goal difference, different masters controlling the destiny of one firm and so on. Each wants to have bargaining edge over the other. The negotiated terms for a foreign investor's operations depend on how much the investor, and the host countries need each other's assets. There can be negotiated one-sided concessions if either the MNE or the country has assets that the other strongly desires and there are few or no alternatives for acquiring them. In the early periods, the Middle-East countries depended most on Western Oil Companies for oil exploration or refining as they didn't have the expertise. Few large companies dominated the extraction, processing, shipment, and final sale. The economies with petroleum deposits could do little but accept the terms they were offered because they lacked alternatives for exploiting their oil. If a government refused the terms, a company could easily find another country that would accept a similar proposal now as the supply of oil diminished and petroleum-producing countries found alternatives, the terms gradually favored producing countries. Of course, there are vast differences in bargaining strength among countries, among industries, and among companies.

Positive sum solution lasts for long than zero-sum solution

The bargaining relationship between MNEs and governments depends very much on whether the parties see agreements as zero-sum or positive sum solutions. In a zero-sum solution one party's gain equals the other party's loss. There is no way both can gain. It is win-lose or lose-win syndrome. Positive-sum solution is that both parties have net benefits or gains. It is win-win solution. MNEs by projecting the win-win possibilities can enter countries that are generally hostile to foreign businesses. The line of argument depends on bargaining strength. Parties having competitive strength might press a win-lose solution, while a weak party might press win-win solution.

Country Bargaining Strength lies in their Investor Friendliness and Opportunities

What constitutes country bargaining strength? Better Governance, Economic Upswing and Height, Sound Infrastructure, High Caliber Human Resources, Culturally Cosmopolitan Society, etc. make the nations attractive for investors, assuming investment avenues still not exhausted. There are countries with higher bargaining strength like United States, Canada, UK, France, Japan, Singapore, South Korea and Germany. Generally, companies prefer to establish investments in highly developed countries because those countries offer large markets and a high degree of political stability. These countries are large recipients of foreign investment. Because they are such attractive countries to invest in, they make few concessions to MNEs. In all of these countries, however, regional areas vie for investments by offering incentives. In the recent years the BRIC countries (Brazil, Russia, India and China) vie with each other to attract more FDI from the MNEs. Within these countries several States try to attract the MNEs to their territory by offering freebies like tax holiday,

NOTES

infrastructure advances, etc. If offered incentives fit closely with companies' corporate strategies and when companies believe that the government has the credibility to fulfill its promises, MNEs put up their ventures.

MNE's Bargaining Strength lies in Core Competence Brand and Other Equities

Some MNEs have traditionally enjoyed better bargaining positions than others. Their stature in terms of global presence, competitiveness, brand equity and financial strength outsmart the rest. Such MNEs can dictate terms to countries. The bargain struck between the foreign investor and the host country also depends on the number of companies offering similar resources to the host nation. Usually uniqueness has great bargaining power. Foreign investors are more likely to have a strong bargaining position in foreign operations when they have few competitors and when they control certain unique types of assets- technology, marketing expertise, process, people, net-work, etc. These assets include:

Technology: For example, governments have allowed IBM 100-percent ownership of operations in a number of countries because of the local need for its unique technology. However, they have refused other companies the same ownership. The French government also approved IBM's minority stake in state-owned Group Bull because of the company's specialized technology.

Marketing excellence: For example, Coca-Cola apparently has been able to gain local consumer allies who believe its differentiated products are superior.

Process Expertise: Process represents the critical link between R&D and production. As such, it is a key in achieving integrated solutions. As always, the challenge is to ensure that product, process, equipment, and validation requirements come together to a robust, balanced solution.

Export ability: Ability to export output from the foreign investment, especially when exports go to other entities controlled by the parent company, is a great strength. These investments earn foreign exchange for the country that might otherwise not be forthcoming. China welcomes exporters more than companies seeking only to sell within China.

Brand Equity: Brand equity is that incremental value that accrues to a product when it is branded. Name that sells itself is brand equity. That is the confidence, eminence and fanciness the name spells in consumers' psyche leading to global presence.

Product diversity: Governments will allow more foreign ownership when a company provides greater product diversity.

Large capital: Companies with ability to contribute large amounts of capital may have more bargaining strengths. Many emerging economies encountered debt-servicing problems since the mid-1980s. As alternative to multilateral debt, FDI is preferred by them. Further,

NOTES

governments may not want to commit resources to negotiating with companies that are too small to make a substantial impact on their economies.

Consortium of companies: The development of Airbus Industries, a consortium in Europe to compete against Boeing in aircraft production, is an exercise to boost the global say of the Airbus Industries in its dealings. Similar consortia are in EU in consumer appliances, medical electronics, telecommunications, and television. Eureka program, a Europe-wide Network for Industrial R&D, strengthening European competitiveness by promoting 'market-driven' collaborative R&D, involving industry and institutions. It includes about 2600 entities of large, medium and small companies, research institutes, universities, etc from 42 countries (38 of which are European) to develop a wide range of technologies in frontier fields including nano-sciences. Consortia have higher bargaining power.

Domestic Pressures to counter MNEs' bargaining strength

Domestic companies which are direct or indirect competitors of the MNEs concerned will exert pressure against allowing the MNEs entry on the ground of lack of level playing field for them being technologically backward and other reasons. Political opponents will vehemently oppose MNEs' presence merely to gain a political leverage by whipping son-of-the soil or company-of-the-soil sentiments issue. Other critics may argue that the government must press for extracting more concessions from the MNEs.

Reactions from the host-country governments to local pressure groups depend on the timing, bargaining powers of the agitators, etc. Taking shelter under these protests, the governments do extract further concessions from the MNEs. Rejecting entry for MNEs will involve repercussions. Of late business-government relationship is thick and every government wants to interests of companies of its soil. There used to be trade retaliations as a mark of protest. Yielding to pressure from its garment industry, the United Kingdom limited imports of Indonesian T-shirts, and the Indonesian government retaliated by denying the construction of a British-owned chemical project. Companies also may face pressures from stockholders, workers, consumers, governmental officials, suppliers, and non-governmental organizations (NGOs) concerned with their own interests.

4.5.2 Negotiation Process in International Business

Negotiations are a means by which an MNE may initiate, carry on, or terminate operations in a foreign country. Generally negotiations are needed for direct investments. Of late, licensing agreements, debt repayment, and large-scale export sales as well need negotiation. The negotiation process often leads to multi-tiered bargaining with a local company for tie-up to provide technology in exchange of part ownership stake. The situations in countries differ. In certain countries clear-cut guidelines are there with automatic approvals provided the applications are routed through appropriate authorities. Few high profile FDI stakes only go to the Government for case by case clearance. The government agency may

NOTES

approve, disapprove, or propose entirely new terms. The MNEs have to re-negotiate with its home government and then get back to the host-country government.

Stages in Negotiation: A ten-stage negotiation process that uniquely combines that puts together the best of many other approaches to negotiation is given below.

