INTERNATIONAL BUSINESS

(DBUS40)

(MBA 3YEARS)

ACHARYA NAGARJUNA UNIVERSITY

CENTRE FOR DISTANCE EDUCATION

NAGARJUNA NAGAR,

GUNTUR

ANDHRA PRADESH

BLOCK 1 INTERNATIONAL BUSINESS : ROLE AND PROCESS

Block 1 : **International Business : Role and Processes** concentrates on the conceptual framework of international business and its importance in the ever-growing interdependent global economy. It deals mainly with the activities of multinational enterprises (MNEs), and attempts to comprehend the company specific advantages and the environmental constraints faced by them in managing their overseas operations in order to achieve the optimum resource utilization, higher profits, growth in business and positive adjustments in foreign markets. This block has three units.

Unit 1 **Introduction** attempts to familiarise you with the basic concepts of international trade and business. The unit begins by explaining the meaning of international business. The international business is not a new phenomenon, it is rather thousands of years old. Its ancestry can be traced to Mesopotamian, Greek and Phoenician merchants. But the involvement of a large number of MNEs in international production and sales operations around the world emerged only in the post-World War II period. The unit gives an idea about the historical developments of international business and the central actors in it. The role of trade in services and the role of international trading houses in stimulating world trade is dealt with. The spread of globalisation is also examined. A brief account of the World's largest multinational (transnational) companies is given toward the end.

For efficient management of MNEs, an understanding of the analytical concepts relevant to the international business is desirable. The theories are grouped into two categories : the International Trade Theories, which explain the reasons for inter country trade, and the FDI Theories, which are concerned with the intercountry investment in manufacturing, services and their management. Unit 2, **International Business Theories,** is devoted to the theoretical issues of international business.

The internationalisation of business has captured the imagination of many a country, especially the developing world. A firm could enter the international market through various means and modes. Successful international businesses, generally, evolve slowly and go through a process of internationalisation. The process moves from a low level of involvement to a gradually increasing commitment. The development cycle for internationalisation follows a sequence before a firm becomes a global company. All these matters are dealt with in Unit 3 **International Investment Process and Finance.** The unit begins with a discussion about the successive stages through which a firm embarking upon the international market may often pass. Various alternative modes of entry into foreign markets are explained. Models which may facilitate the choice of the entry mode are discussed. The unit then describes the factors affecting the international investment decision. Finally, factors affecting the choice of location for FDI and the controversial question of transfer pricing are explained at some length.

UNIT - I

INTRODUCTION

Objectives:

After reading this unit you should be able to:

- define international business and highlight its importance,
- explain the historical developments of international business and its dimensions,
- understand the role of MNEs as central actors in international business,
- appreciate the role of trade in services and the role of international trading houses, and
- understand the role of international business in the world economy and spread of global competition.

Structure :

1.1 Concept of International Business
1.2 Nature and Importance of International Business
1.3 Growth of International Business and FDI
1.4 Dimensions of International Business
1.5 Central Actors in International Business
1.6 Differences between Domestic and International Business
1.7 Trade in Goods and Services
1.8 State Trading in International Business
1.9 International Trading Houses
1.10 International Business in World Economy
1.11 Globalisation of Business (Spread of Global Competition)
1.12 World's Largest Multinationals
1.13 Summary
1.14 Key Words
1.15 Self-Assessment Questions
1 16 Further Readings

1.1 CONCEPT OF INTERNATIONAL BUSINESS

The conceptual framework of international business starts with its definition. International business can be described as the business carried on across the national borders between two or more nations. The concept of international business stems from the business processes intersected by the national borders. Since the international business processes are not confined to the geopolitical boundaries in the conventional sense, the term 'national border' is to be used in a wider perspective. A more flexible concept of the national border is the contact line between people and

the multinational enterprises (MNEs) possessing a distinctive character attributable to their different social, cultural and economic environments.

A three-pronged approach may be adopted for understanding the concepts relating to international business. The first prong deals with the transmission of resources from one country to another in the form of shipment of goods, transfer of funds, and movement of people. The second prong is concerned with the relationship of the MNE with the host societies. The third prong involves the elements of conflict arising from the national sentiments and nationalistic attitudes guiding both the parent and the host countries. Here, the MNE has to grapple with the profitability aspects. It has also to grapple with the question of how best to accommodate the interest of the parent and host nations.

Resource transmission is based on the mutual benefits expected from the trade flows between the trading nations and the investment activities undertaken by the MNEs abroad. The resource allocation, according to the Comparative Cost Doctrine propounded by Ricardo, benefits the countries engaging in trade. The state intervention may cause trade diversion, which may distort cost differentials and may direct resources to their inefficient uses. Trade across borders and investment in other countries (resource transmission) provide opportunities to the MNEs for taking advantage of their superior technology, innovativeness, and economies of scale.

The diverse business systems prevailing in different societies confront an MNE with the choices between conformity and innovation. A suitable growth strategy has to be adopted by introducing changes in a gradual manner, acceptable to the host governments, keeping in view the employment and welfare of the people. Despite the efforts of the MNEs to follow a balanced approach, areas of conflicts do arise because of different national interests. The MNEs are often seen as penetrating into the host country markets for exploiting their economies. The objectives of foreign investors and socio-economic objectives of the host governments may come in conflict. The conflicts relating to equity participation, use of local inputs, employment, expansion of exports, etc., may be resolved through negotiations.

A multi-national enterprise carries out its international operations in two ways. It may deal with the individual countries separately according to their politico-economic and social environments, taking care of the national interests of both the parent and the host countries. With different environmental factors prevailing in different countries, this approach may lead to a diversified and fragmented global pattern for the MNE.

Usually, an MNE operates simultaneously in many countries. The multi-country operations necessitate a suitable overall conceptual framework for international business. Here, some kind of conflict may arise between the need for specificity and the need for uniformity in managing multi-country operations. In the second approach, guided by the need for uniformity, an international firm considers the entire world as a global market, and attempts to use similar global strategies and goals in the diverse environments of different countries. The conflicts arising from pursuing discrete and uniform policies and strategies are related to problems such as product policy, logistic plans and ownership. Although it may appear difficult for an MNE to achieve unified policies in the face of its unique global characteristic due to different business laws in different countries, the success of the global firm lies in achieving a balance between fragmentation and unification. The thrust in the balance however may be towards unification.

1.2 NATURE AND IMPORTANCE OF INTERNATIONAL BUSINESS

The international business operations comprise many facets; and international trade is just one of these. Other aspects, such as licensing, joint ventures and Foreign Direct Investment (FDI) of international business usually follow later, but not necessarily.

The United States is by far the largest investor and most of its investment is in the industrialised countries. The international trade and FDI, being integral parts of international business, are complementary to each other. A large part of the trade of the developed countries is among themselves, and investment is also mostly in each other. Earlier, the foreign investors invested their capital in activities like plantations and mines, but beginning from 50s, the major type of the FDI took place in the manufacturing industries, reflecting the steady development of the technology of the MNEs.

In recent years the reverse investment began in the case of the United States, and it became the most important and largest host country to the FDI. The increasing FDI into the United States is because of certain country-specific factors, namely, large market potential, abundant raw materials, declining labour costs as compared to other higher income countries, and the restricted trade policy for some products. Certain firm specific advantages gained by the European, Japanese and Canadian MNEs also encouraged them to invest in the United States.

Multinationals from the developing countries have also begun competing with the companies of the developed countries. Brazil, Argentina, Mexico, India, Hong Kong, Taiwan and South Korea are the important third world nations in some fields like construction contracts. The international companies from South Korea, Brazil, India and Taiwan have offered serious competition to the companies from the United States and even to the aggressive Japanese and German firms. Their advantage lies in their more adaptive attitudes, willingness to enter into joint ventures, partnerships, lower cost of production and lower profits and remittances.

The importance of a country in the world economy may be known by its share in international trade. The United States occupies the largest share in world trade followed by Germany, Japan and France. But, its share is declining continuously and that of the other developed countries increasing. The developing countries, especially the oil producing countries of the Middle East, have increased their share in the total world trade.

An interesting part of international trade is that some countries like Singapore, Hong Kong and Taiwan have exports and imports substantially greater than their GNP. This happens due to the nature of their trade and their role as offshore assembly platforms (trade entrepots). Such trading countries export most of their production and allow export related imports.

International business is important because of its concern with (i) quantum, composition and direction of trade flows and FDI; and (ii) the effects of trade and foreign investment on the importing and exporting firms, and the world economies at large. In the absence of international business, the world could have remained stagnated as different countries would have been producing all the goods of their requirements by using their factor endowments at sub-optimal level. It was the merchandise trade in the initial stages and then the trade in services which provided the stimulus to gainful resource allocation according to the cost advantages. The imperfections and trade barriers in world market gave rise to licensing, joint ventures and FDI as other important forms of international

operations. Therefore, the study of international business is significant in order to understand the intricacies behind the international trade and FDI and their effect on the world economic growth and welfare.

Activity 1

Contact some exporting company in your town, and ascertain the reasons for the increase, if any, in its exports.

.....

.....

1.3 GROWTH OF INTERNATIONAL BUSINESS AND FDI

The genesis of international business may be traced to the ancient times when the Mesopotamian, Greek and particularly the Phoenician merchants carried out their trading activities in different parts of the world. The Phoenicians controlled the sea-borne trade and the goods procured by them from Egypt, Babylonia and Assyria were sold throughout the Mediterranean. They were doing foreign business even upto Cape Verde and the Azores Islands in the Atlantic, and for this purpose used the straits of Gibralter.

In those days, India's spices and textiles were also being traded by the Phoenicians to Egypt, Turkey, Greece, and Rome. The trading was mainly confined to the West Coast of India. Goods were landed in Southern Arabia through sea routes and transported to the Mediterranean ports for shipping to other trading places.

The Roman merchants were active in international business and played an important role in the development of the Roman empire by providing finance for the military expeditions. Trade was facilitated by the construction of roads and development of the banking system. The banks, owned by private entrepreneurs, accepted deposits for providing loans and credits to the merchants.

Rome was not only the centre of attraction for the merchants. They were operating as far as the Atlantic Coasts of Africa and Europe and reached Germany upto the Baltic Sea. Some penetrated even to Turkestan to purchase Chinese goods.

The decay of the Roman empire and the rise of Turks and the Arab crusaders shifted the control of strategic ports into the hands of the Arabs and, subsequently, that of the overseas trade and markets. They purchased goods form India by establishing trading ports in Sind and dominated the trade on the Indian West Coast. During the 13th and 14th centuries, the Arabs spread their network in South-East Asian countries, notably in the present day Malaysia, Indonesia, Brunei and Southern Philippines.

The international business received stimulation from the events that happened at the beginning of the 11th century. The crusaders were forced to search out new avenues for trade. New commercial centres in Italy, such as Genoa and Venice sprang up and the Europeans, after losing their control of the sea routes to India through Red Sea and the Straits of Harmuz, had to circumnavigate Africa in order to obtain the Indian spices and textiles, which were in great demand in Europe. Meanwhile, the European Renaissance led to voyages and the discovery of America by Columbus and the arrival of Vasco de Gama at Calicut in 1498.

The hurdle in the growth of international business was eased by the development of credit institutions and the introduction of methods of payments. The trade instruments like the bills of exchange and drafts facilitated the rapid increase in trade transactions, as there was no need for actual gold or silver to be delivered to settle the unfavourable balance of trade. The bill of exchange assured the payment to the exporter on a specified date. Associated with this, the banking houses, functioning in the Eastern Mediterranean region in the 14th century, became important financial centres. By the 16th century, Holland developed into an international financial centre, and the Dutch banks financed the business all over Europe.

The considerable expansion of international business needed lots of money, and the individual investors were unable to cope with the situation. It became inevitable to pool capital together for carrying out large transactions. The mechanism of joint stock company developed. Initially, the individual investors were returned their shares after the completion of a particular trade for which the capital was raised, but later on, the investors were permitted to keep their money with the company and earn dividends. The shareholders could sell their shares to the company depending upon their market value.

As a matter of fact, a great influence on the international business was brought about by the Industrial Revolution, which facilitated the application of machinery into the production process. The Industrial Revolution occurred in the U.K., and not only the production of manufacturing goods took place there but also these goods become cheaper. The excess production was exported and, in return, food-stuffs and raw materials were imported.

A series of innovations after the Second Industrial Revolutions in 1880 caused large scale production of a variety of goods which required more raw materials from other countries. Capital began to flow out for the purpose of production of raw materials, which were mostly in the extractive industries, transport, communications and electric power. The world became interdependent; manufactured goods began to be exported by the European countries and food and raw materials by the less developed countries. The import of capital by some countries provided them an opportunity to develop their own industries and, thus, they became a part of the industrial world. Japan, in recent years, became an important industrial power by taking advantage of the capital inflows.

Emergence of Multinational Corporation : It was as early as the Fourteenth century that the multinational companies were involved in foreign business. The trading firms in the Italian trade centres of Genoa and Venice operated across the border throughout the Eastern Mediterranean area. In Britain, trading companies were well-known for their foreign business during the reign of Queen Elizabeth I. The trading firms enjoyed monopoly powers in world markets, but they were surpassed by new forms of enterprises created by the Industrial Revolution. The need arose for direct investment abroad in order to produce sufficient raw materials to meet the requirements of the manufacturing plants at home.

The outcome of this process was the formation of multinational companies making direct foreign investment for extraction, processing and transportation of raw materials to their parent countries. Some individuals were the forerunners in the establishment of multinational enterprises. In 1865, Friedrick Bayer, a German purchased some shares in NewYork just after two years of establishing a chemical plant in Germany. In 1876, he established dyestuff factories in Russia, in

1882 in France and in 1908 in Belgium. According to Fortune Survey of 1990, this German firm "Bayer" ranked 39th among 500 world's largest companies in terms of their sales.

Alfred Nobel, a Swedish industrialist established a plant at Hamberg, Germany in 1866. Similarly, the Singer company founded a plant at Glassgow, Scotland in 1887. In India, the commencement of the multinational corporate business may be assumed to have stated with the establishment of the East India Company at the beginning of Seventeenth century. In 1788, Thomas Perry was the first to act as a free merchant in Madras followed by Jessop's predecessors, Breen & Co, in Calcutta.

Such trends in the FDI provided new dimensions to the international business activities. The payments for multinational business took the form of royalties, license fees and management fees in return for the use of patents, trade marks and technological know-how.

The United States multinationals began their operations as early as 1850, when the United Fruit Company established its plants in Honduras and Nicaragua. As in the case of the others, the U.S. multinationals also developed in their early stages due to the need for new sources of raw materials. The U.S. foreign investment took place mainly in oil companies and mining. It was after the World War I that the U.S. first came on the international scene on a massive scale and industries, such as automotives, chemicals, petroleum and machine tools developed rapidly by supplying products to the allies. As the greater part of the 1920's saw a worldwide economic prosperity, the U.S. automotive industry, began dominating the world markets.

International Business in the Post-World War II Period : After suffering a setback following the 1930's severe recession in the world economy, the growth of international business in the post-World War II period, especially after 1950 was tremendous. Both the international trade and investment grew fast due to changes in the international economic arrangements like the proliferation of the bilateral investment treaties specifically meant for the promotion and protection of the FDI. Other factors such as favourable political and economic environments of the host countries, prospects of profits and the developments of new forms of investments also provided a spurt to the growth of international business. After the production of merchandised goods, the MNEs also played a leading role in the international trade in services. In 1989, the contribution of the trade in services accounted for $ 1000 billion out of the total world trade amounting to $ 3100 billion.

The new investment arrangements in the form of non-equity involvement in licensing agreements, turnkey contracts, management contracts, franchising, international sub-contracting and equity sharing in joint ventures have grown rapidly since the mid 1970s. The newly industrialised countries (NICs) entered into such contracts and, after attaining export capability, they began exporting technology abroad, both in the form of joint ventures and the FDI. Many OPEC nations are now having joint venture arrangements with the parent companies in their downstream processing, refining and distribution of related petroleum products. In the ASEAN countries, Japan is the major partner in the petrochemical joint ventures.

During the decades of the Fifties and Sixties, United States continued to be the major investor in foreign countries. The book value of the U.S. FDI increased from $ 11.8 billion in 1950 to $ 78.1 billion in 1970. The bulk of the U.S. foreign investment went to Canada and Western Europe, which received more than 50 percent of the total U.S. FDI in 1970. The influx of American investment in Western Europe was mainly meant to take advantage of the emerging prosperity of the Common

Market countries and to protect its export markets from their tariff barriers. The markets for Euro-dollars and Eurobonds also developed in West Europe, promoting U.S. investments there. When the U.S. Government imposed restrictions on the American FDI, the U.S. MNEs continued to expand by using these markets.

The LDCs were not a large recipient of the U.S. direct investment during this period. The reason was America's lesser accent on investment in the extractive industries and greater accent on investment in manufacturing. The U.S. investment in Latin America in the manufacturing sector, increased only from $ 1.8 billion in 1950 to $ 4.6 billion in 1970. In Asia, during the same period the investment increased from $ 100 million to $ 150 million, indeed a meagre amount. The total U.S. direct investment in manufacturing increased from $ 6.4 billion to $ 32.3 billion over the same period. Thus, the U.S. multinationals changed their geographic as well as investment foci, resulting in very marginal or no development of LDCs.

In the 1970s, the developed countries invested relatively large amounts in the developing economies. In 1975, the U.S. foreign investment going to the developing countries amounted to about 47 percent of its total international investment, and to Japan it was about 60 percent. However, the trend was reversed in the 1980s and the developing countries again received relatively small amount of FDI. In 1986, the foreign investment by the U.S. and Japan to the developing countries was about 27 percent and 33 percent respectively.

The increase in FDI in the developing countries during the 1970s was in response to the optimism about the growth potential of these countries which did not continue in the 1980s. Some of the important reasons for this decline may be stated as the decreasing confidence in their credit worthiness due to the debt crisis in those countries, recession and macro economic instability (which further went to undermine the confidence of the investors), reduction in the attractiveness of large resource based projects, particularly petroleum owing to the nationalization drive in the Middle East and the relative improvement in the profitability in the industrialized world itself.

The greater amount of Japanese investment is still being directed to the United States, but it has also shown an upward trend in Latin America and Asian countries, particularly the NICs. The interesting aspect of the international business during 1970s and 1980s is the decline in the dominance of the U.S. MNEs and the increase in the competitive strength of the European and Japanese multinations, and of even sone MNEs of the developing countries. A reverse investment occurred in the U.S. The MNEs from Europe and Japan began investing large amounts of FDI in America. They have also provided competition to American firms in the overseas markets. A greater foreign investment took place in the manufacturing and service industries, showing a movement away from resource based projects.

Those of the LDCs which have liberalized their economic policies have attracted relatively larger amount of FDI and have made good progress in their economies. Two lessons emerge from the investment behaviour in relation to FDI. One, the magnitude of FDI depends on the economic success of a nation. One would rarely find a case where foreign investors have taken interest in countries where unfavourable attitude to the international investment and an uncongenial environment prevails. Two infrastructural development is an essential prerequisite for attracting FDI. The prospects of the FDI in the LDCs, therefore, will depend upon the economic policies pursued by those countries with regard to the foreign investment and predictable political stability, and also the protection these countries can give to the trade marks.

Activity 2

From the above discussion about the growth of international business, list some important events which provided a spurt to the foreign trade and investment.

.....

.....

.....

1.4 DIMENSIONS OF INTERNATIONAL BUSINESS :

International business has many dimensions. It is not merely the border crossing which is sufficient to comprehend the numerous problems faced by the MNEs in the overseas markets. Different countries follow different business laws, tax systems, and have different political, economic and cultural environments. The strategies of the MNEs aiming at efficient management and optimum returns are shaped by the external factors. An MNE, having company specific advantages on which it may have some control, has to confront and manage the foreign environments which may not be within its control. The formulation of policies to achieve efficiency in the functional areas, such as production, finance, marketing and human resource management, has to take into account all these realities.

Two types of theoretical issues are involved in the international business management. The first type involves the study of trade and the FDI theories, and the second type is concerned with the financial matters which are, in turn, affected by the financial factors such as fluctuation in foreign exchange rates, changes in political and economic conditions and inflation. All these factors have to be taken into account while evaluating the fruitfulness of the foreign investment.

The MNEs are often criticized in their host countries. It is, therefore, advisable to maintain good relations with the host governments and convince them that their intention is not merely the pursuit of profit but directed at raising the level of growth and employment. It is important for an MNE to adopt an adjusting attitude towards the policies and programmes of the different host nations.

The international business also includes the study of international accounting, pricing, international management and marketing as they have a direct bearing on the operations of an MNE. Foreign competition is a continuing phenomenon, and this requires an MNE to make the necessary changes in its production techniques for lowering cost, raising productivity and improving the quality of its products, to exist in a globally-oriented business.

The various dimensions of international business may be summarised in Table 1.1.

Table 1.1
DIMENSIONS OF INTERNATIONAL BUSINESS

Host Country Environment Factors	MNE specific Advantages

International trade theory foreign exchange theory, Economic variables such as input, foreign exchange and balance of payments. Non economic variables, such as political, cultural and social systems	FDI theory adoption of entry methods and policies for risk management
Host country laws about trade, foreign investment taxes and foreign exchange controls. International organisations such as IMF, GATT, UN Agencies and the international code of conduct.	Multinationals responses to the government policies, such as transfer price, tax planning foreign exchange exposure management. Functional Areas of MNE

Activity 3

From Table 1.1, mention : (i) the company specific advantages and the host country specific advantages; and (ii) also prepare a 'task wheel', showing the controllable and non-controllable factors for an MNE.

Company specific advantages	Host Country Specific Advantages
.....	
.....	

1.5 CENTRAL ACTORS IN INTERNATIONAL BUSINESS

The multinational enterprises are the central actors in international business. An MNE – also known as Multinational Corporation (MNC), International Corporation (IC) and Transnational Corporation (TC) – conducts the business across the borders of a country and has been described in various manners. The U.N. Centre for Transnational Enterprises defines the Multinational Corporation as "enterprises which own or control production or service facilities outside the country in which they are based." Feyerweather defines them as "multicultural, multinational global spanning systems". Rodriguez and Carter refer to a multinational firm as "a company with substantial operations (usually 30% or more of its total activity) carried on outside its own national borders. These activities may be trading or manufacturing"

According to Phatak (Arvind K. Phatak, Managing Multinational Corporation, Praeger Co., New York, 1974, pp 21-22) "A multinational company is an enterprise that has an interlocking network of subsidiaries in several countries, whose executives view the whole world as its theatre of operations, and therefore obtain and allocate financial, material, technical and managerial resources in a manner conducive to the achievement of total enterprise objectives." Like a firm doing business in a domestic market an MNE is also required to take decisions about the prospective returns. In addition, the MNEs may also have to take into the account the fluctuations in interest rates, exchange rates, impediments to trade, repatriation of funds and inflation in the countries where its subsidiaries operate.

Thus, the essence of multinationality is the international production. An MNE is that corporation, whose business operations are across the border, foreign to total sales (F/T ratio) is 30% or more and the attitude of management is geocentric, having a global orientation. The MNE is not supposed to adopt the ethnocentric approach as it is home-oriented, and it will not be called a true MNE even if it follows the polycentric approach which is merely the host nation oriented.

1.6 DIFFERENCES BETWEEN DOMESTIC AND INTERNATIONAL BUSINESS

Both the domestic and international business consist of consumers, producers and agencies purchasing goods and services. People in international business have also to resort to market surveys in order to know the customers' preferences for products, price promotion and distribution strategies. What then are the differences between the two? The striking differences in the domestic and international business are in terms of environmental factors affecting the decisions of the investors.

The economic and political risks confronted in the international business distinguish it from the domestic business. It is important for a multinational enterprise to study the prevailing economic and political conditions of the host country and also forecast the likely trends in them. The balance of payments position explains the performance of the external sector. A large deficit on current account of the balance of payments would mean dismal market opportunities. The rate of growth of the GNP, rate of growth of the labour force and labour productivity and per capita income are also indicators pointing out the future business out the future business possibilities in a particular country.

The political situation also influences the investment decisions. A change in the government may lead to the blockage of funds. In some cases, the political risk may be considered very high when expropriation of the foreign capital, an extreme step, may appear to be a possibility.

In the international business we have also to consider the variations in the exchange rates, inflation and policies of the government. The exchange rate changes involve the transaction, translation and operational risks. The volatility in the exchange rate affects the management of the working capital and the profitability of the international investment. A careful scanning of the environments of foreign economies is highly important in the decision making process for the international investment, its management, expansion of existing subsidiaries and the worthwhileness of the foreign investment.

1.7 TRADE IN GOODS AND SERVICES

It is important to understand the distinction between trade in goods (merchandise trade or visible trade) and trade in services (invisible trade). The merchandise, i.e., the imports and exports of raw materials and manufactured goods may show either trade deficit or surplus in the current account of a country's balance of payments. The invisible trade relating to the traditional services, such as shipping, aviation, communication, banking and insurance, plays a vital role. It supplements the trade in goods and may thus reduce the trade deficit. The trade in services has assumed a new trend, i.e., moving from the traditional services to the non-traditional services such as data processing, computer programming, scientific research, engineering, and consulting. The services

are rapidly growing, and have opened new vistas for international trade. The developed countries are now orienting their economies from the industrial sector to the service sector, because foreign trade in services has become a critical factor for economic growth and employment.

In India, the trade in services has played a positive role, reducing our trade deficit and improving our foreign exchange position. Its role in India's Sixth and Seventh Five Year Plan may be summarized in Table 1.2.

Table 1.2
Key indicators of India's Balance of Payments
(As percent of GDP)

Year	Exports	Imports	Net Invisible	Trade Balance	Current Account Balance
1980-81	4.8	9.2	3.2	–4.4	–1.2
1981-82	4.9	8.7	2.4	–3.8	–1.5
1982-83	5.1	8.4	2.0	–3.2	–1.3
1983-84	4.9	7.7	1.7	–2.8	–1.1
1984-85	5.2	8.1	1.7	–2.9	–1.2
Average 1980-85	5.0	8.4	2.2	–3.4	–1.3
1985-86	4.4	8.1	1.4	–3.7	–2.3
1986-87	4.5	7.7	1.2	–3.2	–2.0
1987-88	4.9	7.7	0.9	–2.8	–1.9
1988-89	5.3	8.9	0.8	–3.5	–2.7
1989-90	6.4	9.3	0.6	–2.9	–2.3
Average 1985-90	5.1	8.3	1.0	–3.2	–2.2

Source: Government of India, *Economic Survey* 1990-91, p.152

Table 1.2 shows that the trade deficit in the Sixth plan averaged 3.4 percent of the GDP, but it was brought down to 1.3 percent on account of the surplus enjoyed by India in trade in services during this period averaging 2.2 percent of the GDP. Although, the surplus in trade in services declined during the Seventh plan to 1.1%, it was still significant, as it lowered our trade deficit from 3.2 percent to 2.2 percent of the GDP.

Activity 4

Study the latest economic survey of the Government of India, and note the role of services on the current account of India's balance or payments. Attempt similar study of the date relating to some other developing countries. Compare the data and offer your comments.

1.8 STATE TRADING IN INTERNATIONAL BUSINESS

State trading, as defined in the Havana Charter, means trading by the government or the government controlled enterprises.

According to Kostecki (in his book *State Trading*, 1978), 20 to 25 percent of the international trade during the 1970s was carried out through the state trading. State trading has occupied an important place in the foreign trade of the developing countries, and ranges from 10 percent (in the case of Brazil) to 90-100 percent (in case or Egypt). As the foreign trade was the state monopoly in the erstwhile communist countries, usually the entire foreign trade transactions were carried out by way of state trading. In India, the share of public sector in total exports was 24.1 percent in 1988-89. Most of the state trading in India is through the State Trading Corporation (STC).

The state engages in the international trade for achieving external and domestic objectives. The external objectives of the state trading are improvement in the international bargaining power and terms of trade, export expansion, fulfilment of the international obligations and linking of trade with socio-economic policies. The aim is improvement in the conduct of the international trade and increasing gains to the nation. The domestic objectives behind the state trading are protection of the domestic industry, achievement of price and distribution policies, augmenting of government revenue, health and the public security.

State trading would improve the welfare of the nation so long as it is employed to overcome the market imperfections. If it tends to distort the international trade flows like tariffs and quantitative restrictions, it may adversely affect the international welfare. Moreover, state enterprises have generally not been found operating as efficiently as private enterprises, and on this ground their contribution to the welfare of the nation is relatively lower.

1.9 INTERNATIONAL TRADING HOUSES

International trading houses are established to facilitate the trading activities at the global level. The foremost function of an international trading house is to coordinate the exchange of goods and services between the importers and exporters of different countries.

Having a world-wide network of staff and communication units, these trading houses carry out market research in order to identify the potential buyers of different products supplied by different countries in the overseas markets. They also maintain trained personnel for assisting the exporters in procedural matters and the business laws of the trading partners. They also arrange the logistics, and accept financial liability for the shipments.

As a matter of fact, the international trading houses are extensions of export management companies (EMCs), which are independent businesses and act as the export departments of some other manufacturers who are not directly engaged in the export activity. In countries, such as Canada, certain manufacturers organise an export consortium for trading their exportable products. There are several trading houses operating in South Korea, Brazil and the United States, but most

important are the large Japanese trading companies, known as Sogo Shoshas, which after achieving success in various export markets, expanded their role from an international focus to a more global and multinational outlook.

These days, the international trading houses participate in joint ventures, provide finance for procurement of raw materials and assist in the third world country trade negotiations. With their pool of skilled and knowledgeable personnel in different parts of the world, they are well qualified to provide liaison function in multilateral negotiations, and can identify the potential participants in international joint ventures. In many cases, they serve a banking role which is made possible by their close connections with several international banks.

1.10 INTERNATIONAL BUSINESS IN WORLD ECONOMY

Although many structural problems have occurred in the world economy, especially after the 1973 oil crisis, international business has taken an upward trend. International trade has grown from $ 136 billion in 1960 to $ 2 trillion in 1980. During the 1980s, the world trade rose rapidly. According to the data in the 1991 edition of the IMF's *Direction of Trade Statistics Year Book*, international trade accounted for more than 3 trillion in 1990. The value of the world trade increased by about 14.6 per cent (in U.S. dollars) in 1990 compared to 8.1 per cent in 1989, and 14.5 percent in 1988. However, the growth of trade in volume terms slowed by about 3.9 percent in 1990 and 7.1 percent in 1989 due to the decline in global economic activities, disruption in trade among the central and East European countries and rise in the oil prices.

In 1990, the trade of the industrial countries grew at about the same rate as the world trade. Their exports rose by 15.3 percent and imports by 14.8 percent. Germany overtook the United States as the world's leading exporter. The exports and imports of the developing countries increased by 13.0 percent and 15.3 percent respectively in the same year. Among the developing countries, the Middle East recorded the fastest export growth in 1990 (23.9 percent) mainly because of the higher oil prices. Its imports rose by 16.9 percent the same year. The aggregate trade surplus of the Middle East shows the highest rise since 1981 (in US dollars).

The growth in the exports of the developing countries was 12.3 percent in Asia, and it was outpaced by the rise in imports (14.3 percent). The world trade flows are summarized in Table 1.3.

Table 1.3
World Trade Flows

(billion U.S. dollars)

Destination	With Industrial countries		With Developing countries		With USSR and select other countries[1]		Total	
Origin	Exp	Imp.	Exp.	Imp	Exp.	Imp.	Exp.	Imp.
Industrial countries								
1984	871.9	903.2	313.1	388.5	26.7	29.7	1224.5	1326.3
1989	1611.7	1651.6	463.4	544.2	35.1	30.0	2127.5	2238.9
1990	1867.1	1906.9	527.6	614.8	37.2	35.3	2452.4	2570.7

Developing countries								
1984	345.7	321.5	169.5	172.4	26.3	24.3	565.7	529.8
1989	478.0	469.5	251.2	250.0	32.2	28.4	785.3	763.3
1990	550.3	552.0	283.9	289.0	28.1	25.8	887.3	880.0

1— Albania, Bulgaria, Cuba, Czechoslovakia, former GDR, Democratic People's Republic of Korea and Mangolia.

Source: IMF, *Direction of Trade Statistics Year book,* 1991.

Activity 5

From Table 1.3 ascertain the growth in foreign trade of (i) industrial countries and (ii) developing countries between 1984 and 1990 (in U.S. dollars).

.....

.....

1.11 GLOBALISATION OF BUSINESS (SPREAD OF GLOBAL COMPETITION)

The Unites States enjoyed a considerable lead in the international business before and immediately after the World War II. The economic recovery of Western Europe and Japan in the early 1950s began eroding the U.S. domination, and created competition for global markets. One of the outcomes was that the number of the largest American companies in the 13 major industries of the world, such as aerospace, automotive, chemicals, electrical equipment, food product, paper, petroleum, pharmaceuticals, textiles, got reduced from 11 in 1959 to 7 in 1976. Companies from Japan and Western Europe, particularly the German, Swiss and Dutch, have increased their share in the international trade and investment.

The spread of competition may be realised from the rise of the Japanese MNEs as a global force. In 1970, there was only one Japanese company among the 50 largest industrial companies in the world. The number increased to six by 1980. This trend continued, and in 1990 the Japanese have outstripped the United States in automobiles and steel. On the trade front also, the pattern shows a decreasing share for the United States and European countries, and a larger share for Japan. Even the multinationals from the developing countries are now in competition with each other in the international market.

The success of the European and Japanese multinationals in the face of the global competition can be attributed to their higher rates of savings, investment, technological development, improvement in management styles and higher productivity of labour. In view of the superiority gained by the multinationals of these nations, Lester Throw (*A Strategy for Revitalising American Industry,* Columbia Management Review, XXVII, No. 1 (Fall, 1984, p.9) lamented that unless the US corporations and government took urgent measures, its dominance as an industrial power would fast disappear and it would be overtaken by Japan. In his words:

"America faces a problem that is simply put. The huge technological edge enjoyed by America in the 1950s and 1960s has disappeared... We are now faced with competitors who may be in the process of achievements and may be with the process of moving a head of us... when our effortless superiority has vanished, the American economy has been absorbed into a world economy. For most goods there is now a world market not just an American market. Competition is world-wide—not just American."

What Lester Throw has said may be taken as a warning by all those countries and governments, which are slack in upgrading their technologies and improving the quality of their products. but wish to compete at the world level where intense competition is a fact of life today.

1.12 WORLD'S LARGEST MULTINATIONALS

International trade and investment are now being dominated by the world's largest multinational companies. The "United States which enjoyed a considerable lead before and immediately after World War II in the international business lost much of its share to European, Japanese, Canadian and even to the multinationals of the third world countries. The relative performance and the number of the multinationals controlled by a particular country are indicative of its economic strength at the global level

The relative importance of the multinationals may be determined in terms of their sales, profits, assets, stockholders equity and the number of the employees. One can understand the tides and trends of the world economy by looking into the operations of these companies. Some of the world's largest multinational companies are General Motors (U.S.), Royal Dutch/Shell Group (Britain/Netherlands), Exxon (U.S.), Ford Motor (U.S.), I.B.M. (U.S.),British Petroleum (Britain), Mobil (U.S.), Toyota Motor (Japan), General Electric (U.S.), Phillip Morris (U.S.), Fiat (Italy), Pemex (Mexico), Siemens (Germany), Boeing (U.S.), and Asea Brown Boveri (Switzerland).

Among the largest U.S. multinationals, the producers of motor vehicles and petroleum are the biggest companies. Other important multinationals of the U.S. deal in aerospace, computers, electronics, beverages and chemicals. Like the U.S. multinationals, the European group of the largest multinational companies is also dominated by the petroleum and motor vehicle industries. In West Europe, nearly a quarter of the total multinationals are Germany based which shows its rapid industrial development in the post World War II period. The three countries, namely Germany, France and Britain, account for more than fifty percent of the largest fifty multinationals of West Europe. Other important multinationals where European countries are having adequate shares are food, chemicals, farm products, electronics, aerospace, and building materials.

Japan has made significant development in the international business by accelerating its foreign investment. The traditional efforts in exporting have been supplemented by FDI made by the Japanese multinationals. Toyota Motors of Japan occupies a place in the top ten largest multinationals of the world. The Japanese multinationals are dominated by motor vehicles and electronics. In addition, they are providing intensive competition in the overseas market in the fields of computers, office equipments, metals, farm equipment and petroleum refining.

From the third world countries, South Korea dominates the scene. South Korea has diversified its industrial structure, and has made a good progress in electronics, motor vehicles and textiles. The third world multinationals have to be aware of the R & D activities of the multinationals of the developed countries. They should pay attention to the upgradation of technology, cost

effectiveness and improvement in the quality of their products in order to face the rapidly growing competition in the international business.

1.13 SUMMARY

The international business may be defined as the business carried out across the national borders. The concept of international business stems form the business processes intersected by the national borders. These processes may be reviewed in three ways: (a) resource transmission approach; (b) interaction between the MNE and the host societies; and (c) conflicting interests between the parent and host nations.

The genesis of international business may be traced back to the ancient times when the Mesopotamian, Greek and, in particular the phoenician merchants, carried out their trading activities in different parts of the world. The sea-borne trade was controlled by the Phoenicians, and the network of their foreign business spread in many countries.

When the Turks and Arabs took over the control of the strategic sea routes such as the Red Sea and the straits of Hormuz, the crusaders were forced to search out new avenues, and they had to circumnavigate Africa in order to procure the Indian spices and textiles which were in great demand in Europe. Many voyages were undertaken culminating in the discovery of America by Columbus and the arrival of Vasco de Gama at Calicut in 1498.

The development of credit institutions, construction of roads and introduction of the methods of payment like the bills of exchange and drafts stimulated the growth of the foreign business. As the individual investors could not cope with the increasing financial requirements of international business, the growth of the foreign business was facilitated by the establishment of joint stock companies.

The enormous impact on international business was brought about by the Industrial Revolution at the beginning of the Seventeenth century, facilitating the application of machinery into production process. A series of innovations after the Industrial Revolution caused large scale production of a variety of goods, which required raw materials from abroad in greater quantities. The outcome was the extraction, processing and transportation of raw materials to the parent countries.

The growth of international business was tremendous in the post World War II period, especially after 1950. Both the world trade and investment grew rapidly. During the decades of the 1950s and 1960s, the FDI was dominated by the United States, but in the subsequent period, the trend moved in favour of the European and Japanese and even some MNEs from the developing countries. The bulk of the FDI by the developed countries occurred among themselves and LDCs were by and large neglected for international investment.

International business has many dimensions. It is not merely the border crossing which is sufficient to comprehend the numerous environmental factors faced by the MNEs in the overseas markets. The external factors are also to be taken into account by the MNEs while formulating strategies for efficient management and optimum returns. International business also includes the study of International accounting, international pricing, international management and international marketing as they have a direct bearing on operations at the international level.

The MNEs, like the global octopuses, are the central actors in the international business. They have received both appreciation and criticism. Their contribution to the spread of knowledge and technology and in raising the standard of living all over the world has been highlighted by many writers, while there is no dearth of the critics who have spoken about their exploitation of local markets, transferring of obsolete technology and keeping the less developed countries (LDCs) dependent upon the developed world.

International business differs from the domestic business in terms of the environment they face. The foreign investors confront different socio-economic, cultural and physical environments in different countries. Therefore, they make necessary adjustments in their strategies keeping in view the diverse environments in the overseas markets.

Recently, the trade in service has assumed significance and has helped several countries in reducing their trade deficit. Governments have entered into international business for minimising the possibility of monopoly concentration and for meeting their welfare objectives. State trading is competing in many products in the foreign markets.

The international trading houses have been established in many countries for facilitating both foreign trade and investment. The international business has taken an increasing share in the economy. There is now global competition in the international business. The domination of the United States before and immediately after World War II has been constantly challenged by the European and Japanese companies, and even by the multinationals of the LDCs.

1.14 KEY WORDS

International Business : Business carried out across the national boundaries. Some important forms of international business are: export and import of goods and services, licensing agreement, management contracts, joint ventures, manufacturing and or marketing in other countries.

Multinational Enterprises (MNEs) : The central actors in international business whose business operations extend beyond the national borders. Foreign to total sales ratio (F/T ratio) is usually 30 percent or more, and the attitude of its management is globally oriented.

Fragmentation : An approach under which an MNE present different policies for different world markets (or countries) depending upon the unique conditions prevailing in those countries.

Unification : An approach to international business dealing with multi-country problems. In this case, the MNE has a multi-country orientation, treats the entire world as a global market and attempts to unify the diverse environments of the world economies.

State Trading : Trading by the government or government controlled enterprises.

International Trading Houses : Exports consortia of non-competing manufacturers for exporting the member's products. The international trading houses facilitate trading activities at the global level by coordinating the exchange of goods and services between the exporters and importers of different countries. They are now extending all sorts of services relating to the foreign business.

Soga Shoshas : Japanese large trading companies operating as international trading houses.

Trade Entrepots : Offshore assembly platforms maintained by certain countries, like Singapore, Hongkong and Taiwan for export purposes. They freely allow export related imports.

Ethnocentric : Home oriented attitude of the MNEs.
Polycentric : Host-nations oriented attitude.
Geocentric : Globally oriented attitude.

1.15 SELF-ASSESSMENT QUESTIONS

1) Define international business, and bring out the differences between the domestic business and international business
2) What is the essence of multinationality? Elaborate this concept on the basis of several definitions of an MNE.
3) Examine the impact of the Industrial Revolution on international business.
4) Compare and contrast the growth of international business during the pre and post World War II period.
5) Explain the factors responsible for the development of the modern multinational enterprise.
6) Discuss the various dimensions of international business.
7) Discuss the relative performance of one largest MNE from each of the United States, Europe, Japan and the third World countries.
8) Discuss the changing nature of the FDI in the United States. What factors, in your opinion, have contributed to the rise of European and Japanese multinationals? What new patterns are emerging in FDI?
9) Examine the importance of the trade in services, and highlight the role of the international trading houses in stimulating the foreign trade and investment.
10) Analyse the importance of international business in the world economy.
11) In what ways has the state trading provided a formidable challenge in the international business?
12) Discuss evolutionary patterns in the organisation structure of international business.
13) Compare the key global strategies and the organisational structures of the MNEs of the United States, Europe, Japan and India.

1.16 FURTHER READINGS

Aharoni, Fair, 1980 "The State-Owned Enterprise as Competitor in International Markets", *Columbia Journal of World Business,* Spring 1980; 14-22.

Fishwick F. 1982. *Multinational Companies and Economic Concentration in Europe,* Praeger: New York.

Negandhi, A.R. 1937. *International Management,* Prentice Hall of India Private Ltd: Delhi.

Negandhi, Anand B. 1985. "Management Strategies and Policies of American, European and Japanese Multinational Corporations", *Management Japan,* Spring 1985; 12-20.

Root, Franklin B, 1984. "Some Trends in World Economy and their Implications for International Business Strategy," *Journal of International Business Studies,* Winter 1984; 19-23.

Rugman, A.M., Lecraw, D.J. and L.D. Booth 1985. *International Business*, McGraw-Hill Book Company: New York.

Schmitzer, M.N., Liebrenze, M.L., and Kubin, K. W. 1985. *International Business.* South-Western Publishing Company.

Schmitzer, M.C. et al 1985. *International Business,* South-Western Publishing Co., Cincinnati, Ohio.

Vernon, R. 1991. *Manager in International Economy*, Prentice Hall of India Private Ltd: New Delhi.

Walter, I. and T. Murray (Ed); 1988. *Handbook of International Business,* Johan Wiley and Sons: New York.

Wilkins M. 1971. *The Emergence of Multinational Enterprises: American Business Abroad from the Colonial Era to 1914. Harvard University Press (1971). The Maturing of Multinational Enterprise: American Business Abroad from 1914 to 1970. Harward University Press : Cambridge, Mass.*

Young, John A. *"Global Competition: The New Reality". California Management Review*, Spring 1985. 11-25.

UNIT - 2 INTERNATIONAL BUSINESS THEORIES

Objectives :

After reading this unit, you should be able to:

- understand the analytical foundations of international business
- be familiar with the international trade theories
- explain the FDI approaches to international business.

