INTERNATIONAL BUSINESS - INTRODUCTION

The beverages you drink might be produced in India, but with the collaboration of a USA company. The tea you drink is prepared from the tea powder produced in Srilanka. The television you watch might have been produced with Japanese technology.

Most of you have the experience of browsing internet and visiting different websites, purchasing the goods and services without visiting those manufacturing countries. All these activities have become a reality due to the operations and activities of International Business. Thus, international business is the process of linking the global resources with global people.

EVOLUTION:

The origin of International Business goes back to human civilization. Sindh civilization had many traces of having a trade relationship with the Eastern civilization. Later the concept of International Business – a broader concept of integration of economies goes back to 19th century.

The first phase was took with the end of first World War in 1919. the import of raw materials by colonial countries emperor from colonies and exporting them finished goods again to the colonies. There is an increase in the level of international business.

But after second world war in 1945, the most of the colonial governments refused to export the raw materials and import finished goods for the purpose of protecting the domestic companies. There is a decrease in international business.

The consequences of World War II had made the world countries to feel the need of international co-operation of global trade which led to the formation of various organizations like International Monetary Fund (IMF) and International Bank for Reconstruction and Development(IBRD), now called AS World Bank.

NATURE:

Globalization – is an attitude of mind – it is a mindset which views the entire world as a single market so that the corporate strategy is based on the dynamics of global business environment. The concept of globalization has filled up the concept of International business. In

fact, the term International Business was not popular before 2 decades. International Business is come from the word International marketing and International Marketing is come from the word International Trade.

International Trade – International Marketing:

Originally, the producers used to export their products to the nearby countries and gradually extended the export to far-off countries. Gradually the companies extended the operations beyond trade.

International Marketing – International Business:

The MNC's which are producing in home country band marketing them in foreign countries, now started locating their plants and other manufacturing facilities in foreign/ host countries.
Later they started producing in one country and marketing in other foreign countries.

A true global companies views the entire world as a single market. There is a great renovision, given by Arvindh Mills:

- Source raw material wherever they are cheapest.
- Manufacture wherever in the world is most cost effective.
- Sell in those markets where the prices are highest.
- Raise finance globally.
- 'forge international strategy alliance.
- To manage all these, take the best talent from all over the world.

And you will have achieved the stature of a true multinational.

MEANING:

International Business refers to the exchange of goods and services between two parties of different countries.

International Business may be understood as those business transactions involve crossing of national boundaries.

International Business is the process of focusing on the resources of the globe and objectives of the organization on the global business opportunities and threats in order to produce/buy/sell or exchange of goods and services worldwide.

FEATURES:

1. **Large Scale Operations**:

In International business, all the operations are conducted on a very huge scale. Production and marketing activities are conducted on a very large scale. It first sell its goods in the local market and then the surplus goods are exported.

2. **Integration of Economies**:

International Business integrates (combines) the economies of many countries. This is because it uses finance from one country, labour from other country and infrastructure from another country. It designs the product in one country, produces its parts in many different countries and assembles in another country and sells in many countries.

3. **Dominated by developed countries and MNC's**

International Business is dominated by developed countries and their multinational companies. Europe and Japan dominate the foreign trade, this is because they have high financial and other resources.

4. **Benefits to Participating countries:**

International Business gives benefits to all participating countries. However, the developed countries get the maximum benefits, the developing countries also get benefits. They get foreign capital and technology. They get rapid industrial development. They get more employment opportunities.

5. **Keen Competition:**

International Business has to face competition in the world market. The competition is between unequal partners. In this situation, the developed countries are in favorable position as they

produce the superior quality goods and services, but developing countries find difficulty to face competition.

6. Special role of science and technology:

International Business gives a lot of importance to science and technology. Science and Technology helps the business to have a large scale production. Developed countries use high technology. International business helps them to transfer top-end technology to the developing countries.

7. International Restrictions:

International Business faces many restrictions on the inflow and outflow of capital, technology and goods. Many government do not allow international business to enter their countries. They have many trade blocks, tariff barriers, foreign exchange restrictions, etc. All this is harmful to international business.

8. Sensitive Nature:

The International Business is very sensitive in nature. Any changes in the economic policies, technology, political environment has a huge impact. Therefore it must conduct marketing research to find out and study these changes. They must adjust their business activities and adopt accordingly to survive changes.

9. International Business need **accurate information** to make appropriate decision.

10. International Business house need not only accurate but also **timely information**.

11. International Business house segments their markets based on the **geographic market segment**.

REASONS FOR THE EMERGENCE OF INTERNATIONAL BUSINESS:

- **To achieve higher rate of profits**

The basic objective of the business firm is to earn profit. The domestic markets do not promise a higher rate of profits. Business firms search for foreign market which hold promise for higher rate of profits. Thus the objective of profits affects and motivates the business to expand its operations to foreign countries.

- **Expanding the production capacity**

Domestic companies expanded their production capacities more than the demand for product in domestic countries. In such cases, these companies are forced to sell their excessive production in foreign developed market.

- **Severe competition in home country**

The countries oriented towards market economies since 1960's, experience severe competition from other business firm in the home country. The weak companies which could not meet the domestic countries started entering the markets of developing countries.

- **Limited home market**

When the size of the home market is limited either due to the smaller size of the population or due to lower purchasing power of the people or both, the companies internationalize their operations.

- **Political Stability v/s Political Instability**

Business firms prefer to enter the politically stable countries and are restrained from locating their business operations in politically instable countries. In fact, business firms shift the operations from politically instable countries to the politically stable countries.

- **Availability of Technology and Managerial Competency**

Availability of advanced technology and competent human resource in some countries acts as pulling factors for business firms from the home country. The developed countries due to these

reasons attract companies from developing world. In fact, American and European countries depend on Indian Companies for software products and services through their BPO's.

- **High cost of transportation**

Initially companies enter foreign countries trough their marketing operations. At this stage, the companies realize the challenge from the domestic companies. Added to this, the home companies enjoy higher rate of profit margins where as the foreign firms suffer from lower profit margins. The major factor for this situation is the cost of transportation,

Under such conditions, the foreign companies are inclined to increase their profit margin by locating their manufacturing unit in foreign countries where there is enough demand either in one country or in a group of neighboring countries.

- **Nearness to Raw materials**

The source of highly qualitative raw materials and bulk raw materials is a major factor for attracting the companies from the various foreign countries. Most of the US based companies open their manufacturing unit in Middle East countries due to the availability of petroleum. These companies, thus, reduces the cost of transportation.

- **Availability of Quality HR at less cost**

This is the major factor, in recent times, for software, high technology and tele-communication companies to locate their operations in India. India is a major source for high quality and low cost human resources unlike USA and other developed countries.

- **Liberalization and Globalization**

Most of the countries in the globe liberalized their economies and opened their countries to the rest of the globe. These changed policies attracted the multinational companies to extend their operations to these countries.

- **To increase market share**

Some of the large-scale business firms would like to enhance their market share in the global market by expanding and intensifying their operations in various foreign countries.

- **To achieve higher rate of economic development**

International Business helps the governments to achieve higher growth rate of the economy, increases the total and per-capita income , GDP, industrial growth, employment and income levels.

STAGES OF INTERNATIONALISATION:

Every company in the International Business will pass through the 5 different stages of Internationalization. They are:

- Domestic Company
- International Company
- Multi-National Company
- Global Company
- Transnational Company

- ***Stage – 1: Domestic Company***

Domestic Company limits its operations, mission and vision to the national boundaries. This company focus its view on the domestic market opportunities, supplies and customers. These companies analyze the national environment of the country, formulate the strategies to exploit the opportunities offered by environment. They never think of growing globally. They believe in saying, " if it is not happening in home country, it is not happening".