Stage	**Action**
Prepare	Know what you want. Understand them.
Open	Put your case. Hear theirs.
Argue	Support your case. Expose theirs.
Explore	Seek understanding and possibility.
Signal	Indicate your readiness to work together.
Package	Assemble potential trades.
Close	Reach final agreement.
Sustain	Make sure what is agreed happens.
Renegotiate	When sustenance gets struck, renegotiate
Terminate	Stop negotiation, once and for all**i.**

Preparation: Negotiation requires through preparation to present one's side as well as to counter, if need be, opposing views from any side. Complete knowledge of the MNE, full details of the current proposal, the win-win results, success stories of earlier ventures of similar types, the core issues, etc need to be fully conversant. A rehearsal would do well with mock teams. What one wants, what one can give, what others might expect, can that be accommodated, etc need to be well analyzed from different perspectives.

ii. Open the discussion: This is the 'love all' opening of the match on the discussion table. Always offer to let the other party speak first. The other party may have overestimated what you are going to ask for and may actually offer more than what you were going to request. The general contours of the proposal, the specific agenda, the range of issues needing detailed discussion, etc are presented. You may take 10-15 minutes. The other side need to be invited to respond and as they do just keep listening. If need be takes notes down. Always try not to interfere and give time as much as you took just earlier. Of course, generally, the size or seriousness of the negotiation, the extent of past negotiations, if any done, and areas of acceptance and disagreement reached already, etc determine the amount of time needed to negotiate it. Approximately 90% of negotiations get settled in the last 10% of the discussion.

NOTES

The outcome of foreign negotiations will depend partly on other recent negotiations or events, which serve as models. Abroad, what has transpired recently either between other MNEs and a host-country government or between similar types of MNEs or the same MNE in similar countries may serve as a common reference. Negotiations are unlikely to stray too far from that established precedent.

There are zones of acceptance and non-acceptance for the proposals presented. If the acceptance zones of parties overlap, an agreement is possible. If acceptance zones have no overlap, positive negotiations are not possible. For example, if Ford Motors insisted on 51-percent ownership of an Indian facility but would accept up to 100 percent and the Indian government or partner insisted on 51-percent local ownership but would accept up to 75 percent, there would be no overlap of acceptance zones in which to negotiate. However, if Ford insisted on a "significant" interest in an Indian facility (say, 25 percent) but would take as much as it could get and the Indian government or partner required 51-percent local ownership and wanted to maximize it, there would be a wide zone acceptable to both parties-for instance, 25 to 49 percent for Ford's ownership and for the Indian side from 51% to 75%.

iii Argument: When the going is tough, the tough gets going. Arguments in favour of one's view points and against that of others are needed. Arguments must be crisp, focused and functional. Always respect and listen to what your opponent has to say. This is important even if he or she does not extend the same courtesy to you. Do your best to remain calm and pleasant even if the other party is displaying frustration or anger. Remember some people will do anything to intimidate you. Acknowledge what the other party says. Everyone likes to know that what they say is important. If the other party opens first, use it to your advantage, by paraphrasing what you have heard. Repeat their important ideas before you introduce your own stronger ones.

Language to use to show understanding/agreement on a point: I agree with you on that point; That's a fair suggestion; So what you're saying is that you... ; In other words, you feel that... ; You have a strong point there; I think we can both agree that...; I don't see any problem with/harm in that;

Language to use for objection on a point or offer: I understand where you're coming from; however,...; I'm prepared to compromise, but...; The way I look at it...; The way I see things...; If you look at it from my point of view...; I'm afraid I had something different in mind; That's not exactly how I look at it; From my perspective...; I'd have to disagree with you there; I'm afraid that doesn't work for me. Is that your best offer? Be polite & un-provocative

iv Exploration: Normally the 80:20 Principle works. 80 % of areas agreed in about 20% of negotiation process. The balance 20% really needs 80% of deliberations. Explorations in all wards needed. Creativity and innovation is needed. Change the problem setting.

NOTES

Look from a different perspective. Meantime try to convince the other side that the solutions suggested are fine enough. May be a sub-team to work on new avenues may be though off. Or both sides agree to meet again after a recess to come with fresh thinking, mutual accommodation, shifting distant things near and near things to a distant. The areas of agreement must be enhanced after passage of deliberation. Exploration must be for agreement, not disagreement.

Signal: After the exploration, make the fresh offer. First signal your readiness to resume deliberation from where it was left. Invite the other side with same, if not more, readiness to resumption of talks and early settlement. Certain urgencies may be cited, if appropriate, while at the same time telling that let all issues be threadbare discussed despite the time factor. Lasting solution does more good than hastily pushed up ones. Pay attention to your own and your counter-partner's body language for that may signal something special.

Body Language	**Possible meaning**
Avoiding Eye Contact	Lying ; Not interested; Not telling the
Serious Eye Contact	Trying to intimidate ; Showing anger
Touching the face/fidgeting	Nervousness; Lack of confidence
Nodding	Agreeing; Willing to compromise
Shaking the head/turning	Frustrated; In disbelief; Disagreeing with a

V Assemble: Categorize the areas of agreement reached. As this is done, tell that what is left out is better concurred with so that sense of fulfillment results. International negotiations may take much longer and may include provisions unheard of in the home country, such as a negotiated tax rate. Further, governments vary in their attitudes toward foreign investors, so their negotiating agendas also vary. Most countries offer investment incentives to attract MNEs. Direct incentives that countries have offered foreign investors include tax holidays, employee training, R&D grants, accelerated depreciation, low-interest loans, loan guarantees, subsidized energy and transportation, exemption of import duties, and the construction of rail spurs and roads. Countries also provide indirect incentives, such as a trained labor force and labor laws that prevent work disruptions.

Potential lines of agreement may be listed so that a consensus is reached sooner.

vii. Close: A final accord is arrived at. Thank the participants for their time, ideas, flexibility, innovative thrusts, benign accommodation of other person's views, maturity shown in the wake troubling issues, sacrifices made and above all good comradeship shown.

viii. Sustain: The agreement must be implemented. Members must dedicate themselves for truthful implementation of the accord. Negotiations are seldom a one-way street. Companies agree to many performance requirements aimed at helping host countries reach economic and noneconomic objectives, such as a favorable balance of payments, growth and high employment. These must be fulfilled sooner than later. Further, certain conditions

NOTES

such as obligatory levels of local input into products manufactured, limits on the use of expatriate personnel and on old or reconditioned equipment and local control over important decisions must be fulfilled from ab initio. There is always a risk that promises will be broken, putting sustenance in jeopardy.

ix. Renegotiate:

It happens, that even when a project is on stream, the changed political guards may press for a renegotiation, when they solidly prove national interests are better served with a fresh look. Of course, damage to national culture might happen. In the early years of foreign investments in emerging economies the MNEs were given many concessions. In the middle things did change. MNEs were forced to accept a renegotiation to their disadvantage. This happened to the Enron's Dhabol power project in Maharastra, India.. After investing $300 million, the new government halted further work, but agreed to renegotiate the agreement. The companies lost about $250,000 per day during the renegotiations. Finally, the government agreed to use more Indian naphtha (a fuel) rather than Qataran natural gas to generate electricity. Ownership relocation was also done. reducing Enron's ownership to 50 percent, and the price of power by 22.2 percent.