Structure :

2.1 Foundations of International Business

2.2 International Trade Theories

Theory of Mercantilism

Theory of Absolute Cost Advantage

Theory of Comparative Cost Advantage

Hecksher-Ohlin Model

Leonief Paradox

2.3 FDI Theories

Market Imperfections Approach

Product Life Cycle Approach

Transaction Cost Approach

The Eclectic Paradigm

2.4 Summary

2.5 Key Words

2.6 Self-Assessment Questions

2.7 Further Readings

2.1 FOUNDATIONS OF INTERNATIONAL BUSINESS

The analytical framework of international business is build around the activities of MNEs enunciated by the process of internationalization. The FDI on the part of an MNE attempts to overcome the obstructions to trade in foreign countries. The strategies relating to the functional areas, such as production, marketing, finance and price policies, are adopted by the MNEs in such a manner that an amicable relationship between home and host nations is created.

Foreign direct investment can be distinguished from the other forms of international business, such as exporting, licencing, joint ventures and management contracts. Basically, it reacts to the restrictions in foreign trade, licensing, etc., and its growth at the global level has taken place mainly due to the imperfections in the world markets and protective trade policies pursued by different countries for the sake of protecting their economies. The ways in which the MNEs have provided

challenges to the imperfections and restraints in the world markets from an important part of the conceptual methods underlying the expanding role of international business.

Before the emergence of the MNEs, foreign trade and international business were regarded as synonymous, and international trade doctrines based on labour cost differentials and free trade guided the international transactions among different trading partners. The multinationals undertook FDI abroad, and their innovative efforts in technological development and management techniques, in a way, refuted the traditional trade theories. Several FDI theories have been developed in support of international business for the improvement and welfare of world economies.

The fast growth of international business has also been conducive to foster close international economic relations among different countries of the world. Now, the world economy is not only interdependent but also inter-linked and any kind of R & D taking place in any part of the world has its impact on the entire global economy.

The multinationals are to keep a constant surveillance on the fluctuating foreign exchange rates and inflation as these have a direct bearing on the profitability of international operations. The socio-cultural, political and economic environments of host countries also affect the investment decisions of foreign investors.

2.2 INTERNATIONAL TRADE THEORIES :

International business began with international trade operations, facilitated by the laissez faire in the world economy. It improved the well-being of many nations, and the imposition of trade barriers reduced the gains from trade, giving rise to the search for alternate avenues to exporting. The latter resulted in the establishment of subsidiaries in foreign countries through FDI. In this context, it is pertinent to understand the determinants of and the effects of international trade and FDI on the trading partners, international operations of multinationals and the economies of the home and host countries. Several theories have been formulated, from time to time, which form the bases of international trade and FDI.

Theory of Mercantilism :

During the sixteenth to the three-fourths of the eighteenth centuries, the world trade was being conducted according to the doctrine of mercantilism. It comprised many modern features like belief in nationalism and the welfare of the nation alone, planning and regulation of economic activities for achieving the national goals, curbing imports and promoting exports.

The mercantilists believed that the power of a nation lied in its wealth, which grew by acquiring gold from abroad. This was considered possible by increasing exports and impeding imports. Such reasoning gathered support on the ground that gold could finance military expeditions and wars, and the exports would create employment in the economy. Mercantilists failed to realize that simultaneous export promotion and import regulation are not possible in all countries, and the mere possession of gold does not enhance the welfare of a people. Keeping the resources in the form of gold reduces the production of goods and services and, thereby, lowers welfare. The concentration in the production of goods for domestic consumption by using resources in a less efficient manner would also mean lower production and smaller gains from international trade.

The theory of mercantilism was rejected by Adam Smith and Ricardo by stressing the importance of individuals, and pointing out that their welfare was the welfare of the nation. They believed in liberalism and enlightenment, and treated the wealth of the nation in terms of the "the sum of enjoyments' of the individuals in society. Any activity, which would increase the consumption of the people, was to be considered with favour. Their trade doctrines were based upon the principles of free trade and the specialisation in the production of those goods where resources were most suitable.

Theory of Absolute Cost Advantage :

The theory of absolute cost advantage was propounded by Adam Smith (1776), arguing that the countries gain from trading, if they specialise according to their production advantages. His doctrine may be understood with an example presented in Table 2.1.

Table 2.1
Labour Cost of Production (in Hours)

	1 unit of goods A	1 unit of goods B
Country I	10	20
Country II	20	10

Table 2.1 shows that, in the absence of trade, both the goods are produced in both the countries, because of their demand in the domestic markets. The cost of production is determined by the amount of labour required in the production of the respective goods. The greater the amount of labour, the higher will be the cost of production, and the commodity will have a larger value in exchange. The pre-trade exchange ratio in country I would be 2A = 1B and in country II IA = 2B.

If trade takes place between these two countries then they will specialise in terms of absolute advantage and gain from trading with each other. Country I enjoys absolute cost advantage in the production of good A and country II in good B. One unit of good A may be produced in country I with 10 hours of labour, whereas it costs 20 hours of labour in country II. The production of the unit of good B costs 20 hours of labour in country I and 10 hours of labour in country II. After trade, the international exchange ratio would lie somewhere between the pre-trade exchange ratio of the two countries. If it is nearer to country I domestic exchange ratio then trade would be more beneficial to country II and vice-versa. Assuming the international exchange ratio is established IA = IB, then both the trading partners would be able to save 10 hours of labour, which may be used either for the production of other goods and services or may be enjoyed by the workers as leisure, which improves their welfare in either way. The terms of trade between the trading partners would depend upon their economic strength and the bargaining power.

Theory of Comparative Cost Advantage :

Ricardo (1817), through adhering to the absolute cost advantage doctrine of Adam Smith, pointed out that cost advantage to both the trade partners was not a necessary condition for trade to occur. It would still be beneficial to both the trading countries even if one country can produce all the goods with less labour cost than the other country. According to Ricardo, so long as the other country is

not equally less productive in all lines of production, measurable in terms of opportunity cost of each commodity in the two countries, it will still be mutually gainful for them if they enter into trade. Ricardo's theory may be explained by referring to Table 2.2.

Table 2.2.

	1 unit of good A	1 unit of good B
Country I	80	90
Country II	120	100

In Table 2.2, country I enjoys cost advantage in the production of both the goods A and B as compared to their production in country II. But country I has comparative cost advantage in good A and country II in good B. We take the help of the concept of opportunity cost in order to know the relative comparative advantage in the production of the goods in the two countries. The opportunity cost to produce one unit of good A is the amount of good B which has to be sacrificed for producing the additional unit of good A.

In the example given in Table 2.2 , the opportunity cost of one unit of A in country I is 0.89 unit of good B and in country II it is 1.2 unit of good B. On the other hand, the opportunity cost of one unit of good B in country I is 1.125 units of good A and 0.83 unit of good A, in country II. The opportunity cost of the two goods are different in both the countries and as long as this is the case, they will have comparative advantage in the production either good A or good B, and will gain from trade regardless of the fact that one of the trade partners may be possessing absolute cost advantage in both lines of production. Thus, country I has comparative advantage in good A as the opportunity cost of its production is lower in this country as compared to its opportunity cost in country II which has comparative advantage in the production of good B on the same reasoning.

The gains from trade in terms of Ricardo's doctrine may be understood by distinguishing the terms of trade under "autarky" (i.e., having no trade with the outside world because of the closed economy) and in terms of trade with the outside world. The domestic exchange ratio is determined by internal cost of production. In Table 2.2, the exchange ratio before trade in country I should be 1A-0.898 and in country II 1A = 1. 1B. If the international exchange ratio prevails between 0.89 and 1.2., the international trade would be gainful to both the countries. Assuming it settles at 1A=1B then country I gains 10 hours of labour and country II gains an equivalent of 20 hours of labour.

Both the absolute advantage and comparative advantage theories failed to realise that the welfare of society does not depend only on the gains from the international trade but depends upon the way the gains are distributed. The individual gains under the theories are not guaranteed unless the government adopts an appropriate redistribution policy. There have to be certain incentives for the producers also in order to keep them engaged in the exportable production. These theories have also been criticised on the ground that labour is not the only input determining the cost of production.

Activity 1

With reference to Table 2.3, examine whether India enjoys an absolute advantage or

disadvantage in wheat and petroleum. In what commodity do India and the U.A.E. have comparative advantage? What are their gains from trading with each other, if the international exchange ratio is established at 6W=6P.

Table 2.3

Output / Labour Hour

	1 unit of Wheat	1 unit of Petroleum
India	6	4
U.A.E.	1	3

Patterns of Multilateral Trading :

Trade patterns in more than two countries involving two or more than two commodities may be summarised in Table 2.4 and 2.5.

Table 2.4

Domestic Exchange Ratios

Country I	1 unit of A = 0.89 unit of B
Country II	1 unit of A = 1.2 unit of B
Country III	1 unit of A = 1 unit of B

Table 2.4 explains that given the domestic exchange ratios in different countries, the possibilities of multilateral trading among them would depend upon the existing international terms of trade. The limits within which the three countries may be benefited by trade are 0.89B < PA /PB < 1.2B. After trade, if PA / PB settles as PA / PB > 0.89B and > 1B, then country I exports goods A to both the countries II and III, and imports B from them. All the three trade partners benefit by such trade. On the other hand, then PA / PB is greater than 1 unit of B but less than 1.2 units of B then both the countries I and III export good A to country II and import good B from these countries. In the case of PA / PB settling equal to 1 unit of B, trade will occur only between country I and country II. Country I will export good A to country II and import good B from country II. Country III would not benefit from its entry into the international trade.

Table 2.5

The Case of More Than Two Commodities

Commodity	Price in country I in Rupees	Price in country II in Dollars	Price in country III in Franks
A	2	10	3
B	5	8	5

C	7	7	7
D	9	5	10
E	13	2	14

In Table 2.5, price per unit of different products are given in three countries in terms of their respective currencies. What commodities would or would not be dealt with among the trade partners would depend upon the prevailing exchange rates of their currencies in the market. If Re = $1=F1, the price ratio in country II and country III remains the same.

Country I will export commodities A and B to country II and import commodities D and E from this country. In the case of country III, the exports of country I would consist of commodities A, D and E while commodities B and C would be non-tradable between them. Commodity C is non-tradable among all the trade partners.

Along with the change in the exchange ratio in the currencies of the trade partners, the prices of all the commodities in the trading countries are expressed in the same currency and then compared with the prices in the domestic economy. For instance, if Re 1 equals $2 and Re 1 is also equal to F2 then the prices of different goods in country II and III will be calculated in rupee terms and then compared with the price in country I for the purpose of exports and imports.

Activity 2

With reference to Table 2.6 determine which commodity will be exported to and imported by India from Japan if (a) Y1=Re 1, (b) Y1= Re 1.5 and (c) Y1= Rs. 2.

Table 2.6

Commodity	Price in India (Rupees)	Price in Japan (Yen)
A	2	18
B	8	14
C	12	12
D	16	8
E	24	2

Efficiency in International Trade :

Efficiency may be achieved in international trade and gains maximised if a country trades in those goods where it has comparative advantages determined by the international price ratios. Given the competitive market system, a country under non-trade situation would be optimising its production and the welfare of its people when the marginal rate of substitution in consumption (MRS) equals the marginal rate of transformation (MRT) in production, and it is, in turn, equal to the relative price of the two goods, say A and B, PA/PB. The supply side of the economy of a country is illustrated by production possibility curve (PPC) and the preferences of the consumers are given by the community indifference curve. The efficiency in the production situation and the optimisation of the welfare of a country under autarky trade policies may be understood from Figure 2.1.

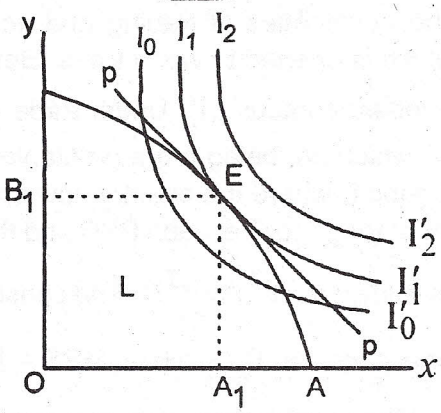


Figure 2.1: Efficiency under Autarky

In Figure 2.1, the production limits of a country are explained by the AB Production Possibility Curve. There are two goods A and B. Good A which may be assumed an agricultural commodity, is measured along the X axis and good B, a manufacturing commodity is measured along the Y axis. Given the resources and the techniques of production, the country may either produce OA amount of good A or OB amount of good B. An equilibrium in the domestic economy is achieved at point E where the price line PP in tangent to the production possibility curve and the community indifference curve I_1I_1 is also tangent to the price line at the same point MRS = MRT = PA/PB. On either side of E, the consumer will get on the lower indifference curve and lower welfare, which is not a preferred situation when the same resources can yield higher satisfaction. The country will not have resource allocation inside the PPC, because it will end up with low production of goods. The efficiency in both production and consumption in a closed economy will be at point E.

The country will experience gains from trade, if the international terms of trade differ from the domestic terms of trade and the resources are reallocated towards the production of the commodity having remunerative price in the foreign market. The efficiency in and the gains from international trade may be illustrated in Figure 2.2.

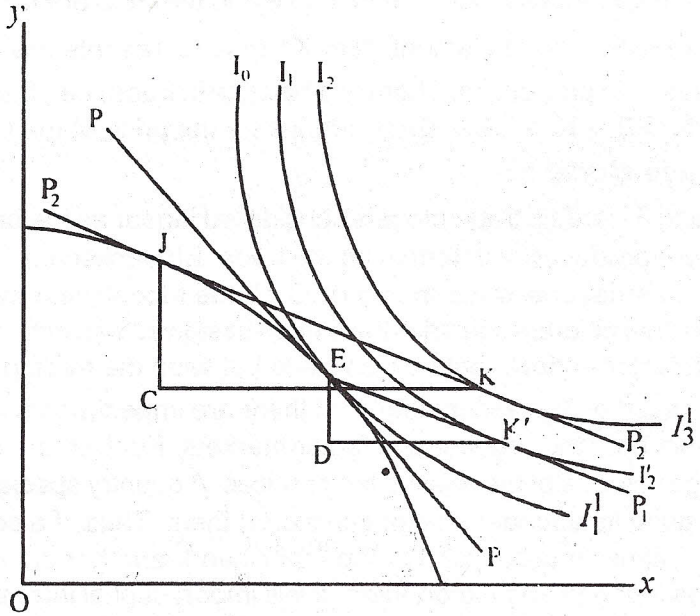


Figure 2.2: Efficiency under International Trade

Figure 2.2 examines the possibilities of trading and achieving efficient production and consumption in an economy which is opened to world trade. Before trade, the country produces and consumes at point E with welfare contour I_1I_1'. Under trade, the world price is given by P_2P_2 showing the exports of goods A which are being more profitable in the international market. The production is oriented towards good B where the country now enjoys competitive advantage and produces at J, which is the point of tangency between PPC and the world price line. At point J, the MRT= the international terms of trade, i.e., P^TA/P^TB. The consumption is at K where the highest I_3I_3' is tangent to the international price line P_2P_2. Here, MRS = P^TA/P^TB. The gains from trade are apparent by the movement of the country from indifference curve I_1I_1' to I_3I_3', which is a higher social welfare curve.

The gains from trade arise because of two reasons: (a) the possibility of exchanging goods on favourable terms in the foreign exchange markets: and (b) the possibility of specialisation in exportable products. If a country is unable to change its production structure, the trade will still be gainful due to the higher prices abroad. For instance, the $K'D$ amount of goods A may be imported by exporting only the ED amount of good B while production continues at E. This places the country at $I_2\ I_2'$, indifference curve, which is higher than I_1I_1', and yields a higher amount of welfare EP_1 is the world price line, and it is drawn parallel to $P_2\ P_2$ world price line, which means that trading is taking place at the international price line $I_2\ I_2'$ and the indifference curve is tangent to the EP_1 world price line at K'. The movement from E to K' is the gain from trade arising from the possibility of exchange.

However, this would not be the optimal situation. The country would be maximising gains if it could produce more of good B by withdrawing resources from good A and produce at J and consumes at K. Both the community indifference curve and the PPC are tangent to the world price line P_2P_2 and MRT = MRS. The movement from K1 to K represents the gains arising from the possibility of specialisation in production. There is a balance in trade, i.e., the exports of the country are equal to its imports: PB $\times$ JC = PA $\times$ CK; P stands for the price of the tradable goods.

Heckscher-Ohlin Trade Model :

Adam Smith and Ricardo's trade models considered labour as the only factor input and the differences in the labour productivity determining the trade. Eli Heckscher (1919) and Bertin Ohlin (1933) developed the international trade theory (H.O. Trade Model) with two factor inputs, labour and capital, pointing out that different countries have been bestowed with different factor endowments, and the differences in factor endowments cause trade between the trading partners.

The theory is based on the assumption that there are impediments to trade, and that there is perfect competition in both the product and factor markets. Further, the theory is based on the comparative advantage in terms of the relative factor prices. A country specialising in the production of the goods which require its abundant factor can export them. Thus, if a country is rich in capital, it will produce capital intensive products. On the other hand, another country, rich in labour, will produce labour intensive goods and export them. It will import capital intensive goods.

In the H.O. trade theory, the factor abundance has two meanings: the factor abundance in terms of the factor prices, and the factor abundance in terms of the physical amount of the factors. Assume there are two countries: I and II, then the richness of the country in terms of factor prices means relatively low price of the factors of production. Country I is rich in capital as compared to country II, if $P_{ic} / P_{ic} < P_{2c} / P_{2c}$ P_{ic} is the price of capital in country I and P_{iL} is the price of labour in country I, and P_{2c} is the price of capital in country II and P_{2L} is the price of labour in country II. The second definition of the factor abundance compares the overall physical amount of labour and capital. Country I is capital rich, if the ratio of capital to labour in this country is larger. $C_1 / L_1 > C_2 / L_2$, where C_1 and L_1 are the total amount of capital and labour in country I, and $C_2 L_2$ are the total amount of capital and labour in country II, respectively. The H.O. trade theory holds good, if the factor abundance is defined in terms of factor prices, because of the incorporation of the demand factor in it. The importance of this theory, which has the effect of determining the trade patterns and the gains from trade, may be summarised in Figure 2.3.

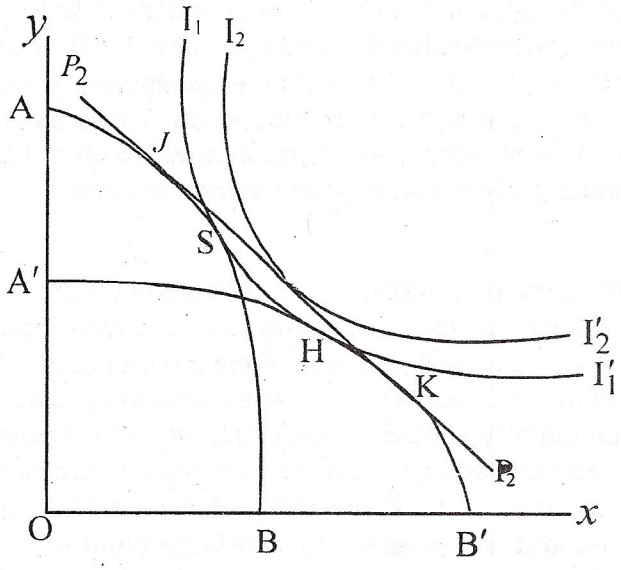


Figure 2.3: Trade Patterns and Gains from Trade under H.O. Theory

Figure 2.3 illustrates the pre-trade and after-trade production and consumption in the two countries. Country I—capital rich, is measured along the Y axis and country II—labour abundant, is measured along the X axis. There are two goods. Good A is capital intensive and good B is labour intensive. Before trade country I is producing and consuming at G and country II at H. The II , II_1 community indifference curve in the two countries is tangent to their production possibility curves AB and A^1B^1 at G and H, respectively. In the domestic market of country I, good A is cheaper and good B is expensive. In country II, it is good B which has lower price, good A being costly.

In the overseas market, the price is given by the P_2P_2 international price line. Now, the countries move to the points J and K tangent to the International price line, and country I is producing more of good A and country II more of good B. By exchanging goods of their specialisation under free trade, they reach to the $I_2I^1_2$ indifference curve at point E and enjoy gains from the international trade as E lies on the higher indifference curve.

As in the case of the classical trade model, the H.O. trade theory also cannot guarantee the (desired) income distribution among different classes in the country. In country I, the returns to capital are higher and, in country II, the returns to labour are higher because of the greater demand for producing respective goods for the world market.

The basic trade models are based upon certain assumptions, such as no transportation cost and free flow of information to all the producers and consumers. They do not take into account the effects of trade on the world prices. These trade theories are static, and ignore the effects of technological progress on the growth of the world economy. These are the real issues and need to be incorporated in a modified version of the classical and neo-classical theories.

If a nation has monopoly in certain products, it may influence the world price. It may enhance its gains by "optimum tariffs", which seek to maximise the welfare of the country. Trade may complicate the growth process. It may affect the employment and may even reduce the welfare of the country. This may occur in the case of **immeserising growth** (when benefits from the higher output are neutralised by the unfavourable terms of trade). The country ends up with lower real income after growth because the gains arising from higher output are wiped out by the deteriorating terms of trade. It may, however, by noted that the modified version of the basic theory does not alter the conclusion that a country produces and exports the commodity in which it has comparative advantages, and uses the abundant factor in its production. Trade benefits the nation, but the distribution of gains may be skewed. Adjustment to trade is not costless but the short-term cost to adjustment should be weighted against the long-term gains from trade.

The Leontief Paradox :

There was a setback to the proponents of the H.O. trade theory in the early 1950's, when Leontief tested his hypothesis that capital rich countries export capital intensive goods and import labour intensive goods and vice versa with the help of the input-output data of the United State's economy. His results refuted the H.O. contention. It was a shocking news for the economists that the U.S. being a capital rich country should be exporting labour intensive goods and importing capital intensive goods. Several explanations were looked into for resolving the Leontief Paradox. The key factors identified in support of the Leontief Paradox were: U.S. **protective trade policy, import of natural resources and the investment in human capital.**

William P. Travis examined the Leontief theory in terms of the U.S. tariff policy. When Leontief tested his hypothesis, the U.S. was importing more of such items as crude oil, paper pulp, primary copper, lead, metallic ores and newsprint, which are capital intensive. Thus, according to Travis, the U.S. protective trade policy was responsible for Leontief's findings.

The U.S. imports of natural resources like minerals and forest products and the exports of farm products further support the Leontief presentation. Investment in human capital raises the productivity of labour. That is why the exports of the U.S. consisted of labour intensive products and its imports were of capital intensive nature.

Activity 3

Draw the production possibility curve and a set of indifference curves for a country showing R as the autarky equilibrium point and p as the equilibrium point of optimum gains from international trade.

2.3 FOREIGN DIRECT INVESTMENT (FDI) THEORIES

The search for FDI theories is a recent phenomenon, despite the domination of world production and trade by the MNEs in the post Second World War period. It was in 1960, when Stephen, H. Hymer, in his doctoral dissertation. *The International Operations of National Firms: A Study of Direct Investment* (published in 1976) revealed that the orthodox theories of international trade and capital movements are unable to explain the involvement of MNEs in foreign countries. Their existence owed to the local firms wielding market power, and who acted as their agents.

The approaches which explain the activities of multinational enterprises may broadly be classified into four groups. Firstly, there is market imperfection approach whose theoretical framework considers certain specific advantages, also known as ownership advantages, enjoyed by an enterprise. The FDI is controlled through these advantages and the international companies also enter into collusion with other firms for increasing their profits. Secondly, Product Life Cycle model examines the various stages of the firm. There are sequential stages in the life cycle of the products innovated by a particular company.

Thirdly, the failure of the orthodox theories of international trade and capital movements based upon the assumption of perfect competition and its prevalence indifferent segements of international market provide adequate explanation for the substitution of the FDI. It gave rise to the transaction cost theory of the FDI that the firms undertake foreign investments for raising their efficiency and reducing the transaction costs. Fourthly, the eclectic paradigm encompassing other FDI theories which provide an analytical framework to the analyst for carrying out empirical investigations most relevant to the problem at hand. The eclectic paradigm is not a theory in itself but some sort of synthesis of the conflicting theories.

Market Imperfections Approach :

The rise of the MNEs continuously puzzelled the minds of neoclassical economists as to how these enterprises could make profits in foreign countries where production costs are more than at home. Being generally unaware of the host country's environment, it should be rather difficult to take advantage there. It may be better for the foreign company to pass on its advantages to the local entrepreneurs who, together with other local (inherent) advantages, could produce at a lower cost than the foreign investors.

The answer to this paradoxical situation is available in the presence of the imperfect market in the foreign countries. Hymer presented a case for market imperfection approach. According to him, the orthodox theories of the international trade and capital movements were inadequate to explain the involvement of MNEs in international business. Their presence is due to market imperfections. The advocates of this approach thought that the prevailing market imperfections were 'structural' (imperfections of monopolistic nature), and arose from the innovation of superior technology, access to capital, control of distribution system, economies of scale, differentiated products (by the introduction of different advertising methods) and superior management. These factors enabled the foreign enterprises more than offset the disadvantages from their operations in the foreign environment and the additional cost incurred there.

Hymer was basically concerned with the market power of the MNEs, which restricted the entry of other firms. The market power arises from collusion with others in the industry to avoid

competition which results in the larger profits. There is one way casual link between the behaviour of the firm and the imperfect market structure. The market power is first developed in the domestic country and, after the profit margin becomes lower in the home country, the firm invests abroad and controls the foreign markets by its patent rights.

Product Life - Cycle Approach : The product life-cycle approach is associated with the work of Raymond Vernon. Published in 1966, it deals with the evolution of the U.S. multinationals and foreign direct investment patterns. In Vernon's model, three stages are followed in the introduction and establishment of new products in the domestic and foreign markets, with emphasis on innovation and oligopoly power as being the first basis for export and later for the FDI.

The first stage in the sequential development of the product is the new product stage which emerges in the home country following innovations as a result of intense R & D activities by the company. The product is introduced in the overseas market through export, and the innovating firm earns excessive profits both from domestic sales and exports abroad because of its monopoly position.

The second stage is characterised by the mature product stage, when the demand in the foreign countries expands and the host country firms begin to produce competing products. The home country enterprise is induced to invest abroad for taking advantage of its technology and increasing demand for the product. As the company specific advantages of the firms controlling the technology are much higher than the local firms, the production in the host country would be cheaper. It stimulates foreign investment in subsidiaries.

In the third stage, the product becomes standardized, and competition grows in the world market. The MNEs invest even in the LDCs, where the cost of production is lower. The host country, otherwise, has to import these products from abroad because its own production cost is more. The foreign investment may take the form of licensing arrangements also.

The initial analysis of the product life cycle approach gives a good account of the nature of the expansion of the U.S. companies after World War II. The Theory was modified by Vernon in 1971 and 1977 in the light of the oligopoly threat arising from global innovative activities. He identified the first stage as the emerging oligopoly, the second stage as the mature oligopoly and the third stage as the senescent oligopoly, referring to the state of production when the standardized product is entirely produced abroad. The home country, where the product was initially innovated, imports all of the goods that it needs. Vernon's PCM model may be summarised in Table 2.7.

Table 2.7
Vernon Product Life Cycle Approach

Nature of Stage Product	Produce at Home of Abroad (1966)	Nature of Internal Business	Foreign invest.	Modified (1977)
New Product I	Home	Export	Nil	Emerging oligopoly, (innovation based)

Maturing II Product	Abroad	Import	FDI (By subsidiaries)	Mature oligopoly
Standardized III Product	Abroad	Import	(By licensing arrangements)	Senescent oligopoly

Table 2.7 shows the original and modified product life cycle models of Raymond Vernon.

The product life cycle model is useful in explaining the foreign investment patterns of the U.S. companies, but it has limited application to the firms going international, which were motivated by location advantages. The location advantages led to the establishment of assembly plants of automobiles in the foreign countries. The FDI is also stimulated by the import restrictions and currency realignments. When a domestic devaluation of dollar occurred in the 1970s in relation to such major currencies as Japanese Yen and German Deutsche Mark, the exports of these countries no longer remained profitable in the U.S. market. The Japanese and German firms increased their investment in the U.S. economy to establish production facilities there.

Transaction Cost Approach :

The transaction cost or internalisation approach was brought into prominence in the 1970s by McManus et. al. by emphasising the effects of the MNE on the internalisation of the external markets. The imperfections in the foreign markets are assumed of natural types rather than of structural type, I.e., imperfections of monopolistic nature. The analysis of the proponents of the Transaction Cost Approach is based on the criticism of neoclassical economics which arises from the non-realization of the assumptions of perfect competition.

In the absence of the perfect market and the price system giving flawed signals, the transaction costs, such as the cost of information, enforcement of agreements, and the cost of bargaining are often quite high. The price existing in the foreign countries may not be based on market forces. The agents of the corporation in the foreign markets may exploit the multinational by generating non-pecuniary externalities. Such disadvantages to the company may be neutralised by adopting a mode of organisation which attempts to coordinate the different production units in a hierarchical manner.

The multinationals adopt a hierarchy for reducing the transaction costs. The MNEs through the FDI create opportunities for interactions in the host country for the appropriate mode of production and distribution patterns. Such interactions increase the gains from trade benefiting the interacting parties. Hymer and Kindleberger have treated the FDI as a way to maximise the monopoly position for internalizing the pecuniary externalities. The transaction cost theorists have considered the FDI for reducing the transaction costs and internalizing non-pecuniary externalities.

The distinction between pecuniary and non-pecuniary externalities is made on the basis of the type of market. If the market is of the structural imperfections type, where the monopolists differentiate their products, the pecuniary externalities arise out of the monopolistic behaviour of the participating companies. The non-pecuniary externalities occur in a natural type market imperfections. For transaction cost approach, it is not necessary for a firm investing abroad to possess monopolistic power. It needs the market to be of such a type as to make hierarchical coordination possible, thereby reducing the cost of production as compared to coordination through the price system.

Thus, the MNEs undertake the organisation of their production in a hierarchial manner rather than through the market for eliminating the cost of natural imperfection. The internalisation is possible in many ways through horizontal investments as well as vertical investments. The latter type consists of both backward and forward integration. The internalisation is also possible through equity joint ventures, spot purchases and long-term contracts, new forms of investment and counter trade.

Horizontal Investment :

Horizontal investments take place for the internalisation of such assets of the company, which are intangible and cannot be priced in the market. Some of the intangible assets are the firm's specific knowledge, goodwill, management skills and marketing know-how. The basic problem is the protection of the investor's right against the infringement of his patents (in the case of knowledge) and trade marks or brand names of the products creating goodwill for the producers.

If the patent system is such that the host country authorities provide full protection to the patents, then the more prevalent form of international business will be the licensing arrangements. When the patent rights are not well-protected and the transfer of knowledge may not easily be codified into patents and the fear of imitation is around, the horizontal investment will be the alternative undertaken by the investor himself for keeping his innovations secret and internalising the foreign market for his particular technology.

Vertical Investment :

The vertical FDI for integrating the various stages involved in the final production is the most common form of internalisation. It has been found both in backward and forward integrations. The MNEs based in the developed countries have undertaken direct investments for procuring and maintaining smooth supply of such raw materials as crude oil, iron ore and natural rubber needed for their downstream activities. The transaction cost theorists advocate that such backward integration is made when the transaction costs of buying new materials and intermediate products are high. The quality control also becomes possible in vertical integration.

Internalisation of foreign markets also takes place through forward integration in the form of distribution and marketing services. If the distribution and marketing services are left to the distributing agents, these may be problems with regard to their reliability. These may even be defaults in the timely supply of the products, its demonstration, installation, after sales services, etc. All this bring a bad name to the company. Thus, an MNE invests abroad not only to lower the transaction cost but also to retain its goodwill.

Free standing companies :

In the period prior to World War I, many of the European multinationals were free standing companies. They were active in mobilising resources from the capital rich countries like the United Kingdom, and investing them in the capital poor countries. The foreign investment in Malaysia in the rubber plantations and tin manufacturing conforms to this type of investment pattern. Indeed, free standing firms raise funds freely from the major capital exporting countries, and locate the plants abroad for reducing the transaction cost. The lenders prefer to invest in equity capital rather than buying foreign bonds, because they can exercise a greater degree of control over the management of standing firms.

Some writers such as Fieldhouse do not include the free standing firms in the transaction cost approach. Their assertion is that the MNEs acquire competence from their R & D activities in the domestic market. These advantages are exploited in the foreign markets later on. The free standing firms do not develop any skill, and they just operate on a little more than a brass name plate somewhere in the city. The incapabilities and the lack of efforts on the part of the free standing firms to develop specific.advantages have been found to be the main reasons for the failure of some British and U.S. companies.

Equity Joint Ventures :

Equity joint ventures are also explained by the transaction cost approach and preference for such alternatives as contracts, mergers and acquisitions. Under the equity joint ventures, the management and profits are shared by two or more participants, while in contracts a single party holds the responsibility. The possibility of supplying the low quality input is much greater under the contract management, as the contact supplier does not share the loss of profit. In the case of equity joint ventures, the party supplying the inferior input is to bear the burden according to its equity stake. Thus, the equity joint venture arrangements are preferable, because they combine the interests of the interacting parties.

The equity joint ventures are in a better position to meet the high transaction cost conditions in contrast to the mergers and acquisitions, when there are complementary assets in the parent and host countries. If such assets are pooled in joint, ventures, the company specific advantages and the country specific advantages are coordinated more efficiently, leading to success. The case of Japanese MNEs is prominent in this regard. They preferred to enter into joint ventures, when their experience of foreign markets was little because of the new businesses being different.

Spot Purchases and Long-Term Contracts :

Spot purchases and long-term contracts for the supply of the raw materials and intermediate products are used as the efficient mode of organization when the predictability of environment is quite satisfactory. It reduces the cost of enforcement, because of the *ex-ante* arrangement reached between the partners. But the drawback of contractual arrangement is that it operates under uncertainties, and its execution becomes complicated as the degree of uncertainties rises. The contracts are more operative and successful in the case of recurrent trades involving small number conditions and relatively predictable environment.

New Forms of Investment and Counter Trade :

These are the substitutes of FDI. The transaction cost theorists treat them as an attempt to have greater enforc; ability of the contracts, which is not possible in the simple type of contracts. Counter trade, which is a recent phenomenon, is not merely a barter trade. It also involves the reciprocity clause and inherent attributes of increasing the enforciability of the contracts. The counter trade constitutes more than 15 percent of the world trade. It served very well when the FDI was not considered a viable or desirable option.

On the same lines, new forms of investment as contractual substitutes to the FDI, like turnkey contracts, franchising, product sharing and management contracts, have been supported by transaction cost approach as other ways of international business. They have been encouraged by the LDCs to obtain technology, management skills and access to the markets dominated by the MNEs. At the same time, it avoids the cost of environmental uncertainties.

The Eclectic Paradigm :

The eclectic paradigm was developed by John Dunning in 1979 as an attempt to synthesise the other FDI approaches based on the company specific advantages, internalisation advantages and country specific advantages. As it is a synthesis of some of the foreign investment theories, it does not qualify to be a separate theory itself.

The main purpose of the eclectic paradigm is to provide an analytical framework to the analyst so that he could choose the most suitable approach for the investigation that he intends to undertake. For example, the transaction cost approach may be most relevant for the investigations relating to the hierarchical coordination of the different stages of the production process. An MNE adopts both backward and forward integrations in this case.

The eclectic paradigm assumes that the MNEs possess ownership advantages from their intangible assets in the form of technology. This has enabled them to reduce the transaction cost through the internalisation process. Internalisation advantages arise because of the exploitation of technology and the locational and other advantages accruing in the host country.

Although, the ownership advantages may be transferred to the host country though the licensing arrangements; yet certain advantages are such that non-transferable benefits from them would occur only if they are managed within the MNEs themselves. Such advantages are organisational and entrepreneurial capabilities of the managers of the international firms, their experience of foreign markets, their political contacts and long-term business agreements with other enterprises. The control over technology and its coordination with the host country resources would promote R & D efforts, which can lead to the rapid growth of internationalization of the world economy.

The MNEs follow different approaches for reaping the ownership advantages. Some adopt the competitive approach for competing in the international markets, while others pursue the monopolistic approach. According to the competitive approach, the MNEs develop their competitiveness for a place in the foreign countries. In the case of monopolistic approach the ownership advantages arise from the monopolistic competition where the firms sell differentiated products.

The eclectic paradigm provides merely a comprehensive framework. It does not specifically highlight the advantages of competitiveness in the foreign countries. It also does not take into account any single FDI theory on priority basis. It points out the circumstances which the investigator should take into account in deciding which FDI theory would suit his needs. The relevance of the eclectic paradigm lies in its application to the simultaneous operation of the market imperfection approach and the transaction cost approach. The former theory helps in identifying the benefits enjoyed by the MNEs due to the imperfections in the foreign countries, and the latter is helpful in the reduction of the cost of transactions.

Activity 4

What differences do you note between the international trade theories and the FDI theories? State the distinguishing features of the FDI approaches?

.....

.....

2.4 SUMMARY

The analytical framework of international business is built around the activities of the MNEs explained by the process of internalisation. Before the emergence of the multinationals, foreign trade and international business were synonymous. International trade doctrines based upon labour cost differentials and free trade guided the international transactions. Innovative efforts of the MNEs, in technological development and management styles superseded the international trade theories. The theorists began to develop the FDI approaches in support of international business for the improvement and welfare of the world economies.

Several theories have been formulated, from time to time which have attempted to explain the basis of international trade and FDI. With regard to international trade, the doctrine of mercantilism was the earliest. Its postulation was that a nation could become rich by acquiring gold from abroad which was possible by increasing exports and decreasing imports. The interest of the nation was supreme to them. Adam Smith and Ricardo rejected the mercantilist nations on the ground that the gains of individuals were the gains of the nation and any activity which increased the consumption of the people should be considered with favour.

Adam Smith propounded the theory of the Absolute Cost Advantage, in 1776. He argued that countries gained form trade if they specialised according to their production advantages. Ricardo (1817) pointed out that even if one country enjoyed absolute cost advantage in the production of goods as compared to the other country, the trade would still take place and would be gainful to both of them if the other country was not equally less productive in all lines of production. They would specialise according to their comparative cost advantages and gain from trade.

The Heckscher (1919) and Ohlin (1933) formulated their trade doctrines known as the H.O. Trade model. It is a two factor model and proposes that countries are endowed with different factor endowments, and the differences in factor endowments give rise to trade between the two trade partners. The theory treats the comparative advantage in terms of the relative factor prices. A country specialises in the production and export of those goods which require its abundant factor. Thus, a country rich in capital specialises in capital intensive products, exports them and imports labour intensive products. There was a setback to the proponents of the H.O. Trade Theory in the early 1950's when Leontief refuted this theory by testing the input-output data of U.S. economy. He found the U.S. –a capital rich country—exporting labour intensive goods and importing capital intensive goods.

The search for the FDI theories is a recent phenomenon. It was in 1960 that Hymer, in his doctoral dissertation, pointed out that the orthodox theories of international trade and capital movements were unable to explain the involvement of the MNEs in foreign countries. The FDI approaches may be classified into four groups. First, the market imperfection approach which considers that an MNE enjoys certain ownership advantages and controls the FDI through them. The advocates of this approach thought that the prevailing market imperfections were structural imperfections of a monopolistic nature, which arose due to innovations, superior technology, access to capital, control of distribution system, economies of scale, differentiated products and superior management. These factors enabled the MNEs to offset the disadvantages of their operations in foreign environments.

Second, the product life cycle model examines the various stages of the international involvement by the firm. There are sequential stages in the life cycle of the products innovated by a particular company

Third, the **transaction cost of internalisation approach** which is based on the recognition of the fact that the assumptions of the neo-classical economies can be met in actual practice. This model considers the imperfections of the natural type in foreign markets which are different from the structural imperfections of monopolistic nature. The MNEs undertake the FDI to raise the efficiency and reduce transaction cost like the cost of information, enforcement and bargaining. If production is left to the agents in foreign countries the transaction costs may be excessive because of the generation of non-pecuniary externalities by them. Such disadvantages to the firm may be minimised by replacing the price systems with the adoption of a mode of organisation, coordinating the different production units in a hierarchal manner.

Internalisation is possible in many ways through horizontal investments, vertical investments (arising from backward or forward integration), equity joint ventures, spot purchases and long-term contracts, new forms of investments and counter trade.

The fourth is the eclectic paradigm which encompasses other FDI theories. It aims at providing an analytical framework to the analyst for carrying out empirical investigations in accordance with that theory (or approach) which is most relevant to the problem in hand.

2.5 Key Words

Absolute advantage: Greater advantage or efficiency in the production of goods enjoyed by one country over another country. This is the basis of trade according to Adam Smith.

Basis of Trade: Factors that cause the international trade.

Gains from trade: Gains arising from international trade which takes place on account of specialisation advantages of the trading partners.

Law of Comparative Advantage: Ricardo's basis of international trade. It states that trade would still be gainful even if one country is less efficient than the other, but specialises in the production of commodities or goods where its disadvantages are relatively lower (comparative advantage) and exports the same.

Autarky: The absence of trade or the economic isolation of a country.

Production Possibility Curve: It shows the various possibilities of production of two goods in a country, given the factor endowments and technology. The curve is also known as **transformation curve or production frontier.**

Community Indifference Curve: Curves showing various combinations of two goods giving equal amount of satisfaction to the community or country.

Terms of trade: Ratio of export prices to import prices.

H.O. trade Theory: Postulation that countries specialise in the production and export of those goods which require their abundant or cheap factors. A capital rich country exports capital intensive goods and imports labour intensive goods.

Leontief Paradox: Theory that refutes the H.O. Trade model by stating that the capital rich country exports labour intensive goods and imports capital intensive goods.

Immeserising growth : It occurs when benefits from the higher output in LDCs are wiped out by their deteriorating terms of trade, I giving low real income.

Unnatural market imperfections: Market imperfections arising from the ownership advantages of a company. The market imperfections approach is based on this premise.

Natural market imperfections: Imperfections arising from lack of perfect knowledge on the part of the buyers and sellers. The natural market imperfections give rise to the development of the transaction cost like the cost of information, enforcement and bargaining.

Dunning's Eclectic theory: It attempts to synthesize all the FDI theories, and provides an analytical framework to the analyst for selecting a theory most relevant to his problems.

Product Life Cycle model: It explains the various stages of the international involvement of the firm.

Firm specific advantages: Also known as ownership advantages, such as the superior technology, access to capital, organisational and marketing skills, trade marks, brand names, economies of scale and product differentiation.

Country specific advantages: Also known as locational advantages, they include natural resources, efficient and skilled low-cost labour and trade barriers restricting imports.

2.6 SELF-ASSESSMENT QUESTIONS

1) Briefly discuss the foundations of international business.
2) Explain the theory of mercantilism. Is it being applied in the present day world?
3) Examine the implications of Adam Smith's **Theory of absolute cost advantage.**
4) Critically examine Ricardo's comparative cost **Theory of international trade.** What is common between Smith's and Ricardo's trade theories?
5) Discuss the Heckscher-Ohlin Trade Model. In what ways does it differ form the earlier trade doctrines?
6) Explain the Product Life Cycle Theory of the FDI. Give suitable examples of countries which have gone through the various stages of product life cycle model.
7) Discuss the Market Imperfections Approach. How did the company specific advantages help the formulation of this theory?
8) What is the Transaction Cost Approach? Examine the relevance of the natural type market imperfections in its development, and discuss the various ways the transaction cost theory operates in the foreign countries.
9) What is eclectic paradigm? Discuss the applicability of this model.

2.7 FURTHER READINGS

Pitelis, C.N. and Sugden, R (ed), 1919. *The Nature of Transnational Firm,* Routledge: London.

Robock, S.H., et al. 1977 *International Business and Multinational Enterprises*, Richard D. Irwin, Inc., Homewood, (III).