- ***Stage – 2: International Company***

Domestic companies which grows beyond their production capacities, think of internationalizing their operation. Those companies which decide to exploit the opportunities outside the domestic country are stage – 2 companies.

These companies believe that the practices the people and products of domestic business are superior to those of other countries. The focus of these companies is domestic but

extends the wings to the foreign countries. These companies select the strategy of locating a branch in foreign markets and extend same domestic operations into foreign markets.

- ***Stage – 3: Multi-National Company***

International companies turn into the Multi-National companies when they start responding to the specific needs of different country market regarding product, price and promotion. This stage is also referred as Multi-Domestic companies. These companies formulate different strategies for different markets. They operate like a domestic market of country concerned in each of their market.

- ***Stage – 4: Global Company***

A global company is the one, which has either global strategy. Global Company either produces in home country or in a single country and focuses on marketing these products globally or produces globally and focuses on marketing these products domestically.

- ***Stage – 5: Transnational Company***

It produces, markets, invests and operates across the world. It is an integrated global enterprise that links global resources with global markets at profits. There is no pure Transnational.

APPROACHES TO INTERNATIONAL BUSINESS:

Douglas Wind and Pelmutter advocated four approaches of International Business. They are:

- Ethnocentric Approach
- Polycentric Approach
- Regiocentric Approach
- Geocentric Approach

Ethnocentric Approach:

The domestic companies normally formulates their strategies, their product design and their operations towards the national markets, customers and competitors. The company exports the same

products designed for domestic markets to foreign countries. Thus maintenance of domestic approach towards International business is Ethnocentric Approach.

- **Polycentric Approach:**

The company establishes a foreign subsidiary company and decentralizes all the operations and delegates decision-making and policy making authority to its executives. In fact company appoints executives and personnel who direct reports to managing Director of that company. Company appoints key personnel from he home country and all other vacancies are filled by people of host country.

- **Regiocentric Approach:**

The company after operating successfully in a foreign country, thinks of exporting to the neighboring countries of the host country. At this stage, the foreign subsidiary considers the regional environment for formulating policies. It markets more or less the same product design, under polycentric approach in other country of region with the different market strategy.

- **Geocentric Approach:**

Under this approach, the entire world is just like a single country for the company. They select the employees from entire globe and operate with a number of subsidiaries. Each subsidiary functions as an autonomous company in formulating policies, strategies, product design, etc,.

DIFFERENCES BETWEEN DOMESTIC AND INTERNATIONAL BUSINESS:

Basis	Domestic Business	International Business
Approach	DB's approach is Ethnocentric Approach.	IB's approach is either Polycentric or Regiocentric Approach.
Operating	Db formulates the strategies,	IB formulates the strategies, product

Activities	product design towards the national markets, customers and competitors.	design towards the International markets, customers and competitors.
Geographic scope	DB's geographic scope is within the national boundaries of the domestic country	IB's geographic scope varies from the national boundaries of 2 countries up to a maximum of the entire globe.
Operating Style	Operating style including production, marketing is limited to the domestic country	Operating style can be spread to the entire globe.
Environment	It analyses and scan the domestic environment.	It analyses and scan the relevant international environment.
Quotas	Quotas imposed by various countries on import and export not influence the domestic business.	Quotas imposed by various countries on import and export significantly influence the international business.
Tariffs	Tariff rates of various countries do not affect the domestic business	Tariff rates of various countries do affect the international business.
Foreign Exchange rates.	Foreign exchange rates and their fluctuations do not directly and significantly affect the domestic business.	Foreign exchange rates and their fluctuations directly and significantly affect the international business.
Culture	Mostly domestic culture of the country affects the business operations	Mostly cultures of the various countries affect the operations of the international business.
Export-Import procedure	Domestic business is not affected	International business is affected by the procedure of the various countries.
Human Resources	Domestic business normally employs the people from the same country	International business normally employs the people from various countries.

Markets and customers	Meets the needs of the domestic markets and customers	Meets the needs of the markets and customers of the different countries.
	Business transaction with in the country.	Business transaction between two different countries.

ADVANTAGES:

1. ***High Living Standard***

   Customers in various countries can buy more products with the same amount of money in the International Markets. In turn, it can also enhance the living standard of the people through enhanced purchasing power and by consuming high quality products.

2. ***Increased Socio-Economic Welfare***

   International business enhances the consumption level, and economic welfare of the trading countries.

3. ***Wider Markets***

   International business widens the market and increases the market size. Therefore, the companies need not depend on the demand for the product in one single country or customer's taste and preferences.

4. ***Reduced effects of Business Cycle***

   The stages of business cycle vary from country to country. Therefore, MNC's shift from the country experiencing a recession to the country experiencing the boom conditions. Thus, international business firms can escape from the recessionary conditions.

5. ***Reduced Risks***

   Both commercial and political risks are reduced for the companies engaged in international business due to spread in different countries.

6. ***Large Scale Economics***

MNC due to the wider and larger markets produce larger quantities, which provide the benefit of large-scale economies like reduced cost of production, availability of expertise, etc.

7. ***Potential Untapped Markets***

International business provides the chance of exploring and exploiting the potential markets which are untapped so far. These markets provides the opportunity of selling the product at a higher price than in domestic markets.

8. ***Provides the opportunities for and challenge to domestic business***

International Business firms provides the opportunities to the domestic companies. These opportunities include technology, management expertise, market intelligence, etc,.

9. ***Division of Labour and Specialisation***

International business leads to division of labour and specialization. Brazil specializes in coffee, Kenya in tea, Japan in automobiles.

10. ***Economic Growth of the world***

Specialisation, division of labour, enhancement of productivity, posing challenges, development to meet them, innovations and creations to meet the competition lead to ovrall economic growth of the world nations.

11. ***Optimum and proper utilization of world resources***

International business provides for the flow of raw materials, natural resources and human resources from the countries where they are in excess supply to those countries which are in short supply or need most.

12. ***Cultural Transformation***

International business benefits are not purely economical or commercial, they are even social and cultural. There is a close cultural transformation and integration.

13. Knitting the world into a closely interactive Traditional Village

International business ultimately knits the global economies, societies and countries into a closely interactive and traditional village where one is for all and all are for one.

DISADVANTAGES:

1. **Political Factors**

   Political instability is the major factor that discourages the spread of international business.

2. **Huge Foreign Indebtedness**

   The developing countries with less purchasing power are lured into a debt trap due to the operations of MNCs in these countries.

3. **Exchange Instability**

   Currencies of countries are depreciated due to imbalances in the balance of payments, political instability and foreign indebtedness. This, in turn, leads to instability in the exchange rates of domestic currencies in terms of foreign currencies.

4. **Entry Requirements**

   Domestic governments impose entry requirements to multinational.

5. **Tariff Quotas and Trade Barriers**

   Governments of various countries impose tariffs, import and export barriers in order to protect the domestic business. Further these barriers are imposed based on the political and diplomatic relations between or among various governments.

6. **Corruption**

   Corruption has become an international phenomenon. The higher rate bribes and kickbacks discourage the foreign investors to expand their operations.

7. **Bureaucratic Practices of Government**

   Bureaucratic attitudes and practices of government delay sanctions, grants permission and licenses to foreign companies.