Obsolescing Bargain Theorem: Bargaining relationship between MNE and Host Country is function of both parties' goals, resources and constraints. Goals assumed to be conflicting, but game is positive sum (win-win game) so both parties achieve absolute gains. Relative gains depend on relative bargaining power. Outcome favors MNE, but its bargain obsolesces over time. Renegotiation is pressed by the host government.

Generally, an MNE's best bargaining position exists before it makes an investment in a foreign country. Once an MNE transfers capital and technology abroad and trains local nationals to direct operations, the MNE's bargaining power weakens. The MNE's assets are not easily moved to more favorable locales. The host country may be in a better position to extract additional concessions from the company. This erosion of the MNEs' bargaining strength is known as the theory of the obsolescing bargain. Rate of obsolescence depends on relative resources and constraints.

Regaining Bargaining power: As MNEs are used to these finger burning, they have become smart. Instead of pushed to renegotiation, they push the host government for renegotiation promising improved technology, which may albeit be only withheld technology. Another strategy is to use plant expansion or export markets as bargaining weapons. In addition, an MNE may cede part of its ownership to local interests in exchange for guarantees on remission of its earnings.

x. Termination of Negotiations: Termination is an admission of failure. The negotiators are prone to publicly blame others to save face. This had happened in such high profile trade negotiations under the WTO banner in Doha. Such accusations may complicate

NOTES

future dealings the country or the MNE may have with other parties. Although termination is stressful, when it is necessary, the same be provided for without much publicity.

4.5.3 Cultural, Language and other intangible Factors Affecting Negotiations

Cultural and language factors affect negotiations because there are differences across nations and within nations across different societies as to the way they negotiate, the facilities, norms and contours of negotiation. Knowledge of these diversities help in effective business.

a. Cultural Factors and Negotiation

Culture shows ways in which people interact and communicate with others and develop and maintain relationships. There used to be cultural differences across different societies/ regions/nations. Understanding those differences and adapting to them is the key to successful negotiation.

Low-context Vs. High-context cultures: Negotiators from low-context cultures want to get to the heart of the matter quickly. Negotiators from high-context cultures want to spend time developing rapport and trust before addressing business details.

Pragmatist cultures Vs. Idealistic cultures: Negotiators from pragmatist cultures attempt to separate the issues into small categories (getting closure on items in a linear fashion), while negotiators from idealistic cultures view negotiations more holistically.

High trust Vs Low trust cultures: Negotiators from cultures with high trust are less prone to want to cover every possible contingency in a contract than are negotiators from cultures with low trust.

Mono-chronic cultures Vs. Poly-chronic cultures: Negotiators from mono-chronic cultures will want to give their undivided attention to one issue at a time. However, negotiators from poly-chronic cultures feel uncomfortable if they do not simultaneously take care of other business affairs.

Punctuality stressing culture Vs. Easy going culture: Negotiators from cultures that place a high importance on punctuality and schedules are more prone to set deadlines and then make concessions at the last minute to meet the schedules than are negotiators from cultures that place less importance on punctuality and schedules. Further, Negotiators from cultures that place a high importance on punctuality may underestimate the importance their counterparts place on the negotiations if their counterparts arrive late and don't stick to schedules.

The importance of cultural factors changes during renegotiations because the parties already know each other. If the relationship was amicable in the original negotiations, that quality is likely to be carried over. However, if the past relationship has been hostile, the renegotiations may be suffused by even more suspicion and obstruction than existed during

NOTES

the original process. The fact that managers' counterparts in negotiations come from countries with different cultures does not necessarily mean they will behave according to their culture's norm.

First, a counterpart may be an exception to the country's norm. Second, a counterpart may know the other's culture and be adaptive to it. So managers should determine at the start whether they will adjust to their counterparts, allow their counterparts to adjust to them, or follow some form of hybrid adjustment.

b. Language Factors and Negotiation

The choice of language, use of interpreters, etc have influence on business negotiation.

English – the Universal language is better: Because English is understood worldwide, people may understand quite well most of what is said in English. At the same time they can eavesdrop on confidential comments and form responses while remarks are being translated into their language.

To have or not language interpreters: Cultural factors influence whether interpreters are acceptable. For example, Saudi managers generally prefer to negotiate in English, even if their English is not very good. When negotiators do use interpreters, each side should have its own. Good interpreters brief their teams on cultural factors affecting the negotiation process.

Interpreters are textual and not contextual: Take as an example the experience of a U.S. politician who spoke through an interpreter in China. With typical American forthrightness, [the politician] said, "I'm going to tell you where I'm coming from." The interpreter said, "He'll now give you the name of his home town." Then he said, "I'm going to lay all my cards on the table." The interpreter said, "He'll play cards now." Then, making a joke, he said, "I'm not a member of any organized political party; I'm a Democrat." The interpreter said, "I think he just made a joke. Please laugh." The audience laughed and the politician knew he had their rapt attention.

c. Intangible factors

Intangibles are often the key factors in many negotiations. It is important to communicate very carefully. Subtle verbal and body language can make a difference in how your negotiation progresses. Spend more time listening than talking and make direct eye contact. Use the word "and" instead of "but." This helps to send the signal that you are interested in the other party and are seeking common ground. Some of the intangibles are dealt below.

Communications: Communications must be careful about using the phone, e-mail, and other non-visual communication vehicles. A lack of facial expressions, vocal intonation, and other cues can result in a negotiation breakdown. Constantly reiterate your interest in the other side's concerns and your determination to find a mutually satisfactory resolution.

Personalities: Personalities must be conscious of aspects of your personality such of your own needs and interpersonal style as well as the other person's personality; these factors will play a key role and understanding yourself will be an important factor relevant to reaching a solution.

Your own personality and style: How much you trust the person; how free with your emotions; how much you want to conceal or reveal and such other factors

Physical space: Sometimes where the negotiation takes place can be important; are we negotiating in a space we are uncomfortable and other is comfortable?

Past interaction: If there is a history of conflict resolution with this person, think about how this history might affect the upcoming negotiation.

Time pressure: Think about whether time pressure will affect the negotiation and whether you need to try to change this variable.

Subjective utilities: Be aware that people place very different values on elements of a negotiation. For example, in negotiating for a job, you may place a high value on location and relatively lower on salary; it is important to be aware of your subjective utilities and try to ascertain the other person's subjective utilities; it is difficult to know in advance or even during the negotiation what a particular outcome will mean to the other party. Finding out what is "valued" is one of the key parts of negotiation.

QUESTIONS TO CONTEMPLATE AND DELIBERATE

Q.1.5. a. Present the Scope of Negotiations between Government and MNEs

Q.1.5. b. Discuss the Negotiation Process in International Business and the stages involved therein

Q.1.5. c. Explain the Cultural and Language Factors that influence Negotiation process.

Q.1.5. d. Present the factors that influence the bargaining power of the MNEs and the Government.