Rugman, A.M., et. al. 1985. *International Business*, McGraw-Hill Book Company: New York.

Schnitzer, M.N., et. al. 1985. *International Business*, South Western Publishing Company, Cincinnati, Ohio.

UNIT - 3

INTERNATIONAL INVESTMENT PROCESS AND FINANCE

Objectives :

After going through this unit, you should be able to:

- develop a perspective on how a domestic firm turns into a multi-national enterprise
- identify the alternative methods of entry into foreign markets
- evaluate the entry options and suggest the optimal one for a firm at a given time and space
- understand the mechanism of transfer pricing and its role in multinational business management.

Structure :

3.1 Introduction
3.2 Internationalisation of Firms
3.3 Corporate Life Cycle Theory
3.4 Alternate Methods of Entry
Licensing
Franchising
International Joint Ventures
Subsidiaries and Acquisitions
Strategic Alliances
3.5 Models for Making Entry Mode Choice
3.6 Determinants of International Investment Decisions
FDI as a Response to Risks
Factors Influencing Foreign Investment Decisions
3.7 Choice of Locations for FDI
Interface between Strategy and Choice of Location
3.8 Transfer Pricing
3.9 Summary
3.10 Key Words
3.11 Self-assessment Questions
3.12 Further Readings

3.1 INTRODUCTION

In the previous three units we discussed the concept of international trade theories of FDI and international trade, growth of international business etc. In this unit our discussion will centre around international investment process and finance. The internationalisation of business is a widely observed phenomenon today. More and more firms are seeking business outside their national boundaries. In its effort to go international, a firm often grows through various successive stages. In this unit, we will explain these stages and also, at considerable length, various alternative modes of entry into the foreign market. This unit will later address itself to determinants of international investment decisions, factors influencing FDI, FDI location choice and, last but not least, the practice of transfer pricing.

3.2 INTERNATIONALISATION OF FIRMS :

The internationalisation process of a firm can be visualised as a series of successive stages of development. A purely domestic firm graduates to a multi-national enterprise stage through the following stages:

- Domestic firm with no export
- Marginal exporter
- Exporting through marketing intermediatries
- Exporting through own marketing facilities abroad
- Foreign production through investment abroad.

This classification of successive stages focuses only on the distribution aspect of marketing and, therefore, does not provide a complete picture. More specifically, while it does describe correctly, through incompletely, the growth stages, it does not explain the behaviour of the firms.

3.3 CORPORATE LIFE CYCLE THEORY :

A more perceptive theory explaining the evolutionary processes through which a company passes has been termed as 'corporate life cycle in international marketing'. The stage of a company in the evolutionary cycle can be determined by the degree of commitment it has towards export markets. The stages in the evolutionary cycle are:

Stage 1	Opportunism
Stage 2	Limited Commitment
Stage 3	Limited Fixed Investment for Exports
Stage 4	Substantial Dependence on Exports
Stage 5	Equal Treatment of Domestic and Export Business.

In the first stage, the attitude is essentially reactive. There may be some excess capacity at a point of time. If there are overseas enquiries, the firm takes advantage of it and exports. In stage 2, the firm discovers that exports can be a profitable long-term supplement to domestic business and decides to earmark a certain proportion of total production for the export market. Export business thus becomes a part to the corporate planning process. In the third stage, the firm gets sufficiently emboldened to invest specially for export production, i.e., it creates additional production capacity. In the next stage, the extent of export business increases in quantitative terms. In the final stage, the distinction between domestic and export business ceases to exit and the firm becomes global.

While this **corporate life cycle theory** is definitely an improvement, this does not still explain why a firm decides to follow this sequence. The theory which provides an explanation has been advanced by Ahorani, who suggests the following stages of entry in foreign markets:

- Licensing
- Exporting
- Establishment of local warehouses and direct local sales
- Formation of a Joint Venture
- Foreign Direct Investment.

These entry strategies are assumed to be hierarchical in nature. The explanation of this hierarchy is based on the hypothesis that foreign business is risky. A firm exposes itself to an increasingly higher level of risks based on its level of commitment of international business. At its most risk-averse phase, a firm decides to enter foreign markets through licensing arrangement with a local party. In the next stage, the firm is willing to accept the risks of servicing foreign markets through exports. This means exposing oneself to the risks of transit, non-payment, currency fluctuations, among others. In the next phase, the firm discovers that to consolidate and expand the gains of export business, it must invest on the creation of a marketing set up in the foreign market(s). Once the firm achieves a certain threshold of export turnover, it commits itself to local production but in view of the large risks involved in setting up foreign manufacturing facilities, it tries to reduce the risk exposure by entering into joint venture arrangements. In the final stage, it decides to go alone and emerges as an international firm.

This is the accepted explanation of the internationalisation process of a firm in the international marketing literature. In the management literature, however, this theory has been questioned and an alternative theory of internationalisation has been proposed. This theory suggests that a firm makes a conscious evaluation of the three alternative ways of servicing foreign markets, viz.,

1) through direct exporting, with / without foreign marketing facilities,
2) through a licensing arrangement with a local party,
3) through direct investment.

Which strategy will be optimal at a point of time and for a specific market will depend upon the relative cost-benefits of each strategy. We will discuss this theory in detail at a later stage. We will now take up for discussion each element of the entry strategies as proposed in the marketing literature.

Activity 1

a) Do you agree with the concept of corporate life cycle? Can you identify some Indian firms currently operating at each stage of this life cycle?

b) Several Indian business houses have set up 100 percent Export-Oriented Units. Conceptually, where should such units be slotted in the Corporate life cycle?

.....

.....

.....

.....

3.4 ALTERNATIVE METHODS OF ENTRY :

A firm seeking to enter into foreign markets may do so through one or more of the following mechanisms arrangements.

Licensing : When a Company is unwilling to take any risks for the sake of international business, it sometimes opts for licensing as the mode of entry. Licensing is, simply put, nothing but entering into a contract to allow another firm to use an intellectual property, such as, patent or a trade mark. This definition clearly brings out the fact that as an entry mode, this option is not available to all firms. Only those which have saleable technology, know-how, can use the licensing route.

The attraction of licensing lies in the fact that it involves no investment and very little up-front expenditures. And if successful, it can generate a fairly high rate of return.

Under a licensing agreement, the holder of the knowledge (technology or know-how) transfers the same to the buyer for his use against the payment of a fixed amount, which can either be a one time lump-sum payment or a percentage of sales, or a combination of the two.

Licensing arrangements suffer form several disadvantages from the standpoint of the licensor. First, the licensor does not have any management control over the licensee and is therefore unable to control either the quality or price. An unscrupulous or inefficient licensee can therefore cause damage to the long-term development of the market potential. Second, licensing is extremely limited in its scope. The licensor cannot have a share of the returns from the manufacturing and marketing operations of the licensee. Third, the life of the successful licensing arrangements is normally short, as the licensee may develop his own manufacturing capability within a reasonable short period. But the most dangerous aspect of the licensing arrangement is that sometimes the licensees, after they internalise the technology and also in some cases improve upon it, turn into competitors of licensors.

Franchising :A similar method of entry is franchising which is globally very common in the food, soft drinks and fast food business. Franchising is a form of marketing, under which the parent company allows the franchisee to use its methods, symbols, trademarks and architecture. The contract will specify the place of operation of the franchisee and the period for which the arrangement

will remain valid. Several forms of franchising are in operation. One form is hundred percent franchisee ownership; the second form envisages a concept of area or master franchisee who in turn can appoint sub-franchisee(s). The third is where the franchise is in fact owned by the parent firm itself. This happens essentially at the market-testing stage. The principal wants initially to find out the market potential himself before deciding whether large scale franchising will be profitable.

The basic advantage of this entry method is akin to that of licensing. The upfront expenditure is minimal while the return can be substantial. The disadvantage lies in the fact that unless strict monitoring is done, franchisees may default on quality and delivery, thus affecting the reputation of the principle.

According to some foreign experts who have recently been in India, franchising has a promising future because of India's democratic system and its emphasis on small business development. They believe that current economic trends will expand franchising opportunities (create new entrepreneurs, new jobs, products and services and greater possibilities for export). These experts see franchising as "the success story of the 1980s and the 1990s and the wave of the future". Franchising, through it provides consumers with convenience and quality, is still in its infancy. However, it is believed that every imaginable service in future will be franchised. By the year 2010, franchising sales world-wide are estimated at 2.5 trillion dollars.

Economists predict that franchises will account for half of all retail sales in the United States by the year 2000. According to US Commerce Department estimates, currently more than 60 US industries successfully employ franchising to deliver a wide array of goods and services.

Total sales in India's franchising sector are about $50 million per year. The hotel and advertisement industry are the most promising sub-sectors contributing to India's experience with franchising. Latin America, Africa, Central and Eastern Europe are also regarded as potential areas for development of franchising business. American restaurant chains—McDonals, Berger King – are doing good business in Eastern Europe.

International Joint Ventures : International Joint Venture involves creation of a separate legal entity by an association of two or more firms. Normally, one of the partners will be a local firm though it is not necessarily so. The choice of this entry method is dictated by several important considerations. First, it reduces the cost of entry because the equity will be divided between/among the partners. The foreign firm can thus make an entry into a market even with a minority participation and still can have substantial management control. Second, having a local partner can reduce the political risks. In an environment which may not be friendly to foreign investors, having a local partner can help in creating a more acceptable public perception. Third, the local partner is expected to have a good grasp of local operating conditions and therefore can be of great help to the foreign firm which is unaware of these details.

While these advantages can be substantial, the biggest danger of international joint venture lies in the inappropriate selection of a partner. If the choice is proper, the strengths of the parties will be complementary. But if the choice is wrong, either in terms of operative attributes or management cultures, the joint ventures are bound to break up. Several surveys have shown a considerable 'divorce' rate among the joint venture partners or taking over of the businesses by the dominant partners.

The choice of the joint ventures as the entry mode may, however, be dictated by the host country's regulations. Some countries stipulate that foreign firms can set up facilities only in association with local firms.

Subsidiaries and Acquisitions : *Wholly owned subsidiaries have been the preferred entry mode* for large enterprises. The advantages of complete ownership are: avoidance of conflict of interest, as may happen in the case of joint ventures, and fullest exploitation of the market potential in terms of both manufacturing and marketing. But these advantages are to be evaluated against the large scale commitment of financial and managerial resources. Some firms which are anxious to keep their competitive edge under the strictest control, normally favour this entry mode. Examples are IBM and Coca Cola. But the recent attempts of these firms to enter the Indian market reveal that such firms may opt for any other mode, such as, joint ventures, if that facilitates the process of entry.

Acquisitions can be considered as the entry mode if 'greenfield' projects are time consuming, especially when the corporate strategy dictates an earlier entry in the market. The success of acquisition mode is strictly dependent upon the parent firm's ability to integrate the acquisition in its organisational framework. There are several instances where the present firm failed miserably and had to sell the acquired firm later at a considerable loss.

Strategic Alliances : This has emerged as the latest tool in multinational business management, though it is also used sometimes as a specific entry mode.

To some extent, its popularity is due to the growing disenchantment with the tool of take-overs and mergers which dominated the last decade. Strategic alliances seek to create a synergy between two firms by complementing each other strengths. The urge to become a partner rather than a competitor is due to the need to become an insider in all the major markets simultaneously. This has become critical for several reasons including the astronomical costs of R & D, product launch and the increasingly slender leadtime before which competitors catch up. Even for the largest companies in the world, the need to find partners in such a scenario is becoming critical.

For examples, two of the largest global firms Daimler-Benz and Mitsubishi Corporation have entered into a strategic alliance. Explaining the need for the alliance, the Chairman of Daimler-Benz said. "What we are trying to do is just to remain competitive in a global industry, and this globalisation of industry, at least in our sectors, means that you have to set up international alliances because the time has come to an end when you can dream of just acquiring huge companies in other parts of the world."

Time-Warner, the world's largest entertainment company is trying to develop a set of multilateral strategic alliances with several market leaders in Europe. The strategic objective of Time-Warner is similar to that of Daimler-Benz. In an interview with the Business Week, Steven Ross, Chairman of Time-Warner Inc. said:

> "To succeed in this business (of entertainment) today, you must be in all the major markets of the world. Our objective is to build global partnerships. European and Japanese are annexing American properties outright. We are making alliances at the subsidiary level with the partners keeping (in mind) their strengths."

Which are the firms suited to become alliance partners? Several factors need to be considered:

- the degree of complementarity between the product portfolios of the partners;
- the degree of sustenance that an alliance partner can draw from the services and marketing strengths of the other.
- the extent of commonality in the geographical markets presently being served by each firm.

It is clear that the greater the complementarity in terms of products, services, marketing attributes, and higher the dissimilarity in terms of markets being served, the greater will be the potential benefits from the alliance. For example, in the Mitsubishi-Daimler-Benz alliance, Mitsubishi wants to have access to the very strong service networks of Daimler-Benz in Europe while Daimler-Benz wants to benefit form the tremendous technological muscle of Mitsubishi. Similarly, in the Time-Warner case, all the partners would benefit from an access to an enlarged software bank (movies, TV shows, etc.) with a minimum of new investment. The partners in addition would be able to use Time-Warner's very strong international distribution network.

Strategic Alliance for Project Exports

(An Indian Example)

Larsen & Toubro and SPIC have forged a strategic alliance to jointly bid for a substantial part of the project contracts in the Middle East, Malaysia, Indonesia and Thailand. L & T and SPIC-SMO (the fertiliser giant's engineering division) have recently signed a three year memorandum of understanding for jointly taking up project works in these countries in the petrochemical, chemical, fertiliser, oil and gas sectors.

Once they emerge as successful bidders, the order will be shared between the companies on the basis of a 60:40 formula. The company assuming the lead position will get 60 percent of the project value while the balance will go to the other partner. In case the project role supplying a number of equipments, L&T will take the lead role because of its undisputed strength in the field. If it is a project for intermediate management like designing, processing, etc., SPIC-SMO will assume that role.

Adapted from a write-up in the Economic Times, May 9, 1991.

Activity 2

Scan few recent issues of some business magazines and prepare a list of firms adopting various modes of entry.

.....

.....

.....

.....

Activity 3

1) *Read one or more business magazines (e.g. Business India, Business Today, Business World)* and ascertain if any strategic alliances have been entered into by Indian firms with foreign multinational firms for (i) operations in India, and (ii) operations abroad.

Name of Firms entering into Strategic Alliance	**Main Features of Strategic Alliance**
.....	.....
.....	.....
.....	.....
.....	.....

3.5 MODELS FOR MAKING ENTRY MODE CHOICE :

Several models have been developed in the literature which help in bringing to the surface the variables which are to be considered in making a decision on the entry mode. We have outlined below the basic structure of the model, developed by Agnon, Hersch and Rugman which is the most accepted version now.

The model's basic hypothesis is very simple. Each mode of entry has a set of specific costs. Therefore, what a firm has to do is to quantity these costs and pick up that mode which promises to be the least costly.

There can be two conceptually distinct types of FDI decisions. First, where the FDI is being made to service a foreign market. This is the normal situation. But there can be a second type. This occurs when an enterprise is making the investment abroad to service the home market, by bringing back the output.

The analytical procedure for both cases is the same as shown below:

Model 1 : Servicing the foreign market

i) Export if : $C + M^* < C^* + A^*$

(Exporting is cheaper than FDI)

and $C + M^* < C^* + D^*$

(Exporting is cheaper than licensing)

ii) FDI if : $C^* + A^* < C + M^*$

(FDI is cheaper than exporting)

and $C^* + A^* < C^* + D^*$

(FDI is cheaper than licensing)

iii) License if : $C^* + D^* < C^* + A^*$

(Licensing costs less than FDI)

and $C^* + D^* < C^* + M^*$

(Licensing costs less than exporting)

Notations are:

C	Normal cost of production at home
C*	Normal cost of production abroad
M*	Export marketing costs including tariffs, freight, etc.
A*	Additional cost to the firm to operate abroad, viz. environmental, cultural, political, information costs.
D*	knowledge dissipation costs, as the licensee starts sharing the knowledge.

Model 2 : Serving the Home market

The firm has three options:

i) produce domestically

ii) produce abroad and bring back home the production

iii) License a firm abroad for export to home market.

The decision, here too, will depend upon the comparison of cost relevant to each mode.

Specifically, the conditions will be:

i) produce at home if $C < C^* + M^* + A^*$ and $C < C^* + M^* + D^*$

where M is the additional cost of importing the output from the foreign location.

ii) produce abroad if $C^* + M + A^* < C$ and $C^* + M + A^* < C^* + M + D^*$

iii) license if $C^* + M + D^* < C^* + M + A^*$ and $C^* + M + D^* < C$

3.6 DETERMINANTS OF INTERNATIONAL INVESTMENT DECISIONS :

Foreign direct investment decisions are quite often taken in the context of the risk perceptions of the firm. The most common risk that has prompted possibly the largest volume of foreign investment is the perceived threat of a Government closing access to a specific market through tariffs or other control instruments. But there are many other threats which a company can foresee and its foreign investment policy is formulated accordingly.

Protecting Competitive Edge : Industries which are resource intensive are always conscious of the need to protect their access to these resources, such as crude petroleum or copper. The response is almost always vertical integration by setting up subsidiaries in countries where the resources are located. This response is also conditioned by the fear that some competitors having secure access to raw material resources may cut off supplies to others who have not protected their supply lines. The high-technology firms face a different type of risk but the response, there too, is quite often foreign direct investment, even though the nature of their product-set may not be such as to warrant foreign production under normal trading conditions. The technology-based firms are always afraid that their competitive edge will wither away over time as the technological distance between them and the local producers gets reduced. And this will create pressure on the local government to promote local firms at the cost of foreign firms. The probability of this eventuality can be postponed, if not eliminated, by creating manufacturing facilities in the local markets.

Herd Mentality : Foreign direct investment in highly oligopolistic industries follows a pattern which is based on 'herd mentality'. The economic and the marketing parameters of the oligopolistic industry are such that if one firm decides to make a substantial investment in a market, others will perceive this move as a long-term competitive threat to their own positions, even in their home market. This results in wave-like investment flows in certain sectors in countries where a dominant foreign firm has made a foray. Examples of such behaviour in the recent past are the foreign investments in the semi-conductor and the microcircuit production in South East Asia and the soft drink industry in Latin America in the '60s and '70s.

Threat Reciprocity : Foreign direct investment decisions are also sometimes influenced by the need to take an aggressive posture, faced by competitive threats from abroad. When foreign firms start manufacturing operations abroad, local firms perceive this as a threat. The strategy which some firms adopt in such a situation is to set up their own production facilities in the domestic market of the foreign firms.

Factors Influencing Foreign Investment Decision : Apart form the risk perception, there are many other factors which influence foreign investment decisions. Some of these are strategic while others are responses to operational problems. A study which made a survey of the reasons which promoted firms to invest abroad has identified the following reasons.

I. Defensive Strategies : A company operate abroad to defend its existing business as a result of:

- Government action in establishing or increasing:
  - Δ tariff barriers
  - Δ import controls
  - Δ legislation (at home or abroad) against monopolies or trade agreements.
- Demands for local manufacture and other problems of nationalism in overseas markets.
- Transport costs and delays
- Difficulties with agents, and licensees

- Troubles with after-sales service and other technical difficulties abroad.
- The need to protect patents
- The need to ensure supplies of raw materials and components
- The need to go international when competitors, suppliers or customers do so.
- The need to protect shareholders at home from trade recessions at home by :
  - Δ a geographical spread
  - Δ product group diversification (which may involve geographical as well)

II. Aggressive Strategies

The search for:

- More profitable uses for underemployed resources at home in:
  - Δ Capital and equipment
  - Δ Personnel
  - Δ Know-how
- The more effective use of opportunities by the development of global plans and strategies for resources and markets.
- Access to foreign knowledge or methods.
- The need to expand, when this can only be abroad, and the possibility of escaping from constraints at home.

III. Other Pressures

- Influence of governments, for example :
  - Δ by general encouragement to foreign investment
  - Δ tax concessions
  - Δ cheap loans
  - Δ grants or guarantees
  - Δ buildings
- influence of other companies, e.g. approach for know-how
- Internal to company, such as pressure groups advocating overseas manufacture because of the expertise and insights of members.

A comprehensive enunciation of factors may give one a feeling that all foreign investments are the result of conscious decisions making, that will be a tavestry of truth. There have been many instances where the decision to go abroad have been totally ad hoc and sometimes even against

the declared corporate policy. However, the incidence of such cases has in all probability been declining over time.

3.7 CHOICE OF LOCATIONS FOR FDI :

While the above listing of factors can provide an explanation why a firm opts for foreign direct investment, it does not explain how a firm makes a choice among alternative sites. In other words, how do the vocational factors and host country's policies influence the relative attractiveness?

Among the locational factors, most important are relative labour costs, production and marketing infrastructure, cost of maintaining expatriate staff, transport costs, if the production is to be exported out, possibility of using it as a platform to enter other markets, among others.

Host government's policies can remarkably affect the choice of location. In recent years, governments of developing countries are extending substantial fiscal and financial benefits to foreign investors. These benefits can influence the relative profitability of projects across countries. At the macro level, the level of withholding tax, policies on repatriation of dividends, royalty payments, etc., price stability and overall eco-political stability are some of the important variables to be considered by the investing firm.

An empirical analysis on FDI in manufacturing in developing countries has found some evidence in support of the following hypotheses:

a) Higher the per capita income, more attractive the country is to the foreign investors.

b) Developing countries which are urbanised are favoured.

c) Greater is the infrastructure, more is the attraction.

d) Higher is the tax level, less is the attraction.

Interface between Strategy and Choice of Location : Choice of a location is largely determined by the specific type of corporate strategy being pursued by the enterprise. Three types of strategies have been identified.

Market Strategy : This strategy is adopted when the corporate objective is either to capture or define a market by local production. The investment is basically export-substituting in character. Multinationalisation is achieved by spreading the location of production by setting up 'relay subsidiaries'. The final output is essentially targeted to meet local production. Marginal amount, if at all, may be exported either to the parent's country or to other markets.

Production Strategy : This type of strategy is adopted to take advantage of inequality of production costs between countries. Traditionally, differences in labour costs have explained substantial flows of direct foreign investment in those industrial sectors where labour cost forms an important component of total cost. The objective of such investment is not normally serving the local market. Bulk of the production either will be exported back to the parent firms or to other export markets.

Supply Strategy : This strategy is adopted by firms whose primary production inputs are natural resources, such as oil companies. Historically, large amount of FDI has gone to those countries which have abundant natural resources. Here too, the bulk of the production is for exports.

Choice of Location: an Example

"Once the capital of a global empire, London is increasingly being bypassed as a crowded, expensive polluted city on the fringe of an emerging European Community (EC).

Grand Met, the British food conglomerate that owns Pillsbury, will move its European food headquarters from London to Paris in April, 1992.

The company joins other corporate gaints – Quaker Oats and Sheraton Hotels – that are side-stepping London to set up European operations on the continent.

"With the formation of the European Community, American firms are starting to look at the whole idea of being more central."

Competition to be Europe's paramount city is fierce, with Paris, Brussels, Berlin, Frankfurt, Amsterdam, Rome, Milan and Madrid vying to unseat London, the largest player.

Real estate prices in London, prohibitively high in the 80s, have fallen as a result of the British recession and are now more competitive with other European capitals.

Rental costs were a major factor in Sheraton's decision to move its headquarters for Europe, Africa and West Asia from London to Brusells.

Activity 4

In the above section, we have analysed a large number of factors which are considered by foreign investors in selecting locations for their plants. Attempts an evaluation of few Indian cities in terms of their attractiveness to foreign enterprises.

3.8 Transfer Pricing :

Transfer pricing has emerged as one of the most controversial aspect of MNC operations as it can be used for tax dodging. But there are several important managerial issues with regard to transfer pricing which we will discuss first.

Transfer pricing problem arises whenever there is inter-divisional or inter-unit trade. There can be two situations:

a) where the goods/services being traded between two units of the same enterprise do not have an organised external market. For example, components being supplied by a subsidiary to the parent company.

b) where there is an organised external market.

This distinction is important because in the latter case, it is possible to find out what will be the price, if trade is conducted freely. The price that prevails when the parties to a transaction are not related is called the 'arm's length price'. But where there is no external market, no such benchmark exists. And, therefore, the process of fixing prices for inter-unit or inter-divisional transactions tend to be somewhat arbitrary and judgemental.

In such cases, prices are based on formula such as, manufacturing cost of the unit plus a mark up for covering fixed costs and profit; manufacturing cost of the most efficient unit of the Group plus a standard mark up or price determined by negotiations.

It is obvious that when prices are not subject to market forces but are independently determined, the efficiency of the units cannot be properly measured. The profits/losses of a unit can be the result of purely accounting decisions. In such a suitation, managerial motivation can also become a casualty.

Even when there is an external market and therefore arm's length pricing is technically feasible, an MNC may decide to fix prices in some other way. This may happen because the basic objective of an MNC is to maximise group profits. This may necessitate showing, on paper, more or less profit being earned by one unit than what has been actually realised. This brings us to the issue mentioned at the outset, that of manipulation of prices as a deliberate policy.

Manipulation of Transfer Prices : Manipulation of transfer prices is motivated by several environmental variables. Principal among these are:

- Corporate tax rates on profits
- Import duties
- Risk exposure on remittances.

Let us examine these cases.

Corporate tax rates : The objective of an MNC is to minimise its global tax liability. To accomplish this, the parent organisation will like to show more profits in that country where the tax rate is the lowest, Let's take a simple example. The parent .irm is in USA where profits are taxed at 40 percent. It has two subsidiaries, say at Canada and Hong Kong, with tax rate at 30 percent and 10 percent respectively. Suppose there is some amount of intra-unit trade. It would be advantageous for the company to charge lower prices for sales made by the Canadian subsidiary to the Hong Kong Unit, as it will reduce the profits of the former and boost the profits of the latter. Conversely, when the Hong Kong subsidiary makes sales to the Canadian unit, it will jack up the prices.

The same situation will prevail when there is one subsidiary. In that case, if the tax rate applicable to the parent is lower than that of the subsidiary, more profits will be shown to have accrued to the parent firm at the cost of the subsidiary. It is therefore clear as to why the government of the host country gets concerned with such practice. This is because the country with the higher tax rate stands to lose considerable amount of tax revenues.

Most governments have, therefore, enacted laws to prevent such manipulations to the extent possible. This is sought to be achieved by not accepting the firm's prices but by estimating arm's length prices. If there is a double taxation treaty between the government of the host country and that of the MNC, there is normally a provision regarding transfer pricing in that agreement. This provision usually provides that where there is a common participation in the management, control or capital of the two companies resident in each of treaty territories, and dealings between the two companies have not been on an arm's length basis, so that the profits of one company are lower than they would have been had transactions been arm's length, the taxable profits of the company

whose profits have been depressed may be increased accordingly". (Eric Tomsett, Tax Planning for Multinational Enterprise).

Import Duties : If there are high import duties, the motivation to indulge in export pricing is strong. Suppose, the parent company in USA has a subsidiary in Indonesia which imposes a 50 percent *ad volarem* duty on the components being supplied by the parent unit. By stating a lower price, the MNC can save substantial amount of customs duty. But here too, there is a danger. The customs authorities may refuse to accept such artificially lowered prices and jack up prices for customs valuation and duty assessment purposes.

Remittances on Profits: Many countries in the developing part of the world, impose some restrictions on the amount of dividend payments an MNC will be allowed to take out of the country. Transfer pricing manipulation can circumvent the restrictions on the remittance of dividends. Sale prices of the parent to the subsidiary will be raised while the sales price of the subsidiary to the parent will be reduced. This is the standard method adopted by many firms. There are also interesting variations. In one case, one multinational enterprise having manufacturing capacity in Colombia used to ship the goods to a subsidiary in Mexico, which in turn resold it to the parent firm in USA. The intermediate sale to the Mexican unit was made to facilitate remittances of profits to USA as there were no such restrictions in Mexico.

It can be concluded that transfer pricing is the inevitable outcome of divisionalisation or inter-unit trade. Given the nature of such transactions, there can be some degree of arbitrariness in the fixation of export prices, which cannot be avoided. Deliberate manipulations of export pricing to avoid taxes or other national regulatory measures are however illegal and the government of the host country can take remedial measures.

3.9 SUMMARY :

Internationalisation of business is a phenomenon which can be observed all over the world. Many firms in developing countries which hither to restricted their operations to the domestic market are, with liberalisation of their economies, now looking for markets abroad. They are thus graduating to multi-internationalisation of business. According to "Corporate Life Cycle Theory" the transformation of the firm into successive stages is evolutionary in character and the stage on which a firm may be found would depend on the degree of its commitment towards export market. The various stages in the evolutionary cycle are: Opportunism, Limited Commitment, Limited Fixed Investment for Exports, Substantial Dependence on Exports and Equal Treatment of Domestic and Export Sales. The Theory, however does not explain why a firm decides to follow the laid down sequence. An alternative explanation is provided by Ahorani who suggests Licensing, Exporting, Establishment of Local Warehouses, Formation of Joint Ventures, Foreign Direct Investment as hierarchical stages of entry in foreign markets. This hierarchy is based on the hypothesis that foreign business is risky. The theory by Ahorani has been questioned and another theory has been proposed. According to the latter theory a firm makes conscious evaluation through alternative ways of servicing market viz., Direct exporting, Licensing Arrangement and Direct Investment.

A player intending to enter into international business could do so through various modes: Licensing, Franchising, Joint Venture, Subsidiaries or Acquisition of existing businesses, Strategical Alliances etc. Lately, strategic alliances have appeared in a big way on the international horizon. Each mode of entry has its cost and benefits. Based on these two parameters some quantitative models for deciding entry choice have been proposed. However, the simple decision rule is: Pick up a mode which promises to be the least costly.

FDI decisions depend upon the risk perceptions of the firm. In order to protect its long-term interests a firm may behave or show responses in different ways. Apart from risk, strategic and operational factors may influence FDI decisions. Strategies pursued by a firm operating in foreign markets may be defensive or aggressive. A firm deciding in favour of FDI has to take decisions regarding location of its facilities, plant or business. Relative labour cost, production marketing infrastructure, cost of maintaining expatriates, transport costs, etc. will influence the location decision. Choice of location is largely determined by the corporate strategy pursued by the firm viz., market strategy, production strategy and supply strategy.

Transfer pricing is sin quo non of international business and has been the subject of much debate. The technique of transfer pricing (over and under pricing) for goods and services supplied by the parent to the subsidiary or vice-versa, or by one subsidiary to another in the same group is often used by multi-nationals for tax dogding. The variation in corporate tax rates and import tariffs and restrictives on quantum of remittances provide the necessary motivation for resorting to transfer pricing practices. The governments of concerned countries adopt a variety of mechanisms to combat such attempts of the multinationals.

3.10 KEY WORDS :

Corporate Life Cycle Theory : The postulation that graduation to successive stages in international business is an evolutionary process. At what stage a company is in the evolutionary cycle can be determined by the degree of its commitment to export market.

Licensing : Contract between two firms under which one firm allows another to use its intellectual property, such as patents, trade markets, or know-how.

Franchising : A form of marketing under which a parent company allows the franchisee to use its name, methods, symbols, trade marks and architecture etc. In other words it is a sponsorship by which large corporations set up self-contained branch units.

Joint Ventures : Creation of a separate legal entity by an association of two or more firms (e.g. one or two foreign and one or two local).

Subsidiary : A legal entity set up by the parent company in another country which is owned (fully or partially) and controlled by the latter.

Acquisition : Instead of setting up a new legal entity by the parent in another country, an existing local enterprise may be acquired (often with full ownership) and established as a subsidiary.

Strategical Alliance : An understanding between two or more firms (one often foreign and another local) on some aspects of management, control and operations in relation to manufacturing or marketing or both of the existing or new business.

FDI (Foreign Direct Investment : Direct investment for setting up production and marketing facilities in another country by an international enterprise. FDI may takes place through establishing subsidiaries (fully or partially owned), joint ventures (with equity participation), acquisitions etc.

'Herd' mentality: The mentality depicted in the behaviour of local firms in clustering around the original foreign investor in a potentially new industry/market.

Transfer price: Price charged for goods for services supplied by the parent to the subsidiary or vice-versa or by one subsidiary to another.

3.11 SELF-ASSESSMENT QUESTIONS

1) "India's democratic system and its emphasis on small business development make it a promising market for franchising opportunities. But it is not an automatic assumption. What works in one country will work in another. Whether a concept will succeed in a given country is a function of taste, political environment, the economy and price range. Without careful analysis of the products and the market place, it may not work." Comment on the above statement, What are your own views?

2) What are the different stages through which a firm graduates to become multi-national enterprise? At what stage would you like to place most of the Indian firms which are doing foreign business?

3) What is the Corporate Life Cycle Theory? Explain its various stages with Indian examples.

4) What are the different modes of entry into international business? Explain briefly, by bringing out their merits and demerits.

5) The preferred mode of internationalisation of Indian corporate sector has been the joint venture. Can you explain the reasons behind this behaviour?

6) Reading some relevant recent literature, prepare a brief note on the Government of India's policy on FDI. Do you think this policy will be perceived to be friendly by foreign investors?

7) Discuss some models for making entry mode choice. Explain the models with hypothetical data.

8) What are the determinants or international investment decision? What different strategies could a firm follow?

9) What factors would influence the choice of location for FDI? Which location factors do you think are more important for the foreign investors in the Indian context?

10) What could be the different bases for transfer prices in the context of International business?

11) What factors provide motivation to multinational firms to manipulate transfer prices?

12) What mechanisms are available to the Government to stop/check, manipulative transfer pricing practices? Discuss.

13) Read the passage below which gives a brief account of some recent strategic alliances in Europe. Can you identify some sectors where Indian firms should seek strategic alliances abroad? What arguments can you offer to support the view that for these firms strategic alliances would be the best entry mode?

In March 1992 Philips, the Dutch electronics group, and Grundig, the German consumer electronics company announced that they would join their video and cordless telephone operations.

On the same day, Olivetti, the Italian computers and office equipment group announced an alliance with Canon, the Japanese camera and electronics group, to produce bubble ink-jet printers.

These moves are part of a growing trend among Europe's ailing electronics manufacturers to seek alliances in the hope of regaining their competitiveness in the market place.

They include another recent announcement by Philips that it was joining forces with Motorola, the US group, to design and develop semiconductor chips for Compact Disk Interactive, a new CD-based medium combining graphics, data, CD audio and video.

A sparte of similar links has also taken place in Europe's semiconductor and computer industries over the past year as difficult market conditions forced companies to adopt strategic measures.

Earlier this year Groupe Bull of France, the computer group announced a link with IBM of the US to develop advanced semiconductor chips. And SGS-Thomson, the Franco-Italian semiconductor group is to collaborate with GEC Plessey Semiconductors of the UK in the chip development, and with Philips in a semiconductor plant in Grenoble.

Such partnerships have been spurred by the growing recognition among Europe's indigenous manufactures that their US and Japanese competitors could be the main beneficiaries of the single European market. European electronic companies have accepted they need help to survive in increasingly competitive markets otherwise they will not be able to fund the R&D needed to keep pace with technology.

Even cash-rich Siemens has realised that it cannot afford the investment needed to stay in the race and recently announced ventures in chip development with both IBM and Toshiba of Japan.

3.12 FURTHER READINGS :

Aharoni, Vair, 1966, *The Foreign Investment Decision Process*. Graduate School of Business Administration, Harvard University, Boston.

Plasschaert, S.R.F., 1979, *Transfer Pricing & Multinational Enterprise*. Praeger Publishers, New York.

Brooke, Michael 2, and Lee H. Remmers 1978, *The Strategy of Multinational Enterprise*, 2nd ed. Pitman Publishers, London.

Rugman, Alan N., 1981, *Inside The Multinationals*, Croom Helm, London.

Tomsett Eric, 1989 *Tax Planning for Multinational Companies*. Woodhead Faulkner, London.

BLOCK 2 STRATEGIC MANAGEMENT OF INTERNATIONAL BUSINESS

The previous block, besides highlighting the role of international trade and business, dealt with the theories relating to international trade and business and the process of international investment and finance

This block "Strategic Management" is concerned with strategic aspects of and issues in international business and has three units

Unit 4 gives an account of the evolution in the **Structural Design of MNEs.** The process of integration of domestic and overseas operations of the MNEs is explained. The managerial attitudes of the MNEs – ethnocentric, polycentric or geocentric – are reflected in their policies and practices. These are briefly examined. The unit highlights the evolutionary patterns of American, European and Japanese MNEs. The unit ends with the concluding comments on designing an appropriate structure.

Unit 5 deals with **Strategic Planning in MNEs.** What kind of planning would be needed depends upon the stage of growth of the MNE and the degree of diversification in its operations. The types of planning in terms of focus and modes of planning are explained. This is followed by a discussion about planning practices in MNEs. A subsidiary may start as totally dependent unit but may become, eventually, a relatively independent entity. However, before the latter occurs, the subsidiary may have to traverse a certain evolutionary (or development) path. What in general is this path is discussed. Towards the end, pitfalls of MNE strategic planning, environmental scanning and scanning modes are discussed.

Unit 6 deals with **Strategic Considerations.** It begins with a discussion about ownership strategy and possible areas of strategic alliance. This is followed by a discussion about the need for integration and responsiveness. A multifocal strategy requires multiple tools to build new perspectives. How can these perspectives be built are analysed. The unit ends with a discussion on topics : how to maintain a dynamic balance and what could be the ways to bring about flexible coordination among the units of a multifunctional enterprise and commitment among organisational members.

UNIT - 4 STRUCTURAL DESIGN OF MNEs

Objectives :

- After reading this unit, you should be able to :
- identify the organisational structure and its position in evolution.
- understand the managerial orientation,
- understand the evolutionary changes of MNE structures of the U.S., Japan and Europe, and
- identify the appropriate structure of MNE in its stages of development.

Structure :

4.1 Introduction
4.2 Pattern of Evolution
4.3 Managerial Attitudes and Structure
4.4 American MNEs
4.5 Japanese MNEs
4.6 European MNEs
4.7 Organisation of ABB
4.8 Designing Appropriate Structure
4.9 Summary
4.10 Key Words
4.11 Self-assessment Questions
4.12 Further Readings

4.1 INTRODUCTION :

This unit gives a generalised pattern of organisational evolution of MNEs. As we discussed in the previous block, the changes in structure occur due to the changes in an MNE's commitment to international business and to the needs for integration with domestic business. The structures can vary from a simple export department to a transnational matrix. In fact, changes in structure take place concurrently with changes in managerial attitudes. The unit gives an account of the transformation that has taken place in the organisation structures of MNEs originating from U.S., Japan and Europe. An illustrative status of recent restructuring of ABB is given. Thereafter the unit proceeds to a discussion of general classification of structure on the basis of function, products, area or a combination of two or more bases.

4.2 PATTERN OF EVOLUTION :

There are two related processes involved in the growth of a domestic firm to an international one. These are : geographic dispersion of corporate resources and corresponding changes in organisational development. One can classify the evolutionary pattern of MNEs from purely domestic company to a transnational corporation into five types. The organisation structure and characteristics of these types are given in Table 4.1.

Table 4.1
Evolution of International Business and Organisational Structure

Types	Structure	Diversification	Characteristics
A) Domestic	Export within the Marketing Deptt.	Minimum	Product/market diversification minimum Initial exports, trade, loose formal relationship, no specialized effort
B) Export	Export Deptt as a separate entity	Low	Early foreign product stages and specialized effort, exports become more important, more formal relationship
C) International	International Division	Low	Export bias eliminated and foreign market entry by any strategy, licensing and FDI abroad, mature stage of a few products, standardisation of products and processes, incre-ased formalized relationships
D) Multinational	World-wide Product/Area based structure	Medium	Growth through diversification, increased international investment, greater formalisation
E) Transnational	Matrix/grid type Structure	High	Substantial increase in foreign investments, widespread and diversified international business (globalization of business), increased formalization and greater number of executive incharges.

A company gets into foreign markets by starting export sales to other countries. The growth in international business evolves from the export department to the international division, world wide product, or mixed matrix structures. Chandler's thesis of "structure follows strategy" can be explained in terms of the pattern of evolution of multinational business organisation. It is the strategy of an MNE, which determines the structural design of the organization by enabling it to achieve its objectives. We shall now discuss different types of organizational structures as shown in Fig. 4.1 A and Fig. 4.1 B.

Type A: Domestic Oriented Firm

Fig. 4.1 A : Organisation of Domestic Oriented Firm (Narrow-product line)

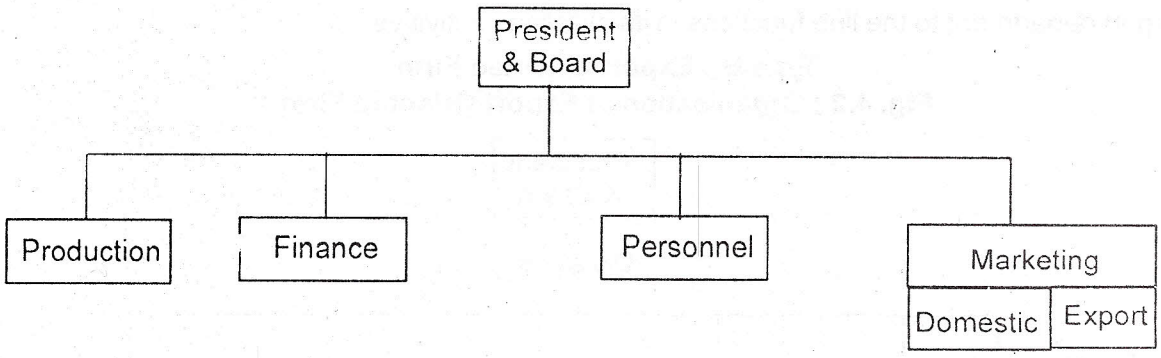
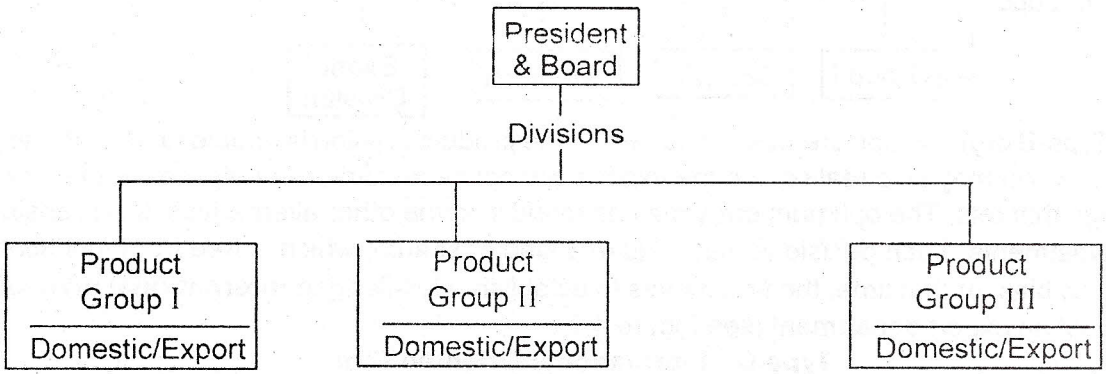


Fig. 4.1 B : Wide Product Line



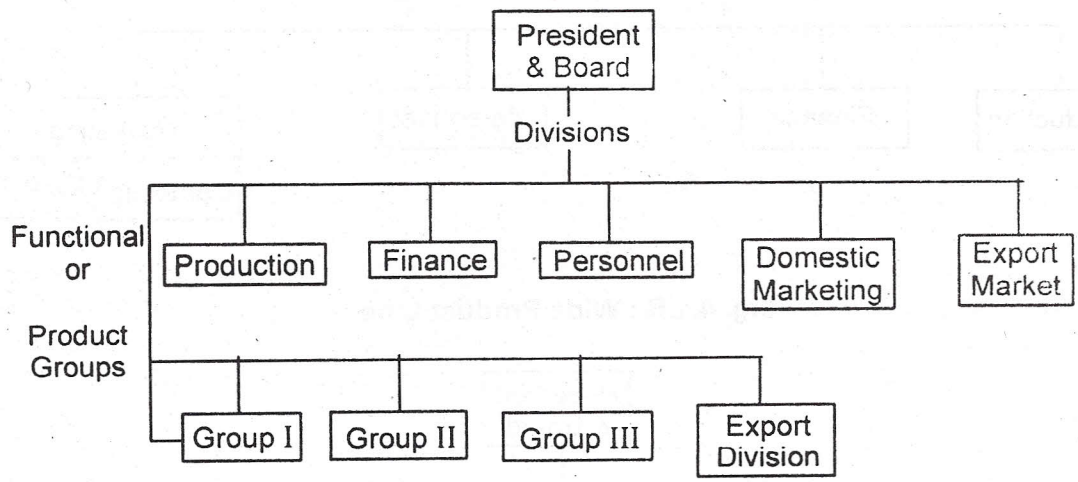
Type – A **domestic oriented** firm can either be organized on functional basis or product group basis. The former is more prevalent when the firm has a narrow product range. Most of the overseas sales occur due to unsolicited orders. As, the orders are small in relation to domestic market, the marketing department/division will look after both domestic sales and exports. (Figure 4.1 A). All sales, whether domestic and export, are looked after by the marketing manager. However, separate supervisors may be appointed to take care of domestic or export sales.