8. **Technological Pirating**

   Copying the original technology, producing imitative products, imitating other areas of business operations were common in Japan . this practices invariably alarms the foreign companies against expansion.

9. **Quality maintenance**

   International business firms have to meticulously maintain quality of the products based on quality norms of each country. The firms have to face severe consequences, if they fail to conform to the country standards.

10. **High Cost**

    Internationalizing the domestic business involves market survey, product improvement, quality up gradation, managerial efficiency and the like. These activities need larger investments and involve higher cost and risk. Hence, most of the business houses refrain themselves from internationalizing their business.

INTERNATIONAL BUSINESS ENVIRONMENT

Introduction:

A global company has to formulate strategies based on its missions, objectives and goals. Strategy formulation is a must for a global company to make decisions regarding the markets to enter, product/service range to introduce in the foreign countries. The fundamental basis for strategy formulation is the environmental analysis. Environment provides the opportunities to the business to produce and sell a particular product. Environment sometimes poses threats and challenges to business. Business should enhance its strengths in order to face the challenges posed by the

environment. Study of environment helps the business to formulate strategies and run the business efficiently in the competitive global markets.

Meaning of International Business Environment:

Environment means surrounding. International business environment means the factors/activities those surround/encircle the international business. In other words, business environment means factors that affect or influence the MNC's and transnational companies.

Factors that affect International Business include Social and Cultural factors (S), Technological Factors (T), Economic Factors (E), Political/Governmental factors (P), International factors (I) and Natural factors (N). [STEPIN]

William F. Glueck defined the term environmental analysis as, ' the process by which strategists monitor the economic, governmental/legal, market/competitive, supplier/technological, geographic and social settings to determine opportunities and threats to their firms".

Factors of International Business Environment:

Business environmental factors are broadly divided into internal environmental factors and external environmental factors. Internal environmental factors include human resource management, trade unions, organization structure, financial management, marketing management and production management management/leadership style, etc.

External environmental factors are further divided into micro and macro external environmental factors. Micro environmental factors include competitors, customers, market intermediaries, suppliers of raw materials, bankers and other suppliers of finance, shareholders and other stakeholders of the business firm. External macro environmental factors include social and cultural factors, technological factors, economic factors, political and governmental factors, international factors and natural factors.

1. CULTURAL ENVIRONMENT:

Culture is, " the thought and behaviour patterns that member of a society learns through language and other forms of symbolic interaction – their customs, habits, beliefs and values, the

common view points which bind them together as a social entity…. Cultural change gradually picking up new ideas and dropping old ones, but many of the cultures of the past have been so persistent and self contained that the impact of such sudden change has torn them apart, uprooting their people psychologically."

Characteristics:

- ✓ Culture is derived form the climatic conditions of the geographical region and economic conditions of the country.
- ✓ It is a set of traditional beliefs and values which are transmitted and shared in a given society.
- ✓ It is a total way of life and thinking patterns that are passed form generation to generation.
- ✓ It is norms, customs, art, values, etc.
- ✓ It prescribes the kind of behaviour considered acceptable in the society.
- ✓ It is based on social interaction and creation.
- ✓ Culture is acquires through learning but not inherited genetically.
- ✓ Culture is not immune to change. It goes on changing.

Factors influencing International Business:

1. ***Cultural attitude and International Business:***

Dressing habits, living styles, eating habits and other consumption patterns, priority of needs are influenced by culture. The eating habits vary widely. Similarly, dressing habits also vary from country and county based on their culture.

2. ***Cultural Universal***

Irrespective of the religion, race, region, caste, etc, all of us have more or less the same needs. These common needs are referred as "Cultural Universal". The cultural Universal enable the businessmen to market the products in many foreign countries with modifications. Example: TV's, cars, vedio games.

3. ***Communication with languages***

Language is the basic medium of communication. There are more that 5000 spoken languages in the world. The same words in the same language may mean different things in the different regions of the country.

4. ***Time and Culture***

Time has different meaning in different cultures. Asian di not need appointment to meet someone and vice-versa. But Americans, Europeans and Africans need prior appointment to meet someone and vice-versa. In Asian Countries, particularly in India, auspicious time is most important for the business, admission in a college, travel, etc.

5. ***Space and Culture***

Space between one person to another person plays a significant role in communication. But, culture determines the pace/distance between one person and another person. Americans need more distance from a third person for privacy. This is unimportant for Indians.

6. ***Culture and Agreement***

The USA is very legalistic society and Americans are very specific and explicit in their terms of agreement. The opposite is true in case of Asian countries. Asians never pick up face to face confrontation. They keep quiet in case of disagreement.

7. ***Culture and Friendship***

Americans develop friendship even in short time. In fact, they don't develop deep personal ties. Sometimes, people in the US complete the business and then develop friendship. People in India, Japan and China firs develop friendship through several means including eating together, presenting gifts and then transact business.

8. ***Culture and Negotiation***

Americans are straightforward. Chinese negotiations are generally tough-minded and well prepared and use various tactics to secure the best deal.

9. ***Culture and Superstition***

Superstitious beliefs like fortune telling, palm reading, dream analysis, phases of the sun and moon, vaastu are prominent in Asian Countries and also in some African Countries. Americans knock on wood, cross their fingers and feel uneasy when a black cat crosses their path. Even Indians feel uneasy when a cat crosses their path.

10. ***Culture and Gifts***

Culture attitudes concerning the presentation of gifts vary widely across the world. In Japan and India gifts are given first, but in Europe only after a personal relationship id developed. The international businessmen should study the customs of the society in offering gifts.

2. SOCIAL ENVIRONMENT

It consists of religious aspects, language, customs, traditions, tastes and preferences, living habits, dressing habits, etc., It also influence level of consumption. Example: The economic position of Germans and French people is more or less same, culturally different. So study of social environment helps in deciding type of market, product, etc.

The various factors of social environment effect on international business are:

1. Religion:

Religion is one of the important social institution on influencing the business. The religious play a vital role in normal and ethical standards in production and marketing of goods and services. Most of the religion indicates in providing truthful and honest information.

2. Family system:

In addition to religion, family system has impact on international business. Example: Most of Islamic countries, women play less significant role in economy and also in family with limited rights. But in Latin American countries, role of women is better compared to that of Islamic countries. But women play a dominant role in European and North American countries.

3. Behavioural factors affecting the business:

Human behaviour affects the business include employee behaviour, consumer behaviour and behaviour of stake holders (Holders of debentures, bonds, etc. Cultural factors also influence the human behaviour cultural differences in various countries results in variations in human behaviour from country to country. Business should consider behaviour pattern of social groups in hiring, marketing and in selecting supplier of inputs and market intermediaries.

4. Behaviour based on group membership:

Attitude towards female employment vary from country to country. Example: Arabian countries discourage females from seeking employment. Family membership is paramount rather than individual achievements in certain societies like India, China, etc.,

5. Motivations and Achievements:

Economic development of a country depends on motivations of people to work hard and desired of achievement. People rank the motivational needs differently from country to country. People from poor countries are mostly motivated by compensation while their counter parts in rich countries are motivated by the higher order needs like more responsibility, recognitions and other esteem needs.

6. Power Distance:

Power distance denotes the relationship between superior and sub-ordinates. People in low power distance prefer little consultations between superior an subordinates. Subordinates in high power distance may prefer participating in decision making among themselves excluding the superior.

7. Individualism V/s Collectivism:

Individualism and collectivism are consequences of the culture and affects the formation of group, productivity and marketing practices.