Q.1.5. e. Explain the intangible factors that impact negotiation process.

4.6. ROLE OF INTERNATIONAL AGENCIES IN CONFLICT RESOLUTION

Select international agencies like MIGA, International chamber of commerce and International Centre for Settlement of Investment Disputes are covered. Besides, pro-active measures to be undertaken by multilateral development bankers, regional development bankers, commercial banks, etc are covered.

NOTES

4.6.1 Role of International Finance Corporation (IFC) in Conflict Resolution

International Finance Corporation is a World bank group institution committed to private sector development. To ensure that its financing actions do not lead to conflicts proper due diligence is followed.

IFC Performance Standards, Common Approaches, Equator Principles - opportunity to raise standards: The IFC's Performance Standards, along with the Common Approaches and Equator Principles, offers an opportunity for financial actors to explore ways of promoting higher standards, as well as encouraging greater harmony of approaches in relation to assessing and mitigating conflict risk in the context global business financing. IFC works more closely with clients to ensure improved understanding of the two-way relationship between investment and conflict, through incorporating the concept of 'conflict-sensitivity' into the new Performance Standards.

Importance of conflict risk: IFC has implicitly acknowledged the importance of conflict risk by including guidance on project security arrangements in Performance Standard and offering some explanation of the nature of conflict risk in Guidance Note. This guidance reflects the general spirit of the Voluntary Principles on Security and Human Rights (VPs).

Social and Environmental risks: Financial institutions and other actors outside the Equator Principle framework which look to IFC for guidance on social and environmental risks will also need to consider the implications of IFC's inclusion of conflict and security issues on their own due diligence practices. IFC in turn must give this issue greater priority in future reviews, particularly as IFC and MIGA projects themselves are some of those which have shown themselves to be least able to understand and manage conflict issues effectively in the recent past.

4.6.2 Role of Multilateral Investment Guarantee Agency (MIGA) in Conflict Resolution

Multilateral Investment Guarantee Agency (MIGA) is a member of the World Bank group. It was established to promote foreign direct investment into developing countries. MIGA was founded in 1988 with a capital base of $1 billion and is headquartered in Washington, D.C. MIGA promotes foreign direct investment into developing countries by insuring investors against political risk, advising governments on attracting investment, sharing information through on-line investment information services, and mediating disputes between investors and governments. MIGA also requires host country government approval for every project. MIGA tries to work with host governments - resolving claims before they are filed.

MIGA's Business: MIGA provides guarantees against noncommercial risks to protect cross-border investment in developing member countries. Guarantees protect investors against the risks of Transfer Restriction, Expropriation, War and Civil Disturbance, and

NOTES

Breach of Contract (for contracts between the investor/project enterprise and the authorities of the host country). These covers may be purchased individually or in combination.

MIGA can cover **only new investments**. These include: New, green-field investments; New investment contributions associated with the expansion, modernization, or financial restructuring of existing projects; and Acquisitions involving privatization of state enterprises. Unlike other insurers, MIGA is backed by the World Bank Group and its member countries.

4.6.3 Role of International Chamber of Commerce in Conflict Resolution

The International Chamber of Commerce (ICC) is an international organization that works to promote and support global trade and globalization. It serves as an advocate of world business in the global economy, in the interests of economic growth, job creation, and prosperity. As a global business organization, made up of member states, it helps the development of global outlooks on business matters. ICC has direct access to national governments worldwide through its national committees among others. The ICC was founded in 1919 to serve world business by promoting trade and investment, open markets for goods and services, and the free flow of capital. The organization's international secretariat was established in Paris in 1923.

ICC International Court of Arbitration: To attain this objective, ICC has developed a range of activities. The ICC International Court of Arbitration is the most respected service of its kind in the world. Its voluntary rule-writing for business **spreads best practice** in areas as varied as **banking, marketing, anti-corruption and environmental management**. Their policy-making and advocacy work keeps national governments, the United Nations system and other global bodies apprised of the views of the world business on some of the most pressing issues of the day. The ICC's **International Court of Arbitration** was created in 1923. Initially representing the private sectors of Belgium, Britain, France, Italy and the United States, it expanded to represent worldwide business organizations in around 130 countries.

World Council, National Committees, and International Secretariat: The **ICC World Council is a general assembly** of a major intergovernmental organization composed of business executives. **National committees** name delegates to the Council. Ten direct members may be invited to participate. It usually meets twice a year. The Council elects the Chairman and Vice-Chairman for two-year terms. The Council elects the Executive Board on the Chairman's recommendation.

The Secretary General heads the **International Secretariat**. The Secretary General works with the national committees to carry out ICC's work programs and is appointed by the World Council. The ICC International Secretariat is based in Paris and is the operational arm of ICC. It carries out the work program approved by the World Council, feeding business views into intergovernmental organizations.

NOTES

The **Executive Board** is responsible for implementing ICC policy. The Executive Board has between 15 and 30 members of both business leaders and ex-officio members. They serve for three years. They have a one third rotation in membership. The Chairman, his immediate predecessor, and the Vice-Chairman form the Chairmanship.

National Committees represent the ICC in their respective countries. They recommend to the ICC their respective national business concerns in its policy recommendations to governments and international organizations. There are established formal ICC structures in over 90 countries. In countries where there is no national committee, companies and organizations such as chambers of commerce and professional associations can become direct members. ICC has access to national governments through its network of national committees.

Finance Committee advices the Executive Board on all financial matters. It reviews the financial implications of ICC's activities and supervises the flow of revenues and expenses of the organization. The Chairman is elected by the ICC World Council.

Commissions develop international and national government initiatives in their subject areas. They also develop business positions for submission to international organizations and governments. **Commissions are composed of more than 500 business experts from member companies.**

Dispute Resolution Services: ICC International Court of Arbitration continues to **provide the most trusted system of commercial arbitration** in the world, having received 14000 cases since its inception in 1923. Over the past decade, the Court's workload has considerably expanded as its reputation for fast, flexible dispute resolution services spreads around the globe. The Court's membership has also grown and now covers 86 countries. With representatives in North America, Latin and Central America, Africa and the Middle East and Asia, the ICC Court has significantly increased its training activities on all continents and in all major languages used in international trade.

In the world of international commerce, the ICC is perhaps best known for its role in promoting and administering **international arbitration as a means to resolve disputes arising under international contracts**. It is one of the world's premier and leading institutions in providing international dispute resolution services, together with the American Arbitration Association, the London Court of International Arbitration (LCIA), the Singapore International Arbitration Centre (SIAC), and the Stockholm Chamber of Commerce.

It is **common for international commercial contracts to provide for an agreed means of resolving any disputes that may arise, and the ICC is one of leading institutions** for administering international arbitration. The ICC's dispute resolution services also include Alternative Dispute Resolution (ADR) procedures such as mediation and expert determinations.

NOTES

Business Actions Stopping Counterfeit And Piracy (BASCAP): With the launch of ICC's BASCAP initiative, more than 130 companies and trade associations are now actively engaged in a set of projects designed to defeat the pirates and increase public and political awareness of the economic and social harm caused by this illegal activity. BASCAP is using ICC's global media network and national committee structure to spread the word. BASCAP was launched in 2004 and it is an operational platform established by ICC that connects all business sectors and cuts across all national borders, drawing them together to ensure that their message is clearly heard by governments and the public.