In cases where the firm has a wider product line, it might have organised on the basis of product groups. Each product group division will have all the functional departments. In such a situation, the exports from each product group may be small compared to the domestic market. In such a situation, each group handles exports separately. As exports are small, the firm does not need to move corporate resources to fully exploit the foreign markets (Figure 4.1B).

As exports start increasing in proportion to its total sales, the company may think of having a separate export department with the necessary specialists to facilitate the exploitation of foreign markets. The export effort gets centralised in the corporation and a separate is set up. This is shown in Figure 4.2. The firm may be organized on functional or on product group basis. As the export profit may be more than the domestic, the corporation tries to shift from the staff function of the export department to the line functions in its overseas activities.

Type B : Export Oriented Firm

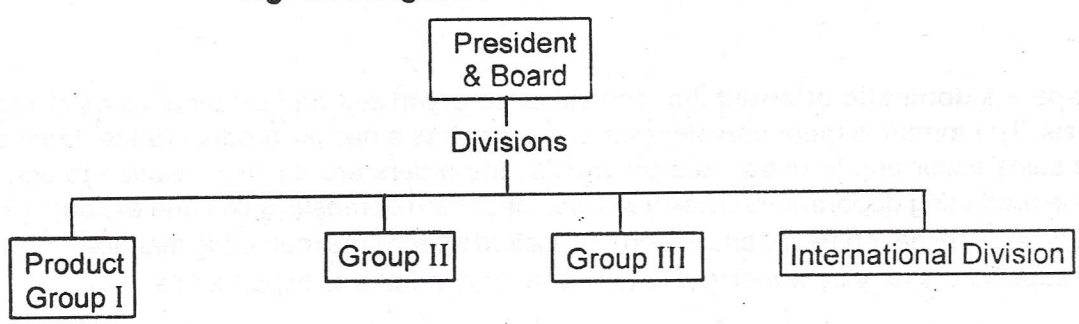
Fig. 4.2 : Organisation of Export Oriented Firm



Type-B organization creates tension when the product division is unable to meet the export orders. The firm may also realise that the exports are not necessarily the only means of entry into the foreign markets. The optimum entry may be found in some other alternatives, like licensing or direct investments. Such decisions may require a kind of search, which is free from functional or geographic bias. At that time, the firm moves to establish a full-fledged **international division** as against just an export department (see Figure 4.3).

Type C : International Oriented Firm

Fig. 4.3 : Organisation of International Firm



Subsidiaries in several companies my be set up. The international division coordinates all overseas operations (subsidiaries businesses, franchises, govt. ventures, etc.) of the company. "The subsidiaries in foreign countries are often organized by regions which report to the international division. The importance of international division lies in the fact that it provides a base of "umbrella" for the international operations of the company. The working of the subsidiaries abroad is balanced in a manner so that optimum yields are achieved. This form may help an MNE to allocate resources or make investment worldwide.

The international division type of structure may sometimes create frictions between domestic and international divisions, such as divided loyalties, completion in attracting competent operating personnel, etc. The international division, in course of time, may get isolated from other segments of the corporate headquarters. It may become an organisation in itself. Decisions may be taken which are unwholesome from the total point of view. As long as it does not depend on the corporate resources, it may tend to operate independently. The international division may enter into various contractual arrangements, including joint ventures in overseas markets.

Such an organisation is suitable under the following conditions :

- when foreign sales are relatively small to the domestic sales,
- when activities are spread over a limited number of countries,
- when product lines are few, and
- when the demand pattern is homogeneous.

Type-D structure emerges when the international operations continue to grow. The critical psychological level is reached when the international activities become equal or greater then any one of the activities of the domestic division. At this stage, strains may develop due to the size of operations and heavy flow of communications. The international division gives way to product groups which are given, concurrently, the world wide responsibility in case of wide product line companies. A world wide product based organisation is responsible for production, marketing and profitability of products throughout the world. A comparatively narrow product line company will organize itself into and have a region-wide integration e.g., North American, Latin American, Western Europe, Asia and so on. (see Figures 4A & 4B).

Type D : Multinational Firm

Figure 4.4A : Organisation : Narrow Product Line

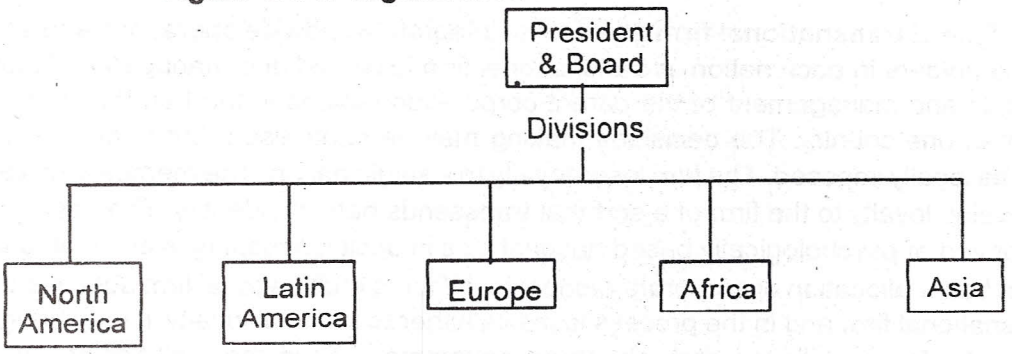
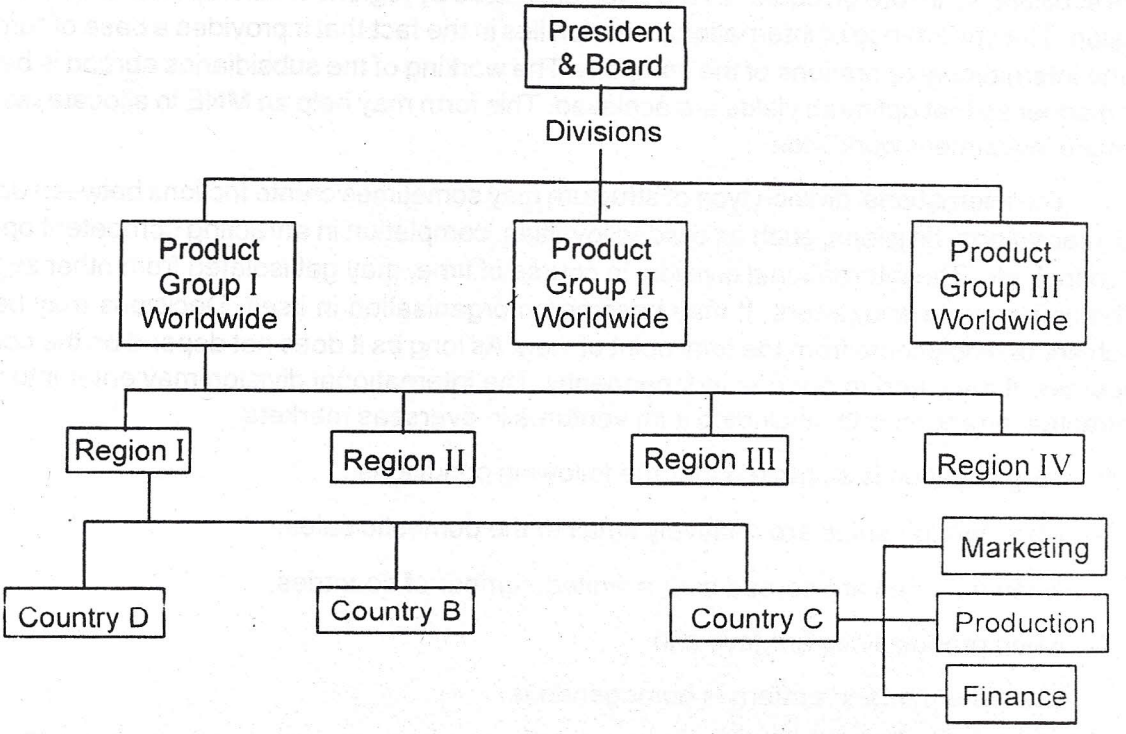


Fig . 4.4B : Organisation : Wide Product Line



The units in the countries within a region are likely to be fairly interdependent. A firm at the stage or its evolution is a multinational firm. The ownership and management of the parent corporation is essentially with the materials of one (i.e., parent) country. The firm has units/ subsidiaries in different countries but its production system is integrated internationally (i.e., centralised control of production). The centralised control is leased primarily on ownership, (i.e., equity based control. Most top corporate managers are novice-country materials. Initially all decision making in relation to subsidiaries may be centralized at the headquarters. However, as the firm grows overseas, political pressures develop to compel greater local control and newer subsidiary autonomy. It is also quite possible that as the firm gathers more environmental expertise in headquarters and perceives more clearly the advantages of greater integration, it will attempt to re-establish central control over its foreign operations.

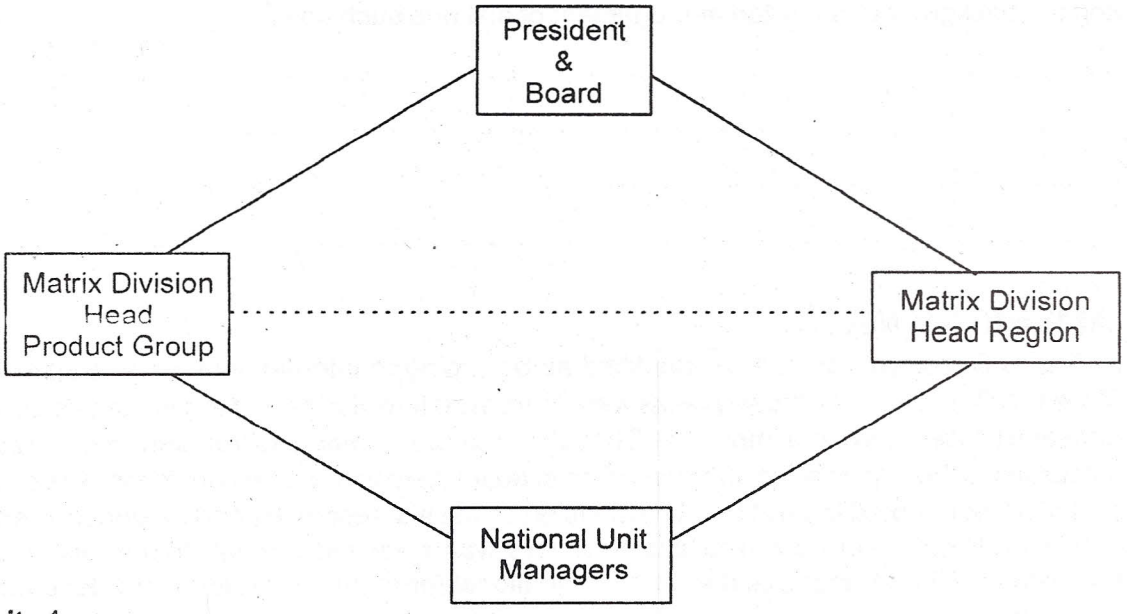
Type-E **transnational firm** attempts to integrate worldwide operations and seeks to serve the stakeholders in each nation. A transnational firm is owned and managed multinationally, i.e., ownership and management of the parent corporation resides in the haridds of the nationals of more than one country. The decisions making may be centralised, but is free of national bias, except as legally imposed. The firm loses loyalty to a single nation. The members of a transnational firm develop loyalty to the firm of a sort that transcends national identity. The national outcome is that, convert of psychologically based national bias in decision making is eliminated and this may result in better allocation of corporate resources. When a multinational firm acquires the character of transnational firm and in the process loses its hither to national loyalty, it may bring the latter to some kind of friction with its (establish) parent government. Thus, the evolution of a multinational to

a transnational firm may bring with its significant changes in its behaviour. A transnational firm may generally have a matrix structure which tries to integrate three dimensions: functional areas, product lines and regions. This provides sufficient decentralisation to national managers to meet regional needs and the needs of product lines. However, there is a centralized coordination system (Figure 4.5).

It has been observed that the traditional organisational structure (independent international division) is now changing fast into global product divisions because of the inherent competitive advantages of the latter. The benefits such as cost effectiveness, improved communication and resource transmission, and above all, a global strategic focus are the main reasons for a more worldwide organisation. Thus, an MNE goes through a series of structural changes in search of more suitable design fitting its strategy. The organizational structure keep on changing in response to the strategies adopted by an MNE.

Type E : Transnational Firm

Fig. 4.5 : Matrix Organisation



Activity 1

Identify the organisation structure adopted by the parent company of your unit (if it is a subsidiary). Draw the organisation chart and discuss the rationale behind such a structure.

.....

.....

4.3 MANAGERIAL ATTITUDES AND STRUCTURE :

Perlmutter has identified three types of attitudes in the choice or organisational structure. They are :

Ethnocentric	-	Home-oriented
Polycentric	-	Host-nation oriented
Geocentric	-	Internationally oriented

The international division or multinational product wise division tries to concentrate all concerned activities into a centralised division. Foreign units or subsidiaries are given guidance from the central office. The ethnocentric firm organises itself into product groups, and views the world as homogenous. Most of the staff are from home countries, and they could have less international experience. There might be difficulties in communications and host governments may expert pressures on the MNEs to change ethnocentric attitudes.

A polycentric organisation is based on area. Each region is treated as an independent profit centre. The regional managers control the operations in their region. It responds to local interests more effectively.

A geocentric firm integrates its worldwide operations, and uses a matrix structure. It is staffed by the best men from any nationality.

Activity 2

Identify the managerial personnel in various units of an MNE with which you are familiar, specifically drawing the background of the top management of any one such units.

.....

.....

.....

.....

4.4 AMERICAN MNEs :

The U.S. companies can be identified as belonging to international (or diversion) model (i.e., Type C of Table 4.1). As the key tasks were to transfer knowledge and expertise overseas, the structure and process became important. Though the parent companies transferred new products and processes to the subsidiaries, they were free to adapt them to the local conditions. The structure was that of a 'coordinated federation'. The decision on assets, resources and responsibilities were decentralised with control from headquarters. This was achieved through formal planning and control systems. The structure is that of a multinational form but subsidiaries are dependent on headquarters.

Studies of the U.S. Companies during the 1960s revealed that they had three types of structures; international division, area-based global structure and product-based global structure. The United States' MNEs have widely used international division type of structure with domestic orientation. However, by the end of the 1960's, many MNEs gave up the international division. This was due to the mature nature of MNEs. For instance, UNIVAC division of Sperry-Rand International Corporation abolished international division due to the difficulties they faced in transferring ideas from the domestic groups to international operations. Similar experiences led several U.S. companies to change to the area or product based global structures.

The U.S. companies had no non-U.S. members on their subsidiary boards until recent years When the U.S. companies moved towards the multinational (or international diversion) structure, regional headquarters were established. However, they faced the following problems:

- The personnel assigned had little international experience
- The psychological barriers came in the way of allocating corporate resources in the interest of global optimisation.
- Non-availability of the headquarters' personnel led to the employment of local managers.

These factors led the U.S. companies to move towards multinational structure with polycentric orientation.

It may be stated that the number of the MNEs in the United States with global product/area-based structures is still low. According to the study conducted by Hulbert and Brandt James M. Hulbert and William K. Brendt, *Managing the Multinational Subsidiary,* Holt, Rinehart & Winston NY 1980, the multinational companies with geocentric attitude accounted for one third of the companies surveyed while two thirds followed international division structure.

4.5 JAPANESE MNEs :

The Japanese pattern of multinational business is closely related to the operations of their trading companies. The organisational structure of the Japanese companies developed on the basis of the information collected by them in the process of exporting and their linkage with the major banks providing financial resources.

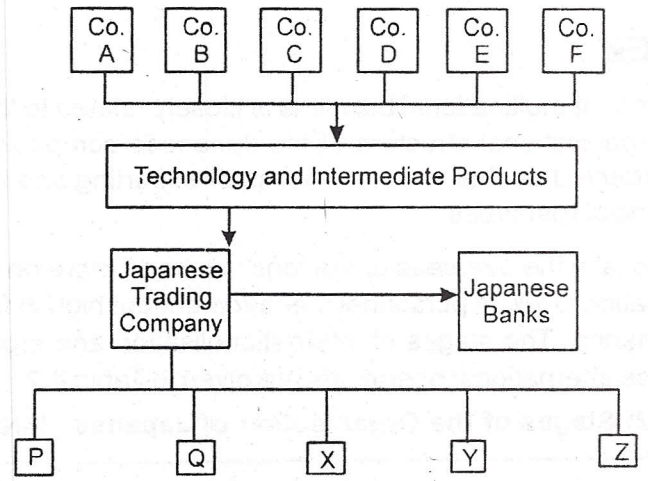
Traditionally, the focus in the overseas operations has been more on trade than business. The level of multinationalisation is low in personnel management but high in functional areas such as R&D, marketing and finance. The stages of internationalisation and organisational structure with respect to the Japanese international operations are given in Table 4.2.

Table 4.2: Stages of the Organisation of Japanese MNEs

Stages	Management Perspective	Focus	Organisation
I)	Management by HQ	Trade, Technology licensing	Export Department
II)	Delegation of Management to Operating Units	Overseas Production units coordinate all aspects	Overseas projects department/International business department
III)	Regional Coordination	Overseas business a more Central role	Full-time director for overseas projects Department
IV)	Management from a global perspective	Separate management of overseas operations	Separate operational HQ or special subsidiary
V)	Integrating global into the firm as a whole	Global Perspective both domestic and overseas operation	Re-integrated in a unified organisation

The Japanese companies are considered to be on the, global organisation, model (Stage V of Table 4.2). This model assumes centralised assets, resources and responsibilities. The overseas operations are a means to reach foreign markets to build global business. The subsidiaries have a limited role of implementing plans and policies of the headquarters. The character of the structure is like that of a 'centralised hub'. Even after opening subsidiaries in foreign countries for manufacturing, the web-like structure (see Figure 4.6) of the trading companies remained intact, reflecting their importance. The Japanese multinational trading companies have their domination on the different aspects of involvement in international business. The subsidiaries operating in foreign countries are not independent with regard to decisions on sales promotion and selection of distribution channels. They have to seek advice from their parent trading companies. The parent trading companies continue to perform search, financing and control functions. The Japanese companies do not yet permit the non-Japanese on their boards.

Fig 4.6 : Shows the scheme of Japanese trading company's multinational structure.



The Japanese MNEs have a special problem in the multinational management. The strength, which led them to become 'Kaisha', has turned to their disadvantage in dealing with personnel, legal requirements and social customs in different countries. Most of the subsidiaries are managed by the Japanese expatriates. All the basic decisions are made by the head office in Japan. The handicap is that Kaisha is based in a homogenous society, and is an integrated institution.

NEC of Japan leaves personnel matters to the local non-Japanese and tolerates differences. Fujitsu has shares in Amdahl but does not involve in the management of Amdahl. So far the Japanese companies have not considered foreigners in the management of their companies.

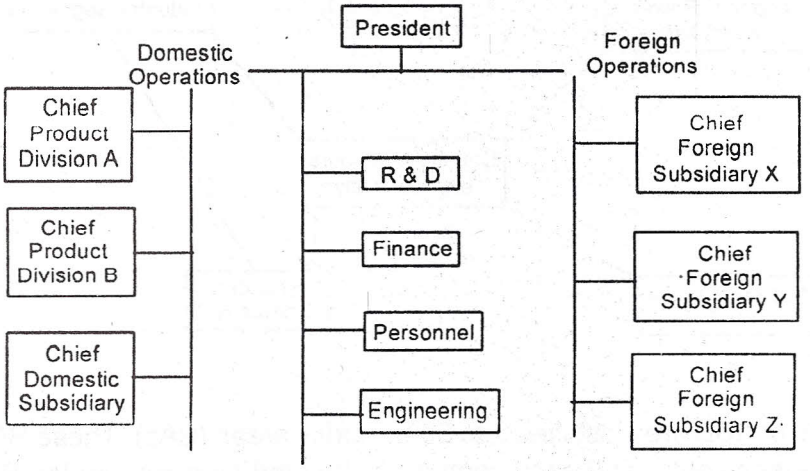
4.6 EUROPEAN MNEs :

The European international companies, at the initial stage, followed "mother daughter" form of organisation (see Figure 4.7) which involved personal and informal contacts between the parent company and the subsidiary rather than a formal system. The reason was that the subsidiaries

operating in the colonial territories administered by the home countries of the parent companies enjoyed certain competitive advantage, e.g., tariff concessions. They were given autonomy, except in the case of large scale capital investment. Every national unit was treated as an independent entity. With increasing competition in the world market, this type of organisation has gradually been replaced by divisionalised and global structures (i.e. Type D of Table 4.1) which provide for greater coordination. Hulbert and Brandt in their study of the organisational structures of United States, European and Japanese multinationals found that European companies had lately become more global oriented in contrast to the U.S. companies. Forty four per cent of the European companies used global structures. The companies operating through the international division structure, according to this study, accounted for only 17 per cent.

The European companies had in their boards nationals of the countries where they exported or manufactured. The management systems are built around a "world federation of national organisations", which are responsive to environmental changes. Most of them are both global and local in their overseas operations.

Figure 4.7 : shows Mother-Daughter International Structure



Indian Multinationals :

Indian companies, mostly, limit themselves to exporting, and thus enthrocentric in orientation. They have gone across the Indian borders mainly to avail of export incentives. A very few companies in India have moved to the international division structure. The number of companies adopting global organisational structure is insignificant.

Activity 3

Try to obtain organisation structure of on MNE each of the U.S., Europe and Japan in India. List the commonalities and differences.

.....

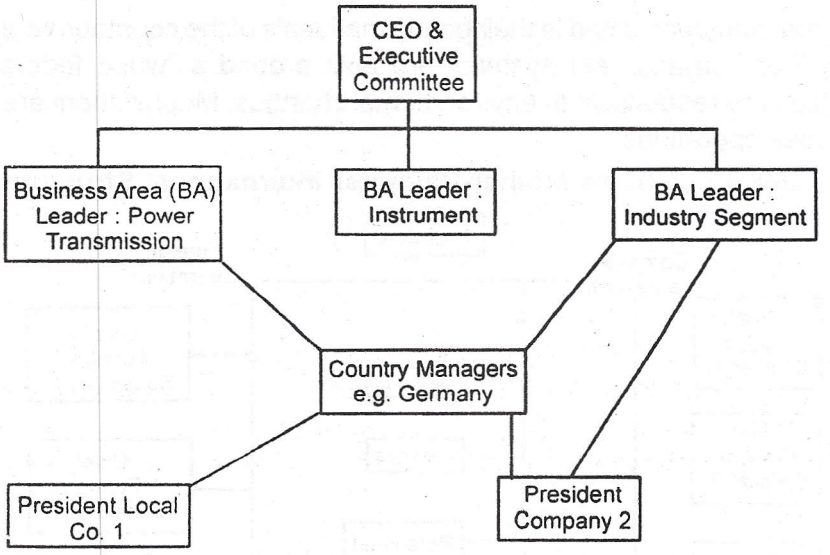
.....

.....

4.7 ORGANISATION OF ASEA BROWN BOVERI (ABB) :

We will now illustrate the matrix structure with a recent example of ABB. ABB was created in 1987 with the merger of two large European companies: Asea (established in 1890), Sweden and Brown Boveri (established in 1891), Switzerland. ABB started entering trans-Altantic by acquisition of rninority investments in 60 companies in the U.S. The major acquisitions were Combustion Engineering ($ 1.6 bn.) and Westinghouse's transmission and distribution operation in 1989. The headquarters of the Company is at Zurich. The structure of ABB is presented in Figure 4.8.

Figure 4.8: Structure of ABB



All activities of ABB are classified into 50 business areas (BAs). These BAs are combined into eight business segments, and each segment is headed by a BA leader. Each country can have any number of business areas. ABB has a total of 1,200 companies. These companies are again split into several profit centres. There are around 4500 profit centres. It encourages the starting of a new company for each business area in a country.

Top Management :

Top management consists of CEO and EC members. CEO is at headquarters. The top management consists of CEO and 13 Executive Committee members. They are responsible for the global strategy and performance. Members are composed of several nationalities like Swedes, Swiss, Germans and Americans. They are located outside Zurich. The Executive Committee meets once in 3 weeks. The meetings are held around the world.

Business Area (BA) Leaders :

The BA leaders are members of the Executive Committee. Each heads one business segment (like power transformers, instruments, industry segments, etc.), one region and some staff functions. He is responsible for global strategy of th business segment, cost and quality standards, allocation of the exports and share of experience by rotating people across borders.

For instance, the BA leader for power transmission is a Swede. The headquarters are at Mannheim, Germany. He controls 25 factories in 16 countries. Each of these units is run as an independent company. The BA leader's job is to set global strategy, and to allow each company's independence to execute (The Motto is : **Think Global, Act Local**). This enables the company to reduce throughput time, maximises design and production flexibility to meet the needs of the domestic customers.

The BA Management Board consists of the BA leaders, who are either Chairmen or Presidents of large companies in the group. It could be located in the U.S., Canada, Sweden, Norway, Germany and Brazil. Their role is to have global strategy for power transformers, review performance and resolve problems. They mess four to six times a year.

The BA staff at Mannheim consists of a few persons, who are responsible for critical activities like purchase, R & D etc. They try to coordinate the local companies. The BA leader distributes the detailed information to all the 25 companies under his group. The functional coordination is done through calling all functional managers once or twice a year to exchange details.

Another BA leader is responsible for Germany, Austria, Italy and Eastern Europe, located in Germany, with the business area responsibility of installation materials.

Country Managers :

ABB, Germany, has its own chief executive and supervisory board constituted as per the local laws (like having German bank officials and trade union representative in the board). It may have separate companies in Germany in 50 business areas. The country Managers are expected to be responsive to the local conditions in respect of all the companies of ABB in that country.

Local Presidents :

The local companies have their own presidents. A president has to report to two bosses: the BA Leader and the Country Manager (the regional line managers). That is, if there are several business area companies in a country, each company will report to its country manager and Business Area Leader. The BA leaders may be different, located at two places.

4.8 DESIGNING APPROPRIATE STRUCTURE :

There are many types of organisation structures, which an MNE can adopt in its international operations: Functional, Product-based, Area-based and Mixed structures.

The Functional Structure is appropriate for a firm producing standardised products. This is suitable during early stages of an international business, with low product or area diversification. Most of the small firm or extractive industries adopt this form of structure. The divisions are based on major tasks. This provides ease of supervision, fosters professional identity and allows specialisation. Sometimes, it may create difficulties in coordinating activities of various departments.

The Product-based Structure consists of divisions according to products or services. This simplifies coordination among functions within the division, and allows growth without loss of control. As the divisional goals are clear, both authority and accountability for decisions is with the

product division. This structure is suitable when the company has dissimilar product lines. Such structures are adopted by automobile companies, e.g., General Motors, Chrysler, etc. However, there are some disadvantages in such structures, like duplication of resources and sub-optimisation among divisions. While it encourages competition among divisions, it might reduce the specialisation of the functional skills.

Area-Based Structure means divisions according to the end-user regions. It helps in simplifying coordination among functions. Under this form, divisional goals are clear and this permits the growth without loss of control. It also allows proper authority with accountability in the division. This structure is suitable for a mature company with narrow product lines. Area-based structure is used by pharmaceuticals, food and beverage MNEs. The disadvantages are similar to the product-based structures.

The Matrix-based Structure has two dimensions, viz., product and area. It attempts to balance the two. While this structure provides resource flexibility and balance in the organisation, it results in dual reporting responsibilities: the matrix structure enables more information flows and helps control at headquarters. This is suitable for the MNEs, which are facing two equally important challenges. Many electronic companies, like General Electric and Philips, have adopted this structure. Experience indicates that this structure may be unstable, and might sometimes lead to conflicts due to the dual authority.

There might be a hybrid type of organisational structures. The hybrid type could **combine elements of two structures to minimise the disadvantages, e.g., functional**-cum-product based.

Activity 4

Approach a knowledgeable executive of a multinational subsidiary, and obtain information on the structure of the parent company. Evaluate its appropriateness

.....

.....

.....

.....

4.9 SUMMARY :

In the context of the international operations, a firm may pass through five-stage evolution. Transformation from one stage to another depends upon its involvement, commitment and other attributes. Along with the changes in structure, the managerial attitudes and personnel manning the various units may also change. Due to historical and cultural factors, they may have ehtnopoly – or geo – centric emphasis. The structural and attitudinal characteristics of the MNEs of American, Japanese and European origin were described. An illustration of ABB was given to highlight the current experiments in the structure of the MNEs. Finally, some indications were provided on choice of appropriate structure out of four basic structures, viz., Functional, Product-based, Area-based and Mixed structures.

The organisational structure of the multinationals has grown from a simple export department to the International division, having subsidiaries and joint ventures in several countries. With increasing competition in the world economy, the organisational structures of the MNEs has moved to product/area based and global matrix forms. The organisational structure of the international business has evolved in response to the strategies adopted by the MNEs in the different phases of their growth.

4.10 KEY WORDS :

International Division : A separate division is formed exclusively to look after foreign business.

Multinational Firm : A firm with units/subsidiaries in various countries, but with an internationally integrated production system. International business is divided into **region-wise or product divisions, looking after both domestic and international** operations.

Transnational : A corporation (parent company) owned and managed by the nationals of more than one country. Decisions are free of the national bias. The firm follows global strategies. The total business is integrated, and matrix structure emerges.

Matrix Organisation : Attempt to integrate functions, product-line and regions. A national unit will report to two bosses.

Ethnocentric : Management attitude and the personnel are home-country oriented.

Polycentric : Management attitude and the personnel are home-country oriented.

Geocentric : Management attitude and the personnel are internationally oriented.

4.11 SELF-ASSESSMENT QUESTIONS :

1) What types of organisation structure may usually be evolved during different stages of internationalisation?
2) Differentiate between the evolutionary pattern of MNEs originating from different countries like U.S., Japan and Europe.
3) Does the organisation design of ABB reflect the emerging pattern of MNEs ?
4) Elaborate on the appropriate design at a particular stage of development of an MNE.

4.12 FURTHER READINGS :

Bartlett, Christopher A. and Sumantra Ghoshal (1989): *Managing Across Borders,* Harvard Business School Press, Boston, Chs. 3 and 4.

Kobayashi, Noritake, (1985) : "The Patterns of Management Styles Developing in Japanese Multinationals in the 1980's" in Susurmu Takauniya & Keith Thurley (ed. 1985): *Japan's Emerging Multinationals;* University of Tokyo Press, Japan.

Negandhi, Anant R., (1987) : *International Management,* Prentice-Hall, New Delhi, Ch.3, pp. 99-125.

Robinson, Richard D., (1978) : *International Business Management* (II ed.), The Dryden Press, Illinois, Ch. 8.

Taylor, William, (1991) : "The Logic of Global Business : An Interview with ABB's Percy Barnevik," HBR, March-April, pp. 90-105.

UNIT - 5 STRATEGIC PLANNING IN MNEs

Objectives :

After reading this unit, you should be able to:

- identify planning needs and focus,
- understand the planning modes adopted and longitudinal changes within MNEs,
- understand the subsidiary development path and its role in MNE planning,
- identify the general pitfalls in planning, and
- understand and appreciate the environmental scanning and modes used.

Structure :

5.1 Introduction

5.2 Type of MNEs

5.3 Planning Needs

5.4 Planning Focus

5.5 Planning modes

5.6 MNEs Planning in Practice

5.7 Subsidiary Development Path

5.8 Pitfalls in Planning

5.9 Environmental Volatality

5.10 Environmental Scanning

5.11 Scanning Mode

5.12 Comparability

5.13 Summary

5.14 Key Words

5.15 Self-Assessment Questions

5.16 Further Readings

Appendix: Hoechst (An Illustrative Case)

5.1 INTRODUCTION :

Strategic planning is an important tool used by the MNEs for meeting their strategic objectives, viz, expansion, etc. The planning concept changes with the change in the stage of development of an MNE. The focus accordingly, may, change from purely financial planning to strategic planning. The planning process depends on various factors. There are some differences in the planning pattern of the MNEs of different country origins. However, one can identify the kind of relationship that exists between the parent company and subsidiaries in so far as planning is concerned. In spite of instituting a formal planning process, many MNEs are prone to pitfalls.

One of the major concerns in strategic planning is environmental volatility. Different industries are affected by different factors with varying intensity. This necessitates an MNE to identify the scope of environment scanning and the appropriate mode of collection of information.

5.2 TYPE OF MNEs :

Most of the MNEs are multi-plant firms. The MNEs try to make full use of (special) 'firm-specific advantages' which are usually intangible, viz, technology know-how, management and marketing skills. They create an "internal" market by establishing property rights over their specific advantages. The firm specific advantages help them in offsetting additional costs and risks which are associated with foreign operations. You will appreciate that a multi-national firm, compared to a local firm, incurs certain inherent disadvantages which arise due to natural market imperfections or uncertainities. It has to incur additional costs (i.e., transaction costs to obtain or collect information about overseas markets) and risks from cross-cultural operations. The MNEs attempt to minimise transaction costs by the process of internalisation i.e., by setting up their offices or units or by transferring their own people abroad. In this way they try to extend their own direct operations rather than simply use the external market. Many intermediate product markets, particularly for types of knowledge and expertise embodied in patents and human capital, are difficult to organise and costly to use. In such cases the firm has an incentive to create internal markets whenever transaction can be carried out more efficiently within the firm than through external markets.

The creation of an internal market permits the firm to transform an intangible piece of research into a valuable property specific to the firm. The firm can exploit its advantage in all available markets and still keep the use of the information internal to the firm in order to recoup its internal expenditure on research and knowledge generation.

The internalization process may result in three types of the MNEs viz, horizontally integrated MNEs, vertically integrated MNEs and diversified MNEs.

The horizontally intergrated MNEs have firm specific advantages in technological knowhow, management skills and marketing knowhow. Such an MNE tries to maintain and utilize its unique advantages as a competent edge over other MNEs in the global markets. Most of these MNEs exploit their firm specific advantages and overcome the market imperfection such as buyer or market uncertainities through internalization. Such MNEs expand horizontally. This kind of phenomenon observed in pharmaceutical industries. The second type of the MNEs are vertically integrated, examples of these can be found in oil and mineral industries. Firms in these industries try to establish control and minimize transaction costs. For example in the oil industry, an MNE

may try to integrate from extraction to transportation to refining and distribution of oil. This creates internal marker within the MNEs.

The third type of the MNEs are those which are diversified into different products. The advantages to the MNEs arise from utilizing the market imperfections in terms of information cost and government regulations in different countries, reducing its cost of information and search cost (Rugman et. al., 1986).

Activity 1

Name and describe any one MNE with which you are acquainted. Identify in what category this company falls.

.....

.....

.....

5.3 PLANNING NEEDS :

The planning needs of the MNEs may differ among different types of companies. One can differentiate on the basis of two criteria stages of growth on the basis of products, and management style (whether it is broad or narrow in scope). Leontiades (1977) has identified three stages in the growth-evolution or organisation structure and strategy, which are presented in Table 5.1:

Table 5.1
Evolution of Structure and Strategy

Stage	Structure	Strategy
I	Functional	Single product line
II	Product	Related product line
III	Divisional	Unrelated product line

The emphasis under these stages may vary, it may be either narrow of broad in scope for the corporate planning. One can classify Polaroid company being at stage I and narrow in scope Proctor and Gamble has diversified from its basic soap and detergents into related consumer goods. Thus, it can be said that the company has moved to stage II from narrow to broad category. Colgate Palmolive, which is very diversified and has a broad management style, is at stage III. Depending upon the company's emphasis, narrow or broad, different kinds of planning approaches are required. If one takes a narrow scope management under different stages, the traditional planning model may be alright at stage 1. The emphasis will be on functional planning. The planning is budget oriented. In stage II, when-an MNE diversifies into more than one product, a specialist in staff functions is required in the planning process. In stage III the specialist will dominate in the planning process of diversification. In contrast to this, in broad scope management there will be an additional role for "Generalist style" in all the stages of development. The main, difference between the narrow and broad scope planning is the receptivity to change. The latter accepts the high risk in diversification and associated activities.

The location of an MNE on the planning matrix prepared on the basis of the Stage and Degree of Diversification will determine the type of corporate planning needs. Accordingly, the planners with appropriate training and orientation have to be assigned the task in the corporate planning function. The mismatch may result in either 'over-killing' by creating a new planning department or in lack of creative planning due to a traditionalist being appointed when actually a specialist is required.

5.4 PLANNING FOCUS :

Planning focus can be analysed in terms of types, time horizon and formality. The basic orientation of the MNEs can be classified into three groups, viz, strategy business unit programming and operations planning. Strategic planning involves overall missions, objectives, goals and policies. It identifies strengths and weaknesses of the company vis-à-vis macro-environment and the time horizon is 5-10 years. Business unit planning unit programming deals with selected strategic business units. It may include market selection, product planning, and marketing strategies. The time horizon is 1-3 years. The operations planning is mainly concerned with short term operational activities. Depending on the organisational set up and the nature of planning, one can classify planning focus into four phases of planning evolution:

Table 5.2 : Planning Evolution

Phase	Objective	Plan orientation	Plan Attribute
1)	Meet budget	Financial planning	Annual budgets, Functional focus
2)	Predict future	Forecast based planning	Multi year budgets
3)	Think strategically	Externally oriented planning	Thorough situation analysis and competitive assessment
4)	Create future	Strategic Management	Well-defined Strategic framework strategically focused organisation. supportive value system and climate.

Adapted from : Gluck, Kaufman and Walleck, Phases in the Evolution of Strategic Decision Marking, Journal of Business Strategy, Winter 1982, Vol. 2, No. 3.

Activity 2

Describe the orientation and objectives of planning in your organisation.

.....

5.5 PLANNING MODES :

One way to view strategic planning process is to look at the structure relationship in a large organisation between the user and the planner.

Corporations have tried various ways to tackle the issue of agency in a complex organisation. They have attempted structural or cultural solutions as control mechanisms. The structural solutions have resulted in multi-divisional structure in a large and diverse corporation. Here, an attempt is made to divide the corporation into manageable units and assigning responsibility and accountability to each unit. The cultural solution assumes shared values and goals. The corporation tries to grow on a set of 'core skills', and invest heavily in socializing the members.

The principles are those who receive, review and approve plans, monitor and reward the performance. The agents are those who prepare, propose and implement plans and manage the business.

In a large organisation, normally those managers who prepare plans will know more than the managers who have the authority to revise or approve.

Due to their superior information, the former, who are a sort of agents, can avoid or defeat control by the latter. There are two dimensions in this agency relationship between the principals and those who prepare plans: Shared Values and skills and experience, and Information Asymmetry. Based on this thinking Allaire and Firsirotu (1990) have classified five planning modes as shown in Table 5.3

Table 5.3 : Planning Modes

Modes	Agents Advantage	Shared Values
Leader driven planning	L	H
Culture driven planning	H	H
Line driven planning	M	M
Number driven planning	H	L
Staff driven planning	L	L

L = Low M = Medium H = High

Most of the companies which depend on the leader-founder have in fact, one-system corporation. There is one-game business e.g., Wall-Mart, Federal Express, etc. Whenever the leader-founder is replaced by a professional manager(s), the company may move either to culture driven or line driven management. The culture driven planning is mostly observed when the product and geographically diverse requirements have a major centre of gravity in terms of goals, skills and values of the company. IBM has a single centre of gravity under worldwide design, manufacturing and marketing computer systems. Similarly, 3M regards itself in bonding and coating packages,

Proctor and Gamble in market development and distribution of consumer packages. These companies have created a culture driven planning, and their plans are simple and action oriented. All this has created a functional culture supported by tangible means of promotion and reward systems. Here, culture predominates over plans or budgets.

In **line-driven planning**, as there may be diversity in the social context and in the geographic diversification of the MNEs, attempts to specify some key requirements such as legitimacy and credibility of numbers, relative information plans between agents and principles, small set of corporate values and unifying themes. An example is Philip Morris who have leadership in product innovation and quality. The incentive systems has to be adaptive and flexible. This type of planning depends on line managers for both strategic thinking and implementation.

Number-driven Planning: When the MNEs diversify into different fields, both product and geographically issued control through the planning process becomes long and detailed. The management tries to control the different activities of its subsidiaries through numbers. The number-driven planning is based on two premises; belief in market control and control by incentives. Strategic business units (SBUs) are set up, and their performance is monitored through quantitative indicators, such as market share, ROI and cash flows. In some concentrated industries, there could be a lagged response from the market. This happened to Pratt and Whitney when they lost to GE in the jet engine business. The Japan Airlines was unhappy with Pratt and Whitney regarding their service, and changed with a long time-lag.

Finally, the Staff-driven planning normally means top-down planning with corporate planners playing an active role. A great deal of information is accumulated to control and catch the line people. The line personnel start thinking that their fate depends on their ability to control pressure from the headquarters. This results in a cat and mouse chase between the staff planners and the line managers. Though a corporation may have a fancy for planning with scenarios, the actual events may bring many surprises.

Out of these five, the first three have been found to be functionally successful in large corporations, while the other two may be found to be dysfunctional.

AN ILLUSTRATION: General Electric (GE)

From Table 5.4, it will be seen that the dynamics of strategic planning at GE have been changing.

Table 5.4 : Strategic Planning at GE

Year	Modes of Planning	Details
1950 and 1960	Culture drive planning	Growth in diversity of business competed in 23 out of 26 two-digit SIC
1970	Number-driven planning	Portfolio planning (1970) Elaborate data bank basis of PIMS 43 SBU
1977	Staff- driven planning	6 Sector executives (1977)
1981	Line- driven planning	Reduction of corporate staff and number of SBUS Emphasis on general values sector executives as chief operating officers

GE has changing its planning modes. Until the 1960s, it was operating on the basis of culture driven planning. By 1968, it had diversified into different industries. It began to move towards number-driven planning. In the early 70s, professional planning was adopted, and 43 strategic business units were defined. Then it started moving towards staff driven planning. In 1981, when Welsh took over as CEO, he tried to push it to line-driven planning, reducing the planning staff and hierarchy. It also reduced SBUs.

Activity 3

Identify the mode of planning adopted by the organization with which you are associated. Describe if any change has taken place in the recent past.

.....

.....

.....

.....

5.6 MNEs PLANNING IN PRACTICE :

Because of the nature of growth and the complexity involved in the multinational operations strategic planning has become almost inevitable. Several studies reveal that there has been tendency on the part of more and more MNEs, after 1970s, to resort to strategic planning. Table 5.5, based on some research studies, gives a comparative view of long range planning adopted by American, German and Japanese companies. Though the sample size is limited to a few MNEs and their various subsidiaries, it indicates that both American and German companies have a strategic planning of 3-5 years at the headquarters. It was found that only 72 percent of the Japanese companies have yearly resorted to strategic planning. Other Japanese companies or ad hoc planning by the headquarters. The strategic planning of 3-5 years for subsidiaries is more prevalent in the American companies than in the German and Japanese. While German companies mostly emphasise mostly on yearly operational planning, Japanese companies adopt both yearly and ad hoc planning of subsidiaries.