8. Risk taking behaviour:

Employees in countries with the highest scores of the uncertainty avoidance prefer a system and a methodological work based on rules that are not to be deviated. Employees in countries with the low scores of uncertainty avoidance prefer flexible organization and flexible work.

Example: People in some countries like Norway trust most of the people and people in some other countries like Brazil are very cautious in dealing with other.

3. TECHNOLOGICAL ENVIRONMENT:

Technology is the application of knowledge. In other words, technology has a systematic application of scientific or other organized knowledge to a particular task.

Features:

a) Technology brings changes in the society, economy and politics.

b) Technology effects on entire globe.

c) Technology makes more technology possible.

Impact of technology on international business:

1. ***Investments in technology:***

Advanced countries spend considerable amount on research and development for further advancement of technology. Example: German spends 50% of research and development budget on product innovation and remaining 50% on process innovation. But Japanese spend 70% on process innovation and 30% on product innovation.

2. ***Technology and economic development:***

Technology is one of the significant factor, determines the level of economic development of a country. The differences between nation is mostly reflected by the level of technology. Example: India has the vast natural resources. It remain importing the products from other countries through exporting raw materials from itself due to its low level of technology.

3. ***Technology and International competition:***

A few companies invent but many companies adopt scientific knowledge to generate wealth by application and communication. The invention process and global competitiveness are the two determinants of a national wealth. Example: Japan concentrates on innovation of automobiles. But Italy concentrates on innovation of textiles and leather.

4. Technology Transfer:

Technology and global business are interdependent. International business spread technology from advanced countries to developing countries by establishing the subsidiaries or establishing the subsidiaries joint ventures with the host countries and arranging technological transfer to the company of developing countries through technological alliances.

5. Technology and location of plants:

MNCs locate their manufacturing facilities based on the technology. In other words, MNCs locate their plants with high technology in advanced countries and establish the labour driven manufacturing facilities in developing countries in order to get the advantages of cheap labour.

6. Scanning of Technological environment:

The level of technology is not same in all the countries. Advanced countries enjoy the latest technology while the developing nations face he consequences of outdated technology. Therefore, MNCs have to understand technology and analyse it before entering foreign market.

7. Appropriate technology:

The technology that suit one country may not be suitable for other countries. As such the countries develop appropriate technologies which suit their climatic conditions, social conditions, conditions of infrastructure etc., Ex: Japanese automobile industry design different type of cars which suit the Indian roads.

8. Technology and globalization:

The industrial revolution resulted in large scale production and the recent technological revolutions leads to the production of high quality products at lower cost. These factor forced the domestic company to enter the foreign countries in order to find market for their products. Thus technology is one important cause for globalization.

9. Information technology and globalization:

The information technology redefined the global business through its development like internet, www sites, e-mails, information super highways and on-line transactions brought significant development to the global business.

Impact of technology on globalization:

- Technological advances have tremendously faster globalization. Technology have been a very important facilitating factor of globalization.
- Several technological development becomes a compelling reason for internationalization technology are substantially increasing the scale economies and market scale required to break even.
- Global sourcing encouraged not only to trade liberalization but also by technological developments which reduces transportation cost.
- Technology monopoly encourages internationalization because the firm can exploit the respective demand without any competition.
- Development in telecommunication and information technologies have reduced the barriers to time and place in doing a business. It is possible for customers and suppliers to transact the business at any time and any part of the globe.

4. ECONOMIC ENVIRONMENT

Economic environment refers to all those economic factors which have a bearing on functioning of a business unit. Economic environment of various countries directly influences the international business. In fact, international economic environment and global business interact with each other.

The major changes include:

- Capital flow rather than trade or product flow across the globe.
- Establishment of production facilities in various countries.
- Technological revolution link the relations between the size of the production and level of employment.
- The macro economic factors of individual nations independently donot significantly control the global economies.

Economic system:

Economic system is one of the important factor of economic development that influences the international business to the greater extent. Economic system is an organization of institutions established to satisfy human needs or wants.

There are three types of economic system viz.,

- Capitalistic Economic System
- Communistic Economic System
- Mixed Economic System

Capitalistic Economic System: This system provides for economic democracy and customer choice for product or service. This system emphasizes on the philosophy of individualism, believing in private ownership of production and distribution facilities Ex: USA, Japan, UK.

Communistic Economic System: Under this system private properties and property rights to income are abolished. The State owns all the factors of production and distribution but the major limitation of this system is to reduced the individual freedom of choice ;and failed to achieve significant economic growth.

Mixed Economic System: Under this system, major factors of production and distribution owned, managed and controlled by the State. The purpose is to provide benefits to public more or less on equality basis. This system, does not distribute the existing wealth equally among people, but believes in full employment and suitable rewards for the workers efforts. Ex: India, UK, France, Holand etc.,

Countries classified on the basis of income:

- Low income countries
- Lower middle income countries
- Upper middle income countries

- Higher Income countries

Low Income Countries: This country is also known as third world countries or pre industrial countries. The characteristics includes, high birth rate, low literacy rate, political instability an unrest, technological backwardness, underutilization of natural resources, excessive unemployment and underemployment, and excessive dependency on imports.

Lower Middle Income Countries: These countries are known as less developed countries. The characteristics of these countries include – early stage of industrialization, expansion of consumer market, availability of cheap and motivated human resource, location for production of standardized products or exporting, ex: clothing for exports.

Upper Middle Income Countries: These countries are called industrializing countries. The characteristic of these countries are – less dependency on agriculture, high exports, increase in literacy, formal education, rapid economic development, occupation mobility of people from agriculture to industry and increased wage rate.

High Income Countries: These countries are known as advanced countries, industrialized, post-industrialized or first world countries. The characteristics include – development of information sector, emphasize on future plan, development of intellectual technology over machine technology and it aims at building information society.

Impact of economic environment on international business:

1. ***Economic growth:***

Business helps for the identification of peoples' needs, wants, production of goods and services and supply to the people. Thus it creates for the conversion of inputs into the outputs and enables for consumption. It leads to economic development. The high economic growth rate of the countries providing an opportunity of expanding market shares to international business firms, managers of the MNCs are interested in knowing the future economic growth rate of various countries in order to select the market either to enter or concentrate more resources to the market.

2. ***Inflation:***

It is the another important factor that affects the market share of the international business firm. It affects the interest rate as the demand for money is high due to the higher prices and it also affects the exchange rate of the domestic currency in terms of various foreign currencies.

3. ***Balance of payments:***

Balance of Payments position of a country is an outcome of international business and also affects the future of the international business. Export and import trade in goods and services affects the current accounts position and flow of capital affects capital accounts position. The managers of MNCs should monitor the balance of payment position of the countries.

4. ***Economic Transition:***

The process of liberalization provided a significant opportunities to MNCs to enter most of the countries of the world either by locating their manufacturing facilities or expanding or both. Thus MNCs are immediate and greatest beneficiaries of L, P and G of world economies.

5. POLITICAL ENVIRONMENT:

The influence of political environment on business is enormous. Political system prevailing in a country promotes, decides, encourages, directs and control the business activities of that country. PE includes factors such as characteristics and policies of political parties, the nature of constitution and Government system and the Government environment influencing the economic and business policies and regulation.

Concepts:

1. ***Political ideology:***

Political ideology is the body of complex ideas, theories and objectives that constitute a socio-political program. Political ideologies of the people in the same country vary widely due to the variations in culture, ethic group, community groups, religious and the economic groups. These

variations influence the people to form different political parties. The difference in political ideologies change the national boundaries. The IB manager should understand these ideologies of various in the countries in order to know the possible political tensions and instabilities.