4.6.4 Role of International Centre for Settlement of Investment Disputes (ICSID) in Conflict Resolution

The International Centre for Settlement of Investment Disputes (ICSID), was founded in 1966 pursuant to the Convention on the Settlement of Investment Disputes between States and Nationals of Other States. It is an institution of the World Bank group based in Washington, D.C. As of May 2005, 155 countries had signed the ICSID Convention.

ICSID has an **Administrative Council**, chaired by the World Bank's President, and a Secretariat. It provides facilities for the conciliation and arbitration of investment disputes between member countries and individual investors. Annual meetings of the Council are held in conjunction with the joint Bank/Fund annual meetings.

ICSID is an autonomous international organization. However, it has close links with the World Bank. All of ICSID's members are also members of the Bank. Unless a government makes a contrary designation, its Governor for the Bank sits ex officio on ICSID's Administrative Council. The expenses of the ICSID Secretariat are financed out of the Bank's budget, although the costs of individual proceedings are borne by the parties involved.

During the past decade, with the proliferation of bilateral investment treaties (BITs), most of which refer present and future investment disputes to the ICSID, the caseload of the ICSID has substantially increased. As of June 30, 2005, ICSID had registered 184 cases more than 30 of which were pending against Argentina – Argentina's economic crisis in the late 1990s and subsequent Argentine government measures led several foreign investors to file cases against Argentina. Bolivia, Nicaragua, Ecuador and Venezuela have announced their intention to withdraw from the ICSID.

Mediation or conciliation of investment disputes between governments and private foreign investors: On a number of occasions in the past, the World Bank as an institution and the President of the Bank in his personal capacity have assisted in mediation or conciliation of investment disputes between governments and private foreign investors. The creation of the International Centre for Settlement of Investment Disputes (ICSID) in 1966 was in part intended to relieve the President and the staff of the burden of becoming

NOTES

involved in such disputes. But the Bank's overriding consideration in creating ICSID was the belief that an institution specially designed to facilitate the settlement of investment disputes between governments and foreign investors could help to **promote increased flows of international investment**.

ICSID activities: Pursuant to the Convention, ICSID provides facilities for the conciliation and arbitration of disputes between member countries and investors who qualify as nationals of other member countries. Recourse to ICSID conciliation and arbitration is entirely voluntary. However, once the parties have consented to arbitration under the ICSID Convention, neither can unilaterally withdraw its consent. All ICSID Contracting States, whether or not parties to a dispute, are required by the Convention to recognize and enforce ICSID arbitral awards.

Conciliation and arbitration proceedings: Besides this original role, the **ICSID** has since 1978 had a set of Additional Facility Rules authorizing the ICSID Secretariat to administer certain types of proceedings between States and foreign nationals which fall outside the scope of the Convention. These include conciliation and arbitration proceedings where either the State party or the home State of the foreign national is not a member of ICSID. Additional Facility conciliation and arbitration are also available for cases where the dispute is not an investment dispute provided it relates to a transaction which has "features that distinguishes it from an ordinary commercial transaction." The Additional Facility Rules further allow ICSID to administer a type of proceedings not provided for in the Convention, namely fact-finding proceedings to which any State and foreign national may have recourse if they wish to institute an inquiry "to examine and report on facts."

A third activity of ICSID in the field of the settlement of disputes has consisted in the Secretary-General of ICSID accepting to act as the **appointing authority of arbitrators** for ad hoc (i.e., non-institutional) arbitration proceedings. This is most commonly done in the context of arrangements for arbitration under the Arbitration Rules of the United Nations Commission on International Trade Law (UNCITRAL), which are specially designed for ad hoc proceedings.

Provisions on ICSID arbitration are commonly found in investment contracts between governments of member countries and investors from other member countries. **Advance consents by governments to submit investment disputes to ICSID arbitration** can also be found in about twenty investment laws and in over 900 bilateral investment treaties. Arbitration under the auspices of ICSID is similarly one of the main mechanisms for the settlement of investment disputes under four recent multilateral trade and investment treaties (the North American Free Trade Agreement, the Energy Charter Treaty, the Cartagena Free Trade Agreement and the Colonia Investment Protocol of Mercosur).

In addition to these activities, ICSID also carries on **advisory and research activities**, **publishing Investment Laws of the World and of Investment Treaties**, and collaborates with other World Bank Group units. Since April 1986, the Centre has published a semi-annual law journal entitled ICSID Review-Foreign Investment Law Journal.

ICSID proceedings do not necessarily take place in Washington, D.C. Others possible locations include the Permanent Court of Arbitration at The Hague, the Regional Arbitration Centres of the Asian-African Legal Consultative Committee at Cairo and Kuala Lumpur, the Australian Centre for International Commercial Arbitration at Melbourne, the Australian Commercial Disputes Centre at Sydney, the Singapore International Arbitration Centre, the GCC Commercial Arbitration Centre at Bahrain and the German Institution of Arbitration (DIS).

4.6.5 Role of World Trade Organization in Conflict Resolution

Settling disputes is the responsibility of the Dispute Settlement Body (DSB) of WTO. DSB consists of all WTO members. The Dispute Settlement Body has the sole authority to establish ‘panels’ of experts to consider the case, and to accept or reject the findings of the panels or the results of an appeal. It monitors the implementation of the rulings and recommendations, and has the power to authorize retaliation when a country does not comply with a ruling.

First stage - Consultation - up to 60 days: Before taking any other actions the countries in dispute have to talk to each other to see if they can settle their differences by themselves. If that fails, they can also ask the WTO director-general to mediate or try to help in any other way.

Second stage - The panel - up to 45 days for a panel to be appointed, plus 6 months for the panel to conclude: If consultations fail, the complaining country can ask for a panel to be appointed. The country “in the dock” can block the creation of a panel once, but when the Dispute Settlement Body meets for a second time, the appointment can no longer be blocked, unless there is a consensus against appointing the panel.

Officially, the panel is helping the Dispute Settlement Body make rulings or recommendations. But because the panel’s report can only be rejected by consensus in the Dispute Settlement Body, its conclusions are difficult to overturn. The panel’s findings have to be based on the agreements cited. The panel’s final report should normally be given to the parties to the dispute within six months. In cases of urgency, including those concerning perishable goods, the deadline is shortened to three months.

The main stages are:

Before the first hearing: Each side in the dispute presents its case in writing to the panel.

NOTES

First hearing: The case for the complaining country and defence: the complaining country (or countries), the responding country, and those that have announced they have an interest in the dispute, make their case at the panel's first hearing.

Rebuttals: The countries involved submit written rebuttals and present oral arguments at the panel's second meeting.

Experts: If one side raises scientific or other technical matters, the panel may consult experts or appoint an expert review group to prepare an advisory report.

First draft: The panel submits the descriptive (factual and argument) sections of its report to the two sides, giving them two weeks to comment. This report does not include findings and conclusions.