Of the same sample, the nature of subsidiary involvement in strategic planning is given in Table 5.6. The table indicates the nature of communication between the headquarters and subsidiaries. Communication is more frequent and more prevalent among the American the MNEs than the German or Japanese. German and Japanese subsidiaries adopt ad hoc informal communication in the planning process. In terms of the extent of information exchange, the majority of communication in all the three countries consists of one way communication from the headquarters to the subsidiaries. This indicates that the MNEs from all the three countries, i.e., the US, Germany and Japan use strategic long-range planning and environmental scanning for the integration and coordination of their global activities. As such, communications are very much headquarters-oriented. The subsidiaries have a marginal role in determining the goals are target-setting of their operations.

Table 5.5 : Long Range Planning

		American	German	Japanese
Sample size:	HQ.	9	7	14
	Sub.	24	43	22
Planning Headquarters				
3-5 years		100	100	72
Yearly		—	—	14
Ad hoc		—	—	14
Subsidiaries				
3-5 years		46	33	18
Yearly		16	63	46
Ad hoc		38	4	36

Source: Negandhi, 1987, p. 233.

Table 5.6: Subsidiary Involvement

	American	German	Japanese
1) Nature of Communication			
Formal	81	54	50
Ad hoc	19	46	50
2) Information exchange			
Extensive	42	33	34
One-way from HQ	58	67	66

Source: Negandhi, 1987, p. 234.

Activity 4

Meet an executive of the subsidiary of an MNE, and discuss with him the nature of strategic planning adopted by the parent company, and the extent of involvement of the subsidiary in the process.

.....

.....

5.7 SUBSIDIARY DEVELOPMENT PATH :

The strategic planning at subsidiary level helps the MNEs to localise the global strategy according to the local market conditions. Here, one has to differentiate between the subsidiary operating as an autonomous functioning unit and a mere branch with no autonomy. The latter more or less is a foreign affiliate, and is meant to work as a public relations office (may be to appease local government). It will be a 'paper subsidiary'. If it is an autonomous business entity, it would act to localise the global strategy of its parent company. Strategic planning process would try to provide a forum for the development of subsidiaries consistent with the company's global mission, objectives

and culture. It will build up the confidence of the local management and also help them in aligning their plans, goals and activities for the common viable purpose.

Localisation of Global Strategy :

Many MNEs have attempted to adapt to differences in market segments. This has been done by Microsoft Corporation, which allows its European subsidiaries to develop their own strategy to meet the local needs. Similarly, Digital Equipment has started its own subsidiary centre in Europe, primarily to serve the European market. This may maximise the subsidiaries, added value. The firm looks after the subsidiary, and its plans are designed to complement and global strategy. The subsidiary's added value is planned to increase in several functional areas.

Growth and Development of the subsidiaries :

The growth of the subsidiary can be measured in terms of the sales volume, asset volume of number of the employees. The growth of a subsidiary, can be classified into three stages. The relationship of the subsidiary with the parent company would depend upon the stage at which the subsidiary finds itself. In other words the relationship would correspond to the stage of growth. Table 5.7 summarises the three growth stages and the corresponding subsidiary culture. In the initial stages subsidiary is concerned with the product and sales of the products. As it grows in the market, it may develop the mentality to act as a branch to the MNE. Once this happens, there is the likelihood of the subsidiary becoming a self-contained business where planning, control and management become integral parts of the subsidiary.

The subsidiary's dependence on the parent company may diminish.

Table 5.7: Subsidiary Development Path

	Growth Stage	Subsidiary culture
-	Childhood	Product and sales mentality
-	Adolescence	Branch mentality
-	Adulthood	Self-contained business mentality

In the initial stages the planning effort is that of top-down from the headquarters to the subsidiaries. As the subsidiary matures, it increases its autonomy in planning its future business. This was the basis of the Digital European Headquarters in Geneva where it has been decentralised since early 1980s. Involving the subsidiaries in strategic planning by the headquarters increases the confidence of the subsidiary managers in the overall global strategy. Proctor and Gamble have started using this approach in recent years. Similarly, Colgate has created a global market. The parent company is involved more in giving the direction, setting global vision, and allocating the company's resources and capabilities, while encouraging entrepreneurship among its foreign subsidiaries. Finally, strategic planning also gives the subsidiary the means to integrate its plan with corporate plans and goals to accomplish its purpose.

Activity 5

Meet the executive of a multinational subsidiary. Discuss with him to identify its culture and position in the stage of development.

.....

.....

5.8 PITFALLS IN PLANNING :

Earlier, it was pointed out that strategic planning is being increasingly adopted by the MNEs. However, some of the surveys have revealed the pitfalls of the planning process of the MNEs. Steiner and Schollhammer (1975), in their Cross Country MNEs study, have stated some critical pitfalls in planning (as identified by the respondents). The author's survey included the US, European and Japanese companies. They have classified 50 reasons into four categories of pitfalls as follows:

a) Pitfalls in getting started.

b) Pitfalls related to misunderstanding of the nature of long range planning

c) Pitfalls in doing long-range planning

   i) Managerial involvement

   ii) Process of planning,

   iii) Credibility of result, and

d) Pitfalls in using long range plans

At each stage of the process, there are several pitfalls in multinational long range planning. Ranking of the 10 pitfalls is given in Table 5.8. These are the ones that most of the executives felt they should avoid. There are some pitfalls, which are considered less important depending on whether the company can easily avoid, or whether they have a limited negative impact on the effectiveness. Such pitfalls relate to assumptions about planning that it is hard or easy, or that techniques are not useful. These pitfalls can be easily overcome. According to the survey, the major pitfall is that "top management becomes so engrossed in **current problems** that it spends insufficient time on long range planning, and the process becomes discredited among the managers and staff. "This may have the greatest negative impact on planning effectiveness. The other reasons in the decreasing importance are given in the aforesaid Table.

Table 5.8 : Ten important Pitfalls in Planning

Range order	Pitfalls
1)	Engrossed in current problems
2)	Delegation in a planner
3)	Developing suitable company goals
4)	Climate (resistant to planning)
5)	Lack of **Involvement**
6)	Assuming planning as **separate** from the management process
7)	Not using **plans as standards for performance.**
8)	Failure to **review by top management** with other levels.
9)	Failure to locate the planner in the **hierarchy**
10)	Failure to **understand** the nature of planning by the top management

Source: Steiner and Schollhammer, 1975

Activity 6

Examine thoroughly the strategic planning precepts and process in your organisation. What do you think are the pitfalls? How could they be avoided?

.....

.....

5.9 ENVIRONMENTAL VOLATILITY :

The MNEs, by their very nature, have to globalise their strategic approach. The globalisation exposes the business to more risks than the domestic operations. Though the global operations give the MNEs flexibility in their operations, the advantages may be short run or may disappear, depending upon how an MNE tackles the environment. As you might be aware, there have been major changes in the environmental; some of these are given in Table 5.9.

The MNEs have to walk on a tightrope between the home and host countries, demands. The factors, for which political pressure may be brought to bear include employment, technology and exports. Both only want to encourage more employment in their respective countries. Once the MNEs establish overseas manufacturing facilities, they might be able to meet the host country demands with regard to employment etc, but may lose competitiveness in the home country due to the 'hollowing effect' i.e., the loss of creative aspects in changing or shifting the production process as this might, in turn, change the country's trade pattern.

The earlier economic logic of looking for low wage countries for production is losing its relevance due to:

- the reducing proportion of direct labour cost in the total cost
- the relative cost advantage becoming marginal, and
- the improvement in productivity as a result of restructuring of the manufacturing systems.

Table 5.9 : Environmental Trends

Environmental Drives	Demands	
	Host	**Home**
Political Factors	Employment Technology Acquisition Exports	Employment Hollowing Effect Trade Patterns
Economic Issues	Labour Use Exchange Rates Industrial Policy	Labour Content Restructuring Productivity
Social Demands	Freedom	Control
Technology Imperatives	Market Access	New Manufacturing Material Science
Competitive Dimensions	Convergence	Divergence

Source: Barrie James (1990).

The social pressues are mounting in different countries as living standards improve. Besides, a new act of manufacturing techniques like CAD (Computer Aided Design), CAF(Computer Assisted Engineering), FMS (Flexible Manufacturing Systems), CIM (Computer Integrated Manufacturing), and Robotics are available now. These developments have reduced the product cost, and increased flexibility in production runs. All these factors create conflicting demands by both host and home countries for the MNEs.

There are divergent pulls of competitive dimensions: one is towards standardisation of products (homogenous products) to meet the needs around the world; and the other is the move towards finer customer segmentation due to different countries being at different stages of development, and also due to different customer preferences.

The MNEs try to minimise these environmental risks either through restructuring of their business or/and through migration.

5.10 ENVIRONMENTAL SCANNING :

The MNEs normally, before entry, try to obtain all the needed information about the market potential and competition in different countries. Once an MNE has established its operations, the information required would broaden. The process of information acquisition is referred to as scanning. Keagan (1982) has identified four major categories of information. These are:

- Market information
- Prescriptive information,
- Resource information, and
- General information.

The market information deals with marketing mix factors, competitive products nature of competitive operations and investments. The prescriptive information is about regulations relating both to the home and the host country, with regard to foreign exchange, taxes, incentives and any other regulations affecting the company. The resource information is mostly about various resources, other regulations affecting the company e.g., manpower, money, raw materials, potential acquisitions and mergers, joint ventures, and any regulations in this respect. General information relates to macro level information. This would cover both economic, social, political, scientific and management practises in different countries.

Activity 7

Describe the characteristics of environment scanning for which information has to be regularly collected.

.....

.....

.....

.....

5.11 SCANNING MODE :

Once the type of information needed is identified by the MNE, there will be a systematic scanning of information. There are two modes of scanning, surveillance and search. In surveillance, information is collected on the basis of whatever crosses the scanning field. In search, there is a deliberate information search. The surveillance orientation can either be just viewing for general exposure or focussed attention. The latter means monitoring well defined external information. In seach orientation, it can be either investigation or research. Investigation has limited scope, and consists of mostly informal attempts to seek specific information. The research is a formal approach to acquire specific information. Most of the MNEs resort in monitoring of surveillance and investigation by search.

5.12 COMPARABILITY :

A number of problems may be encountered regarding the comparability of international statistics. A standard data gathering technique, may be based on several assumptions. However, these assumptions may have different interpretations in different countries. For example, the TV in Germany is treated as recreation and entertainment, but in the U.S. it is a household equipment. Similarly, the definition of youth and age classification may have a different meaning in different countries.

Activity 8

Discuss with the executive of an MNE subsidiary about the scanning mode adopted by it. Ascertain how the parent company makes the data/information comparable?

.....

.....

.....

.....

5.13 SUMMARY :

The firm's specific advantages largely determine the strategy of an MNE. There are three stages in the growth of the organisational structure and strategies of the MNEs. The growth stage, in turn, determines the planning needs as to whether a specialist or a generalist would be required. The time horizon of strategic planning can vary from one year to ten years. The modes of planning can vary from 'leader driven' to 'staff driven'. Some modes of planning may be more appropriate or successful such as leader - driven, culture - driven and time-driven planning. The other modes like number. Driven and staff-driven planning may often be found to be dysfunctional. This fact was highlighted by the illustration of the G.E. planning modes. The role of the subsidiary in the overall corporate planning may change from simple sales mentality to self-contained business mentality, depeding upon its stage of growth and maturity. Despite strategic planning being in existence for a number of years now, the planning processes, in many companies, may suffer from some common pitfalls, such as overriding importance being given to current problems.

Planning involves a good assessment of environmental trends. Many companies have introduced environmental scanning systems to collect and analyse the data.

5.14 KEY WORDS :

Planning Needs : Identifying the purpose and appropriate staff to do the planning

Planning Modes : Modes for initiation of planning activity in the company

Localisation : Adapting to local environment

Volatility : Rapid changes in the environment which may affect the operations of a Company

Scanning : Acquisition of relevant information

Scanning Mode : The method utilised for gathering information.

5.15 SELF-ASSESSMENT QUESTIONS :

1) Which are the evolutionary changes in the MNE strategy and structure?
2) What is planning evolution? Illustrate with a case.
3) How does nationality of an MNE affect its planning?
4) What are the development paths for a subsidiary vis-a-vis the parent company?
5) What are the major pitfalls of planning?
6) How does one identify the environmental volatility for a given company?
7) Describe the variables for the environmental scanning and the corresponding modes of scanning.

5.16 FURTHER READINGS :

Allaire, Yran and Michaela Firsirotu (1990), "Strategic Plans as Contracts," *Long Range Planning,* Vol. 23, No. 1, pp. 102-115.

Barrie, James (1990), "Reducing the Risks of Globalization" *Long Range Planning,* Vol.23, No. 1, pp. 1980-88.

Keegan, Warren J. (1982): *Multinational Marketing Management* (II ed.) Prentice-Hall of India, New Delhi, Ch.8.

Kennedy, Carol (1990); "Hoechst: Re-positioning for a Global Market," *Long Range Planning,* Vol. 23, No. 3, pp, 16-22.

Leontiades, Milton (1977); "What Kind of Corporate Planner Do you Need," *Long Range Planning,* Vol. 10, No. 2, pp. 56-64.

Negandhi, Anand R. (1988): *International Management,* Prentice-Hall of India, New Delhi Ch.6.

Rugman, Alan M., Lecraw, Donald J. and Lawrence D. Booth (1986): *Internation Business: Firm and Environment,* McGraw-Hill Book Co., Singapore.

Sargetn, Lee w. (1990): "Strategic Planning in a Subsidiary"; *Long Range Planning,* Vol. 23, No.1, pp. 43-54.

Serizawa, Yoshio (1989):"Planning for Growth in a Japanese Business," *Long Range Planning* Vol. 22, No. 2, pp. 20-26.

Steiner, George A, and Hans Schollhammer (1975): "Pitfalls in Multi-National Long-Range Planning," *Long Range Planning,* Vol. 8, No. 2, pp. 2-12,

Appendix: HOECHST (An Illustrative Case)

Hoechst started, in 1863, as a small dyestuffs factory, and steadily expanded. During the inter-war period it became a part of the IG Farben Industries along with Bayer, BASF and Afga. After World War II, it was reconstituted to its original shape. The Hoechst group has the highest profit in 1988 (in its over 100 years history). It reported DM 2 billion post-tax profit on its sales of DM 41 bn. The group has 454 companies, "world-wide, the region-wise distribution of market share and revenue earned (1988) is given in Table 5.10.

Table 5.10: Hoechst in World Chemical Market

Region	Market Share %	Revenue Earned %	Production %
West Germany	8	24	48
EEC Excluding West Germany	20	26	15
Rest of Europe	19	9	3
Africa, Asia, Oceania	24	14	7
Latin America	6	5	4
North America	23	22	23

Source: C. Kennedy (1990) p. 20.

Hoechst has 60:40 ratio of specialities in commodities. In agro-chemical products the composition in 1975 was fertilisers (42%), plant protection (46%) and animal health products (12%). During 1989, it announced to phase out fertiliser production and concentrate on the other two. With this, it gave a new corporate slogan 'Hoechst High Chem' (Hoechst means Highest in German)

During the 1980s, it went for acquisition and divesture. The biggest acquisition was the Celanese in 1987 for $2.8 bn. The Federal Trade Commission of the U.S. forced Hoechst to divest the American company's $320 m. polyster business. It first divested, in 1980, its monostyrene and polystyrene business in the U.S. and a further sale of loss-making units in plastics, refineries and fertilisers. It is now trying to concentrate on specialities.

Hoechst was not permitted to have genetic engineering in Germany, which forced it to cancel its pilot plant for human insulin. It is also phasing out its production of fully halogeneated

chlorofluro carbons (CFC) world-wide by 1995. The group spends about 20% of its R&D costs on environmental research.

The Hoechst restructured itself during the 1980's, and strengthened its corporate planning function by making it report directly to the Board. The head of the planning department attends the fortnightly meetings of the Board as a non-Board member.

The planning system has three main layers (Table 5.11). The first layer is the strategic planning of goal setting for a 10 year time horizon. The operational planning, the second layer, is on a rolling basis of four years. The third layer is a control system to monitor the progress of the operational planning.

Table 5.11: Planning System

Duration	Plan	Activities
10 year	Strategic Planning	Goal Setting
2-4 year	Operational Planning	Medium-term Plan and Actions Required
1 year	One-year Plan	Comparison of Plan and Action
Quarterly	Action Plan	Early Results

The strategic planning covers products or activities and regions. It has four phases as shown in Table 5.12.

Table 5.12: Four Phases of Strategic Planning

Phases		Activity
1) Survey of Basic Data	—	Organising the Project
2) Analysis of Critical Issues	—	Environment Trends
	—	Industrial Trends and Competition
	—	Critical Success Factors
	—	Market interviews
3) Strategy Development	—	Development of Strategic Options
	—	Selection and Evaluation of Alternatives
	—	Formulation of Strategy
4) Implementation	—	Making a Time Table
	—	Defining the Milestones
	—	Action Planning
	—	Incorporation into the Budget

Hoechst adopted a 'workshop' system for decisions. A workshop comprises teams from the divisions and one or two members from the corporate planning department. The planning staff only provides the Hoechst-wide view. The final decisions are taken by the divisional members. Who and where depends on the level of competence. There are three main workshops in the planning process: 1 for diagnosis, 2 for developing strategic options and 3 to decide on measures to implement the chosen strategy. This may take a year to work through. The large product groups, like pharmaceuticals are divided into sub-product groups to evolve the strategic plan.

The operational planning is evaluated for every product group (Hoechst has 350 product groups) on the basis of the turnover and profit level forecasts.

Hoechst introduced the concept of 'business units'. This came into operation world-wide, since 1991. Under this concept all functions necessary for a business are combined under one person, who reports to divisional management. This concept first seemed to have a negative effect on the pharmaceuticals division. But this was due more to the German Government policy decision to switch from the branded to generic drugs. However, this led to rethinking and restructuring of the pharmaceutical division into five business units. By, 1991, this might extend to 100 units, world-wide, including all products.

UNIT – 6 STRATEGIC CONSIDERATIONS

Objectives

After reading this unit, you should be able to:

- Understand the basis of ownership strategies adopted by MNEs,
- Identify the critical factors when the MNEs go for strategic alliances,
- Understand various methods adopted by the MNEs to integrate subsidiaries' role,
- Appreciate the multi-dimensional nature of the MNE management,
- Understand the various tasks confronting the MNEs and how they resolve them.

Structure

6.1 Introduction
6.2 Ownership Strategy
6.3 Choice of Strategy
6.4 Strategic Alliances
6.5 Integration and Responsiveness
6.6 Managing a Multifocal Strategy
6.7 Building New Perspectives
6.8 Maintaining a Dynamic Balance
6.9 Flexible Coordination
6.10 Commitment
6.11 Summary
6.12 Keywords
6.13 Self-assessment Questions
6.14 Further Readings

6.1 INTRODUCTION

There are various entry strategies available to an MNE in its international operations. The central issue is ownership of its subsidiaries. This may vary, depending on both internal and external factors. Sometimes the MNEs enter into strategic alliances to take advantage of their market access and the R&D capabilities. Once the decision to enter a foreign market, for instance, by setting up the subsidiaries is made, the next question is to integrate the activities of the subsidiaries to the overall operations. There are different roles played by the MNEs and subsidiaries.

The MNEs have faced many barriers while managing in a diverse environment. Developing new perspectives and maintaining a dynamic balance become important. A flexible coordination is required. The MNEs of different nationalities have evolved their own distinct characteristics, and are using different tools to build understanding, identification and commitment of individual managers to the overall corporate goals. In the previous units of this block we discussed the structural forms and issues relating to strategic planning in a multinational enterprise. In this unit, we shall focus on some aspects of strategic management in a multinational organization. We shall also consider integration and responsiveness, and the crucial question of maintaining a dynamic balance within the organization.

6.2 OWNERSHIP STRATEGY

There is a continuous debate regarding the relative advantages of the MNEs having 100% ownership subsidiaries vs. joint ventures vs. contracting. MNEs usually have the synergistic advantages from an integrated operation system. These advantages arise from operating on an international scale, exploitation of comparative advantages of different countries on account of differences in cost of capital, labour, resources, etc., and capability to provide consumer satisfaction. The MNEs have the capacity to exploit all these differences with their massive resources. This may perhaps imply that the MNEs would like to have central control and 100% ownership of the overseas operations. However, the MNEs are becoming increasingly aware of the advantages of doing international business through joint ventures or contracting.

The question of ownership depends on mutual negotiation between an MNE and a local firm regarding obligations and assets of each other. The obligations may consist of transfer of assets by lease or sale, personnel, knowledge or investments, lease or sale, from one firm to another. The transfer may be based on a contract or participation in equity. The contract mode would often be used if the contracting firm has valuable transferable assets, e.g. copyrights, trademarks, patents, skills, machinery or access to information. The intangible properties may be transferred either through sale or license or lease. The equity mode involves transfer of funds in the company abroad. In a sense, every overseas firm is a joint enterprise.

MNEs can be judged on the basis of their choice of the project, nature or relationship (varying ownership or contract) and operating policies. These three have to remain within tolerable limits among the parties involved, which are an MNE, foreign associated firm, host government and home government. If the parties concerned perceive each others contribution having a positive or at least neutral impact on their interests arising from MNE's nature of project, relationship and operating policies, then there would be no conflict of interests.

The relationship between an MNE and foreign associated firm can vary from 100% owned subsidiary through zero % ownership to negative ownership. Similarly, the contractual relationship can vary in either direction. The negative ownership is possible, e.g., Iran's investment of 25.1% in Krupp GmbH, the German Steel firm or Libya's purchase of 10% of Fiat, Italian auto firm.

Various combinations of contract and equity are possible. The technology contracting (licensing) as an alternative to Foreign Direct Investment (FDI) may be due to various reasons, such as:

- Shortage of funds for investment
- Lack of management
- Lack of knowledge of the market or the market being too small
- Strong competition and entry difficulty
- Political risk or pressure for licensing

In some joint ventures, there may be tendency of conflict between the two parties. Normally the ownership strategy is directly related to various functional strategies such as sales, production, finance and management. The selection of an optimum strategy depends a set of circumstances. As such MNEs try to retain ownership of those rights and assets which are of continuing value. These may not be available from competitors or local firms. It is necessary for the foreign associated firm and the host governments particularly in the developing countries to have 'continuous value' for survival of MNEs. This means continuous inflow of assets or services. The case of Kennecott's Copper Mine in Chile illustrates. The Chileans perceived that the value of American Capital inflows is not commensurate with the returns received by American companies. They felt that copper mines were manned by Chileans and 90% of products were sold to Europe and Japan. So, in 1970s it was nationalized. Similar fear was expressed in Europe against the U.S. in 1960s; and in Europe and U.S. against Japan in 1980s.

The ownership across an international frontier is different from the purely unemotional situation. There are four major differences.

1) National priorities with respect to allocation of resources may be different
2) Legal concepts may vary with regard to ownership
3) The levels of national wealth may vary in different countries
4) There may be differences in monetary systems and per capita GNP.

Many developing countries have introduced some 'entry agreements' such as, non-expropriation, phasing out of foreign personnel, increased local value added over time and limit on ownership. Even developed countries, in recent years, have introduced 'local content' in the value added (a la EEC). However, the relative power of an MNE may shift downward once it invests in a country. This can be checked if MNEs participation is kept low and earnings are derived from externally bought inputs in a foreign associated firm.

6.3 CHOICE OF STRATEGY :

The ownership strategy depends on three factors viz., rights and assets owned by MNEs, rights and assets owned by local firms and the type of foreign associate.

MNE

The reasons usually given for 100% ownership of foreign ventures by MNEs are:

- bad experience with joint ventures,
- lack of confidence in foreign business groups,
- uncertainty of identity for local equity holders,
- difficulty in maintaining quality,

- conflict of interests in functional policies,
- strong desire to integrate foreign units in the total corporate system.

The optimum ownership strategy depends in five factors:

- competitive position
- availability of acceptable associates
- legal constraints
- control requirement, and
- benefit / cost relationship

Most of the MNEs are in between a pure monopoly and a perfect competitive situation. The monopoly situation may arise from a unique product, unique process, unique access to market and relevant skills or capital. The competitive situation arises when there are other MNEs who are equally willing to enter into ownership or contractual relationships.

The acceptable associates may or may not be available in foreign country. If the associates are not readily available, the parent MNE considers the cost of finding and developing appropriate local nationals. This depends on the benefit/cost associated with the contribution expected from the associate.

The legal factors have a direct bearing on the ownership and contracting policy of the MNE. There may be restrictions imposed by host governments on foreign ownership, foreign tax credit and repatriation, ownership sharing (many such as France, Sweden, Netherlands, European countries require partial employee ownership), and on access to local resources etc.

Another critical factor relates to control requirements as equity ownership means control. The assumption is that an MNE's total control from head quarters should not be distributed. Adequate control is possible with equity ownership and total control is legally possible with 100% ownership. The adequate or total control is felt necessary for implementing MNEs functional strategies among the foreign associates. The leverage enjoyed by MNEs depends on continuation of ownership (control over Board and financial policies), market access (brand names, trade markets, channels), technology (patents and R&D), finance, personnel, supply, physical assets, etc.

Finally, it depends an analysis of the general benefits/costs of various ownership relationships. One may differentiate between one time contribution and that which continues over time. It also depends on the perceived mutual benefits/costs of both the MNE and the foreign associates. If there are substantial difference's in the partners' concept of their own benefit/cost ratio, there will be conflict. Some of the differences can be overcome through better communication between partners.

Local Firm : The local firm, particularly in a joint venture, would like to have meaningful control over the operators, whether through equity ownership or otherwise. Thus its case is the reverse of what has been said about MNEs above. As MNEs move toward transnational ownership, some of these conflicting interests may diminish.

Foreign Associates : In selecting a foreign associate an MNE may be confronted with three types of options: regarding sector (public or private), option regarding dispersion (Private Ltd. Company or Public Ltd. Company) and option regarding nationality (local firm, parent country entity or a multinational from other country).

It is difficult to generalize as to which ownership strategy equity or contractual ownership is superior However, any strategy chosen should be appropriate in the context of the circumstances prevailing at the time of entry decision by the MNE.

Activity 1

Identify the Key factors of the ownership strategy of an MNE (with which you are familiar) in entering India. Take the case of one such subsidiary.

.....

.....

.....

6.4 STRATEGIC ALLIANCES

Before 1980s, MNEs were interested in having 100% ownership in their international operations. Some of the other contractual arrangements were initiated as a response to host government interventions. During 1980s, many competing MNEs from different nations started having joint ventures and collaborative arrangements among themselves.

Alliances like General Motors with Toyota (1983), IBM with Nippon Telephone and Telegraphs (1985) showed the new trend of strategic alliances among MNEs to strengthen their competitiveness. Joint ventures were traditionally associated with MNEs for entry into the developing countries. Now this has become a global phenomenon with long-term consequences.

Having lost $39 million in 1990, Texas Instruments plans to invest $1 bill in next few years in Asia in the new facilities for computer chips. TI is forging alliances with Asian partners to supply capital for new factories. TI has joint venture with Kobe Steel of Japan to make custom logic chips. It has $350 million advanced memory chip plant in Taiwan financed by Acer, a good customer of TI.

TI has displayed its skill at using O.P.M. (Other People's Money) in Singapore for its $330 million water plant for memory chips. 24% of the equity shares are held by Hawlett-Packard, 24% by Canon of Japan, 26% by Singapore's Economic Development Board (TI has option to buy it out in five years), and rest by TI. The winning strategies focus on what the company can do best. The practices of American players in Asia can be summed up this way; invest steadily, rely on local managers, forego alliances for capital, adapt western products and services to Asian tastes.

The major reasons for strategic alliances are scale economies, technology development, market opportunities and neoprotectionism.

For many industries the scale economies have become critical to survival in the market, for instance auto manufacture in Europe. Many companies, though competitive in domestic market, are not so in the global market e.g. Citroen in Germany, BMW in Sweden, Volvo in Italy, Fiat in U.K. The scale of operations of these companies with niche marketing pricing tactics may be sufficient in their domestic market but has been felt inadequate vis-à-vis General Motors or Toyota in the global context.

The high technology industries have difficulty in having control over all the critical technological elements in a single company. The example of large MNEs like NTT (Japan) and IBM (U.S.) have technological patent exchanges between them in telecommunications and computers.

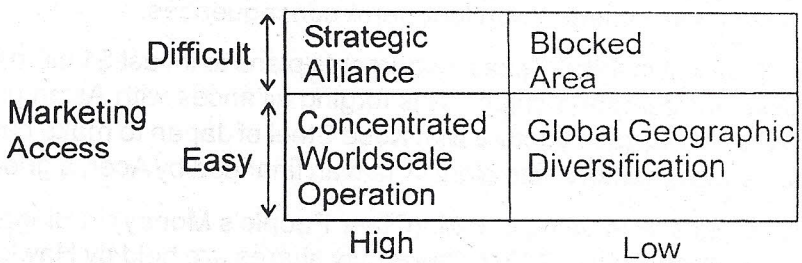
Barring a few ones, MNEs do not have the strength to exploit global market opportunities. To overcome this deficiency, they use the device of alliances e.g. Toshiba's high-speed facsimiles are distributed by Pitney Bowey in U.S. and by ITT in Europe.

Many countries experienced slowdown in their economies, which resulted in neo-protectionism in 1980s. Besides, regional integrations were taking shape. The concerned countries tried to discriminate between 'insider' and 'outsider' companies. Strategic alliances overcame these problems.

There are marked differences in strategic options adopted by MNEs in different industries. Two factors are playing important role: market access and R&D. A combination of these two gives four types of strategic alliances a shown in Figure 6.1.

The strategic alliances provide market access with cost advantages regarding scale or joint R&D. This is more prevalent in aircraft construction, computers, bio-engineering and automobiles. The concentrated world scale operation requires scale economies and high R&D, but market should not be a problem. This is true in pharmaceuticals, fine chemicals, medical equipment and knowledge products. In industries where the market access and R&D are not problems, MNEs go for global geographic diversification such as processed foods, steel and synthetic fibres. There are industries where multinational operations are limited, such as telephone networks, armaments etc. These are blocked for MNE operations.

Fig 6.1: Determinants of Strategic Alliance



Source: Subhash C. Jain (1987)p. 107

Table 6.2
Stategiv Alliances : Cost/Benefits

Costs	Benefits
A. Mutual Dependence B. Outcome Uncertainty C. Division of Authority D. Top Management Time and Money	A. Complementary Resources B. Risk Sharing C. Reduce Competition D. Market Access

There are two sides in strategic alliances. There may be costs involved in mutual dependence among partners. The same aspect may help in proper utilization of existing capabilities e.g. Airbus venture. The alliance may lead to an uncertain outcome as it is a long-term agreement, but it can reduce the risk of a venture by sharing risks among partners. Some of the R&D investments may be beyond the capacity of a single company, e.g. the wide body jets: the 767 and A320. When these large aircrafts were in the final stages of production, the demand for smaller planes increased. The uncertainties led the companies to enter into alliances.

The alliances create problem relating to locus of decision making power and division of authority among partners which may lead to conflict. However, it may also reduce competition due to cooperation. For smaller MNEs, cooperation is more attractive than competition. The alliances may demand more time and energy in meetings, research and planning. But the joint efforts of the partners can help in having market access in several countries and in overcoming the constraints of government policies.

The successful strategic alliances have for characteristics: they fulfil complementary needs, they supplement each others' strengths, they enable sharing of power and balance the benefits.

Activity 2

Meet the executive of any company which has entered into strategic alliance with another company. Discuss with him the main features of alliance. Then attempt to place the company in the Strategic Alliance matrix and give reasons for your choice.

.....

.....

.....

6.5 INTEGRATION AND RESPONSIVENESS

There are three major motives, which prompted MNEs to invest overseas. The earliest one was to secure key supplies like minerals, energy and scarce raw materials – e.g. oil, mineral and metals. Secondly, the development of technology or brand recognition led to internationalization in industries like chemicals and beverages. Third, there were factor cost-differences and unnatural tariff barriers which again led to internationalization.

Integration

Different MNEs try to integrate their subsidiaries differently. There are three types of 'mental maps' which bias the structure and the interrelation ships between parent and subsidiaries. They are: the UN model Assumption, Headquarters Hierarchy Syndrome and Multi-Centre system.

The U.N. Model Assumption attempts a flexible approach to overseas markets. It emphasizes the modification of products, strategies and management practices country by country. The worldwide strategy is the sum total of the multiple national subsidiaries' strategies. However, there is an attempt to apply uniform information and control systems. The subsidiaries are evaluated on a standardized criteria with role and responsibilities expressed in general terms. So MNEs assume a homogenous role for the subsidiaries and expect them to implement standardized global strategies. For instance, Uniliver identified its different **business areas** based on the need for global coordination and the need for national responsiveness. **Functional needs** for each business

area identified on the same basis which were further classified into various tasks within a particular functional area. The tasks/functions which were supposed to be critical for global integration were centralized, while others were localized.

The Headquarters Hierarchy Syndrome focuses on products for a world market and global scale of manufacturing. It assumes that the national tastes and preferences are similar e.g. Coca Cola. The decision making and resources are concentrated in the Headquarters. The Headquarters assign different roles to subsidiaries.

The Headquarters have the responsibility of coordinating and controlling the key decisions. The subsidiaries have to implement and adapt the global strategy to the local environments. This approach creates several problems such as underestimating differences in different national environments, underutilization of assets and negative effect on motivation of subsidiaries.

Multi-Centre system views the several centres of gravity as a network. The hierarchy model, you must have noted, depends on position-based power. The authority and decisions flow downwards unidirectionally. In the multi-centre system, the control of critical resources is multi-directional and can flow upwards, downwards or horizontally. A unit within the group may have the responsibility for product development and for selling it worldwide. The unit thus may have the distinction of being a centre of gravity for a product line. The management of Atlas Copco's Air Power division located in Belgium accounts for half of its total turnover. Similarly, several Swedish MNEs have large divisions with foreign-based managements. Electrolux has seven divisions and Sandvik Co. six divisions which are managed outside the headquarters. These centres of gravity are created not only through proprietary links but also through exchange relationships. This envisages a change from centre-periphery systems to multi-centre systems.

Activity 3

In the context of international business, three types of managerial attitudes were discussed in unit-4: Ethnocentric, Polycentric and Geocentric. Do you find any similarities between these approaches and the three models of parent-subsidiary relationships described in the above section. Analyze.

.....

.....

Activity 4

Arrange a meeting with a knowledgeable executive of a multinational subsidiary and discuss with him how integration is brought about by the parent company with the subsidiary operations.

.....

.....

RESPONSIVENESS: SUBSIDARY ROLE

The national subsidiaries may have competence enough to influence the MNE's global strategy. The competence may be in technology, production or marketing. This will determine the role of subsidiaries. They may function as **strategic leaders, contributors, implementers or simply as black holes.**

The **Strategic leader** tries to develop strong leadership in certain business areas. For instance, Philip's U.K. subsidiary played a key role in developing the leadership position in the teletext TV business. In spite of lack of interest by Philips headquarters, the subsidiary continued to develop and introduced teletext in 1976. By 1985, the product spread rapidly and Philips could reach a dominant position in this market. U.K. subsidiary is identified as company's centre of competence for teletext TV sets.

The **Contributors** try to benefit the worldwide operations through their local capabilities. For instance, Ericsson's Australian subsidiary made a significant contribution in the development of AXE system. Australian Government forced Ericsson to cross-license its technology to two other local firms and insisted on local R&D team to service. In addition, there was strong local managerial leadership. This helped subsidiaries to take up global tasks in additional to local tasks. Ericsson has provided information and resources to the subsidiary to take up worldwide development tasks.

The **Implementers** have enough competence to maintain their local operations. The majority of subsidiaries of MNEs play this role. They have neither access to critical information nor control over scarce resources. Their role is to capture economies of scale and scope with respect to global strategies. For example, Proctor & Gamble created inter-subsidiary teams to develop Eurobrands for coordinating various subsidiaries in Europe to achieve efficiency and competitive advantage.

The **Black Hole** means that the subsidiary has only minimum capability of the subsidiary. For example, Philips in Japan, Ericsson in the U.S. and Matsushita in Europe have only local presence for maintaining global position of the firm. Sometimes, this situation may lead the MNEs to have strategic alliances with other dominant local companies. For instance, Fujitsu entered into alliances with ICL in the U.K. and Amdahl in the U.S.

6.6 MANAGING A MULTIFOCAL STRATEGY

MNEs have either a strong geographically management or a functionally based management. The former is meant ro respond to various opportunities, country by country. This helps in manufacturing rationalization, product standardization and low cost global sourcing. The latter tries to spread the knowledge and skills throughout the company, wherever it has its presence.

With the changing environmental forces, the competitive viability of an MNE depends on flexibility. In this context, the primary task is to covert the organization from uni-dimensional to multidimensional one. The barriers and the tasks to overcome these barriers have to be identified. This has to be followed by using some tools to change the management perspectives. There are three barriers in overcoming organizational biases. They are: strategic, organizational and cultural.

Barriers

The **strategic** barrier arises when the core group of an MNE perceives a threat to its power or role. Kao company became MNE through building its technology (licensing overseas), marketing and, recently, manufacturing efficiency. In this transformation, the core groups domination in Kao belonged to technical and marketing functions. When Kao tried to introduce geographic orientation in the early 1990s, the functional groups were directly involved in the globalization strategy. The attempt at localization move did not succeed. This was primarily due to the dominance of functional

groups who still played dominant role in the geographic divisions. Thus, building the need for appreciating diversity of management views is required. The key tasks are: build internal understanding for the need to broaden competitive capability and recognize that any change in the organization need not be zero-sum game to the earlier core groups.

The **Organizational Barriers** may result from historical reasons. Kao had functional unit groups, which had line responsibilities. In 1970's Kao introduced medium term planning system. The plans were reviewed by Functional managers at the headquarters. In 1980s Kao introduced on-line information system linking headquarters directly with the data systems of the overseas units. The institutionalized the central group's dominance.

The **key tasks** to overcome this kind of barrier are: challenging the former structure and adopting the formal control systems. The former involves giving decision making power to the new groups ensuring at the same time it is not vetoed by former line authority. The formal informational control system should provide access to the information and legitimacy in relevant decision-making forums.

The **Cultural** barriers are manifested in management mentalities and informal relationships. The dominance of the technical and marketing groups in Kao which was an established credo and was reinforced by the informal relationships that the senior managers has with these groups. A similar background influenced the decision for recruitment and promotion within the company.

The **key tasks** are to modify the norms and attitudes of the top management. Kao undertook the formal education of management personnel and emphasized that international operations were not merely an appendage of the domestic organization. Top management was able to bring the necessary changes in attitudes to implement the new organizational perspectives.

Activity 5

Discuss with a knowledgeable and experienced executive of subsidiary of an MNE about the barriers it faced in its relationship with the parent company at any point in its history. What tasks were undertaken to overcome these barriers.

.....

.....

6.7 BUILDING NEW PERSPECTIVES :

Mere structural change is not enough to build the new perspectives in the organization. In the previous section, we discussed the barriers, which give an indication of tasks required. All those tasks can be grouped under three headings: Legitimacy, Access to Information and Influence in decision-making. The tools/means adopted to accomplish these tasks can be illustrated with the experience of P&G who created the **legitimacy** at its European headquarters. During the late 1970s, the economic crisis, which P&G faced, made them think, at some point of time, in terms of transferring its R&D facilities from Europe to the U.S. However, instead of doing this, the company appointed an R&D man of the status of Vice President to head the European headquarters. Euro-teams were created to rationalize product lines and integrate development activities. The terms developed several new products. With this the credibility of European headquarters was established. The tools adopted for legitimacy are: transferring high status managers from the dominant group to the new team and aligning its activities to the needs of the dominant group.

P&G created a new forum of communication to form linkages. This encouraged **sharing of information** and joint decision-making. With the success of Euro Teams in technical fields, P&G established Euro Brand Team. This included brand and advertising managers from country subsidiaries, key functional manager from Headquarters with general manager of the lead country subsidiary as chairman of the Team. This team introduced first Euro Brand Vizir (liquid laundry detergent) in Germany.

In addition to legitimacy and access to important information **influence in critical decisions** has to be ensured. P&G transferred back the head of European headquarters to the MNE headquarters at Cincinnati in 1981. He was made Senior Vice-President. He reorganized corporate R&D as he did in Europe. The link between R&D and business strategies of product and geographic line managers was established. The technology group became a viable unit in P&G organization. The tools adopted were in providing the new management team to have influence over **allocation of resources** and **distribution of responsibilities**. The latter enabled the new group to negotiate with the established groups.

6.8 MAINTAINING A DYNAMIC BALANCE :

Some MNEs are able to respond to the changes in the environment by their ability to shift management responsibilities and organizational relationships. Any fluidity in the organization can create internal tensions and conflicts. Ericsson has been successful in maintaining management diversity. These **tools** adopted were: (a) a good foundation, (b) managing misfits and ambiguity, and (c) means to resolve the conflicts. These tools are explained in the following paragraphs.

Ericsson established product divisions in 1940 in place of functional departments. In the 1950s the cross divisional coordination was emphasized, which led to heightened importance of functional specialists. Many subsidiaries had the skill to produce and assemble AXE switch. The flexibility of the organization enabled the company to redeploy employees in subsidiaries to concentrate on software and peripheral development. The new challenges were met with new organizational adaptations, which had their foundation in handling flexibility and maintaining diversity.

Ericsson created ambiguity, fluidity and overlapping among its subsidiaries. This helped in developing R&D capability in its Australian subsidiary and in encouraging entrepreneurial spirit. This had the effect of shifting division headquarters from parent company to the subsidiaries.

However, the fluidity may create tensions. For the resolution of such conflicts, Ericsson used several "off-line" forums like project teams, task forces and committees. This tool has been effective in isolating and resolving specific issues through discussion. Resort may be had to one management group to resolve the conflicts between others, like area and business managers. The functional managers act like brokers between central product divisions and national subsidiaries. The formal authority still lay with the product and area managers.

6.9 FLEXIBLE COORDINATION :

MNEs had traditionally developed either autonomous national units to respond to the local environment or had the decision making centralized at the headquarters for strategic direction and operational support. In recent years, due to increased complexity, MNEs have adopted several mechanisms.

Mechanisms

Three mechanisms originating in different countries have emerged among MNEs:

- Centralization (Japanese)
- Formalization (American)
- Socialization (Europe)

As the Japanese MNEs expanded overseas, the managers of parent company managed the subsidiaries. The centralization, by leveraging corporate resources, led to rapid decision making. With the growth in size and complexity of overseas business, the centralized coordination however became difficult. The subsidiaries started sending information, asking for guidance, support and decisions. This led to increased dependence of subsidiaries and overloading of the central process.

American MNEs adopted **formalized** system for coordination purposes. This process reduced costs. The authority is distributed between headquarters and subsidiaries. Most of the decisions are routinized. The company's established 'way' of doing/accomplishing a certain task is considered the best. P&G had 'Proctor way" of marketing. This involved exhaustive product and market testing before launching a product. The prelaunching activities sometimes helped the competitors in launching imitative products. Further the attention of managers may be focused in meeting the requirements of the systems rather than meeting the consumer needs.

The system enacted by European MNEs was influenced by founding families. The coordination relied on close personal relationships. This involved careful recruitment, development and acculturation of key managers which essentially meant **socialization**. This system overcame the headquarters, overload problem arising from centralization and inflexibility formalization. The system relied on shared values and objectives. Unilever had internalized this system from the beginning. The system work effective till it started facing problems by 1980s due to environmental changes.

Integrating Multiple Tools

As many existing coordination mechanisms proved inadequate to meet the environmental changes, MNEs started integrating different tools. This involved building coordination capabilities and allocating responsibilities.