2. ***Democracy:***

It refers to political arrangement in which the supreme power is vested in the hand of people.

3. ***Political rights and Civil liberties:***

It helps for evaluating the freedom of citizens. The major indicators of political liberties include:

- conduct of elections fairly and competitively
- power and ability of the voters in casting their votes in the process of electing
- people ability in forming political parties and groups.

The major indicators of civil liberties include:

- Degree of freedom of the press,
- Equality for all individuals under the law,
- Freedom from extreme in difference of Govt. and corruption.

Totalitaranism:

It refers to an individual freedom is completely subordinated to the power of authority of the state or concentrated in the hands of one person or in a small groups.

Political Relations and International business:

Political friendly relationship results in the growth of bi-lateral or multi-lateral trade. Ex: The friendly relationship between Indian companies but also the MNCs operating in India to have a close business linkages with the USSR. Similarly the friendly relationship between Pakistan and USA helped the Pakistan companies to have a close business linkages with USA.

Types of Political System:

Appraisal of political system help us in having a ideas of political system and their impact on international business. The are classified as:
Two party system: Two parties takes turn of controlling the Government under two party system Ex: USA and UK.

Multiparty system: In a multiparty system, there are many parties and no party is strong to gain the control of the Government: Ex: Germany, France and India.

Single party system: In this system, only one dominant party gets the opportunity to control the Government even through several parties exists Ex: Egypt.

One party Dominated system: In this system, dominate party rules the Government even though there are more than one party. Ex: USSR, Cuba.

Political Risk:
Political risk refers to risk of loss of assets earning power or managerial control, due to the events or action that are politically motivated.

Political risk that affects the international business:
The international business firms face political risk as and when there are changes in Government policies or changes in political parties in power. Risks are based on host Government actions like:

Confiscation: The process of nationalization of property without compensation is called confiscation.

Expropriation: It is the process of nationalization of a property with compensation.
Nationalisation: It is a process of shifting the ownership of private property from private individuals to Government.
Domestication: In this, foreign business firm control and ownership in favour of domestic investors either partly or fully.

General Instability risk: These risk are due to social, political, religious, unrest in the host country.

Operation risk: These risk are due to imposition of controls on foreign business operations by the host Government.

Political instability can be viewed from the corruption, social unrest, attitudes of nationals and policies of host Government.

How to minimize the political risk?

The risk that are involved in international business cannot be avoided but it can be minimized. It can be minimized from the following:

Stimulation of the local economy: The foreign company can stimulate the economic development of host country by investing in their priority area. The foreign countries can stimulate the host country economy by being export oriented.

Employment of nationals: MNCs can minimize political risk by employing, developing and promoting the local people.

Sharing ownership: Foreign company should allow the domestic investors to invest and share the ownership by converting the company into public limited company and ownership can be shares through joint ventures.

De-civic minded: The MNCs in addition to doing business in foreign countries should also be good corporate citizen. It may help the foreign countries in different ways like constructing schools, hospitals, roads, etc.,

Political Neutrality: MNCs should not involved in political risk or disputes among the local group of host countries from the point of view of long run interest.

MODES OF ENTRY TO INTERNATIONAL BUSINESS

INTRODUCTION:

Companies desiring to enter the foreign markets, face the dilemma while deciding the method of entry into a given overseas location. Companies can reduce the dilemma by analyzing the decision factors.

Decision factors:

After deciding to go to foreign markets, the companies have to decide the mode of entry. This dilemma can be solved to some extent by considering the following factors:

- Ownership advantages
- Location advantages
- Internationalisation advantages

Ownership Advantages: Ownership advantages are those benefits designed by a company by owing resources. These benefits provide competitive advantages to the company over its competitors. These advantages are both tangible and intangible.

Location advantages: Certain locational factors grant benefit to the company when the manufacturing facilities are located in the host country rather than in the home country. These locational factors include:

- Customer Ned, preferences and tastes
- Logistic requirements
- Cheap land acquisition cost
- Cheap labour
- Political stability
- Low cost raw materials
- Climatic conditions

Internationalisation advantages: Internationalisation advantages are those benefits that a company gets by manufacturing goods or rendering services in the host country by itself rather than through contract arrangements with the companies in the host country.

1. EXPORTING:

Exporting is the simplest and widely used mode of entering foreign markets. The advantages of exporting include:

~ Need for limited finance: If the company selects a company in the host country to distribute, the company can enter international market with no or less financial resources. Alternatively, if the company chooses to distribute on its own, it needs to invest financial resources, but this amount would be quit less compared to that would be necessary under other mores.

~ Less risk: Exporting involves less risk as the company understands the culture, customer and the market of the host country gradually. The company can enter the host country on a full-scale, if the product is accepted by the host country's market. A British company selected this mode to export jams to Japan.

~ Motivation for exporting: Motivations for export are proactive and reactive. Proactive motivations are opportunities available in the host country.

Forms of Exporting:

Forms of exporting include: indirect exporting, direct exporting and intra-corporate transfers.

1. ***Indirect exporting***: Indirect exporting is exporting the products either in their original form or in the modified form to a foreign country through another domestic company. Various publishers in India including Himalaya Publishing House sell their products, i.e., books various exporters in India, which in turn export these books to various foreign countries.

2. ***Director exporting***: Direct exporting is selling the products in a foreign country directly through its distribution arrangements or through a host country's company. Baskin Robbins initially exported its ice-cream to Russia in 1990 and later opened 74 outlets with Russian partners. Finally, in 1995 it established its ice-cream plant in Mascow.

3. ***Intra-corporate Transfers***: Intra-corporate transfers are selling of products by a company to its affiliated company in host country (another country). Selling of products by Hindustan Lever in India to Unilever in the USA. This transaction is treated as exports in India and imports in the USA.

Factors to be considered:

The company, while exporting, should consider the following factors:

- Government policies like export policies, import policies, export financing, foreign exchange etc.,
- Marketing factors like image, distribution networks, responsiveness to the customer, customer awareness and customer preferences.
- Logistical consideration: These factors include physical distribution costs, warehousing costs, packaging, transporting, inventory carrying costs etc.
- Distribution issues: These include own distribution networks, networks of host country's companies. Japanese companies like Sony, Minolta and Hitachi rely on the distribution networks of their subsidiaries in the host country.

Export Intermediaries:

Export intermediaries perform a variety of functions and enable the small companies to export their goods to foreign countries. Their functions include: handling transportation, documentation, taking ownership of foreign-bound goods, assuming total responsibility for exporting and financing.

Types of export intermediaries include:

- Export Management: companies act as export department of the exporting firm (its client). These companies act as commission agents for exports or they take title to the goods.
- Co-operative society: The domestic companies desire to export the goods form a co-operative society, which undertakes the exporting operations of its members.
- International Trading Company: This company is engaged in directly exporting and importing. It buys the goods from the domestic companies and exports. Therefore, the companies can export their goods by selling them to the international trading company.
- Manufacturers' Agents: They work on a commission basis. They solicit domestic orders for foreign manufacturers.
- Manufacturers' export agents: These agents also work on a commission basis. They sell the domestic manufacturers' products in the foreign markets and act as their foreign sales department.

- Export and Import Brokers: The bankers bridge the gat between exporters and importers and bring these two parties together.
- Foreign forwarders: Foreign forwarders help the domestic manufacturers in exporting their goods by performing various functions like physical transportation of goods, arranging customs documents and arranging transportation services.