Interim report: The panel then submits an interim report, including its findings and conclusions, to the two sides, giving them one week to ask for a review.

Review: The period of review must not exceed two weeks. During that time, the panel may hold additional meetings with the two sides.

Final report: A final report is submitted to the two sides and three weeks later, it is circulated to all WTO members. If the panel decides that the disputed trade measure does break a WTO agreement or an obligation, it recommends that the measure be made to conform with WTO rules. The panel may suggest how this could be done.

The report becomes a ruling: The report becomes the Dispute Settlement Body's ruling or recommendation within 60 days unless a consensus rejects it.

Appeals: Both sides can appeal the report. Either side can appeal a panel's ruling. Sometimes both sides do so. Appeals have to be based on points of law such as legal interpretation — they cannot reexamine existing evidence or examine new issues.

Hearing by 3 members of a permanent 7-member Appellate Body: Each appeal is heard by three members of a permanent seven-member Appellate Body set up by the Dispute Settlement Body and broadly representing the range of WTO membership. Members of the Appellate Body have four-year terms. They have to be individuals with recognized standing in the field of law and international trade, not affiliated with any government.

Uphold, Modify or Reverse: The appeal can uphold, modify or reverse the panel's legal findings and conclusions. Normally appeals should not last more than 60 days, with an absolute maximum of 90 days.

Acceptance or rejection by DSB: The Dispute Settlement Body has to accept or reject the appeals report within 30 days — and rejection is only possible by consensus.

4.6.6 Role of Multilateral Development Bankers (MDBs), Regional Development Bankers (RDBs) and Export Credit Agencies (ECAs) and other banks

NOTES

Multilateral Development Bankers (MDBs), Regional Development Bankers (RDBs) and Export Credit Agencies (ECAs) and other banks can do a lot in mitigating investment led conflict by proper choosing of exposures, collective surveillance, etc. These and other measures by these institutions are dealt here.

Tightening policy coherence: MDBs such as the World Bank (specifically through IFC and MIGA), as well as regional development banks (RDB), such as Asian Development Bank (ADB), offer a variety of financial products associated with project finance. While MDBs and RDBs are accountable to government shareholders, and disburse a large part of their funding to public sector projects, there is an increasing focus on private sector-related activities, reflecting the growing trend among development institutions of looking toward the private sector as a strategic partner for the realization of development goals.

Conflict prevention, peace building and post-conflict reconstruction work by MDBs: MDBs and RDBs have in recent years begun to develop a role in conflict prevention, peace building and post-conflict reconstruction work. This effort has included the introduction of new analysis tools for use by country desk staff; the option of formulating development projects designed to address the root causes of conflict; as well brokering projects to rebuild infrastructure and institutional capacity in the aftermath of conflict. MIGA, MDB and RDB are beginning to define a niche as providers of finance in such contexts.

Extractive Industries Review (EIR) to adopt human rights policies: The World Bank Group has come under particular scrutiny for the role IFC and MIGA have played in the support of extractive industry projects linked with social disruption, increased vulnerabilities, social hostility and conflict. The Extractive Industries Review (EIR) commissioned by the World Bank in 2003 recommended that World Bank Group (WEG) institutions (including IFC and MIGA) mainstream human rights into all areas of policy and support project sponsors to adopt human rights policies. The EIR also recommended an end to WBG support for extractive industry investments in countries prone to or affected by violent conflict, given that the overall developmental benefits of such investments in such conditions are far from positive. While this recommendation was not adopted in the WB's management response to the EIR, using conflict-sensitive lending practice - not only for extractive industry but for all private sector projects conflict prone regions - would be one step towards addressing the concerns relating to the relationship between projects and violent conflict that were voiced by stakeholders during the EIR process.

High correlation between poverty and conflict, investments to not exacerbate conflict: Adopting a conflict-sensitive approach to providing financial products and services in project finance transactions would be a good first step at improving coherence between

NOTES

global poverty reduction goals and the need to augment the number of private sector investments that to 'do no harm.' Such investment approach would not exacerbate conflicts.

Export Credit Agencies (ECAs) to be conflict-sensitive to projects: If private sector development is the key to economic growth and poverty reduction, then public financial institutions like Export Credit Agencies (ECAs) also have a role to play in supporting sustainable, conflict-sensitive projects that further national government's commitments to poverty reduction. Indeed, as ECAs should be obligated to ensure that ECAs business activities are coherent with other public policy commitments – including development and conflict prevention goals.

ECAs to have close linkage with wider international policy to avert conflicts: ECAs sit within governments that themselves are increasingly committed to conflict prevention and peace building as part of development assistance and foreign policy. A coherent national policy approach requires reviewing investment promotion and trade policy from the perspective of security – both national and within the international system. At present however these arms of government tend to sit far from each other culturally and functionally, resulting in agencies such as ECAs having little linkage with wider international policy goals. The fact that some foreign ministries have begun to share country analyses with ECAs as an input to risk analysis is a small but important step in the right direction.

ECA projects to be screened for transparency to avert corruption: Given the correlation between poor governance and the incidence of violent conflict, addressing corruption in ECA projects would be one way to begin moving agencies towards required levels of policy coherence. ECA-backed projects have been heavily criticized for reinforcing corruption in conflict-prone areas. Some individual ECAs have taken steps to improve transparency and address potential for corruption (for instance, the UK ECGD screening of companies through the World Bank corruption list). However these remain unilateral initiatives, and more needs to be done. Increased efforts to improve harmony between MDB and other public financial institutions in policies on private sector investment promotion, development assistance and conflict prevention would help create the right environment for project finance to become a factor enabling peaceful and sustainable development in the global world economy.

Voluntary Principles on Security and Human Rights, OECD Guidelines for Multinational Enterprises and the Extractive Industry Transparency Initiative (EITI): In relation to the activities of extractive industry actors, regulatory instances include the Voluntary Principles on Security and Human Rights, and the Extractive Industry Transparency Initiative (EITI). UN Special Representative on Business and Human Rights focuses on conflict and weak governance zones and leads to useful guidance and norm-setting. MDBs, ECAs and banks alike could do more to ensure that they actively promote meaningful adherence to these standards by clients, as well as existing standards such as

NOTES

the OECD Guidelines for Multinational Enterprises, including through monitoring implementation as part of the financial relationship.

OCED's Financial Action Task Force 40 Recommendations (FATF 40 Recommendations): Developments in international financial regulations also point to possible measures to links between conflict and finance. International efforts to combat money laundering, such as the Voluntary Wolfsberg Principles or the OCED's Financial Action Task Force 40 Recommendations (FATF 40 Recommendations), offer some opportunities to promote conflict-sensitive finance practices. The FATF 40 recommendations are a series of 40 guidelines to prevent money laundering and terrorist financing.