Firstly, the issue of coordination relates to the value and intensity of task due to diffused assets and resources. Secondly, the need for using diverse tools was felt because it was believed that flexibility was necessary in the face of fast changes taking place.

The move of MNEs from different countries in this respect seems as follows table 6.1:

Table 6.1: MNE Moves

MNEs	Move From	To (additional)
Japanese	Centralisation	+ Formalisation
American	Formalisation	+ Socialisation
European	Socialisation	+ Centralisation

Matsushita tried to introduce new systems such as medium and long-term planning for international operations. While Americans tried to revive the informal processes and value systems in their firms, European firms tried to centralize some functions such as Philips, which created product divisions to coordinate the worldwide policy. In all these the tools used to change are self-regulating and managed. The self-regulatory means are adopted, e.g. P&G in creating Euro Brand Teams, and Matsushita to internal 'bidding' by product divisions for R&D allocations. In addition to the self –regulation, some systems are managed by integration.

Allocating Responsibilities

There are two issues involved in coordination: the flows between units and the strategic roles of units. The flows are of three kinds: goods, resources and information. The flow of goods involves integrating the network of interdependence of units with respect to components, sub-assemblies and finished goods. The second flow relates to resources-financial, technical and human. Many of these were managed centrally. The third flow is that of information. Information flows are mostly achieved through the socialisation mechanism. Matsushita used the socialisation as a leveraged learning in its foreign units by arranging 'block meetings' of subsidiaries in regions to highlight the 'best practices'.

MNEs use differentiate approach in the coordination processes so as to match the roles of different units. The matching may be as follows Table 6.2:

Table 6.2: MNE Matching Tools

Role of Subsidiary	Tools
Implementer	Formalisation
Contributor	Centralisation
Leaders	Socialisation + Formalisation
Black Holes	Socialisation + Centralisation

Thus, different tools are used by MNEs for its various subsidiaries.

Activity 6

Identify the major mechanisms adopted by MNEs for achieving flexible coordination among the various units all over the globe. What mechanisms are being adopted by an MNE with which you are familiar.

.....

.....

6.10 COMMITMENT :

The behaviour of individual managers within the organisation is an important concern of build top management of MNEs. MNEs try to understanding, identification and commitment of individual managers to the overall corporate agenda. There are three tasks involve in changing the mentality of managers towards global perspective. They are:

- a shared vision
- understanding and acceptance and
- the binding commitment

These tasks are achieved through various tools adopted by MNEs.

A shared Vision :

This is achieved through a clarity of the objectives, continuity in pursuing and consistency in interpreting them across all the organisational unit. The company's purpose should be expressed in a simple way, it should be relevant to the activities and should reinforce the core vision. For instance, NEC's commitment is to "computers and communications". This can be designated as "C&C" compared to AT & T's 'C&C' and 'IBMs' 'C&C'. This symbolism a simple way of conveying complex strategic thrust of the company. These have to be converted into action plans of managers, which give more clarity of meaning. The reinforcement of the core vision is done effectively by Matsushita that translates grand visions to specific objectives and priorities.

The successful MNEs have the continuity of purpose for a longer time. The strategic changes of GE in Brazil resulted in losing its dominance in the market. The GE changed its thrust from radio, TV and audio (1930s) to refrigeration and air-conditioning (1950-70), to housewares market (1980s). The subsidiary management was not sure of the overall corporate strategy. On the other hand, Unilever had consistent objectives in Brazil and could keep its dominance in the market. This is mostly due to enduring commitments of Unilever in Brazil.

Besides clarity and enduring commitment, the consistency of purpose is necessary to make all to share the corporate vision. Philips had difficulty with its North American unit in its worldwide strategies. The later refused to introduce V2000 in video cassette recording system. Instead it went for sourcing of Japanese products which led to the dominance of Japanese in the VCR business in America.

Acceptance:

The success of the vision of the company depends on the acceptance of the goals and objectives by individual members of the organisation. This leads to the emphasis on human resource management. The important components of HRD are: the recruiting and selection process, training and development, and the career path management.

Many MNEs had home country bias in their recruitment policies. As they started facing problems in getting sufficient personnel, they changed their practices. Philips and Ericsson have broken the relationship between specialisation and centralisation. They have now wider sourcing for recruitment than just restricting it to the home country basis. This similar to the success of Unilever which was recruiting on worldwide basis since 1930s. American and Japanese MNEs are trying to localise managers from host countries instead of depending on expatriates to manage subsidiary may vary from strategic leader to just implementer of parent company's policies.

Flexible Coordination:

Adoption of multiple mechanism by an MNE to coordinate different units. Instead of a single traditional mechanism of centralisation, or formalisation or socialisation, a combination of these mechanisms may be followed.

Commitment:

Developing identification among mangers through various ways to the overall corporate agenda.

Centre Periphery System :

A system in which business centres (units) have peripheral importance because they do not have control over full range of activities.

Multi Centre System :

A system in which there is a network of multiple centres of gravity. These centres have control over full range of activities (both input and output decisions).

6.13 SELF-ASSESSMENT QUESTIONS :

1) What is ownership strategy? Why is a particular strategy chosen?
2) What are the four types of strategic alliances?
3) How do MNEs integrate their subsidiaries?
4) What are different types of subsidiary roles? Discuss by citing examples that you know of.
5) What is a multi-focal strategy? What are the major barriers in managing a multi focal strategy?
6) What traditional mechanisms in different countries have been adopted by MNEs for achieving flexible coordination?
7) How do MNEs try to develop and maintain commitment of the individual managers?

6.14 FURTHER READINGS :

Bartlett, Christopher and Sumantra Ghoshal (1989): Managing Across Borders, Harvard Business School Press, Boston, Chaps 6, 8, 9 and 10.

Jain, Subhash C. (1987): "Perspectives on International Strategic Alliances" in S. Tamer Cavusgil (ed): *Advances in International Marketing*, Jai Press Inc. Greenwich, Vol 2, pp. 103-120.

Robinson, Richard D: (1978) *International Business Management* (II ed)., The Dryden Press, Illinois, Ch 5, pp. 357-443.

BLOCK 3 CONTROL AND EVALUATION

Management should strive to evolve business strategies that match organisational structure with opportunities in the international business environment. However, identification of strategies consistent with organisational structure and opportunities in the environment may not guarantee success for the firm in realising its objectives. Even promising strategies can fail to produce their anticipated results if they are poorly implemented and improperly monitored. The institutionalisation of appropriate control mechanisms, information system and performance measurement methods is crucial to the success of international business. Block 3 deals with all such issues and also issues concerned with the interaction of MNCs 'corporate culture with the hot countries' culture. The block has three units.

Unit 7 : Control and Information in International Business deals with basic issues relating to control of international operations and the need for information systems. The unit begins by examining the need for and objectives of control in multinationals. The various approaches to control and the influence of national cultural traits on the control system are analysed. The unit then focuses on the important question of the extent of control exercised on the submit operations and the related question of delegation of decision making authority. While the answer to the question "how much to delegate?" depends upon several variables, a fair acceptable generalisation is that strategic issues are best centralised and operational matters are best decentralised. An example of the former is the capital budgeting decision. In what way ownership is related to control is also discussed. The role of organisation structure in control is highlighted. A company's organisational structure establishes the distribution of decision making power through formal and informal lines of authority and responsibility. Organisational structure, along with information system, constitutes the basis of forma' ontrol system. Toward the end of the unit some accounting aspects of multinational control and issues relating to control of international joint ventures are discussed.

Unit 8 : Performance Measurement and Evaluation in a way supplements the previous unit by providing the supporting material. The basic concepts and variables in performance measurement and evaluation are discussed. The mechanics, modalities, and tools and techniques of measurement and evaluation are described. The issues relating to productivity, socio-economic performance and performance evaluation of projects are analysed, In concluding part, performance evaluation in relation to international trading and transnationals in India are examined.

Unit 9 : Multinational Corporate Culture and Host Countries deals with issues arising from the interaction between the culture of multinational companies and the culture of the host countries. It also discusses the ways in which conflicts arising from this interaction can be resolved. It begins with a description about the nature of the MNCs and the patterns of decision making taking place in such firms. The unit then discusses the issues relating to intra-firm trade, technology transfer and employment and labour relations. The typical management practices of MNCs and their business culture are highlighted. What kind of policies are framed by the host countries to overcome the undesirable influences of MNCs' policies are examined. The forms of MNC collaboration and restrictive practices adopted by MNCs are also discussed.

multinational operations. The unit examines the questions of delegation of authority for decision making or the autonomy to the subsidiaries. Various methods of control are examined and the reporting and information systems are discussed. The role of informal communications in the control process is highlighted. Thereafter, the unit discusses some accounting problems concerned with measuring of performance. The unit concludes with a discussion about control in international joint ventures.

7.2 THE NEED FOR CONTROL

According to Child', "control is essentially concerned with regulating the activities within an organisation so that they are in accord with expectations established in policies, plans and practices." This definition is in conformity with the views expressed by Tennenbaum[2] who states that the importance of control lies in achieving the **ultimate purpose** of the organisation. Control therefore encompasses any process in which a person (a group of persons of organised persons) determines or internally affects what another person, group, or organisation will do. "The coordination and order created out of diverse interests and potentially diffuse behaviours of members is largely a function of control..... control is an **inevitable** correlate of organisation.

Looked in another way, control denotes all those relationships and devices that are meant to ensure that strategic decisions are made in accordance with corporate objectives and goals, and tactical (or operational) decisions are made in accordance with selected strategic decisions.

As a matter of fact corporate organisation structure should be looked from the point of view of establishing and maintaining adequate control over the firm's activities at the least cost.

You would recall that organisational structure is nothing but a network of channels through which authority flows, and it includes the feedback generated and network of informal flows. What really matter in the control process are the **nature** of flows within the system and the *devices* used to ensure that actual operations are in conformity with intended decisions.

Headquarters' control of sub-unit behaviour and performance is a necessary integrating function in all complex organisations. The importance of control as an integrating mechanism within organisations stems from the fact that it reduce uncertainty, increases predictability and ensures that behaviour originating in separate parts of the organisation is compatible and supports common organisation goals. Given the complex environment facing most MNCs and the greater physical and cultural distances separating its sub-units, exercising organisational control at the parent-subsidiary level is generally viewed as of much more crucial in multinationals than in domestic companies.

In the context of international business several key questions arise. Some of them are:

1) Where should decision making authority reside in the firm with respect to the strategic choices i.e. the global allocation of corporate resources?
2) Where should the strategic and tactical decision making authority in relation to subsidiaries / affiliates be located?
3) What should be the frequency and content of the reports relating to operating performance

i.e. how should the information system be structured?

4) What should be the role of communication system and by what means should decisions be communicated?

5) What measures of performance should be used so that strategic decisions conform to the organisational objectives and goals, tactical decisions conform to strategic decisions and actual operations conform to tactical decisions?

You might be wondering that as the questions listed above equally apply to any domestic firm, what is unique about international business? In a way you are right. However, as you might be aware, we have been highlighting the differences between domestic and international business in the previous units. These differences have their implications for the control systems. Let us recapitulate some differences and their implications.

1) **Distance:** The subsidiary units are often located at distant places. The geographic distance and cultural differences increase the possibility of error in cross-national communications, besides greater need for time and expense. The intents of the planning and control system may not be fully understood or appreciated by subsidiary managers. The information sharing or communication between foreign managers and headquarters tends to be less frequent than between domestic managers and headquarters. This necessitates greater reliance on the formal data.

2) **Diversity:** The subsidiaries operate in different socio-economic and cultural conditions in different countries. The market size, labour cost, currency and other factors differ from one country to another. The task of setting standards and evaluating performance is rendered extremely complicated. Currency differences require a more careful approach to pricing, working capital management, and selection of sources for funds. More care is needed in interpreting the meaning of overseas balance sheets and earning statements.

3) **Uncontrollables:** Performance evaluation is of little use in control unless it is accompanied with corrective action. Many foreign operations have to take care of the interests of foreign stakeholders, whose objectives may be somewhat different from the parent. In short run, the firm may have no influence in changing government regulations. Hence, the corrective action by the firm may be quite circumscribed. Besides, the foreign managers have little control over many important decisions made by parent company which may seriously affect their performance.

4) **Uncertainty:** Control implies stating goals and developing plans to meet the goals. Economic and industrial data may not be available in the foreign environment to the extent it is available in the parent country. This makes the task of budgetary goal setting more difficult. Furthermore, political and economic conditions are subject to rapid changes in some locales. This situation impedes the stating of plans, especially long range plans, and reduces the certainty of results from the implementation of plans.

Although, the above factors make control more difficult in the international context, companies do follow procedural and structural practices in an effort to ensure that the foreign operations are congruent with the overall corporate goals and philosophies. It may also be stated that most companies maintain more effective communication links between headquarters and overseas

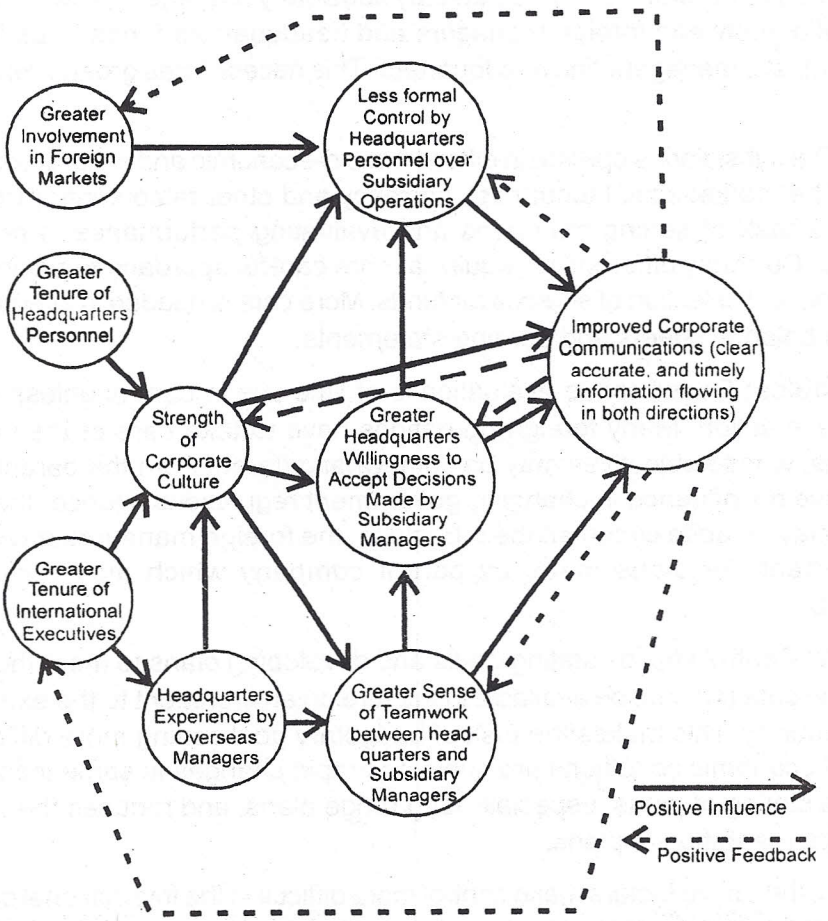
operations than others. And this may be due to : i) greater involvement in foreign markets, ii) longer tenure of headquarters' and overseas managers, iii) more headquarters experience by overseas managers, iv) less formal control by headquarters personnel over subsidiary operations, v) greater headquarters willingness to accept decisions made by subsidiary managers, and vi) greater sense of teamwork between headquarters and subsidiary managers.

What we have described here as the reasons for more effective communication links are, by and large, the ingredients of a **strong corporate culture** which envisages internalisation of common values and rules of behaviour by the employees. The more effective this internalisation (or socialisation) process, the less is the need for formal rules to be articulated and disseminated. The corporation can be said to have its own "language".

As communication is the key to effective control, it is important to understand some of the necessary conditions for maintaining effective international communication network.

Fig. 7.1 portrays these conditions and how they relate to each other, including some of the

Figure 7.1: Some Factors Enhancing International Corporate Communications



Source : Robinson, Richard D. International Business: An Introduction, ' The Dryden Press, 1983, p.267.'

positive feedback loops. The companies in which the tenure of managers is relatively longer and in which they are promoted by seniority (i.e. an age group moves together), all else being equal, have more effective international communication network. The corporate culture would tend to be strong when the process of socialisation of those within it is relatively more effective. The Japanese system in which there are few intercompany transfers of managers and in which there are personal ties of long standing is an example in point. Much of the communication network is informal. The socialisation process is so effective that relatively few formal standard operating procedures need to be transmitted. Managers know what is expected of them without being explicitly told or directed.

Activity 1

We have described some of the positive aspects of Japanese corporate culture in the above section which in a nutshell, is that the international communication network within an established Japanese corporation is quite tightly drawn.

What could be the negative effects of such a culture (or system)?

.....

.....

.....

.....

7.3 OBJECTIVES OF CONTROL IN MULTINATIONALS :

A good or effective control system in a multinational enterprise should have the following objectives:

- It should *supply adequate data for top management* to monitor, evaluate and adjust the global strategy of the enterprise as the situation demands.
- It should provide the *means for coordinating* the units of the enterprise so that they work toward common objectives, if any.
- It should provide the *basis for evaluating the performance* of the units and their managers at each level of the organisation.

The evaluation of global strategy is a dynamic process. For this purpose, the information system should deliver data from the organisational units on the business environment, demand, and competitive developments that the units are facing.

For coordination purposes, the control system should be structured in such a way that it shows the areas where multinational economies can be realised. The control system should also discourage unit from following independent sub-optimisation practices. The firms that fail to achieve multinational economies by expanding to a global level are likely to be left behind in the global competitive race[3].

For performance measurement the system must measure the performance of organisational units and the achievements of the managers towards corporate objectives against those elements which the managers can control.

Much would depend upon the basic philosophy, approach and fundamental attitude of the multinational enterprise.

The overall perspective of the enterprise in fact would have an overriding effect and would determine its strategies and hence its control system. In other words, whether the enterprise is actually an international business, or a multinational business, or a transnational business would have an influence on its overall strategies. This in turn would influence its control system. The different parts (or units) of a multinational enterprise face somewhat unique individual environments and, therefore, while maintaining a common thread, they may have different sets of objectives/ goals. The control system therefore has to take care of the sub-entity objectives and goals.

7.4 APPROACHES TO CONTROL :

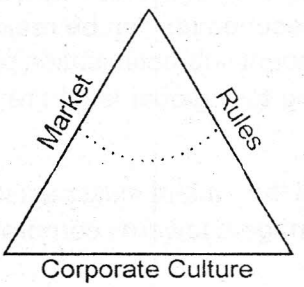
In establishing a control system, an organisation has to determine the relative emphasis it will place on input (or behavioural) controls and output controls at each level. Input controls create control *ex-ante* and operate through the behavioural interaction. The subordinates receive guidance and direction through personal interaction. The expectations are communicated in advance of the action. The rewards and punishments are based on the extent to which the expectations are met. Input controls influence or modify the behaviour before the event. Output control, on the other hand, operates *ex-post* and rests more on the feedback rather than on personal interaction e.g., performance against budget, cost variances, etc.

Input controls work better where an organisation is small, relatively homogeneous, and the effects of actions are fairly clear. Output controls work better in a large or complex organisation where standard measures can convey a picture of what is happening in a relatively objective way and gives some basis for making comparisons.

In an MNE, output controls are more likely to be found, particularly at the higher levels in the organisation where the tasks being reviewed are more complex and heterogeneous and where it is less clear as to what the effects of specific actions would be for any unit.

Multinationals may exhibit differences in the emphasis they place on input and output controls. They may also exhibit differences in the degree of explicitness of the rules through which control is exercised. Based on the work of Ouchi et al[4], we can derive a triangular continum of Market, Rules of Corporate Culture approaches as shown in **Figure 7.2.**

Figure 7.2: Control Approaches



Market Approach: Under this approach external market forces are allowed to control the behaviour of management within the units of the multinationals. Typically, the units of the organisation are decentralised and transfer prices are freely negotiated. Each unit has the freedom to buy or sell inside or outside the multinational system. The decisions of each unit and the behaviour of the managers are largely directed by the market. The control system of a firm managed on the basis of market approach therefore rests predominantly on output controls.

Rules Approach: Instead of the market feedback, a rules-oriented organisation places greater reliance on strongly imposed rules and procedures. It usually has highly developed planning and budgeting system with extensive formal reporting. The usual drawback of such orientation is that the firm may not be able to respond quickly to changes in the environment. This type of control uses both input and output controls in a highly formalised way. A rules-oriented multinational usually has quite an elaborate and comprehensive control manual.

Corporate Culture Approach: In a corporate culture controlled organisation (such as Japanese, as we indicated earlier) the members of the organisation internalise the goals by developing a strong set of beliefs and values which influence their operations. Though the organisation may have strong norms of behaviour, they are informal and less explicit and, as such, allow the members considerable latitude in working out the solutions as the situations arise. The corporate culture **constantly evolves** as environmental changes take place. The major changes naturally take more time to bring about the needed organisational changes or adjustments.

The control process commences with an individual's induction to the values, beliefs, norms and practices of the organisation as well as through formal training, and initiation into the rituals an ceremonies of the organisation, such as early morning prayers, annual conferences, planning reviews, etc. (Some writers also call this process as the process of indoctrination). The cultural approach usually rests more strongly on input controls through its emphasis on inculcation of "the way we do things around here."

7.5 NATIONAL CULTURAL TRAITS :

In designing control mix (i.e. the mix of inputs and output controls, markets, rules and corporate culture approaches, within a multinational, it is advisable to consider the attitude towards control which might vary among national cultures. The attitude may have considerable bearing on the perception and approaches to such aspects as the budget preparation, the budget horizon, the importance of achieving or exceeding budgets and reaction to feedback. In a comparison between U.S. and Japanese controllers and managers, Daley and associates, for example, found that Japanese controllers and managers had a long term planning orientation and viewed budgets as a communication device unlike their American counterparts[5].

While one control approach may work very well within a given national culture, it may actually impede performance within another. It is, therefore, desirable to recognise such differences and build a control system which accommodates national culture differences. However, stretching the idea too far may not be desirable as allowing too many national peculiarities may weaken control and comparability and thus reduce the opportunities for effecting economies and efficiencies across the boundaries.

One method for classifying national cultures has been advanced by Hofstede[6] whose four dimensions vary across national cultures. Each dimension has important implications for design and operations of an effective control system.

Power Distance: *According to Hofstede, power distance is the degree at which a culture accepts* unequal distribution of power and privileges and the exercise of absolute personal authority. In a country where inequality is accepted and hierarchical authority is valued, a strong rules approach to control is likely to work best. The lateral relationships in the organisation are minimal and a strong dependence on chain of command is more likely to exist.

In a country where power distance is smaller and there is greater wish to minimise inequality, the organisation structure is likely to be flatter and decentralised, with participation and teamwork at a premium and hierarchical interference at a discount. The culture in such a country would accept a more corporate culture approach.

Uncertainty Avoidance: This is a measure of the extent to which a society is risk averse. A risk averse society tends to establish more formal rules and is less tolerant of deviant behaviour. The preferred control system is thus likely to be more rule-based as the risk averseness and power distance increase.

Individualism-Collectivism: This dimension describes the extent to which the social norms constrain individuals – that is how much individualistic behaviour is accepted. In any individualistic society with emphasis on initiative and action, such as the United States adaptability to change and a fast reaction time are essentials. A market approach to control appear more appropriate. In a collectivist society, such as countries in the Indian subcontinent or in the East, group norms control individual behaviour. The control emphasis would be more on maintaining group coherence and participation. Hence a corporate culture approach would be more appropriate.

Masculinity-Femininity: Hofstede's fourth dimension classifies national cultures on a scale according to their adoption of "masculine" values (such as assertiveness, equitiveness, money value evaluation) as against "feminie" values (such as caring and concern for others and quality-of-life orientation). A masculine national culture would be more likely to produce a market approach or a rules approach to control. A feminine culture would be more likely to adopt a corporate culture approach with strong norms for group coherence.

In using, Hofstede's four dimensional classification model, it seems more appropriate to examine a national culture for its general positioning under each of the four dimensions than to make an attempt to classify each nation into a category defined along the four dimensions. The approach then becomes more of a diagnostic tool than an attempt at formal classification.

Cultural traits of the multinational's parent nation also appear to have an influence on the control system. In a comparative study of control patterns of the U.S., U.K. and European multinationals, Egelhoff[7] found significant differences between the U.S. and European multinationals in types of control utilised, with U.K. firms generally lying between the two. U.S. multinationals tended to measure quantifiable and objective aspects of a foreign subsidiary and its environment, while European multinationals tended to measure more qualitative aspects. The European multinationals also filled a significantly higher percentage of key marketing and manufacturing positions in foreign subsidiaries with parent company nationals than either the U.S or U.K. multinationals. They thus relied more heavily on input control.

The study by Brandt and Hulbert (referred to in Block 1) showed that U.S. multinationals employed local nationals for managerial positions in their subsidiaries more frequently than did either European or Japanese firms. On the other hand, communication patterns between the parent and the subsidiaries also differed. Most U.S. companies held annual meetings for the chief executive officials of their affiliates, whereas fewer than half of the European and Japanese firms held such meetings annually. Also visits of the head of the Brazilian subsidiary to his or her home office superiors averaged 4.8 times per year for the U.S firms compared with 3.4 and 2.9 for the European and Japanese companies respectively.

It may not be out of place to mention here that cultural traits in a nation may change over time. This is particularly true in the present times when countries are pulling closer to each other economically, technologically and culturally in the wake of greater accent on globalisation (or global integration).

Activity 2

Arrange a meeting with a manager of the level of General Manager who as at least five years of experience working in a multinational unit operating in India. Discuss with him the following.

i) the broad approach (out of the three approaches discussed in the proceeding section) that determines the control system in the organisation;

ii) and the extent and the ways in which the basic approach followed in the country of the parent company has been modified in the light of India's cultural traits. How would you describe India's cultural traits?

.....

.....

.....

7.6 DECISION MAKING AUTHORITY :

What degree of control will be exercised on the affiliates and what degree of decision making will be retained at the corporate headquarters would depend upon may factors. These are in fact the questions which are concerned with delegation of decision making authority. The question in other words is "how much to delegate?" The issue is particularly complex in the context of multinational corporations. If decisions are made at the foreign subsidiary level they are considered to be decentralised. On the other hand, if they are made above the foreign subsidiary level they are considered centralised. There are countervailing pressures for centralisation and decentralisation. Overall, the policies must be adapted to the firm's, specific and unique situation. Complete centralisation and decentralisation are the two extremes. In actual practice, companies seldom totally centralise or totally decentralise decisions. Instead, they adopt policies based on the nature of the question and particular circumstances involved.

The geographical dispersal in theory, should encourage the headquarters to delegate as much authority as possible to subsidiary managers because this increases the responsiveness of the letter to local conditions. and results in decisions being made at the level where information is

available. It also assists in the development of subsidiary managers. The geographical dispersal, however, may also raise fears among the top management that subsidiary managers would be guided in their work by parochial considerations. Before the headquarters' managers realise this, it may be too late to prevent the damage from such considerations. These fears tend to limit the actual delegation to subsidiary management.

The decision of how much should be delegated to subsidiary managers would depend upon several factors.

1) Ownership structure : The ownership question relates to the ownership structure of the parent company and the ownership structure of the affiliates. How is the ownership of parent company structured may matter. For example, if ownership of the parent company is in the hands of the family, the family may like to exercise surveillance over strategic choices in regard to ownership, management, and finance relating to the subsidiary. Thus the parent company may retain control in all these areas in its own hands.

How is the ownership structure in any affiliate may also influence the nature of control. The joint ventures, for example, are likely to be more autonomous than wholly owned subsidiaries. This point is further elaborated in a subsequent section dealing with **ownership and control.**

2) Age of Subsidiary : A newly acquired affiliate which continues its old product lines under the formal management tends to have greater autonomy. Also, control is seldom consistent over time. During early stages of affiliation, control may be quite loose, but may tighten as the foreign operations grow upto a point.

3) Expertise in Corporate Headquarters : The greater the headquarters have relevant expertise, the less autonomy a foreign affiliate may enjoy.

The size of the total foreign operations of the MNC as well as the size of a particular operation in a foreign country exerts influence on the location of decision making. Studies of financial as well as marketing decisions have indicated that increased centralisation is feasible when a corporate staff is large enough and is qualified. The company with very limited foreign operations may not be able to afford centralised expertise and therefore has to delegate decisions to the operating managers overseas. In case operations in a specific country are very large, then it can afford to have its own, specialised staff. It can be treated differently than smaller operations in some other countries.

4) The Nature of Industry and Importance of the Decision : Companies in certain industries tend toward more centralised control—for example drug manufacturing because they require product consistency.

The main function of the subsidiary is also a determining factor. Some functions may be more tightly controlled than others. Manufacturing subsidiaries are more like to be tightly controlled than marketing units. Similarly finance as a managerial function tends to be centrally controlled. The question sometimes asked is how much can be lost through a bad decision?

The matters relating to logistics (i.e., movement of goods and other resources) are more often centrally controlled The corporate profits may be improved by movement of product factors—capital, personnel or technology—from one subsidiary to another. Without some central control

point, reports will have to be disseminated from one unit to another to determine the resources from one locale that could be used elsewhere. Another movement concerns exports. If exports among subsidiaries are needed to maintain a continual production flow (e.g. vertical integration or interdependent components needed in the company's end product), centralised control may be required to assure this flow.

Exports to non-affiliated companies involve jurisdictional question. For example, if a firm has manufacturing facilities in the U.S., Venezuala and West Germany, which one will export to South Africa? By answering this question centrally, the firm may avoid price competition among the subsidiaries that could result in reduced corporate income. Besides, a number of different factors may have to be considered, including production costs, transportation costs, tax rates, exchange controls, and capacity utilisation.

5) Range of Products and Markets : Those subsidiaries which have a wide range of products and services may tend to be more autonomous than affiliates with uniform products and markets. For technically sophisticated products there may be little need for local adaptations. Consequently, at least for marketing policy, decisions may be made that apply to a very broad spectrum of countries A good contrast is between Nestle's food products which depend on geographic differentiation, and General Electric's power generation and Jet Engine businesses which are sophisticated products requiring little adaptation to local needs. The former type of product lends itself much more to decentralisation than the latter. It also happens that many products are first introduced in the larger market and later introduced in the smaller markets when the country of original production is in a latter stage of product cycle. In such instances centralised staff often asserts control in order to ensure that the same mistakes are not repeated in the latter countries. If product technology changes rapidly, there is usually a greater need for headquarters' involvement than if it is stable for a long period of time.

6) Physical Proximity : The distance between the headquarters and a particular subsidiary could also be a factor influencing the extent of delegate. Distant subsidiaries tend to have greater autonomy, particularly if located in countries with unfamiliar environment. However, with the development of rapid means of transport and newer and more effective means of telecommunications, the importance of this factor is gradually diminishing.

7) Cultural Proximity : The perceived differences in the operating environments in the home and host countries has an effect on the degree of control exercise on the subsidiary. If the economic, political and social contexts of home and host countries are similar (or almost similar), the managers of the subsidiary may be given less latitude in decision making. For example, the corporate managers of a U.S. company will feel more confident in formulating policies and practices for a Canadian than for a Mexican subsidiary. A similar difference may also be felt between a Mexican subsidiary and an Indonesian subsidiary. The Canadian subsidiary operations will be presumed to be (almost) parallel to the U.S. operations.

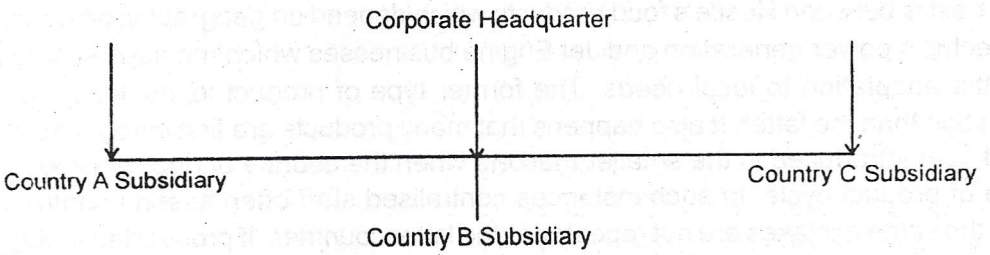
8) Interdependence : The volume of internal transaction has a good deal of influence on the extent of delegation. The corporation with a great deal of intra-firm movement of goods and services tend to maintain a higher level of headquarters control.

The role played by a particular subsidiary in the overall functioning of the multinational corporation generally has a significant influence on the extent of delegation permitted to a subsidiary

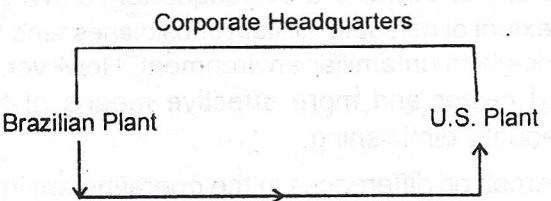
management. For instance, top management of a subsidiary that essentially services a very limited host market could be granted a high level of delegation. Furthermore, if the subsidiary contribution to the objectives (sales, profits, etc.) of the multinational corporation is very limited, then delegation to subsidiary management could be further increased. On the other hand, if a subsidiary is very critical to the overall functioning of the multinational corporation (as a provider of key inputs, absorber of outputs, key contributor to overall corporate objectives, and so on), then delegation would probably be lower. In a sense, the extent of delegation, i.e., in other words, tightness or looseness of the coupling between headquarters and its subsidiaries, would vary as a function of the interdependence between the headquarters and its subsidiaries.

The degree of interdependence between headquarters and subsidiary would be affected greatly by the type of strategy chosen as well as nature of the firm's technology. Three types of interdependence that may exist within an organisation have been identified: **Pooled, Sequential and Reciprocal.** These are presented in **Figure 7.3.**

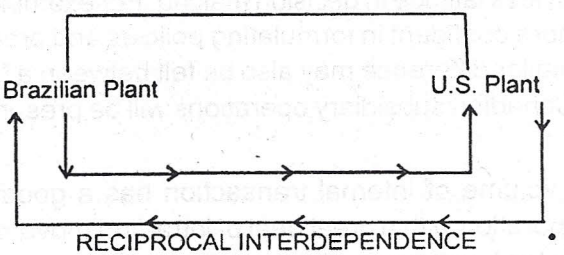
Figure 7.3: Types of Interdependence within organisations



POOLED INTERDEPENDENCE



SEQUENTIAL INTERDEPENDENCE



RECIPROCAL INTERDEPENDENCE

Key : ⟶ indicates direction of flow of materials

(*Based on Thompson, J.D., Organisations in Action, McGraw Hill, 1968)

Pooled interdependence exists where organisational members share common resources but are otherwise quite autonomous. Sequential interdependence exist where output of a part of the system is fed into another part of the system. For example, if the General Motors' (GM) subsidiary in Brazil supplies critical components (such as is engines) to GM (U.S.) then these two units would be sequentially interdependent. Problems with supply from G.M. (Brazil) would have (or sequential) effects on G.M., operations elsewhere, generating a greater need for control for ensuring that decisions taken by GM (Brazil) are consistent with those in other parts of the systems.

Reciprocal interdependence is the most complex form of interdependence. Reciprocal interdependence arises when organisations or organisational units feed their work back and forth among themselves. To take our previous example, if GM (U.S.) works on components provided by GM (Brazil) and ships them back to GM (Brazil) for additional processing, this would be an example of reciprocal interdependence. This kind of interdependence creates the maximum need for control, coordination and consistency in decision making. This need would be further pronounced if optimal functioning of the reciprocally interdependent parts of the organisation were vital to the achievement of overall organisational goals or objectives. All these factors would indicate that a stronger coupling is required which would reduce delegation to subsidiary management. The reason being that inappropriate decisions by subsidiary management can prove particularly costly to MNC system.

Sequential and reciprocal interdependency would call for some level of action planning (i.e. imposing specific decisions and actions at specific points in time which may result in **behaviour formalisation** wherein actions and decisions to be carried out are specified.) If the interdependencies are very significant, behaviour formalisation is required because global output control measures would not be able to handle the independency[8].

9) Importance of Foreign Market: The relative importance of the foreign market and perceived success of the affiliate is also a factor affecting the decision. If there is high degree of headquarters confidence in the subsidiary management and it is perceived in headquarters as a successful one, it may be given greater autonomy.

10) Considerations of Economy and Standardisation: Economies may be lost if foreign operations veer so drastically from the overall line or method of business; even control may be completely lost. If units in different countries are allowed to alter products, policies and methods in different directions, even slowly or gradually, the eventual diversity may be so great that economies may no longer be possible. The interchangeability of personnel, products and ideas may be rendered difficult. Similarly, the question relating to standardisation may sometimes be paramount, e.g. machineries used in production process.

The pricing and product decisions of one subsidiary may affect demand in other countries. With the growing mobility of consumers, especially industrial consumers, a good or bad experience with a product in one country may eventually affect sales elsewhere. This is especially true if industrial consumers themselves want uniformity in their end products. If prices differ substantially among countries, consumers may even be inclined to import them from the country where products are available at lower rates rather than buying locally.

We have discussed above the various factors that would in general influence the degree of control or the delegation of decision making authority. It may be mentioned that the question relating

to where the decision making should lie on the basis of economic or managerial criteria may have to be suitably modified in the light of local considerations. Although there may be some strong reasons for taking decisions at the corporate level for reasons of efficiency, still the decisions may have to be delegated to subsidiaries for reasons of morale and motivation. When local managers are prevented from doing what they consider as the best in the interest of their own operation, there is tendency on their part to think "I could have done better, but corporate management would not let me." These managers may lose commitment to their jobs and may not gain the experience needed to move into jobs of greater responsibility.

Similarly, political and social considerations cannot be ignored. There has been a widespread feeling in the LDCs that their own people have not been employed in responsible positions. They have been particularly critical that very little R & D has been done by MNEs outside their home countries, and even the portion which has been done outside has almost been done in other industrial countries.

Box 7.1: Basis for Control

The dependency of subsidiaries on headquarters for resources—technology, export markets, or management and financial resources—facilitates control.

The dependency of a subsidiary can take one of several forms:

1. The pattern of resource deployment in a business may be such that no one subsidiary has the skills or the facilities to duplicate the total capability of the parent in that business. There were cross-shipments of IBM products around the world during the late 1970's. It is obvious that all subsidiaries are interlocked in a complex web of relationships, and no subsidiary could survive without the others. Further, the pattern of product and component flows is orchestrated by the central staff. That gives them significant influence over any one subsidiary. The nature of control over subsidiaries in such a situation is significant, irrespective of the size of the subsidiary, its technological maturity or the sophistication of its management. The dependency of the subsidiary rests on the fact that it represents only a partial and not the total capability of the parent. IBM represents an extreme case of careful planning on the part of the company, over a long period of time, in deploying resources and skills around the world in such a way that no one subsidiary or region can be independent of the rest of the IBM.
2. A variant of the overall IBM pattern of resource deployment is the development of subsidiaries that serve primarily as sourcing platforms. Austria for Philips and Singapore for General Electric and Philips are good examples. An overwhelming portion of the subsidiary's resources is devoted to serving other markets in the DMNC's network. As a result, headquarters can have significant influence on decisions regarding capacity, technology used, product mix, and such operational decisions as plant loading.
3. If the subsidiaries are dependent on the parent for technology and/or management resources, the parent can use that dependency to influence the actions of subsidiaries. A significant proportion of U.S. DMNCs in technology-intensive businesses use the dependency of subsidiaries on technology as a basis for control. That dependence could be based on access to a central design data base, as was the case for Dresser. All subsidiaries in Dresser's compressor business prior to 1980 were linked to headquarters. When the Reagan Administration imposed an embargo on shipments of compressors to the Soviet Union, the French government insisted that Dresser (France) honor the contract and supply the compressors to the Soviets. Dresser's headquarters in the United States was forced to sever its ties with Dresser (France). Dresser top management ordered the computer links between Pittsburgh and France cut off, thus temporarily immobilizing

the French subsidiary. The Dresser incident is an illustration of the influence that headquarters can impose on the subsidiary, if the subsidiary is dependent on the parent for technology or management support.

4. The three illustrations above may lead the reader to the inappropriate conclusion that the only mechanism available to headquarters in exercising control over subsidiaries is to ensure a pattern of resource deployment that keeps subsidiaries dependent on each other, with headquarters providing the crucial coordinating link[3]. While maintaining a level of dependency at the subsidiary level facilitates operational control (global integration), strategic control is as such is dependent on having the key subsidiaries share *a common vision* with headquarters. The ability of headquarters to assign differentiated strategic missions to various subsidiaries, as a function of an overall global strategy, depends on the ability of headquarters to involve the key subsidiaries in evolving that strategy and communicating it effectively. Further, top managers must recognize that subsidiaries' performance must be measured according to their assigned strategic mission in the overall global network rather than on stand-alone, autonomous business. Let us, for example, consider CPC and Unilever locked in a battle over the packaged cooking oil market around the world. The role assigned to the German subsidiary of CPC, let us assume, is to attack the profit sanctuary of Unilever in Germany, so that CPC's Brazilian cash flow can be protected. The strategic mission assigned to the German subsidiary of CPC is clear—reduce the profitability of Unilever in its most important market, even if it means taking a profit penalty in Germany in order to protect the cash flow of CPC Brazil. Such strategic coordination requires that all subsidiaries perceive the threat of Unilever as urgent and important and are willing to make sacrifices in their operations to protect the integrity of the whole. It also requires top managers to ensure that the contributions of the CPC managers in Germany are measured differently. Measurement of the contribution of the CPC managers in Germany are must go beyond the profit contributions made by Germany as an autonomous unit and must incorporate the strategic contributions made by them to protect the overall cash flows of CPC.

*DMNC= Diversified Multinational Corporation

Source : Prahalad, C.K. and Yues L. Doz. The Multinational Mission, The Free Press, 1987, pp.161-164.

7.7 OWNERSHIP AND CONTROL :

There seems to be close and indistinguishable inter-relationship between ownership and control of foreign subsidiaries. As the firm accumulates certain expertise in conducting international business, its desire to incur and unify the overseas into a global system increase. To accomplish this goal, the firm tries to increase its integrated share of the overseas subsidiaries. For instance, Stopford and Wells have reported in their study of 187 United States MNCs: "In most cases in which firms showed strong preference for wholly-owned subsidiaries the issue of control appeared to be paramount[9]."

They further stated that certain strategies demanded tight central control; other did not. Strategies that are generally extracted through a tight controlled organisation which are usually associated with a strong preference for wholly-owned subsidiaries[10]. Overall, they found that firms emphasising marketing and advertising techniques, rationalisation of production processes and control over sources of raw materials tend to prefer wholly owned subsidiaries.

The preference of United States MNCs for wholly-owned or majority-owned overseas subsidiaries reflect their drive for unification and rationalisation of global units. In the United States

ownership means control, and without extensive control over the subsidiaries' activities, it is difficult to achieve unification. In contrast, European and particularly the Japanese company's willingness to enter into joint ventures reflects their adaptability to the developing countries' demands.

It also indicates that there are other means of control available to international corporation besides 100% ownership. These include input and output controls exercised through technology and personnel transfers[11].

Ownership as a Control Measure:

As is well known, until recently the ownership has remained a thorny issue in the developing world. There is perceptible change with the opening up of the economies of many developing countries. Not too far in the past, even the industrialised countries such as Canada, Australia and France have been demanding local equity in foreign enterprises.

Traditionally, the countries with potentially large natural resources/large markets—such as India Mexico, Indonesia, Australia, Malaysia—have been demanding greater local equity participation in foreign enterprises. In view of the restrictive ownership environments prevailing in many countries, MNCs have been constrained to use other means of control to integrate their subsidiary operations which include:

- Technology transfers (throughout controls),
- Marketing policies (or output controls),
- Procurement policies into controls,
- Financial policies,
- Strategic long range planning,
- Human Resource Policies,
- Use of expatriates,
- Personnel visits of overseas units,
- Methods of entry.