2. INTERNATIONAL LICENSING:

In this mode of entry, the domestic manufacturers leases the right to use its intellectual property, i.e., technology, work methods, patents, copy rights, band names, trade marks etc. to a manufacturer in a foreign country for a fee. Here the manufacturer in the domestic country is called 'Licensor" and the manufacturer in the foreign country is called "Licensee'. The process of the licensing is as shown in the figure.

Licensing is a popular method of entering foreign markets. The cost of entering foreign markets through this mode is less costly. The domestic company need not invest any capital as it has already developed intellectual property. As such, the domestic company earns revenue without additional investment. Hence, most of the companies prefer this mode of foreign entry.

Licensor	Licensor
Leases the right to use The intellectual property	Receives Royalty Money

Uses the Intellectual Property to product Products for sale in his country	Pays royalty to the Licensor for Using intellectual property
Licensee	Licensee

The domestic company can choose any international location and enjoy the advantages without incurring any obligations and responsibilities of ownership, managerial, investment, etc.

Basic issues in International Licensing:

Companies should consider various factors in deciding negations. Each international licensing is unique and has to be decided separately. However, there are certain common factors, which affect most of the international licenses. They are: specifying the agreement's boundaries, determining the royalty, determining rights, privileges and constraints, defining resolution methods, specifying the duration of the contract.

- ***Boundaries of the agreements:*** The companies should clearly define the boundaries of agreements. They determine which rights and privileges are being conveyed in the agreement.
- ***Determination of royalty:*** The most important factor in deciding the licence is the amount of royalty. It is needless to mention that the licensor expects high rate of royalty while the licensee would be unwilling to pay much royalty. However, both the parties negotiate for a fair royalty for both the sides in order to implement the contract more successfully.
- ***Determining right, privileges and constraints***: Another important factor in granting license is determining clearly and specifically the rights, privilege and constraints. For example, if the Indian licensee of Aiwa TV uses interior inputs in order to reduce price, boost up sales and profits, the image of the Japanese licensor would be damaged.
- ***Dispute settlement mechanism:*** The licensee and licensor should clearly mention the mechanism to settle he disputes as disputes are bound to crop up. This is because, settlement of disputes in courts is costly, time consuming and hinders business interests.
- ***Agreement duration:*** The two parties of the agreement specify the duration of the agreement. Licensing cannot be a short-term strategy. Hence, the duration of the licensing should not be of the short-term. It would always be appropriate to have long duration of the licensing. Tokyo Disneyland demanded on a 100 year licensing agreement with the Walt Disney company.

Advantages:

- Licensing mode carries relatively low investment on the part of licensor.
- Licensing mode carries low financial risk o the licensor.
- Licensor can investigate the foreign market without much efforts on his part.
- Licensee gets benefits with less investment on research and development.

- Licensee escapes himself from the risk of product failure.

Disadvantages:

- Licensing agreements reduce the market opportunities for both the licensor and licensee. Pepsi-cola cannot enter Netherlands and Heineken cannot sell Coca-cola.
- Both the parties have responsibilities to maintain the product quality and promoting the product. Therefore, one part can affect the other through their improper acts.
- Costly and tedious litigation may crop up and hurt both the parties and the market.
- There is scope for misunderstanding between the parties despite the effectiveness of the agreement. The best example is Oleg Cassini and Jovan.
- There is a problem of leakage of the trade secrets of the licensor.
- The licensee may develop0 his reputation.
- The licensee may sell the product outside the agreed territory and after the expiry of the contract.

3. INTERNATIONAL FRANCHISING:

Franchising is a form of licensing. The franchisor can exercise more control over the franchised compared to that in licensing. International franchising is growing at a fast rate.

Under franchising, an independent organization called the franchisee operates the business under the name of another company called the franchisor. Under this agreement the franchisee pays a fee to the franchisor. The franchisor provides the following services to the franchisee:

- Trade mark
- Operating systems
- Product reputations
- Continuous support systems like advertising, employee training, reservation services, quality assurance programs etc.

Basic issues in Franchising:

- The franchisor has been successful in his home country. McDonalds was successful in the USA due to the popular menu and fast and efficient services.
- The factors for the success of the McDonald are later transferred to other countries.
- The franchisor may have the experience in franchising in the home country before going for international franchising.
- Foreign investors should come forward for introducing the product on franchising basis.

Franchising Agreements:

The franchising agreement should contain important items as follows:

- Franchisee has to pay a fixed amount and royalty based on the sales to the franchisor.
- Franchisee should agree to adhere to follow the franchisor's requirements like appearance, financial reporting, operating procedures, customer service etc.
- Franchisor helps the franchisee in establishing the manufacturing facilities, services facilities, provides expertise, advertising, corporate image etc.
- Franchisor allows the franchisee some degree of flexibility in order to meet the local tastes and preferences. McDonald restaurants in Germany sell beer also and McDonald restaurants in France sell wine also.

Advantages:

- Franchisor can enter global markets with low investment and low risks.
- Franchisor can get the information regarding the markets, culture, customs and environment of the host country.
- Franchisor learns more lessons from the experiences of the franchisees, which he could not experience from the home country's market. McDonald benefited from the worldwide learning phenomenon. McDonald is convinced to open a restaurant in inner-city office building in Japan. This location has become a more successful one. Based on this lesson, McDonald opened its restaurants in downtown locations in various countries.

- Franchisee can also start a business with low risk as he selects an established and proved product and operating system.
- Franchisee gets the benefits of R&D with low cost.
- Franchisee escapes from the risk of product failure.

Disadvantages:

- International franchising may be more complicated than domestic franchising. McDonald taught the Russian farmers the methods of growing potatoes to meet its standards.
- It is difficult to control the international franchisee. As one of the French investors did not maintain the stores as per the standards, McDonald did revoke the franchise.
- Franchising agents reduce the market opportunities for both the franchisor and the franchisee.
- Both the parties have the responsibilities to maintain product quality and product promotion.
- There is scope for misunderstanding between the parties.
- There is a problem of leakage of trade secrets.

4. CONTRACT MANUFACTURING:

Some companies outsource their part of or entire production and concentrate on marketing operations. This practice is called the contract manufacturing or outsourcing.

Advantages:

- International business can focus on the part of the value chain where it has distinctive competence.
- It reduces the cost of production as the host country's companies with their relative cost advantage produce at low cost.
- Small and medium industrial units in the host country can also develop as most of the production activities take in these units.

- The international company gets the locational advantages generated by the host country's production.

Disadvantages:

- Host country's companies may take up the marketing activities also, hindering the interest of the international company.
- Host country's companies may not strictly adhere to the production design, quality standards etc. These factors result in quality problems, design problem and other surprises.
- The poor working conditions in the host country's companies affect the company's image. For example, Nike has suffered a string of blows to its public image because of reports of unsafe and harsh working conditions in Vietnamese factories churning our Nike foot ware.

5. TURNKEY PROJECT

A turnkey project is a contract under which a firm aggress to fully design, construct and equip a manufacturing/ business/ service facility and turn the project over to the purchaser when it is ready for operation for a remuneration. The forms of remuneration includes:

- A fixed price (firm plans to implement the project below the price)
- Payment on cost plus basis (total cost incurred plus profit)

Indonesian Government during 1974 invited global tenders for construction of a sugar factory in the country. Indonesian Government received the tenders from the companies of the USA, the UK, France, Germany and Japan. One of the Japanese company quoted highest price compared to all other companies.