One set of recommendations focuses on national governments, and outlines ways to criminalize money laundering and terrorist finance (e.g. through confiscation of proceeds or property, national monitoring and analysis, law enforcement and prosecution). The other set of recommendations focuses on financial institutions, and outlines ways banks can perform due diligence on customers, especially in "high risk" categories (e.g. by Knowing Your Customer, monitoring accounts and transactions, record keeping, reporting suspicious transactions, establishing integrity standards, and creating internal enforcement mechanisms). The FATF's designated "high risk" categories already include precious metals and stones, but should expanded to cover other areas, such as certain oil, forestry and even agribusiness activities, which also can be part of money laundering schemes and exacerbate violent conflict.

Basel Capital Accord (Basel II): Perhaps the most significant new international banking regulation in the last several years is the new Basel Capital Accord (Basel II), which was developed by a committee of the Bank for International Settlements. Basel II requires banks to analyze all their loans for risk, and set aside particular percentages of capital in reserve based on their risk analysis. So for example, banks would have to keep relatively high reserves for a loan to a company with an unproven track record, but keep lower reserves for a loan to well-established and well-managed company with solid business plan. In all likeliness, Basel II will have the effect of requiring banks to keep a significant amount in reserve for loans to countries engulfed in violent conflict. However, the Basel Committee and most commercial banks are probably not as sophisticated in analyzing the links violent conflict and risk in corporate lending. Adopting a conflict-sensitive approach to project finance may also enhance the ability of banks to qualify for the Internal Ratings Based ('IRB') approach to capital requirements under the Basel II Framework Agreement.

Civil Rights Impact Analysis (CRIA): CRIA is an analytical process used to determine the scope, intensity, direction, duration, and significance of the effects of an agency's proposed employment and program policies, actions, and decisions. The CRIA process will identify conflict issues and promote understanding of the two-way interaction between these and the project, as well as appropriate mitigation strategies. The methodology is

NOTES

designed to accompany the entire life-cycle of a project, which means it should be constantly updated to reflect the changing dynamic in the external context and as the project develops. The key principles guiding the approach are: Participatory analysis; Enhanced communication; Strong local relationships; Shared decision-making. These measures enhance transparency and act as a conflict-risk mitigation strategy, as trust will be built, fostering legitimacy and relieving tensions. While project financiers may find the in-depth and dynamic CRIA approach not suited in every situation, aspects can be built into existing due diligence procedures in order to give a fuller and richer picture of the risk context. An important aspect of enhanced due diligence by lenders would include consideration of the project sponsor's track record in addressing and managing conflict risk. This would require exploring the sponsor's past performance on social and environmental issues, particularly if the sponsor has operated in a conflict zone, and how it has dealt with security and human rights issues. A financial institution may also enquire into the project sponsors' policies on corruption, business ethics, environmental issues, and project security.

Conflict-sensitivity for MNEs: MNEs have begun to pay attention to human rights, the environment and other areas of corporate social responsibility, but they often lack the skills and experience to avoid exacerbating instability or violence. By adopting a proactive approach to conflict-sensitive business practice, businesses can reduce risks to their operations in conflict-affected regions, promote stability and improve relations with local populations. If the economic benefits of their operations are distributed more fairly and transparently, they can play a significant role in building the strong economic foundations that are vital for lasting peace.

Influencing public policy: The European Union, Organization for Economic Co-operation and Development, World Bank, various UN agencies, a number of governments and NGOs all acknowledge the critical role of economic factors in conflict in a number of key policy documents and are beginning to recognize the potential of the private sector to contribute to peace building. There is growing debate on the need for clearer international guidelines and constraints on companies operating in conflict prone zones. Amnesty International, Human Rights Watch, OECD Watch, International Committee of the Red Cross, and Global Witness must help promote a clearer regulatory environment for companies doing business in conflict-prone zones.

QUESTIONS TO CONTEMPLATE AND DELIBERATE

Q.1.6.a Explain the role of International Finance Corporation (IFC) in Conflict Resolution

Q.1.6.b Explain the role of Multilateral Investment Guarantee Agency (MIGA) in conflict resolution with which MNEs are involved.

Q.1.6.c Discuss the role of International Chamber of Commerce in conflict resolution.

Q.1.6.d What is International Centre for Settlement of Investment Disputes? State its role.

NOTES

Q.1.6.e Examine the role of WTO in dispute resolution among countries
Q.1.6.f Explain the actions and precautions that MDBs, RDBs, ECAs and others can take

to prevent/solve project related conflicts with which MNEs are involved.

SUMMARY

Conflict is ‘disagreement through which the parties involved perceive a threat to their needs, interests or concerns’. Conflicts contain substantive, procedural, and psychological dimensions to be negotiated. In the context of this course, conflict means conflict between the parent/subsidiary and the host country elements (may be government, local business groups, social interest groups, political groups, environmental groups, consumer groups or so). Conflict exists “when two or more parties, with perceived incompatible goals, seek to undermine each other’s goal-seeking capability”.

Internal and external conflicts: In the personal sphere, a conflict can be internal (within oneself) or external (between two or more individuals). In the organizational sphere, a conflict can be internal (within the organization) or external (between two or more organizations). In the national sphere, a conflict can be internal (within one nation) or external (between two or more nations).

Conflicts ‘nested’ in conflicts, it is said. For example, conflict within a work team may be the reflection of a broader conflict in the organization as a whole. A conflict is more than a mere disagreement.

Functional Vs Dysfunctional Conflicts: Conflict could be functional when conflict enables improvement. Dysfunctional conflicts are disruptive, damaging and destructive. Conflict adds excitement and suspense that kindle creativity to evolve workable solution. Competition, Co-operation and Conflicts all can co-exist.

Hypotheses concerning conflicts:

i. High concern for outcomes of all leads to mutually beneficial solutions.
ii. High concern for one’s own outcomes only leads to attempts to ‘win’ the conflict.
iii. Low concern for the own interest only leads to allowing the other to ‘win’ the conflict.
iv. Low concern for both side’s outcomes leads to attempts to avoid the conflict.

Conflict sensitivity refers to the ability of any organization to: understand the context in which it operates; understand the interaction between its own activities and the context; and act upon the understanding of this interaction, in order to avoid negative impacts and maximize positive impacts.

Peace-building is those measures designed to consolidate peaceful relations and strengthen viable political, socio-economic and cultural institutions capable of mediating conflict, and

NOTES

to strengthen other mechanisms that will either create or support the necessary conditions for sustained peace.

MNEs and Conflict: MNEs live with global conflict. Violent conflict is a persistent feature of the international landscape and presents a serious challenge for foreign businesses investing in unstable societies throughout the world, especially parts of Africa, Asia and Latin America.

MNE projects are the causes or triggers of conflicts: No project located in a conflict-prone area will be neutral. Project related decisions on the distribution of employment opportunities, security arrangements etc can trigger sparks out of pre-existing structural and proximate conflict factors into violence, to the detriment of the project itself.

Causes of Organizational Conflicts: Structural factors, Specialization, Interdependence, Sharing Common Resources, Goal Differences, Authority relationships, Status Inconsistencies, Inconsistencies in asset endowments, Jurisdictional Ambiguities, Personal Factors, Personality clash, Perception differences, Values and Ethics, Communication barriers, Cultural Differences, hurt Emotion, Scarcity, Deprivation, Moral stance, and Identity or individuality are causes of organizational conflicts.