Methods of entry :

Related to the questions of ownership is the method of entry in foreign markets. Basically four different options are available to the firm to enter international markets: 1) Exporting from the home country 2) Licensing arrangement in the host country 3) Joint manufacturing venture 4) Acquiring or forming a wholly-owned subsidiary.

As described in blocks 1 and 2 method of entry appears to be evolutionary in character in terms of a firm's experience. In the earlier stage of entering the international markets, the firm may start out with exporting goods and services. Progressively, it moves through the other stages of licensing, forming joint manufacturing ventures, and forming wholly-owned subsidiaries. The method of entry is also related to the stages of a product life cycle. Initially, when the firm is still at the innovative stage it may simply export its technological and marketing knowledge. As the technology matures and the product is standardised, the firm will face intensive competition in both the domestic and overseas markets. It may then be obligated to manufacture overseas either through a joint venture arrangement or by owning overseas subsidiary operations. Based on various qualitative and quantitative researchers dealing with licensing and joint venture decisions, the following propositions can be formulated:

- The smaller the firm the greater is the propensity to license.
- The less experienced the firm in international business, the higher is the propensity to license.

- The greater the level of diversification of the firm's products and services, the higher is the propensity to license.
- The more mature the product lines of the firm, the higher is the propensity to license if foreign investment is not possible or desirable.
- The greater the similarities in market and economic conditions of the home and host-countries, the higher is the propensity to license (i.e. cross-licensing among industrialised countries).
- The greater political and economic risks perceived by the firm, the higher is the propensity to license.
- The greater the demands made by the host country for local participation, the higher is the propensity to license.

7.8 CONTROL AND ORGANISATIONAL STRUCTURE :

Strategic decisions relating to the development and servicing of various markets may be made in the domestic operating divisions; in a domestically-oriented corporate headquarters assisted by staff specialising in exports; in an international division; or in a multinational regional, product or functional headquarters. These variations in the corporate organisation were outlined in unit 4. what is needed to be stressed is that control is inexorably linked to the organisation structure and is exercised through it. Let us briefly recaptulate the structural forms from the international business prospective.

Broadly speaking, there are three primary ways to organise an international business: 1) The International Division; 2) the Global Product Structure; and 3) the Matrix Structure. The international division established as a separate unit in the corporate structure is, typically, the first stage for an MNC and is still used by a large number of companies. This approach has the advantage of concentrating all aspects of international operations into one division. However, this kind of arrangement may cause isolation from domestic operations and may encourage the development of independent geographic regions rather than world wide development of product lines. The international divisions is most effective when there is a limited diversity among the company's various product lines and where there is effective integration between domestic and international operations.

In the global product structure the mangers are incharge of different product lines which are marketed world wide. There are several potential benefits of this structural arrangement, such as improved cost efficiency by having manufacturing facilities located in areas of lower cost, skilled labour, improved communication etc. However, this structural form has not worked effectively for all MNCs and may give rise to certain barriers in communication and coordination.

The global matrix attempts to balance the roles of foreign are-based managers with central office product managers. The matrix structure, as you might be aware involves sharing of responsibility and authority, and integration of activities through cooperative action. Nestle, DOW chemical, and Ciba-Geigy emphasise the geographic element of the matrix whereas American Cynamid and General Electric (G.E) focus on product division. One of the major advantages of the matrix structure is its flexibility Authority and influence can be shifted between the product and geographic structure. However, it is inherently unstable. "Each multinational company must continually re-examined its changing needs and requirements fine, tune its matrix, and strive to find the appropriate balance. This self-examination is by no means easy; considerable managerial skill and flexibility are required[12].

Each structure has certain advantages and disadvantages. The management should look at these alternatives from the point of view its own specific situation. The structure should fit the particular environmental, technological and psychological circumstances. However, MNCs have learnt that continual reorganisation in order to find the perfect structure may be unnecessary. It may be more advisable to improve the existing processes through management education and organisational development rather than resorting to frequent reorganisations. The successful MNCs do not continually reorganise their operations. These companies see the international challenge as one of **building and maintaining** a complex decision making process rather than of finding the right formal structure. The critical task is to develop new management perspectives, attitudes and processes that reflect and respond to the complex demands the companies face in their international operations. The successful MNCs develop an organisational cultural that allow the manager to sense, analyse and respond to the strategic international opportunities and demands and to build communication channels between domestic and international operations[13]

7.9 THE CONTROL PROCESS :

There is no gainsaying that appropriate decision making in the control area is not likely unless corporate goals have been spelled out and communicated, and a continuing planning process is institutionalised to make goals operational.

The Annual Planning Cycle: The formal control process is usually structured around an annual planning cycle beginning with the submission of **planning guidelines** to the subsidiaries from the central office. These guidelines often emerge from the development of a global strategy. The planning cycle in the subsidiaries, therefore, must be preceded by what may be called **"international planning process"** at the headquarters. The international planning process is presented in **Figure 7.4**

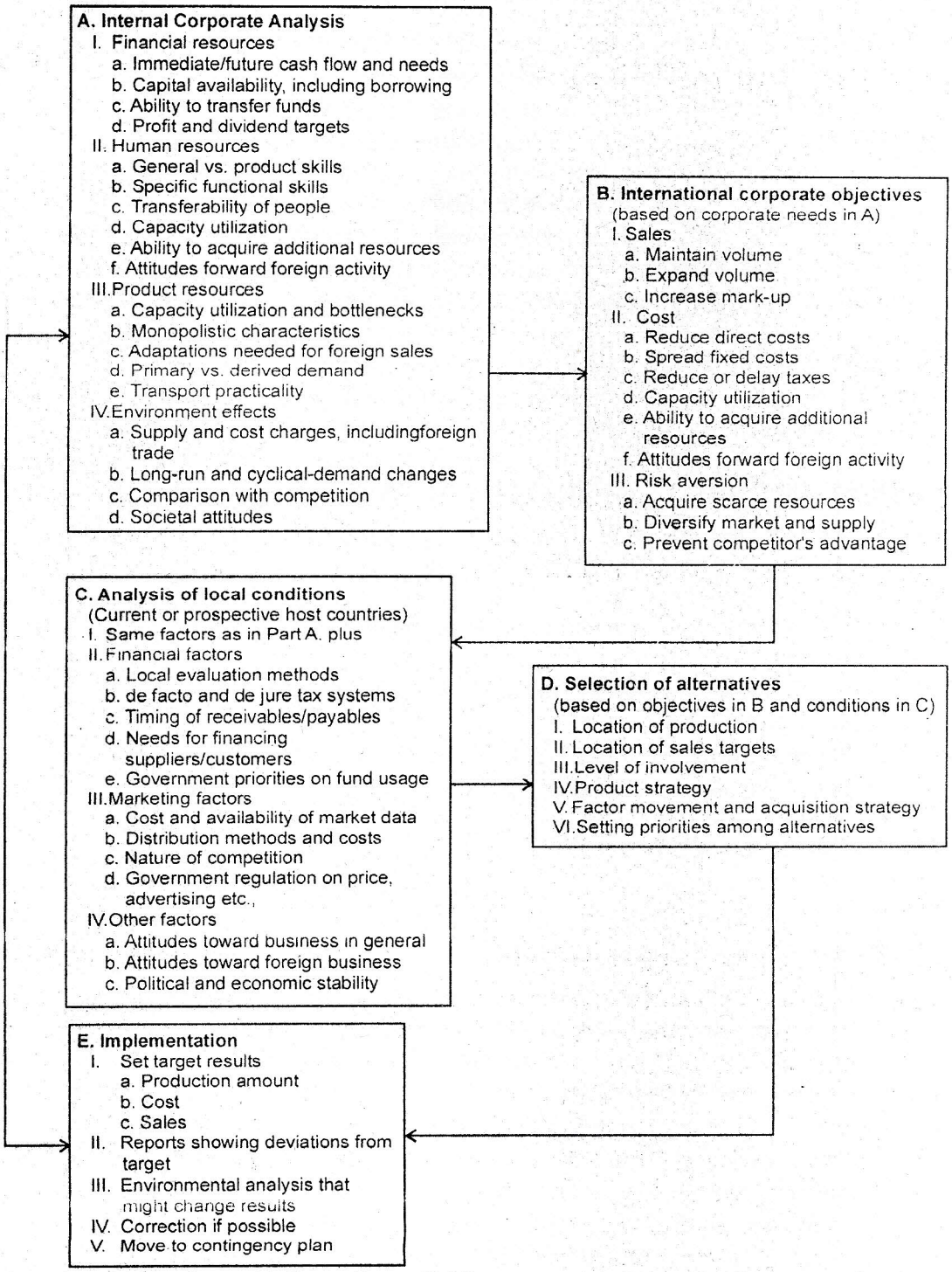
Planning must involve the meeting of objectives with the internal and external environment. The first step is a **self-analysis** of internal resources and constraints on the total corporation a long with the environmental factors; only by taking this first step a firm can set the overall rationale for its international activities. The analysis of the internal resources will help to determine which of these objectives is feasible and most important. It will thus be helpful in the selection of the right alternatives.

Since each country in which the firm is operating or is contemplating to operate may have certain unique elements/features, the local analysis will also have to be made before the final alternatives can be fully examined.

Priorities must be set among alternatives so that programmes may be easily added or deleted depending upon resource availability or situation. Without establishment of priorities, decisions may have to be made too hurriedly to fulfil common objectives even partially. Finally the firm's specific objectives should be set for each operating unit, along with ways of measuring both deviations from the plan and conditions that may cause a deviation. Through timely evaluation, management may take corrective actions or at least move to contingency means for achievement of the objectives.

The planning guidelines, mentioned above, may vary in the amount of detail depending upon the firm's managerial philosophy. Some companies believe that extensive corporate guidelines, even to the extent of specific sales targets, provide better coordination between regions, execution of plans after they have been approved, allocation of capital spending, and the acceptance of more ambitious goals by units in the field[14]. Others believe that "bottom-up" planning which relies heavily on local initiative, encourages better performance from local units because they best understand

their own capabilities. If the latter approach is adopted, the guidelines are minimal. The subsequent global strategy assessment process at the centre is used to focus on those units whose plans seem to be out of line.



After receiving the guidelines, the subsidiary managers prepare their own plans, usually in a format specified in a standard planning or budget manual. The tend today seems to be in favour

or emphasising strategic focus i.e. detailed information on market, competition, etc. rather than routine control by seeking internal accounting information. The subsidiary managements' plans, including assessment of the competitive situation and proposed action, is then subjected to critical central review.

After the annual plans have been received from various subsidiaries, some multinationals hold formal review meetings wherein functional specialists at the headquarters have discussions with the line managers who had submitted the plans. Any points of disagreement are resolved by the Chief Executive. The review meetings may often be on one-to-one basis. But in some cases the managers of all the subsidiaries may be invited to attend. The purpose of the latter approach obviously is to facilitate coordination and avoid repetition of earlier planning mistakes or problems. Such meetings are particularly valuable when subsidiaries are of comparable size and situation.

The formal acceptance of plans gives the line managers a signal to go ahead and implement the proposals in the plans. It acknowledges the targets as reasonable expectation of achievements.

Activity 3

Arrange a meeting as specified in Activity 2. Ascertain the steps involved and the salient features of the organisational control process. Show the process diagrammatically/graphically. List the main reports that flow (both ways) between the headquarters and the units.

.....

7.10 REPORTING AND INFORMATION SYSTEM :

The logical consequences of preparation and acceptance of annual plan are periodic reporting and review of progress during the year. Some firms require monthly reports on sales and certain financial items. Other types of reports may be required quarterly or semi-annually. Some of the control items (measures) on which information may be received by the parent from the subsidiary is presented in Table 7.1.

Table 7.1: Some Control Measures

Marketing Control

- Total sales revenue
- Sales revenue by product line
- Sales to specific accounts
- Total selling expense
- The components of selling expense (such as commissions, travel expense)
- Selling expense by product or product line.

Manufacturing Control

- Total manufacturing expense
- The components of manufacturing expense
- The cost of specific raw materials
- Units of output by product
- Manufacturing variances from a standard cost system
- Quality control data.

Financial Control

- Subsidiary total profit
- Subsidiary profit by product line
- Inventory levels
- Accounts receivable turnover

Several channels may be used for reporting within the multinational system. The prime channel is reporting by the managers up the line ultimately to the CEO. In addition, controllers or financial officers, production managers, chief engineers, and directors of R & D may report directly to their counterparts in the headquarters on certain aspects of performance without going through their own chief executives.

Timely reports from all operating units of an international firm are needed so that management can allocate resources properly, make corrections in plans, and reward personnel for their performance. Let us look first at the resource allocation. Profits from one unit may be used within that unit, elsewhere for expansion, for dividends, for reducing the need for borrowed funds, or for meeting possible contingencies. Similar line of thinking may be valid for use of personnel, technology and end-product. The decisions on the use of any of these resources is of continuous nature. Consequently, reports must be frequent and show recent situations so that resources are put to the best use. Second, plans need to be updated in order to be realistic and to assure that there is a high probability of meeting the desired objectives. Feedback on both results and conditions that might affect results are essential so that corrective action, whether in the form of new strategies or in the form of altered objectives, may be undertaken. Finally, reports are needed in order to evaluate the performance of personnel in the various operating units of the company.

Several studies of reporting systems utilised in international firms indicate that the systems used for foreign operations are similar to those used domestically. The main purpose of MNEs' reporting systems is to assure adequate profitability by identifying deviations from plans which, in fact, may be indications of possible problem areas. The focus of the reports may be on short-term performance or on long-term indicators which are pointers to the achievement of the strategic thrust of the organisation. The emphasis should be on the evaluation of the subsidiary as a unit of the organisation rather than on evaluation of the subsidiary manager, although the profitability of the foreign unit may be one of the important ingredients in the managerial evaluation[15]

In some companies, the various reports are an input for the periodic or monthly management meetings where progress is evaluated and trouble spots are identified. When problems have been identified, plans may be revised; or where appropriate, a task force be may dispatched from the headquarters or some other subsidiary to make repairs.

Subsidiary managements hold more positive attitude towards international reporting when the frequency, quantity and quality of feedback are higher[16]. High quality feedback would include relevant questions of strategy and the changing competitive environment. Attitude towards feedback may also vary among cultures. Brandt and Hulbert's study of Brazilian subsidiaries of U.S. multinationals showed that most of the subsidiaries received monthly feedback whereas fewer than 10% of the European and Japanese subsidiaries received regular feedback[17]

7.11 CONTROL THROUGH COMMUNICATION :

The formal control procedures are only one part of the overall control process. The formal control communications are usually supplemented by many more informal exchanges via telephone, telex, fax, E-mail and by meetings. In many cases, the informal communications will even by-pass the organisational hierarchy.

Where operations are in different countries and managers have different cultural and language backgrounds, control through programmes of "corporate acculturation" (or socialisation), as briefly mentioned in a preceding section, and "people transfer" can be important and effective. Corporate acculturation is the process of training subsidiary managers extensively so that they understand and generally accept the company's way of doing business. A part of this process is to have key subsidiary personnel spend part of their career at the headquarters. Likewise, headquarters personnel should have experience of working in the subsidiaries.

Edstorm and Galbraith studied transfer of managers form one subsidiary to another between countries in three European multinational firms. They concluded that the transfer of managers from subsidiary to subsidiary was a distinct control strategy in one firm. The transfer process created international, interpersonal verbal information network throughout the firm which were utilised for coordination and control[18]. On a more global level, Stopford and Wells point out that one way of combating control problems is the creation of a sense of cooperation and shared values among organisational members around the world. They also point out that this requires heavy expenditure on communications including frequent meetings and retraining sessions[19].

Based on a retrospective look at his experience as an executive with Unilever, Peter Kuin state that the "magic" which helped the Unilever to function multinationally was its distinct corporate culture. "This culture was maintainable because of the long tenure of the employees and the fact that almost everyone knew English". He noted a distinct **enculturation** process which included in house training programmes and the rotation of managers around the world[20].

Personal contacts through short-term or long-term people transfers greatly increase the ability of the managers with diversified backgrounds to understand each others' point of view. In the Brandt and Hulbert study, two factors which strongly influenced the effectiveness of the communication with headquarters were that: i) whether superior at headquarters had worked in the Brazilian subsidiary or not and ii) the tenure of the chief executive of the subsidiary with the company.

Studies have shown that European and Japanese companies have successfully integrated their subsidiary managers into corporate decision and policy-making structures. For example, on study found that 61% of the Japanese executives were represented in one or more of the strategically important corporate committees. And this was in addition to 32% membership on the corporate Board. In contrast only 17% of the U.S and 33% of the German subsidiaries' executive participated in the headquarters committees[21]

It is believed that top-level Japanese executives maintain close ties with the managers of their overseas subsidiaries. Through strong personal relationships and extensive socialisation the Japanese organisations are able to implement the so called "Ringi" system or bottom-up decision making system.

Overall, the results of the various studies on communication processes reflect the organisational system and management styles of each nationality group. The U.S. style is more formal objective and problem-oriented. The Japanese are less formal, unstructured and goal-oriented. The Europeans seem to incorporate both the elements of U.S. and Japanese styles.

The following guidelines based on the experience of the managers who have worked in the international area may be helpful. It is all desirable that decisions (except those considered vulnerable legally or politically) made at a level higher than that implementing the decision should be committed to writing, in respect of how they were communicated initially. Given the pitfalls of international communications, this rule is more important than in comparable domestic situations.

- Visits by decision making authorities or to other representatives should be on a regular basis, and not when crisis arises.
- Periodic conferences of key personnel of similar function from both domestic and foreign operations are of great help in developing universally valid strategies and in the delegation of tactical decisions to lower levels.
- Management training and development has considerable importance for foreign operations because of differences in cultural backgrounds, particularly when managers from one national society move to another. If the objective of decentralisation of authority is the improvement in the quality of decision making, such training is helpful as it catalyses the process.
- Periodic relation of overseas managers to regional or corporate headquarters may be one of the most effective ways of communicating overall corporate goals and the rationale for corporate strategy.

7.12 ACCOUNTING ASPECTS OF MULTINATIONAL CONTROL SYSTEM :

You would recall that it was earlier pointed out that by and large many multinational enterprises have relatively sophisticated planning and control systems. A uniform system of planning, budgeting and performance reporting provides the headquarters with comparable data from all parts of the enterprise. The main advantage of such an approach is that it enables all managers to speak a common "company language", regardless of background or nationality. In designing such a uniform system, however, some decisions have to be made as to exactly how the data are to be recorded. In addition to this, there are pitfalls in interpreting standard data relating to situations which are often non-standard.

Income Measurement :

Measurement of net income is an important task for assessing the performance. Headquarters generally charge royalties, service fees, and allocations of headquarters and research expenses to the subsidiaries. Generally, the headquarters management have certain objectives in doing so (e.g. systemwise optimisation). They have the financial authority in such matters. The financial performance of a subsidiary thus depends as much on the decisions of the headquarters as it does on local conditions.

The objective with which a subsidiary was set up may have a bearing on its profitability. The objective in setting up a subsidiary may have been to reinforce performance elsewhere in the system. For example, a unit may have been advised to raise substantial debt to provide funds to

other subsidiaries in the multinational system. Taxation may also complicate matters. A low local tax rate may encourage the multinational to charge only lower amounts of central overheads. Thus, income before-tax and after-tax would be affected. All these matters as well as the allocation of central overheads can make measurement of real (or intrinsic) profitability of a unit quite difficult which in turn would affect the comparability on a fair basis.

Investment Measurement :

Measurement of income (in absolute terms) alone may not be considered sufficient. Many multinationals relate it to the investment in the subsidiary. In such a case, investment base has to be measured. There are two crucial questions in this context: one is what Assets and liabilities are to be included (or considered) and the other is how or on what basis the assets and liabilities have to be valued? Whatever procedures are adopted in this respect, they have considerable influence on the behaviour of the managers. For example, if the evaluation of assets is based on historical cost, investment in the subsidiary will be understated and the managers in the countries with high inflation rates, directly on indirectly, may be encouraged to underprice the products and expand volumes and investment beyond what may be considered as optimal for a subsidiary or its performance.

Though the use of standard ROI (Return on Investment) measure is quite widespread, managers however have a preference for specific ROI targets laid down for them which reflect the specific objectives and environmental conditions applicable in their cases. The standard ROI may not provide an equitable basis for comparison. The participation of subsidiary managers (whose performance is to be evaluated) in establishing their target (or budgeted) goals would contribute to a spirit of cooperation and responsibility for achievement.

Performance Evaluation :

The meaningful performance evaluation can be made only on the basis of realised profits before allocated charges and taxes. The evaluation of managers' performance on the basis of "what is within his control" (i.e. control criterion) is considered a better indication of his real contribution in the light of the objectives set for him.

It is generally agreed that subsidiaries should be evaluated separately from the management within subsidiaries. The purpose being that managers are not penalized for conditions and occurrences that are outside their control. Beyond this agreement, however there is a good deal of diversity in practices among firms in what they do and do not include in the managerial performance evaluation. For instance, some firms hold managers abroad responsible for gains or losses in currency transaction while others do not. Most firms deduct interest expenses before measuring the profitability of foreign operations; however, many do not[22].

The cost structures of different affiliates may preclude a meaningful comparison of operating results. For example, the percentage of direct labour to sales in one country may be much higher than in another country if the former is more labour-intensive. There is no guarantee that the firm will produce the same product with the same set of inputs at all plants. It may have to adjust its normal production processes in the light of available labour and capital. Different accounting practices can also create problems. Most international firms keep one set of books that are consistent with parent principles and another set of books to meet local reporting requirements.

Every evaluation measurement has shortcomings when applied internationally. Consequently, a system that relies on a number of different indicators may be preferable to one that relies too heavily on one measurement. Financial criteria tend to dominate the evaluation of foreign operations and their managers. While many different financial criteria are used, the most important for evaluating the operations are budget compared with profit, budget compared with sales, and return on investment. The most common financial criteria for management appraisal are: actual profit against budgeted; actual sales against budget sales; and actual return on sales against budgeted return. Many non-financial criteria are also employed; the one commonly used and given much weight in subsidiary evaluation is the increase in market share. Non-financial criteria are important for evaluating the performance of managers and these include market increase in share quality control, and relationship with the host government[23]

Measurement Currency :

Several multinational require a uniform basis of converting the profit and balance sheet items in one "corporate" currency (and this is usually the currency of the headquarters).such a rule can have tremendous effect on reported results. For example, a subsidiary's performance in a high inflation country will look better (or worse) than it should if the exchange value of the subsidiary's currency depreciates less (or more) in relatio to the corporate currency than relative inflation rates would indicate.

Whether a subsidiary's performance should be measured in its local currency or in the currency of the country where headquarters is located is a controversial matter. One school believes that it should be measured solely in terms of the local currency as that would enable to evaluate the performance of the local manager based on the operating efficiency, uncomplicated by any gain or loss from fluctuating currency values. The other school advocates that multinationals should use the home-country currency as the basis for budgets and for monitoring performance against those budgets. The choice of currency exchange rates, therefore, will shape the performance shown in the corporate currency and influence managerial behaviour.

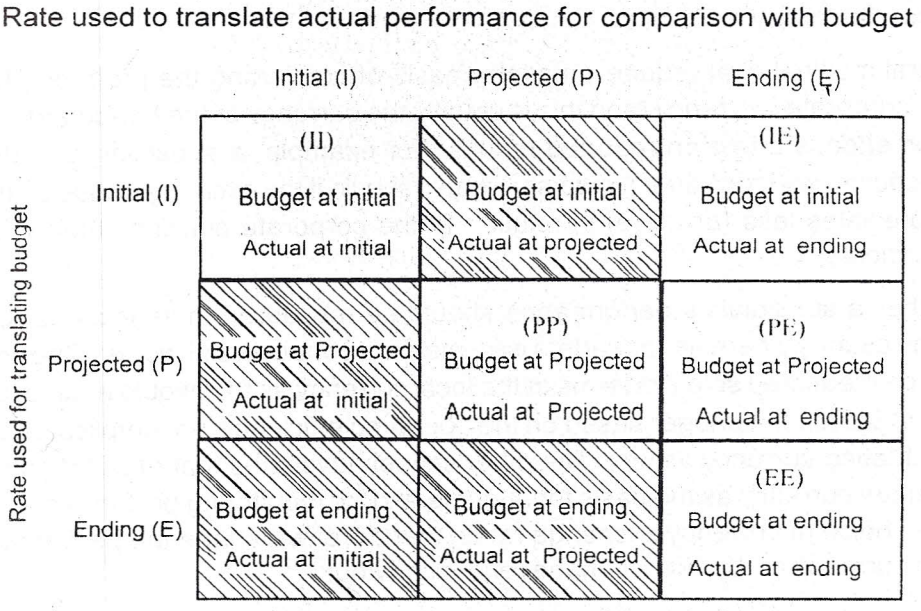
There are three ways of handling the translation of a budget into the corporate currency.

1) The spot rate at the time of the budget (i.e current spot rate) can be used. This is called the **initial rate**.
2) A spot rate for the end of the budget period can be forecast This is called the **projected rate**. This is, of course, subject to considerable forecasting difficulties.
3) The budget itself is translated at the rate current at the end of the budget period (or whenever a comparison is made). This is called **ending rate method.**

The above three alternatives can be used for translating the actual performance figure for comparison against the budget. As illustrated in Fig. 7.5 the three alternatives imply nine combinations of exchange rates that might be used in the budgeting and control process. Of these nine combinations, five seem reasonable. The remaining four, shaded in the figure, are illogical because actual performance is translated neither at the rate used in translating budget nor at the exchange rate current when comparison is made.

Under the three combinations (II, PP, EE), in which the same exchange rate is used for translating both budgeted figures and actual performance, a change in exchange rate creates no variance for manager concerned. Thus the responsibility for exchange rate variation rests with the central corporate office. In only one of these three cases (PP) does the operating manager have to deal with an exchange rate forecast. This is when a projected rate is used to translate both the budgeted and the actual performance. The projected rates under this combination are termed as "internal forward rates". They produce the effect of the corporate office acting as a banker to buy forward receipts in foreign currencies at a guaranteed rate. Besides its elimination of exchange-rate variation from measurement of management, the PP combination has the additional advantage of being able to incorporate

Fig 7.5: Possible Combinations of Exchange Rates in the Control Process



the internal forward rate most appropriate to the corporation's positions when the budget is being mode.

The remaining two combinations (IE, PE) leave the exchange risk with the operating manager. This risk is somewhat reduced when the budget is based on a projected rate (PE) rather than on the rate ruling at the time of the budget. The manager to be measured on actual performance translated at the ending rate will under both combinations be tempted to take steps to cover against the risk. It seems that the best combination of plans is (PP) i.e. "budget at projected—actual projected." Table 7.2 shows the reported use in 1977 of various combinations in a survey of 100 United States multinationals in 1977:

Table 7.2: Use of Various Combinations of Measurement Currency

Method	Approximate percent of firms
(PE) Budget at Projected – Actual at Ending	50

(PP) Budget at Projected – Actual at Projected	20
(II) Budget at Initial – Actual at Initial	12
(IE) Budget at Initial – Actual at Ending	12
(EE) Budget at Ending – Actual at Ending	5

The most common method (i.e., Budget at Projected – Actual Ending) does save accounting cost, but it also make operating manager responsible for discrepancies between projected and final exchange rates. If the projected rate was forecast by the corporate office, the managers results would vary according to the equality of some one else's forecasts.

In translating balance sheet items for internal control purposes, a multinational may use any one of the translation methods. It is not essential that the method used be identical to that used for external financial reporting. Theoretically, the external reporting requirement should have no effect on internal reporting. In a survey of U.S. multinationals (1978), it was found that the majority of the reporting companies, excluded translation gains and losses from the income figure used to evaluate the foreign subsidiary manager[24]

Intra-company Transfer Pricing

Intra-company transfer pricing refers to the prices at which goods and services are exchanged within the corporate family. This has an important effect on control and performance. You might be aware that there are several difficulties in setting a fair transfer price when a free market does not exist. Moreover, problems also arise because of different customs duties, tax rates, and currency risks. Transfer prices are often used as a mechanism for achieving various enterprise goals and to increase the overall enterprise profits.

Difficulties may be confronted if the units operating in foreign countries act as profit centres. If profit centre concept is used, financial rewards of the managers may be based on performance. It then becomes desirable that transfer prices are competitive and relatively uniform between units in the systems whose performances are being compared.

However, through manipulation of transfer prices the total system profit may be maximised. There are techniques to achieve this while retaining the profit centre concept. One method is to share the total realised profit of the company between the parent and foreign subsidiary on the basis of assets used, costs incurred, or on a more subjective basis of equitable treatment. Another way is to keep two sets of accounts, one official for tax and other local purposes and another set for management control purposes. Still another method is to take account of transfer price manipulation in the budget and measure performance against planned results, even if a loss was intended. Each of these techniques has drawbacks. The practices verge on unethical and it is to be seen whether the gains form manipulating transfer prices more than offset the resulting cost and complexity of judging performance. The evidence suggests that firms using transfer pricing as an instrument for enhancement of overall corporate profits place less emphasis on profit-oriented measures in evaluation performance of subsidiary managers[25].

Activity 4

Arrange a meeting as specified in Activity 2 and discuss.

i) How is the income of the units measured?
ii) How is the performance of managers and profit centres measured?
iii) In which currency are the vital accounting data converted? Discuss the rationale behind such conversion? Discuss whether any problems arise.
iv) Whether a comparison is being made of the subsidiaries by the parent company? If yes, what criteria are being applied?

.....

.....

7.13 CONTROLLING JOINT VENTURES :

You are aware that one of the methods of gaining entry into foreign markets is through joint ventures in which at least one parent is headquartered outside the venture's country of operation. Much of the international business activity today involves international joint ventures. Through the control process the parent company ensures that the way a joint venture is managed conforms to its own interest.

Most of the firm's objectives can be achieved by careful attention to control features at the outset of the joint ventures, such as the choice of the partner, the establishment of strategic fit, and the design of the joint venture organisation. Frequently joint ventures are located in the less developed countries where governments enforce a joint venture policy as a means of increasing local control over business decisions to ensure that these decisions are compatible with national objectives.

The most important single factor determining the success or failure of a joint venture is the choice of a partner. Many a time, a firm may rush through the process of partner selection because it is anxious to get on to the "bandwagon" in an attractive market. In the process of selection of partner, it is imperative to ascertain whether the strategic goals of the partner are compatible. The strategic context and the competitive environment of the proposed joint venture and the parent firm will determine the relative importance of the criteria used to select a partner. To facilitate the general fit between the international strategies of the parent and the strategy of the joint ventures, the partner selection process must determine the specific task—related skills and resources needed from a partner as well as the relative priority of those needs. International joint ventures are like a marriage – the more issues that can be settled before the marriage, the less likely it is to break up later.

Control over the stability and the success of the joint venture can be largely built into the initial agreement between the partners. The contract can specify who will have what kind of control in a variety of circumstances such as the contractual link of the joint venture with the parent, the capitalisation and the rights and obligations in relation to property. Much would depend upon whether stakeholders are equal or unequal. It is natural that the partner who has majority stake in the joint venture will have more control. However, it all depends upon mutual understanding. It is quite likely that the parent may delegate the daily operations (or tactical decisions) to the local management, while retaining the important decisions with it.

The experience of Japanese multinationals with joint ventures is of special interest because Japanese firms have had a much higher ratio of joint ventures than United States, European, or Canadian firms. The extent to which a joint ventures subsidiary can be controlled by the parent,

according to one study, depends upon the control that parent has over key resources required by the subsidiary, such as information, technology, management knowhow, finance, and input-output leverage. For Japanese firms most important source of control has been the technical assistance contract, information and know-how flows. The second most important means has been the placing of home-country personnel in the subsidiary. The production manager position has been more heavily relied upon than the financial manager position as a means of control[26]

7.14 SUMMARY :

The managerial function of control is universal. The controlling process is the same whether it is a domestic company, or a multinational corporation with a network of foreign affiliates, or an international joint venture. It is the extent, the focus, and the mechanisms used for control that differ. Control assumes greater importance in multinational companies because they operate in more uncertain environments.

The complexity, scale and diversity of multinational operations make the task of integrating and controlling a worldwide network of subsidiaries, joint ventures, and contractual relationships quite intricate. The management at the headquarters must design appropriate control and information systems taking into account the relevant factors so that performance is evaluated appropriately. The control systems must be flexible and continuously adapted to new or emerging realities.

There are two basic approaches in establishing a control system: one is input control and the other is output control. Input control operates through behaviourial interaction while output control rests on feedback reflected in the actual performance. The control system of a corporation may be market-driven, or rules-driven or it may be bound by its unique culture. National culture traits also impinge upon control systems.

What degree of control would be exercised on the affiliates or subsidiary units would be influenced by several factors, viz., ownership structure, nature of the industry in which the subsidiary operates, importance of particular decisions, range of products and markets, size of subsidiary operation, physical and cultural proximity and degree or nature of interdependence.

Control of foreign operations is inextricably linked with the question of ownership. Because of the prevalence of restrictions on the extent of ownership, the multinationals have hitherto been more guided by other devices for controlling their foreign operations e.g. technology transfer.

The control process begins with the annual planning cycle which begins with the dispatch of guidelines by the headquarters to the subsidiary managements. The logical consequence of annual plans is the floatation of reports (or feedback) on performance. The effectiveness of control, to a large extent, depends upon the quality of the information system that has been designed and developed.

The formal control procedures cannot take care of all the contingencies in a control system. The formal control process is therefore supplemented by informal exchanges, people transfers meetings etc. Because of cross-national operations and varied cultures, special efforts are required to improve the effectiveness of communications.

In the process of control some accounting problems have to be tackled. They relate to measurement of income and investment base, performance evaluation, currency of measurement, and transfer prices. It should be seen that the rules of internal accounting system do not lead the subsidiaries in taking inappropriate actions. It is, of course, difficult, if not impossible to develop

performance standards that are meaningful and also do not interfere significantly with operating objectives.

Joint ventures have become a distinctive feature of multinational operations. Many of the control problems relating to international joint ventures can be taken care of by careful drafting of contractual relationship and selection of a right partner.

7.15 KEY WORDS :

Collectivism : The extent to which group norms constrain individual behaviour. Group norms determine, to a large extent, the individual behaviour.

Corporate Acculturation : The process through which corporate values and beliefs are internalised by or inculcated among the organisational members.

Corporate Culture Approach : A control approach which envisages the internalisation of organisational goals by developing a strong set of beliefs and values. Norms of behaviour are enforced informally and implicitly.

Individualism : The extent to which individual behaviour is accepted. Group norms either do not exist or if they do, they are quite loose.

Input Control : *Ex ante* control that operates through behavioural interaction.

Market Approach: A control approach which allows market forces to control the behaviour of management within the units of multinational.

Output Control : *Ex post* control that rests more on the feedback on actual performance.

Pooled Interdependence : It exists when organisational members share common resources but otherwise are quite autonomous.

Power Distance : The degree to which a culture accepts unequal distribution of power and privileges and the exercise of personal absolute authority.

Reciprocal Interdependence : It exists when organisational units feed their work back and forth among themselves.

Rules Approach : A control approach which places greater reliance on strongly imposed rules and procedures.

Sequential Interdependence : It exists when output of a part of the system is fed into another part.

Uncertainty Avoidance : The extent to which a society is risk-averse.

7.16 SELF ASSESSMENT QUESTIONS :

1) Why the need for control is, particularly, felt in multinational enterprises? What key questions in relation to control arise in international business?

2) From control point of view, what differences exist between domestic and international business?

3) What are the objectives of control in international business operations? In what way corporate culture may be helpful in the control process?

4) Critically examine the various approaches to control. If you were the CEO of a multinational corporation which approach you would prefer and why?

5) In what way national cultural traits influence the control system? Explain with examples.

6) What factors would determine the degree of control exercised by parent multinational on the subsidiary operations.

7) Explain the various types of interdependence that may exist between the units of a multinational enterprise. What effects they will have on the control system?

8) In what way is the question of ownership related to control? What devices have been used by multinational firms to overcome the impediments placed by foreign countries on the extent of ownership?

9) "Control is intimately linked with organisation structure." Elucidate.

10) Briefly describe the control process in relation to international business.

11) What objectives the reports on performance fulfill ? What is the role of an information system in the success of international business?

12) "The success of multinational firms, to a large extent, depends on the effectiveness of communication system." Explain what methods of communication can be effectively employed by such firms?

13) Explain the accounting problems in relation to multinational control system.

14) Examine the pros and cons of converting vital accounting data in "corporate" versus "local currency". Give your own views regarding this controversy.

15) Write a note on "control of joint ventures."

7.17 FURTHER READINGS :

Buss, Martin D.J. 1982. "Managing International Information Systems". *Harvard Business Review,* Vol. 60, No.5, Sept.-Oct. 1982, pp.153-162.

Choi, Fredrick D.S. and I. James Czechowicz, 1983. "Assessing Foreign subsidiary performance: A multinational comparison", *Management International Review,* Vol. 23, No. 4,1983.

Jaeger. Alfred M., 1982 "Contrasting Control Modes in the Multinational Corporation: Theory, Practice, and Implications" *International Studies of Management and Organisation* 12, No.1 (1982).

Jaeger, Alfred M, 1983. "The Transfer of Organisation Culture Overseas: An Approach to Control in the Multinational Corporation', *Journal of International Business Studies,* Fall 1983, pp. 115-129.

McInnes, J.M. 1971. "Financial Control Systems for Multinational Operations: An Empirical Investigation", *Journal of International Business Studies*, Fall 1971, pp. 11-28.

References :

1) Child J., Organisation: A Guide to Problems and Practice, Harper & Row, 1977,p.117.
2) Tennenbaum, A., Control in Organisations, McGraw Hill, 1968.
3) See Prahalad, C.H. &Yves L.Doz, "An Approach to Strategic Control in MNCs" *Sloan Management Review,* Summer 1981, pp. 5-13.
4) Libas, Michael and Jane Weigenstein, "Management Control: The Role of Rules, Markets and Culture," *Journal of Management Studies* 23 (May 1986), pp.259-72.
5) Daley, Lane, et al "Attitude towards Financial Control Systems in the U.S. and Japan", *Journal of International Business Studies,* Fall 1985, pp. 91-110.
6) Hofstede, G.: Culture's Consequences: International Differences in Work-Related Values, Sage Publications, 1980.
7) Egelhoff, W.G., Patterns of Control in U.S., U.K., and European Multinational Corporations, *Journal of International Business Studies,* Fall 1984, pp. 73-83.
8) Lecraw, D.J., et al (eds). Transnational Corporations – Vol. 4: *Transnational Corporations and Business Strategy* (U.N. Libraray), Rutledge, p.375.
9) Stopford, John M. and Louis T. Wells, Jr. Managing the Multinational Enterprise, Basic Books, 1972, p.107.
10) I bid., p. 208.
11) Negandhi, Anant R., International Management, Allyn and Bacon, p.145.
12) Drake, Rodman L. and Lee M. Candill. "Management of the large Multinational: Trends and Furture Challenges", *Business Horizons*, May-June 1981, pp. 83-91.
13) Bartlett, C.A., "MNCs: Get off the Reorganisation Merry-go-round," *Harvard Business Review*, Vol. 61, No. 2, 1983, pp. 138-146.
14) Duerr, Michael and John M. Roach, "Organisation and Control of International Policies," Conference Board (New York), 1973, p. 22.
15) Choi, Fredrick D.S. and James Czechowicz, "Assessing Foreign Subsidiary Performance: A multinational Comparison", *"Management International Review,* Vol. 23 No. 4, 1983, p.15.
16) Leksell, Laurent, "The Design and Function of the Financial Reporting System in Multinational Companies in the Management Headquarters – Subsidiary Relationship in Multinational Corporations", Lars Otterbeck, ed. Gower, 1981, pp. 205-32.
17) Brandt, William K. and James M. Hulbert, "Pattern of Communication in the Multinational Corporation: An Empirical Study," *Journal of International Business Study*, Spring 1976, pp.17-30
18) Edstrom, A., and J.R. Balbraith "Transfer of Managers as Coordination and Control Strategy in Multinational Organisations," *Administrative Science Quarterly*, June 1977, pp. 248-263.

19) Stopford and Wells, op. cit., p. 208.

20) Kuin P., "The Magic of Multinational Management", *Harvard Business Review,* Nov.-Dec. 1972, pp. 88-97.

21) Negandhi Anant Q., and Martin Welge, *Beyond Theory Z: Global Rationalisation Strategies of American, German, Japanese Multinational Companies, Greenwich, Conn:* JAI Press, 1984, pp. 51-54.

22) Choi and Czechowicz, op cit., pp. 18-20.

23) Ibid., pp 18-20.

24) Helen, "The Effect of Translation of Multinational Corporation's Internal Performance Evaluation," *Journal of International Business Studies,* Spring/Summar 1983, pp. 103-112.

25) Yunker, Penelope J., "A survey study of Subsidiary Autonomy, Performance Evaluation and Transfer Pricing in Multinational Corporations." *Columbia Journal of World Business*, Fall 1983, pp. 51-64.

26) Geringer, J. M., "Strategic Determinants of Partner Selection Criteria in International Joint Ventures," *Journal of International Business Studies* (First Quarter 1991), pp. 41-62.

UNIT - 7

CONTROL AND INFORMATION IN INTERNATIONAL BUSINESS

Structure :

7.1 Introduction

7.2 The Need for Control

7.3 Objectives of Control in Multinationals

7.4 Approaches to Control

7.5 National Cultural Traits

7.6 Decision making Authority

7.7 Ownership and Control

7.8 Control and Organisational Structure

7 9 The Control Process

7.10 Reporting and Information System

7.11 Control through Communication

7.12 Accounting Aspects of Multinational Control System

7.13 Controlling Joint Ventures

7.14 Summary

7.15 Key Words

7.16 Self-Assessment Questions

7.17 Further Readings

7.18 References

7.1 INTRODUCTION :

The need for planning, control and information is not unique to international business. However, due to complexities involved in cross-boundary operations, the need for formal planning and control systems is particularly felt in international business. Generally, multinational firms have quite advanced or sophisticated planning and control practices.

This unit describes the objectives and the process of overall control in the multinational operations. It describes the approaches to control and examines the planning process in the

UNIT - 8

PERFORMANCE MEASUREMENT AND EVALUATION

Objectives :

After going through this unit you should be able to:

- Understand the precise meaning of performance of international firms and firms engaged in international business (both styled as international firms in this unit).
- Identify the parameters which determine the performance of firms, underscoring the distinguishing elements applicable to international firms.
- Learn about the tools and techniques used for the measurement and evaluation of enterprise performance.
- Comprehend the significance of the tools and the limitations of their application.
- Apply the tools of measurement to the evaluation of the performance of international firms.

Structure :

8.1 Introduction
8.2 Basic Concepts
8.3 Variables of Performance
8.4 Mechanics and Modalities
8.5 Tools and Techniques
8.6 Comparative and Historical Analyses
8.7 Productivity
8.8 Project Performance Evaluation
8.9 Socio-economic Performance
8.10 Performance Evaluation of International Trading
8.11 Evaluation Systems
8.12 Performance Evaluator
8.13 Prerequisites and Precautions
8.14 Performance of Transnationals in India
8.15 Self-Assessment Questions
8.16 Further Reading

8.1 INTRODUCTION :

Shares of FERA companies (or foreign controlled companies) attract a very large number of investors in India. The public issue of the Tata-Timken equity was over-subscribed by a record, over 4000 times. The Reliance Industries at one time attracted 2,000,000 shareholders. Why?

There is one common answer. These companies performed better, or were perceived to perform better.

Practically every industry in India has some companies, which earn high rates of profits, and some companies which are sick. Obviously, the former perform better; the latter fail to perform.

What is this performance? And how does one measure it?

Organisations are created to carry out specific functions for the achievement of certain goals. The basic goal of any commercial enterprise (or firm) is to produce and market goods and services, and earn profits. The production and marketing involve investment of resources in terms of technology, management, materials and manpower, all eventually translated and expressed into monetary terms.

A successful organisation is one which produces high returns on its investment. Every investor (or resources) wants to maximise his return over short and long periods. The return reflects the ultimate performance.