So, Indonesian Government studied the quotation . this quotation includes: development of the fields for growing sugarcane, development of seedling, construction of sugar factory, roads, communication , connecting the factory, train the local market, plans for the export of surplus sugar, etc. It also made provision for the transfer of the factory along with the total package to the Indonesian Government and follow-up the activities after it is transferred to the Indonesian Government.

Indonesian Government was very much satisfied with the total package and invited the Japanese company to implement the project. The Japanese company Indonesian Government entered an agreement for implementation of this project by the Japanese company for a price. This project is called “Turnkey Project”.

International Turnkey Projects include:

- Nuclear Power Plants
- Air Ports
- Oil refinery
- National Highways
- Railway Lines

The companies normally approach the host country’s government or International Finance Corporation, Export-Import Bank and the like for financial assistance as the turnkey projects require huge finances.

The recent approach to turnkey projects is Build, Operate and Transfer (B-O-T). the company builds the manufacturing/services facility, operates it for some time and then transfers it to the host country’s government.

6. MERGERS AND ACQUISITIONS:

Domestic companies enter international business through mergers and acquisitions. A domestic company selects a foreign company and merges itself with the foreign company in order to enter international business.

Alternatively, the domestic company may purchase the foreign company and acquires its ownership and control.

Domestic business selects this mode of entering international business as it provides immediate access to international manufacturing facilities and marketing network. Otherwise, the domestic company faces serious problems in gaining access to international markets. For ex. Coca-cola entered Indian market instantly be acquiring the Parle and its bottling units. In addition, the domestic company through this strategy of mergers and acquisitions may also get access to new technology or a patent right.

Though mergers and acquisitions provide easy and instant entry to global business, it would be very difficult to appraise the cases of acquisitions and mergers. Sometimes it would be cheaper for a domestic company to have a greed field strategy than by acquisitions. Sometimes mergers and acquisitions also result in purchasing the problems of a foreign company.

Companies adopt this strategy just as a means of entering foreign markets. Procter and Gamble entered Mexican tissue products in 1997 by purchasing Loreto Y. Pena Pobre's manufacturing and marketing systems.

7. JOINT VENTURES:

Two or more firms join together to create a new business entity that is legally separate and distinct from its parents. Joint ventures are established as corporations and owned by the funding partners in the predetermined proportions. American Motor Corporation entered into a joint venture with Beijing Automotive Works called Beijing Jeep to enter Chinese market by producing jeeps and other vehicles. Joint ventures involve shared ownership. Joint ventures are common in international business. Various environmental factors like social, technological, economic and political encourage the formations of joint ventures.

Joint ventures provide required strengths in terms of required capital, latest technology, required human talent etc., and enable the companies to share the risk in the foreign markets. Joint ventures involve the local companies. This act improves the local image in the host country and

also satisfies the governmental requirements regarding joint ventures. In fact, support of the host country's Government is essential for the success of the joint venture.

Advantages:

- Joint venture provides large capital funds.
- Joint ventures are suitable for major projects.
- Joint ventures spread the risk between or among partners.
- Different parties to the joint venture being different kinds of skills like technical skill, technology, human skills, expertise, marketing skills or marketing networks.
- Joint ventures make large projects and turn key projects feasible and possible.
- Joint ventures provide synergy due to combined efforts of varied parties.

Disadvantages:

- Joint ventures are also potential for conflicts. They result in disputes between or among parties due to varied interest. For ex., the interest of a host country's company in developing countries would be to get the technology from its partner while the interest of a partner of an advanced country would be to get the marketing expertise from the host country's company.
- The partners delay the decision-making once a dispute arises. Then the operations become unresponsive and inefficient.
- Decision-making is normally slowed down in joint ventures due to the involvement of a number of parties.
- Possibility of collapse of a joint venture is more due to entry of competitors, changes in the business environment in the two countries, changes in the partners' strengths etc.
- Life cycle of a joint venture is hindered by many causes of collapse.

How to make Joint Ventures successful:

It is indicated that joint ventures mostly fail due to potential problems and cultural variations. Harrigan suggests the following measures to make the joint venture successful.

- Don't accept a Joint venture agreement too-quickly, weigh the pros and cons.
- Get to know a partner by initially doing a limited project together, if a small project is successful, bigger projects are more feasible.
- Small companies are vulnerable to having their expertise lost to larger joint venture partners; small companies must structure such deals with great care and guard against potential losses.
- Companies with similar cultures and relatively equal financial resources work best together, keep this in mind when looking for an appropriate partner.
- Protect the company's core business through legal means, such as unassailable partners; if this is not possible, don't let the partner learn your methods.
- Joint enterprise must fit the corporate strategy of both partners, if this is not the case, there will inevitably be conflicts.
- Keep the mission of the joint enterprise small and well-defined, ensure that it does not compete with the partners.
- Give the joint enterprise autonomy to function on its own and set up mechanisms to monitor its results, it should be separate entity from both parents.
- Learn from the joint enterprise and use this in the parent organization.
- Limit the time frame of the joint enterprise and review its progress frequently.

AN INTRODUCTION TO INTERNATIONAL THEORIES

Theories of International Trade:

International trade becomes possible for mutual benefit to the two countries due to the difference in opportunity costs. International trade between two countries can benefit both countries if each country exports the goods in which it has a comparative advantage. However, initially countries used to earn gold through international trade. A number of theories have been developed by the international economists to explain how does international trade takes place. These theories include:

- Mercantilism;
- Theory of Absolute Cost Advantage;
- Comparative cost advantage theory;
- Relative factor endowments/Hukscher-Owen Theory;
- Country similarity theory;

The first theory of international Trade is mercantilism. Now, we shall discuss the Mercantilism theory of international trade.

1. MERCANTILISM:

Mercantilism is the oldest international trade theory that formed the foundation of economic thought during about 1500 to 1800. According to this theory the holdings of a country's treasure primarily in the form of gold constituted its wealth. This theory specifies that countries should export more than they import and receive the value of trade surplus in the form of gold from those countries which experience trade deficits.

Governments imposed restrictions on imports and encouraged exports in order to prevent trade deficit and experience trade surplus. Colonial powers like the British used to trade with their colonies like India, Sri Lanka, etc., by importing the raw materials from and exporting the finished goods to colonies. The colonies had to export less valued goods and import more valued goods. Thus colonies were prevented from manufacturing. This practice allowed the colonial powers to enjoy trade surplus and forced the colonies to experience trade deficits. The theory benefited the colonial powers and caused much discontent in the colonies. In fact, this was the background for the American Revolution.

The Mercantilism theory suggest for maintaining favourable balance of trade in the form of import of gold for export of goods and services. But the decay of gold standard reduced the validity of this theory. Consequently this theory was modified in Neo-mercantilism. Neo mercantilism proposes that countries attempt to produce more than the demand in the domestic country in order to achieve a social objective like full employment in the domestic country or a political objective like assisting a friendly country. This theory was attacked on the ground that the wealth of a nation is based on its available goods and services rather than on gold. Adam Smith developed the theory of absolute cost advantage which says that different countries can get the advantage of international trade by producing cer4tain goods more efficiently than others. Now we shall discuss this theory .

2. THEORY OF ABSOLUTE COST ADVANTAGE:

Adam Smith, the Scottish economist viewed that mercantilism weakens a country. He advocated free trade among countries to increase a country's wealth. Free trade enables a country to provide a variety of goods and services to its people by specializing in the production of some

goods and services and importing others. Which goods should a country produce and which goods it should import? Adam Smith a theory to answer this question.