Conflict is relational. Conflict is relational in the sense that emotional communication conveys relational definitions that impact conflict. Key relational elements are power and social status.

Causes of Project Related Conflicts: Large infrastructure projects, Project loans/ advising/promotion for controversial projects, Capital flight and money laundering, Financial advising and conflicts, Sovereign loans/bonds/book-runners by human-right violators, Financing state-owned enterprises Trade facilities indirectly used to war-purposes, Export credits and support of arms sales are some causes for project related conflicts.

Poor Governance, Weakest Economies, Poverty and High Corruption are the major causes of violent conflicts. Some of the African countries suffer this risk. There are structural and proximate causes, and triggers of conflicts.

Conflict Resolution: Conflicts must be resolved at the earliest before they assume proportions. There are **behavioural and administrative** measures. The behavioural measures deal with organizational conflicts, while administrative measures address project related conflicts. Conflict resolution actions for organizational conflicts and project related conflicts are dealt in this section.

Thomas-Kilmann Conflict Mode for dealing with Organizational Conflicts: Five basic ways of addressing conflict, namely Avoidance, Collaboration, Compromise, Competition and Accommodation were identified by Thomas and Kilman. This is suited for organizational conflicts.

a. Avoidance: Avoid or postpone conflict by ignoring it, changing the subject, etc. Avoidance can be useful as a temporary measure to buy time or as an expedient means of dealing with very minor, non-recurring conflicts.

NOTES

A. A C**ollaboration:** Work together to find a mutually beneficial solution. The Thomas Kilman grid views collaboration as the only win-win solution to conflict. But collaboration can also be inappropriate when there is not enough trust among participants for collaboration to occur.

B. Compromise: Find a middle ground in which each party is partially satisfied. Compromising is an approach to conflict in which people gain and give in a series of tradeoffs.

C. Competition: Assert one's viewpoint at the potential expense of another. It can be useful when achieving one's objectives outweighs one's concern for the relationship.

D. Accommodation: Surrender one's own needs and wishes to accommodate the other party. Accommodating, also known as smoothing, is the opposite of competing.

Project Related Conflict Resolution Measures

Project Related Conflict Resolution measures are administrative in nature. In order to mitigate the range of conflicts facing projects in risky emerging markets, financial institutions have access to a variety of mitigation strategies, including insisting on substantial commitments from sponsors in the form of equity to ensure the project is adequately covered. **Political Risk Insurance (PRI), Covenants and Warranties, Political Umbrellas, Enhanced Due Diligence (Country Assessment, Human Rights and 'No-go' Criteria), Encouraging better Conflict Risk Management by Project Sponsors** are certain measures.

Basic elements of Negotiation in conflict resolution: Negotiation involves three basic elements: **process, behavior and substance**. The **process refers** to how the parties negotiate: the context, the tactics, the sequence and stages. The **behavior refers** to the relationships among these parties, the cordiality and the styles they adopt. The **substance refers** to what the parties negotiate over: the agenda, the issues, the options, and the agreement(s) reached at the end.

Skilled negotiators may use a variety of tactics including **cherry picking** (cases or data to prove one's line of argument as correct), intimidation and **salami tactics** (divide and rule) may also play a part in swaying the outcome of negotiations.

MNEs' attitude to Governmental Stipulations: MNEs' attitude to Governmental Stipulations may be one of **complying**. This is highly positive. Alternatively, MNEs might

NOTES

circumvent or get around those regulations they find unacceptable through loopholes, legal or illegal. **Avoidance** is avoiding doing business in the locale. It is negative. **Repudiation** is the reverse of **compliance** as the MNE decides not to follow the regulations or some of the same in a given locale and is prepared to face consequences. This is provocative.

One-sided agreements tilt the other way in due course: Middle-East countries depended most on Western Oil Companies for oil exploration or refining as they didn't have the expertise. Few large companies dominated the extraction, processing, shipment, and final sale at the cost of these countries. Now, as the supply of oil diminished and petroleum-producing countries found alternatives, the terms gradually favored these producing countries.

Positive sum solution lasts for long than zero-sum solution: In a zero-sum solution one party's gain equals the other party's loss. There is no way both can gain. It is win-lose or lose-win syndrome. Positive-sum solution is that both parties have net benefits or gains. It is win-win solution. MNEs by projecting the win-win possibilities can enter countries that are generally hostile to foreign businesses.

Country Bargaining Strength lies in their Investor Friendliness and Opportunities: Better Governance, Economic Upswing and Height, Sound Infrastructure, High Caliber Human Resources, Culturally Cosmopolitan Society, etc. make the nations attractive for investors, assuming investment avenues still not exhausted.

MNE's Bargaining Strength lies in Core Competence Brand and Other Equities: MNEs stature in terms of global presence, competitiveness, brand equity and financial strength determines their bargaining strength. Certain unique types of assets- technology, marketing expertise, process, people, net-work, etc are good sources of strength.

Domestic Pressures to counter MNEs' bargaining strength: Domestic companies which are direct or indirect competitors of the MNEs concerned will exert pressure against allowing the MNEs entry on the ground of lack of level playing field for them being technologically backward and other reasons. Reactions from the host-country governments to local pressure groups depend on the timing, bargaining powers of the agitators, etc. Taking shelter under these protests, the governments do extract further concessions from the MNEs. construction Companies also may face pressures from stockholders, workers, consumers, governmental officials, suppliers, and non-governmental organizations (NGOs) concerned with their own interests.

Negotiation Process in International Business: A ten-stage negotiation process that uniquely combines that puts together the best of many other approaches to negotiation is given below.

NOTES

Stage	Action	Stage	Action
Prepare	Know what you want.	Package	Assemble potential
Open	Put your case. Hear theirs.	Close	Reach final agreement.
Argue	Support your case. Expose	Sustain	Make sure what is
Explore	Seek understanding and	Renegotiate	When sustenance gets
Signal	Indicate your readiness to	Terminate	Stop negotiation, once

Cultural, Language and other intangible Factors Affecting Negotiations: Negotiators from **low-context cultures** want to get to the heart of the matter quickly. Negotiators from **high-context cultures** want to spend time developing rapport and trust before addressing business details**.** Negotiators from **mono-chronic cultures** will want to give their undivided attention to one issue at a time. However, negotiators from **poly-chronic cultures** feel uncomfortable if they do not simultaneously take care of other business affairs. **Saudi managers** generally prefer to **negotiate in English**, even if their English is not very good. **Interpreters are textual and not contextual.** Intangibles are often the key factors in many negotiations. Use the word "and" instead of "but." This helps to send the signal that you are interested in the other party and are seeking common ground. Some of the intangibles are dealt below.

International agencies in conflict resolution: Select international agencies like MIGA, International Chamber of Commerce and International Centre for Settlement of Investment Disputes are covered. Besides, pro-active measures to be undertaken by multilateral development bankers, regional development bankers, commercial banks, etc can help in conflict resolution.

NOTES

NOTES

NOTES