Adam Smith proposed Absolute Cost Advantage. Theory of International Trade (1776) based on the principle of division of labour. According to him application of this principle to international scenario helps the countries to specialize in the production of those goods in which they have cost advantage over other countries.

According to Adam Smith, every country should specialize in producing those products which it can produce at less cost than that of other countries and exchange these products with other products produced cheaply by other countries. Trade between two countries takes place when one country produces one product at less cost than that of the another country and the other country has an absolute cost advantage over the first country in producing in any other product.

Skilled Labour and Specialisation Advantage:

Countries have absolute cost advantage due to the following reasons:

- Suitability of the skills of the labour of the country in producing certain products.
- Specialisation of labour in producing certain products leads to higher productivity and less labour cost per unit of output.
- Economic of scale would reduce the labour cost per unit per output.

Natural Advantage:

In addition to the skilled labour and specialization advantage, countries do also have natural advantage in producing certain products due to climatic conditions, access to certain natural resources etc.,

Acquired Advantage:

In addition to the skilled labour and natural advantages, countries also acquire advantages through technology and skills development. Japan acquired advantage in steel production through the imports of both iron and coal. The reason for this success is that Japan acquired labour saving and material saving technology. Denmark exports silver tableware due to the ability of Danish

companies in developing distinctive products. Technologically advanced countries acquired abilities to develop substitute products for a number of natural products.

Assumptions of the Theory:

Adam Smith proposed the absolute cost advantage theory based on the following assumptions: 1) Trade is between two countries

2) Only two commodities are trades

3) Free trade exists between the countries

4) the only element of cost of production is labour.

Implications of Absolute Cost Advantage Theory:

This theory has the following implications:

- By trading, two countries can have more quantities of both the products.
- Living standards of the people of both the countries can be increased by trading between the countries.
- Inefficiency in producing certain products in some countries can be avoided.
- Global efficiency and effectiveness can be increased by trading.
- Global labour productivity and other resources productivity can be maximized.

Criticism:

- No Absolute Advantage: According to this theory, one country should be able to produce at least one product at a comparatively low cost. But, in reality, most of the developing countries do not have absolute advantage of producing any product at the lowest cost. Yet they participate in international trade.
- Country size: Countries vary in size. This theory does not deal with country-by-country differences in specialization.
- Variety of resources: Though thee are several resources like labour, technology and natural resources, this theory deals with only labour and ignores all other resources.
- Transport cost: Though the cost of transportation plays a significant role in international trade, this theory ignored this aspect.

- Scale Economic: Large scale economies reduces the cost of production and form a part of the absolute advantage. But, this theory ignored that aspect also.
- Absolute Advantage for many products: Some countries may have absolute advantage for many products. For ex., Japan, the USA, France, the UK etc. But this theory does not deal with such situations.

3. COMPARATIVE COST ADVANTAGE THEORY:

Absolute Cost Advantage Theory fails to explain the situation when one country has absolute cost advantage in producing many products. David Ricardo, a British economist – expanded the Absolute Cost Advantage theory to clarify this situation and developed the theory of Comparative Cost Advantage.

Assumptions:

- There exists full employment.
- The only element of cost of production is labour. Production is the subject to the law of constant returns.
- There are no trade barriers.
- Trade is free from cost of production.
- Trade takes place between two countries.
- Only two products are traded.
- There are no costs of transport, etc.

Comparative cost advantage theory states that a country should produce and export those products for which it is relatively more productive than that of other countries and import those goods for which other countries are relatively more productive that it is. The comparative cost advantage theory is based on relative productivity differences and incorporates the concept of opportunity cost.

Comparative cost advantage theory also advocates that Japan should export audio tape recorders to India and India should export pens to Japan.

Implications:

- Efficient allocation of global resources.
- Maximisation of global production at the least possible cost.
- Product prices become more or less equal among world markets.
- Demand for resources and products among world nations will be optimized.
- It is better for the countries to specialize in those products which they relatively do better and export them.
- It is better for the countries to buy other goods from other countries who are relatively better at pproducing them.

Comparative cost advantage theory is really an improvement over Adam Smith's theory of Cost Absolute advantage. This theory is not only an extension to the principles of division of labour and specialization, but applies the opportunity cost concept. It is also argued that lower lobour cost need not to be a source of comparative advantage.

4. RELATIVE FACTOR ENDOWMWNTS OR HECKSCHER- OHLIN THEORY:

In view of the criticism cost against comparative cost advantage theory, the question pointed out by many of us was: How do the countries acquire comparative advantage? Eli Heckscher and Bertil Ohlin – Swedish economists – developed the theory of relative factor endowments – to answer this question. Factor endowments are land, capital, natural resources, labour, climate, etc.

The observations made by these two economists include:

- Factor endowments vary among countries. Example: USA is rich in capital, India is rich in labour, Saudi Arabia is rich in oil resources, etc.

- According to these economists, if labour is available in abundance in relation to land and capital, in a acountry, the price of labour would be low and the price of land and capital would be high in that country and vice- versa.
- These relative factor costs would lead countries to produce the products at low costs.
- Countries have comparative advantage based on the factors endowed and in turn the price of the factors. Countries acquire comparative advantage in those products for which the factors endowed by the country are used as inputs.
- Countries participate in international trade by exporting those products which they can produce at low cost consequen upon abundance of factors and imp[ort the other products which they can produce comparatively at high cost.

Land-Labour Relationship:

Countries where area of land available is less in relation to the people, go for multistory factories and produce light-weight products.

Labour-Capital Relationship:

Countries where labour is abundant in relation to capital can be expected to export labour-intensive products and vice-versa is true in case of capital abundant countries. Thus, labour abundant countries acquire export competitiveness in products requiring large amounts labour compared to capital.

Leontief Paradox:

There are certain surprising aspects to the Labour-Capital Relationship in international trade. Wassily Leonief observed that US exports are labour intensive compared with US imports. But, it is assumed that the USA has abundant capital relative to labour. Therefore, this surprise finding is known as the Leontief Paradox. This is because of variation in labour skills. Advanced countries have higher labour skills compared to developing countries.

Technological Complexities:

Technological advancements made it possible to produce products in different methods. Canada produces wheat with more machines and India produces mostly with labour. In addition, industries located different production processes in different countries in order to reduce cost of production.

5. COUNTRY SIMILARITY THEORY

International trade takes place between two industries of two countries as discussed earlier. But, international trade also takes place within each industry (i.e, intra industry) between two countries. Intra- industry trade amounts to nearly 40% of world trade.
Example: Japan exports Toyota cars to Germany whereas Germany exports BMW cars to Japan.

Economic Similarity of Developed Countries:

Steffan Linder – a Swedish Economist explained the phenomenon of intra-industry trade in 1961. According to Lindr, the similarities in consumer preferences in the countries that are at the same stage of economic development provide the scope for intra-industry trade among countries. Example: India and China are in the same stage of economic development.

According to this theory, the companies that develop new products for the domestic market, export the products to those countries that are at the similar level of development after meeting the needs of the domestic market.

Similarity of Location:

Countries prefer to export to the neighboring countries in order to have the advantage of less transportation cost. Example: Finland is a major exporter to Russia due to less transportation cost.

Cultural Similarity:

Countries prefer to export to those countries having similar culture. Example: exports and imports among European countries.

Similarity of Political and Economical Interests:

Similar political interests, close political relations and economic interests enable the countries to enter into agreements for exports and imports. Countries prefer to trade with their politically friendly countries.