Is there any one unique indicator of performance? If yes, what is that? If not, what are the different parameters of performance? How are they measured? What are the tools used to measure them? And using these tools, how do we evaluate the performance?

8.2 BASIC CONCEPTS :

International business is composed, basically, of four types of operations:

1) Production of goods (agro, manufacturing, mining, forest-based or marine products).
2) Marketing (marketing of products or services).
3) Services (such as contracting, consultancy, advertising, banking, insurance).
4) Exports and imports of goods and services (international trading).

The organisational goals and operating structures are divergent in each case. So are their tools of performance, parameters of performance and performance evaluation. This does not imply that there are no commonalities. In fact, the final goal of business organisations is the same, and each involves the same inputs (capital, technology, management, materials and human resource).

International business is carried out by four types of firms:

1) Wholly domestic or joint international firms engaged in
   a) international trade in goods and services.
   b) performing services in other countries.
2) Domestic firms with international capital or technological collaboration.
3) Foreign-controlled companies operating in host countries (multinationals or transnationals)

a) as branches,

b) as locally incorporated companies (subsidiaries),

c) as participative companies with the majority or minority of domestic capital.

4) Joint ventures between domestic and foreign firms operating in one or more of the participating countries or in the third countries.

Performance :

If the goal of an enterprise is to maximise its return (on investment of resources), and its performance measures this return, its measurement is cardinal to (i) investment decisions; (ii) decisions relating to organisation structures; (iii) operational decisions – on product (or service), which it should produce. production-planning. marketing, financial management, human resource deployment and development. Since an enterprise is a living organism, which operates, grows (or contracts), diversifies, interacts, it may perform better during one period, and not so well during another period. It is often found that one constituent of a company performs well, while the other or others do not perform so well. Swadeshi Polytex, a company owned and controlled by the National Textile Corporation (UP) Ltd. produces profits, but other units of the company produce losses. A company may have achieved higher sales during a specific period, but it makes less profit (or more losses) during the same period.

International business, like any other business, is expected to perform for the benefit of

1) marco-economic objectives and

2) micro-corporate objectives.

The present Unit is concerned primarily with the second.

The performance may be viewed from the point of view of return on invested resources (ROI) or operational efficiency of the inputs deployed in the organisation. In the first case, it is the total return of the enterprise; in the second case, it is the net output of a specific input or a group. Since the net output is dependent on the contribution (inputs) of others, it is necessary to segregate the contribution of others, while measuring the performance of a specific individual or group.

Put in a different context, performance is a synonym of productivity. It is measured at four tiers:

- individuals,
- a group,
- the organisation itself, and
- a conglomeration of organisations.

Performance of intangibles (like technology) may also be measured. It reflects, however, in the performance of the agents (supplying, managing or operating it). The performance evaluation at the four designated tiers should take full cognisance of the contributions of intangibles as technology and management systems.

The performance of each an individual (say, a production manager), a group in the organisation (say, Hindustan Lever Ltd.), or a group of companies (say, all Japanese multinational companies operating in India), has its own significance and ramifications and calls or specific treatment. For convenience, the four-tiered structure could be termed:

1.I NDIVIDUAL performance

2.FU NCTIONAL (or group) performance

3.CORPORA TE (or organisational) performance

4.SUB-SECTORAL performance

Since the horizon of the operation at each tier is different as is the intermediate goal divergence. the indices of performance are different too. In theory, the performance of any group, organisation or a defined agglomeration, is the sum total of the performance of its constituents, but it is not always so. First, the performance of a constituent is often not measurable in terms of the performance indices of the group. Profit is an index of performance of a profit centre (group or company), but it is not one of a servicing unit (such as a maintenance unit). Moreover, an individual earns profits only by the combined contribution of others. Secondly, there is normally a synergy in the organisational structure: the output of a group has a multiplier (sometimes negative) over the performance of the sum total of the constituents of the group.

The present Unit excludes the treatment of Individual Performance, which is a function of Personnel Management. It has its own objectives, tools, indicators and appraisal systems.

Since, performance measures productivity is the ratio of output to input, performance is measured in terms of output. If outputs and inputs were all homogeneous and quantifiable, the task of performance measurement would have been simple. Both inputs and outputs are often expressed in heterogeneous terms. Accordingly, it is not easy to measure productivity (or variations in it); and, therefore, performance. Another complicating element is the variability of the media in which different components of the outputs can be expressed. It is, therefore, necessary to identify the goals of performance at each tier, and then translate the output (or performance) in terms of these goals.

Performance evaluation is a four-stage operation:

Fig. 8.1: Stages of Performance Evaluation

Stage	
I	Identify Parameters
II	Identify Tools/Indicators
III	Measure Performance
IV	Evaluate Performance

Parameters and Indicators :

Performance parameters are performance values denoting different outputs, such as, sales and employment. Indicators are the relationships of outputs **inter se** or with other inputs, such as, profitability, productivity, debt-servicing ratios. Indicators, provide the tools for measurement of performance. In common panlance, the terms "parameters" and "indicators" are often used interchangeably. Evaluation of performance is the assessment of the significance of the indicators in the context of corporate or segmental goals (objectives or targets).

8.3 VARIABLES OF PERFORMANCE :

Transnationals may not necessarily be intrinsically better performers than domestic firms, but they possess externalities, which enables them to earn higher profits, says one recent study.

This raises two issues; first, that the transnationals do not possess any intrinsic value, which make them better performers; secondly, that in measuring performance, it is necessary to segregate intrinsic variables from external variables. The latter aspect raises a further question: what are the intrinsic variables and what are the external variables? And a corollary: is there any divergence between endogenous and intrinsic variables?

The variations between intrinsic and endogenous variables do exist. The former are specific elements organic to the organisation; endogenous variables are also specific to the micro units, but may be influenced by external factors, such as, environmental conditions associated with the sector (spatial or otherwise) in which the candidate unit exists. The segregation, however, between intrinsic and endogenous variables is often not feasible in practical terms. It is, therefore, prudent to keep the distinction limited to endogenous and exogenous variables.

While enterprise performance is a function of both endogenous and exogenous variables, the dominance of one or the other set depends on historical as well as structural factors. They are often interactive. More significant variables are set out in Figure 8.2.

Figure 8.2: Factors Contributing to Performance

A.	Endogenous Variables
1.	Linkage benefits
2.	Economies of size
3.	Management skill/styles
4.	Management strategy
5	Technology adaptation
6.	Corporate image'
7.	Brand image
8.	Tie-ups

B.	Exogenous Variables
1.	Policy environments
2.	Industry structures
3.	Inter-firm behaviour
4.	Physical externalities
5.	Technology status
6.	Skills availability
7.	Product image
8.	International market access

The linkage factors are: (a) resource-oriented, (b) management centred, or (c) technology related.

A conglomerate management has backward or forward linkages with the subject unit. When it has backward linkage, it gets preferential treatment in terms of price, quality, or delivery against other competing units. When it has a forward linkage, it incurs lower costs, achieves better marketing access, and may be earns even higher prices. It may have, for example, the benefit of common storage facilities with its sister units.

Economies of size could result in a decisive comparative advantage. Transnationals, supported by group resources, often start with or operate large sized plants or marketing activities; every domestic unit (in developing countries) does not have that advantage. In times of glut in the market, the large size could be a disadvantage; but by and large, it is not unless it is a continuous process plant.

Management skills and styles are very often the key factors in the performance of enterprises. The performance variances between public and private enterprises are attributed mainly to this factor. As observed earlier, in every industry in India, there are some firms, which make high ROI (rates of profits); there are others, which become sick, not only loss-making. It is due very often to

relative quality of management skills and styles, which, in turn, varies with the management strategies.

An industry product has access to different technologies. A unit uses different technologies at different stages of production. Any one technology can make the whole difference in the performance. It is, therefore, necessary that the most cost-effective technologies are adopted for each stage of production. It is not always easy, however, to shift to new technologies because of replacement costs. Technology determines, not merely the total cost of the product, but has a direct bearing on the quality of the product – and the quality influences the price. Again, a specific technology could produce low or high material yield (output-to-input ratio) via wastage factor (of inputs) or rejections (of outputs), lower rate of production or low product quality.

Corporate and brand image may improve (or erode) turnover, or profit performance even when all other factors remain the same. Most transnationals score on this point.

External tie-ups, which can reduce cost, improve quality or increase production, could help in raising performance. The tie-up could be for input supplies, technology, management expertise or marketing.

Exogenous Factors :

Business policy environment is a common factor, which helps all units operating in a given market, whether it is a domestic firm or a transnational. It is, therefore, a differential factor mainly in imparting competitive advantage—or disadvantage—in the international context. Customs duty of over 50 to 80 percent on capital equipment, and of over 100 percent on raw materials and intermediates imparted a decisive disadvantage to Indian manufacturing in export markets. Excise or production duty exemptions to small scale enterprises gave them a distinctive leverage within the domestic markets. Apart from cost components, the restrictions imposed on expansion of diversification of foreign enterprises forced stagnation of transnationals of FERA companies in India. Some of them faced very adverse conditions, such as, ICI (formerly, Chemicals and Fibres, Alkali Chemical Corporation and Indian Explosives).

Exogenous factors are related to:

a) fiscal, monetary, industry and trade policies,
b) cultural patterns and social behaviour,
c) availability of skills and their costs,
d) availability of infrastructure and costs.

Activity 1

Take the case of any international company. Explain how individual performance is different from the firm's performance.

.....

.....

.....

8.4 MECHANICS AND MODALITIES :

Ad hoc Evaluation and On-going Monitoring Systems :

Performance evaluation could be undertaken on an ad hoc basis as a one-time exercise, or weaved into an information and monitoring system. While **ad hoc** evaluation exercises are commissioned as a tool for specific management decisions, it is often an expensive process. Cost and goal effective evaluation calls for the design of an on-going exercise as an information system, in which the feeding-in operation and retrieval form an interactive mechanism. In this on-going system, the performance evaluation itself tends to become an information system, and **vice versa**. A pre-designed operation, being a part of a MIS (Management Information System), receiving data inputs regularly in its normal process, is likely to be a cost-effective system.

When the performance evaluation becomes an on-going process, it takes the form of a Monitoring System.

A performance evaluation monitoring system should be specific in terms of:

a) frequency (or periodicity)
(weekly, monthly, quarterly, annual);

b) contents or components
(parameters of performance to be evaluated);

c) processing techniques
(specifying the indicators to be used);

d) operating route
(from source and inputing procedures to processing and utilisation).

Single Versus Multiple Indicators :

A single indicator, combining all components of performance, would appear to be the most desired target. In appraising new investments, one always looks for one rate of return, since it would be the most transparent and forthright aid to decision-making. In other decision-making areas as well, one does not want to have qualifiers (IFs and BUTs) but a straight answer. Incidentally, socio-economic appraisal, although highly relevant, is avoided, in practice, mainly because it has to depend on multiple indices.

However, a single performance indicator is neither feasible nor desirable. It is not feasible, because it involves performance in terms of values, some of which are not quantifiable; and others, which are quantifiable, but are expressed indifferent denominations. Qualitative change in the corporate image, for example, cannot be expressed quantitatively. Similarly, productivity of an environmental change – in work culture or physical work environment—is not directly measurable in terms of monetary surplus (or profits).

Again, performance appraisal is required for different objects and different interests. A performance appraisal may be required for making technology improvement or for raising capacity or higher worker productivity. A price reduction will be welcome to a consumer; but it may reduce profitability.

A marketing manager is interested in a higher turnover, a production manager in a higher output. A lendor wants a well-protected debt-servicing capability; an investor high returns on his investment; a Finance Minister higher tax revenues to the exchequer, or higher net inflow of foreign exchange.

There ought, therefore, to be multiple performance indicators. The multiple indicators alone can be used as tools of management decisions in respective areas.

Activity 2

Name three parameters of performance, showing how they can be used for specific management decisions.

.....

.....

.....

8.5 TOOLS AND TECHNIQUES :

Classification of Indicators :

The performance indicators could be divided into four major groups based on the types of elements or parameters used:

Figure 8.3: Classification of Indicators

a) Structural indicators
b) Operating indicators
c) Result-oriented (or profit) indicators
d) Socio-economic indicators

Structural parameters of a firm are values (or quantities) of inputs, which are invested in a firm: equity and long term debt, for example.

Structural parameters do not, as such, reflect performance. Their variations and relationships, however, do. Thus, the value of fixed assets is no indicator of performance, but the variation in the value of fixed assets is. If there is an increase in the value of fixed assets over a period of time, this is reflective of capital formation or growth. When it is compared with the rate of capital formation during the same period in a completing firm, it translates itself into the relative dynamics of the two firms, and hence becomes a performance indicator.

Among the operating parameters, the value or volume of sales is not a performance indicator; a variation in it is. Variation could be measured over time, against different products of the same firm or between similarly placed firms.

Operating parameters are the values (or quantities) of elements which, for example, are produced by a given investment, production and sales turnover. The line differentiating structural from operating parameters is often difficult to draw. Debtors when considered as amount of capital reinvested would be a structural parameter; when they are considered as a result of the current operations, that is, moneys not realised out of sales, it is an operating parameter. Similarly, employment is both a structural and an operating parameter.

Operating parameters do not directly reflect performance. These are proxies of some performance indicators.

Result-oriented indicators are the result of the operation of the firm in terms of surpluses, Financial profits are, of course, the basic profit parameter, when seen from the investor's point of view. Viewed, however, from a social (or national) angle, value added, employment and foreign exchange generation (especially in developing countries because of the scarcity of the last resource) are significant profit parameters.

Profit parameters may, therefore, be divided into micro-level and macro-level or social parameters. The distinction, again, between operating and profit parameters is often blurred, as in the case of the foreign exchange earnings.

A caution, however, is called for in the interpretation of certain indicators. Increased employment generation is considered to be a desirable social profitability indicator; from the firm's point of view, it is a negative factor. More employment with the given volume of output means more cost, and, in fact, low productivity. The use of performance parameters, thus, calls for certain amount of discretion.

For an international business firm, the generation of incremental employment and foreign exchange earnings for the hosts country is no objective to look for. Even a domestic firm may not be keen on this. From the standpoint of the host country, the performance of the foreign enterprises in terms of generation of employment opportunities and net foreign exchange earnings are significant indices. While this distinction needs to be recognised, the indicators have their own relevance depending on the specific objective of analysis and valuation.

It would, accordingly, be a more productive strategy to bifurcate profit parameters into profit and social parameters.

Performance Indicators :

Measuring tools are used according to the object of the appraisal and the relationships in the variables involved.

Ratio Analysis :

Measurement of performance in financial terms frequently uses ratio analysis, which establishes the relationships between two or more variables. The relationships are expressed as :

a) **a share,** normally expressed in percentages (e.g., raw material cost is 50% of total cost of production);

b) **a quotient** expressed as a numerical relationship, (e.g., number of persons engaged per tonne of output changed from 8.4 to 6.5 due to technology innovation);

c) **a coefficient** (e.g., the share in cost-reduction of energy consumption is 0.45).

Financial ratio analysis has three dimensions:

a) Structural ratios,

b) Liquidity ratios, and

c) Profitability ratios.

Structural Ratios: The performance appraisal is not directly concerned with structural ratios (such as, debt to equity, equity to net worth, equity to fixed assets, fixed assets to funded debt or liquidity

ratios (such as, Acid Test ratio or current ratio). The structural ratios could be a contributory factor to performance but are not indicators of performance.

Profitability Ratios: Profitability ratios measure performance at intermediate or terminal points. The bottom line of any commercial organisation is profit (short term or long term), but several operating parameters lead to profitability. Without an effective control of these intermediate indicators, the terminal indicators cannot be controlled. The intermediate ratios are, therefore, equally significant.

Profitability ratio analysis could be based on the final determinant (net profit after tax-PAT) or relationships of profits with their components or other operating parameters.

The profitability ratios from the point of different investors are:

1) Operating profit.
2) Net profit.
3) Cash profit.
4) Dividend rate.

For an overall performance appraisal, the profit rates are the significant indicators. From the manager or management point of view, operating and cash profits are, generally, taken as the major indicators. The relationships among the four denominators may, briefly, be delineated as:

	Operating Profit (OP)
minus	Interest
equals	Cash Profit (CP)
minus	Depreciation
equals	Net Profit (NP) or (PBT)
minus	Tax
equals	Profit after Tax (PAT)
minus	Dividend
equals	Retained Profit

In practice, the operating profit is not a fair index, since the interest cost is as much the responsibility of the operating managers as the generation of operating profit (maximise revenue, minimise cost). Depreciation, however, is a part of the investment decision, and is not the responsibility of the operating mechanism. Moreover, depreciation is a historical cost incurred initially and, by and large is not alterable from one operating period to another. It is not a cost which creates payment obligations. Accordingly, cash profit is a significant, if not a decisive, indicator.

Companies are owned by a multitude of shareholders. Reliance Industries Limited has had, at times, more than 2,000,000 shareholders. The company may be profitable, but if the management decides to pay low rates of dividend, the shareholders do not get adequate returns. And a public shareholder is not a perpetual investor. He invests in one company, and withdraws his investment after some time by selling his investment. What he gets as return (directly) is only the meagre dividend (which may vary generally form 20% to 80% of the profit earned). His indirect returns are reflected in the share price. But because of other constraints and general market conditions, the share prices might not increase. He has then to be content with the dividend only.

Tax planning has developed as a special expertise in policy regimes, such as that of India, where a large body of fiscal incentives and exemptions have been introduced. Tax is no longer a fixed flat outgo from profits. Again, what is distributable to the final investors (shareholders) is only the net profit after tax.

The 10-year returns of some leading firms of the USA (Table 8.1), which are important transnationals, show the following tax efficiency ratios (net profit saved after tax) :

Table 8.1: Returns of Some Leading Transnationals of USA

1 %	Annual Return 10 years (1%)	Tax efficiency co-efficient
Pepsico	26.97	0.95
Boeing	25.37	0.94
Ford Motor	27.89	0.93
Proctor & Gamble	20.91	0.92
General Electric	22.80	0.91
Du Pont	19.61	0.89
Exxon	22.07	0.87
IBM	8.70	0.82
Eastern Kodak	9.16	0.80
General Motors	10.94	0.78

Source: Fortune, April 20, 1992.

To any international business entity, tax is of special importance. An investor has to reckon with two tax systems with interactive mechanisms—the tax system of the host and the tax system of the investing country. What the investor gets, finally, is what he is concerned with. (Some countries have double taxation relief treaties under which the tax is paid in the host country). In international trading transactions, customs duties—not production and monitoring costs—often determine international competitiveness.

Profit rates could be computed

a) on an accounting or accrual basis of specific period, a month, a quarter, a half year, or a year, and related to the total investment;

b) on a discounted (DCF) basis for a specific time span, or for the life-cycle of the project or on specific investment.

The investment to which the profit is related under (a) is either the total capital employed or equity capital. The first measures the profitability (or operating efficiency) of the enterprise the latter the profitability of the venture capital (equity).

The rates of profits vary from one period to another, depending on endogenous factors intrinsic to the firm, the intensity and sources of competition and externalities, over which the management of the firm may or may not have any control. It is not rare to find many firms, which earn fairly large profits in the initial stages, witness a plateau or decline in their profits because of

technological and other changes. Conversely, there are firms, which have long gestation and teething periods. But when the firm gathers its natural strength, it starts earning high rates of profits. The three entirely different scenarios are represented by the following cases:

	Firm A Rs mn	Firm B Rs mn	Firm C Rs mn
A) Capital Investment (t_0-t_{10} years of project life)			
t_0	450	900	150
t_4	300	——	300
t_7	150	——	450
	900	900	900
B) Average net cash (excluding A) inflows			
t_1-t_3	67	224	78
t_4-t_6	188	271	113
t_7-t_{10}	468	314	135
Total net cash inflows t_1-t_{10}	2637	2740	1113

The total capital investment is the same in each case (Rs 900 million). The rates of return however differ appreciably.

	Firm A	Firm B	Firm C
Accounting profits (%)			
t_1-t_3	15	25	52
t_4-t_6	25	30	25
t_7-t_{10}	52	35	15
Average	36	30	21

Internal Rate of Return :

Internal Rate of Return (IRR) represents a standard DCF (discounted can flow) technique, which is almost universally used in all professional investment decisions. The IRR tool does not distinguish between an investment rupee and an operating rupee, that is, between capital expenditure and current expenditure and capital receipts and revenues (or sales proceeds). It does not distinguish between venture capital and loan (or fixed return capital). It reckons with cash flows only – ignoring

intangibles, including depreciation—and computes a specific return on capital flows—all inflows of capital and incomes and all outflows minus the outflows of the return on capital and costs.

IRR imparts time value to money. It recognises when the cash flows are generated (or dispersed). It assumes a rupee received (or spent) today has much higher value than the rupee which will be received (or spent) five years later.

IRR is the rate of return, which when applied to all cashflows (inward and outward) compounded by the time when they occur, yields a cash inflow, which is equal to all cash outflows. IRR may be expressed as

$$0 = \sum_{t-0}^{n} (CI - CO)_{at}$$

CI_t =Cash inflow in the year t

CO_t=Cash outflow in the year t

at = the discount factor

IRR is thus a real rate of return on the investments made after compounding the rates of returns, depending upon when cash inflows and outflows take place.

IRR is used more as a tool for new investment decisions, but it could be a much more useful tool for performance evaluation. It shows how operational results have behaved effectively—not only on a gross basis.

Cost Ratios :

Segmental financial ratios can take the form of cost components. Examples:

Ratios of

1) Material cost)
2) Energy cost) to
3) Manpower cost) TOTAL VALUE OF OUTPUT
4) Overhead cost) (OR TOTAL COST)
5) Marketing cost)
6) Financial cost)

Further analysis could be made by dissecting each component, relating it to the relevant segmental cost, such as, advertising or packaging cost to total marketing cost.

Other Operating Ratios :

The performance of the firm is a reflection of other operating parameters, such as, better cash management, which is reflected in liquidity ratios as follows:

a) Current ratio = $\frac{\text{Current assests}}{\text{Current liabilities}}$

b) $\text{Acid Test} = \frac{\text{Liquidity}}{\text{Current liabilities}}$

c) Inventory build-up : inventory in terms of days of output

Profitability in the stock market is denoted by earnings per share.

$$\text{EPS} = \frac{\text{PAT}}{\text{Equity}}$$

The stock market performance, inclusive of the image of the firm, is reflected by PE or the price-earnings ratio. Here the price is the current market price of the equity shares and earning is the earning per share. The higher the multiple, the greater is the confidence of the investor in the firm's present and future operations.

A term lending institution (such as, Industrial Development Bank of India) would be interested not only in the profitability of the company, but also in its capacity to pay the instalments of loans and interest as scheduled. This is best measured by the debt-servicing ratio. It is a ratio of net cash generation in any given period after meeting all current and other obligations to the total sum payable against long term debts (instalment and interest).

Activity 3

Name four ratios, define their meaning, and explain their significance as performance indicators.

.....

.....

.....

Activity 4

Who are most interested in the following indicators and why?

a) IRR b) PR c) Debt-Servicing Ratio

.....

.....

.....

8.6 COMPARATIVE AND HISTORICAL ANALYSES :

Comparative Analysis :

Comparative analysis is based on specific results of a comparable firm or a standard firm or a competitive firm. The most valid comparison would be with a comparable firm: a firm similarly placed, that is, of a similar size, producing comparable products, and having the same exogenous benefits (and disbenefits). It is not always possible to find a wholly comparable firm.

A standard firm provides the more acceptable basis. However, it is also difficult to define and identity a standard firm. There are larger and smaller, better and not so-well located firms. There may, in fact, be no standard firm in the relevant industry. Again the data may not be available for a standard firm. An alternative course, therefore, is to simulate a standard firm.

There are two methods of simulation of a standard firm. The first is to locate an average firm. An average firm would be a "modal" firm. A simulated firm is one that belongs to the category

of firms, which has the largest number of firms in the given industry. If 60% of the sugar mills have a dCC (daily cane crushing capacity) of 2500 to 3500 tonnes, 15% of upto 2500 dCC and 25% of over 3500 dCC, firms in the medium range capacity could be standard firms. This, however, will leave a wide choice, and the chosen candidate may not be a validly comparable case. A more reliable method will be to take the median firm, which does not exhibit any abnormal (not adverse) parameters. (A median is the mid-point of the total range with an equal number of candidates above and below the median point).

The other method is to take the case of a well-performing firm or the best performing firm. The problem arises where the well-performing and best performing firms change their positions. In the absence of an accepted criterion, it is difficult to say which is a "well-performing" or a "best performing" firm.

Historical Analysis :

Historical trends measure performance ratios or parameters over a specific time-span (short term, medium term or long term). There are no universally recognised delimiters of short, medium and long terms. Broadly acceptable spans are:

a) Short term : Upto one year
b) Medium terms : Over one to five years
c) Long term : Over five years

The specific performance indicators are set at specific points of time or period spans. Time spans for short term are a month, a quarter, a half year. Time spans for medium term are generally annual. Long term periods are either annual or specific phases, such as, biennial, triennial or ofuinquennial.

The historical analysis can be by values (or ratios) and by time-trend analysis. When it is by values, like quantities are compared. For example:

	Annual Profit Generation
Unit A	Rs 122 million
Unit B	Rs 180 million
Unit C	Rs 185 million

Or

	Marketing Cost of Sales Turnover
Product A	13%
Product B	15%
Product C	20%

Or

	Rate or Productivity Growth
1985 over 1984	1.9%
1990 over 1989	1.5%

The trend analysis can be linear or non-linear (e.g., exponential).

Linear	**Average Annual Rate of Growth of Turnover**
1981-85	Rs 17.5 million
1986-90	Rs 12.0 million

Or

	Exponential	Exponential Annual Growth of Turnover
1981-85		2.3%
1986-90		3.5%

Activity 5

How do you explain the divergence in the following performance indicators of a firm?

	Growth Rate % annum		
	Profit	Sales	Export Earnings
1981-1985	3	8	20
1985-1990	6	10	25

.....

.....

.....

8.7 PRODUCTIVITY :

While the bottomline of all commercial of all commercial enterprises is the net profit (after tax) it is not always the result of the performance of the enterprise. External factors, especially the government policies, often distort the results substantially. An intrinsically valid measure is productivity.

Productivity is the output of a given quantum of inputs. The differential between the two is the net contribution. Since the differential is an absolute parameter, productivity, which is always a relative measure, is expressed as the ratio of net outputs to inputs.

Some productivity studies have attempted—actuated probably by considerations of convenience—to take gross output as the numerator. This incorporates the contribution of the producers of inputs, but does not yield a true picture. When the gross value of textiles is the numerator for a weaving mill, it includes the "value added" contribution of the spinning mill, and even cotton, which is the contribution of agriculture.

Measurement of performance by the coefficient of productivity has one distinct advantage: it can be measured for the total enterprise or for different factors of production. When it is measured for the total enterprise, it is termed total factor productivity; and when it is measured for each factor, it is termed as partial factor productivity. Given the production function (f)

$$Y = f(L,M,E,T)$$

where Y is net output,
L is labour input,
M is material input,
E is energy input,
T is technology input,

productivity is net output of input. The productivity of capital synonymous with total factor productivity, since the total establishment is represented by capital investment.

Sometimes, capital or labour intensity is confused with capital or labour productivity. Labour and capital intensities are inter-factor functions, measuring each factor with the other, and are not

the same as relative productivity. The former quantum of labour—measures per unit of capital or vice-versa, as the case may be.

On the other hand, energy intensity is normally related to capacity, although it could be related to output as well. When it is related to capital, it measures technology-efficiency; when related to output it spells factor productivity. However, it is relevant both to gross output as well as net output or value added.

Performance coefficient of productivity can be measured in financial as well as physical terms. It could be net output by value or physical quantity. It is particularly suitable for measuring performance of the workers (worker productivity). It could be conveniently applied to functional groups, such as, marketing group (by relating the indicator to turnover).

One constraint, however, is ubiquitous in measuring performance by partial productivity. Productivity of labour cannot be equated with **the contribution** or labour. It incorporates the contributions of technology and management as well. Less efficient management will keep the labour productivity low, howsoever more efficient the labour may be. Similarly, if technology is not efficient, or equipment is worn out or obsolescent, the labour productivity will tend to be low.

Partial or factor productivities thus measure the performance of the enterprise given a certain quantum of labour input, it is nor essentially the performance of labour. However, where other things remain constant, factor productivity does measure the variances in the performance of a given factor. If 900 workers produced a net output (NVA) of Rs 216 million, in 1991, and Rs 225 million, in 1990, with the same equipment and technology, there is a distinct improvement in labour productivity from Rs 2,40,000 per worker to Rs 2,50,000 per worker.

When productivity is applied to specific factors to measure partial productivity, it may be expressed in varying terms, such as, energy efficiency for productivity of energy, material yield factors for material productivity.

In measuring productivity, in terms of values, constant prices must be used.

Productivity, like any performance evaluation indicator is a relative measure. It could be used, historically over short and long time spans, in comparison with competitors and with standard industry norms.

Activity 6

Give an example where total productivity has improved while partial productivity has declined?

.....

.....

.....

8.8 PROJECT PERFORMANCE EVALUATION :

Project investments in new enterprises, or for expansion, diversification and modernisation of the existing establishments become profit centres when completed. Their performance until production commences cannot, therefore, be measured in terms of output or profits.

On the other hand, an effective evaluation system has to start from the beginning of the life

cycle of the investment. Once the initial investment, which is substantial, has been committed, it produces a heavy impact on the operating results for a long period.

It has been observed that projects often suffer from large time and cost overruns. It is true, especially of international projects, which have to pass through inter-country regulatory measures in one or both countries, and involve external factors which are not too precise.

Projects are generally evaluated in terms of capital expenditures incurred. This is an erroneous approach, since it is not related to the work accomplished. When evaluated in physical terms, the process ignores costs involved. A given quantum of work (e.g. civil construction of 10,000 cubic meters) is completed within the scheduled timeframe but might have cost more by Rs 2 million over the budgeted cost of Rs 20 million. Both methods do not take into account the efficiency of the project management (in terms of cost and capital inputs in relation to work done or performance).

In the pre-investment estimates of a process plant project, the budgetary allocation for civil work upto June, 1984, was Rs 184 million. The actual expenditure was of the order of Rs 173 million upto that date. Two views were taken. The first one was that the project has lagged behind schedule since capital expenditure target on civil works was short by Rs 11million. The second view was that there was a saving of Rs 11 million. In fact, both assessments were erroneous. The savings were due only to the deferment of foundation-laying, which was expected to cost Rs 20 million but would now cost Rs 18 million. Even with the reduced cost of foundations, there was a cost overruns on civil works. There was, besides, a slippage in the time schedule (with deferment of the foundation-laying activity).

Slippages in project management occur due to a diversity of variables, which differ from project to project and from one component of a project to another. It also occurs in terms of inputs (material, manpower). A break-up is, therefore, necessary in accordance with the objectives of the project.

The alternative is the Value-based Project Monitoring (VbPM) System. VbPM seeks to establish relationship between the value of the work planned (VWP) and the value of work actually done (VWA). The value of work does not mean the monetary cost of work; it denotes the 'real' quantum of work. Paradoxical as it may seem, the real quantum is sometimes measured in terms of monetary values. This becomes necessary, because the work to be measured is an aggregation of several component activities, which cannot have a uniform measure (for example, civil construction and machinery erection). The problem can be resolved by suing 'constant' prices. The prices at which the VWA is measured is the same as applied to VWP. This will not determine the cost overrun but slippage in work performance. To arrive at cost overruns, it will be necessary to escalate the physical slippage by price inflation.

For a better understanding of the system, it may be appropriate to identify that costs of projects increase because of the following seven basic factors:

- price increase due to inflation.
- changes in project design (including technological and locational changes).
- deficiencies in project design and the need for post-planning revision,
- mistakes committed in construction and erection,

- non-availability of resources on schedule,
- less efficient management causing delays in implementation,
- externalities (factors beyond the control of project management).

It is obvious that the first step is the recording of data juxtaposed against the projected estimates. The data required are by activity and resource inputs. The values are to be recorded in physical quantities as well as values, both in current and constant prices. The extent to which the dissection of the data, in terms of activities and resource inputs, is needed would depend on the size of the project and the critically of the inputs and management objectives.

The analysis and appraisal is first geared to the identified activity centres. It is then extended to activity groups, and then to the project as a whole. The transcription of the data takes the form as shown in Exhibit 1, called "Value-based Project Monitoring Chart". This exhibit has been designed for the total project. The curves delineated are all cumulative.

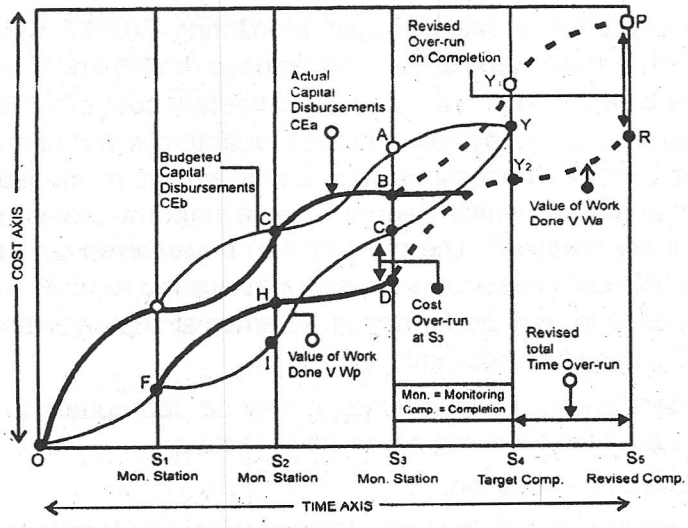
The ordinates S1,S2,S3, mark the audit or monitoring stations in the time scale. There could be as many audit stations as the management finds effective. These should nonetheless, be chosen with good care. Too many of them have been found to be distracting for the project team; too little to be ineffective.

The amount of overrun, at any point of time, is given by the vertical distance between the two curves VWP and VWA, and not between costs which is generally assumed.

Relative cost overrun (or underrun) of a project at any point of time may be expressed in percentage terms as

$$\frac{VWA - VWP}{VWP} \times 100$$

Figure 8.4: Value-Based Project Monitoring Chart



The exhibit also indicates the time over-run. It would be seen that the amount of delay at any particular point of time is given by the horizontal distance between curve S3 and intersection of VWA at the level VWP. The curves also show progressive over-run or under-run of time.

The cost and time over-runs could—at any rate—be different for the future period. The value-based project monitoring chart enables re-drawing of the project scheduling and capital budgets, without which the project completion might encounter more adverse conditions. It is, thus not merely a performance evaluation tool, it can be deployed for re-planning of partially completed projects, which is the objective of performance evaluation.

It is interesting to note that (see Exhibit) PR is greater than CD, which shows that the cost over-run will expand. This could be due to price escalation or direct cost expansion on account of interest cost and cost of project implementation, or both.

In order to get an idea as to how the project has advanced, activity by activity, the analysis could be disaggregated. On the basis of these curves, the management would know the activity which is behind schedule, and in which cost over-run is high to enable steps to be taken to avoid further slippages.

Activity 7

Enumerate 4 factors which cause cost and time over-runs in projects.

.....

.....

.....

8.9 SOCIO-ECONOMIC PERFORMANCE :

In the recent years, Cost-benefit Analysis (CBA) technique, which may be termed as social (or national) profitability analysis, has gained increasing ground. The latter is mistakenly assumed to be a substitute for commercial profitability. For any investment at the micro level, both are equally significant, although the latter, in practice, is not the required objective in private enterprise models.

In the 1970s and 1980s, it was believed that the CBA was a technique patently appropriate for public sector investment, which were to be solely guided by it. Since, the late 1980s, with the increasing trust reposed in market-friendly economic models, the public sector investments are expected to earn first financial surpluses. In the ultimate analysis, it tantamounts to the weightage assigned to commercial profitability.

Serious doubts about the technique of the CBA were expressed even before the set-back to the public enterprise model was in evidence: first, the private investment decision was invariably a function of financial profitability (and not of social returns); secondly, the CBA was not amenable to easy mechanical analysis as is commercial or financial profitability (in terms of the IRR).

The CBA calls for a great deal of information on goods and services traded and not traded, internationally, and no domestic prices and on inputs including opportunity cost of labour, which are not easy to determine. There are other parameters, such as social, rate of discount (the social opportunity cost of capital), which are often subjective unless extensive analyses are undertaken.

The evaluation indicator for the CBA takes the form of the Social Rate of Return (SRR). The SRR is an extended version of the IRR, which

a) adds social costs and benefits (such as, net foreign exchange earnings, employment generation effects, distribution and welfare effects); and

b) transforms the internationally traded inputs and outputs at international prices.

Once, the foregoing adjustments are made, the process is the same. Briefly, the following steps are taken:

1) **Start** with the cash flows—net inflows and net outflows—from the IRR computation.
2) **Add** to the inflows:
   a) premium on net foreign exchange earnings;
   b) social benefits created by the project;
   c) differential of net revenues if the domestic prices of outputs are less than the international prices:
   d) taxes, direct and indirect, on inputs, outputs and incomes.
3) **Deduct** from the inflows

   Social Cost created by the project such as disbenefits from environmental pollution.
4) **Add** to the outflows

   The differential of cost, is the domestic prices of internationally tradable inputs are less than the international prices.
5) **Deduct** from the outflows,

   If opportunity cost of domestic outputs is more than what has been accounted for.

Once the series of net outflows are arrived at, after making the foregoing adjustments, the series of the flows could be subjected to discounting technique to determine the SRR.

Since the process of determining the opportunity cost and the effects of externalities is very involved, something which calls for massive data inputs, it may be more practical to compute disaggregated socio-economic performance indices of performance. The more significant of these indices are given below.

A) Net Foreign Exchange Earnings :

In most developing economies, except perhaps the oil exporters, foreign exchange (forex for short) is a critical scarce resource. Forex earnings, therefore, become a major objective. A commercial enterprise involves both earnings (through exports) and use of forex (for imports and exports of capital goods and spare parts technology, technical and managerial services, raw materials and semi-manufactured components). There are net outflows, at least, in the initial years. Net inflows and outflows of forex resources could be computed for short and long periods. When the net outflows are related to the forex used, it provides a useful indicator of the international impact of the investment.

The performance indicator will take the following form:

$$\frac{f_{in} - f_{of}}{f_{co}}$$

Where f_{in} is forex inflow,

f_{of} is forex outflows,

f_{co} is initial forex investment.

In measuring the forex earnings, the opportunity cost (such as, saving through import substitution) has to be reckoned with.

b) Employment Impact : Every investment generates employment, direct and indirect. Since indirect employment (such as, for distribution network for a given output from manufacturing involves further investment), direct employment may only be taken. The indicator for direct investment is the number of jobs created per unit of investment, say 58 man-years for every Rs 1 million of employment. This indicator can thus be expressed as

$$\frac{E(t,s,u)}{K}$$

Where 'E' is employment in terms of man-years,

'K' is the unit of capital, say Rs one millions,

't' is technical employment in man-years,

's' is skilled employment in man-years,

'u' is unskilled employment in man-years.

The indicator should be expressed in man-year, since some industrial activities create only partial (or seasonal) employment.

a) Environmental Impact :

The environment impact is a major factor, which has so far been overlooked, but will gain increasing importance in the year to come. When a proper social cost-benefit analysis is made, it is a prime element. When disaggregated evaluation is made, the cost and benefits form the environmental point of view have to be computed. The problem arises where the effect is not measurable quantitatively—in physical or value terms.

Where the candidate activity creates pollution, of water, for example, the cost of effluent treatment could be computed. On the other hand, where the activity creates problems, such as, forest erosion, it his multiplier impacts, which cannot be easily quantified directly. Similarly, some activities could, in fact, reduce environmental pollutants. The benefit for this should be taken in the computation. An MDF (medium density fibres boards) project helps to clear cotton stalks (to be used as raw material) from the countryside; it makes a distinct improvement in the environmental conditions.

D) Technology Upgradation :

Induction of advanced technology imported from abroad by the multinationals is an additional benefit, which accrues to the country. The benefit is spread by horizontal transfer, training and upgradation of the manpower and by technical education. The impact is very difficult to quantify. Its impacts can be evaluated only qualitatively. Where induction of technology reduces cost or increased

revenue via larger production or enhanced product quality, impact gets reflected in the profitability coefficients.

E) Value Added :

The development of an economy is measured in terms of the growth in the GDP (the gross domestic product). The GDP is the sum total of the contributions of all economic activity in the country. It is, therefore, very meaningful to measure performance of a micro unit enterprise by its contribution to the GDP. This contribution takes the form of **value added**. Value added is the variance between the gross value of output and the material inputs used in the production.

$$NVA = Y-(RM + E + PC + D)$$

$$i - n$$

Where, Y is the gross value of output.

RM are raw materials, including auxiliary materials, components, process chemicals

E is energy including fuel.

PC is packaging materials,

D is depreciation.

When NVA is related to the investment, the coefficient shows the net productivity capital.

$$\frac{\sum NVA_{i-n}}{K}$$

Activity 8

Recall why Social Rate of Return is difficult to measure.

.....

.....

.....

Activity 9

Assign weights out of 100 according to the importance you attach to these in performance evaluation of international enterprises—Indian and foreign—operating in India.

a) IRR

b) Net forex earnings

c) Employment impact

d) Environmental effect

e) Added value index

f) Technology upgradation

g) Factor productivity

.....

.....

.....

8.10 PERFORMANCE EVALUATION OF INTERNATIONAL TRADING :

International trading is carried out in

a) capital equipment,
b) intermediates (including spare parts and processed materials).
c) raw materials (agro, mineral, marine and other products),
d) technology. and
e) services (construction, consulting, insurance, banking, management, advertising).

The indicators delineated for manufacturing enterprises are applicable equally to all types of business activities, and could be deployed with such adjustment as may be called for to suit the specific business goals and objectives.

The indicators, therefore, for a firm engaged in international trading are not different. Some special characteristics of such business need to be recognised.

a) The fixed capital investment of these firms are relatively small (relative to turnover) and working capital investment at large.
b) Since the fixed capital investment is relatively small, the short term gains (and losses) are of greater significance to these firms.
c) The performance of such firms is, by and large, more volatile, subject to major oscillation from one period to another.
d) These activities have to be internationally competitive. Actual performance is vital for their existence and survival.

8.11 EVALUATION SYSTEMS :

Three systems, which aid performance measurement and evaluation of an organisation are :

1) Budget Programming.
2) Management Audit.
3) PERT Programming,
4) MIS.

A firm's budget is prepared for planning (short term and long term) and financial control. The financial control is exercised by measuring deviations from the budgetary targets. Some budgetary exercises are, in fact, called Performance Budgets. The purpose of these budgets is to measure the performance in the preceding or past periods, and to make targets for the succeeding periods. Once the targets for each activity (and the total enterprise) are laid, it is easy to compute variance, and to measure current performance in relation to comparable performance in the past periods and in terms of targets.

Budgets are expressed basically in financial terms. But physical budgets are also designed and used, which provide a basis for evaluation in terms of physical quantities. Budgets are particularly useful for cost controls The interlinkage between financial and physical budgets provide further basis for performance appraisal. Performance budgets, in fact, lay down the performance targets which become the bench-marks for performance appraisal.

Management Audit is an extended financial audit system, which monitors the quality of management decisions in financial operations. It does not stop at mechanical auditing of financial transactions, but enquires into the causation, modalities, results and impacts of the financial transactions. In effect, it appraises and audits the functioning of the management.

PERT (Programme Evaluation Review Technique) is based on CPM(Critical Path Method). It delineates a given project or programme into a network of activities and sub-activities with a view to optimise time. It computes critical activities with a view to optimise time. It computers critical activities (any delay in which would extend the total project schedule) and slacks (in activities which can be delayed if it helps in reducing costs). The sequencing of activities and their expected time-scheduling is integrated into a network identifying the critical path of activities and their optimal time scheduling. The value-based Project Monitoring System, discussed earlier, is based on such PERT network only.

PERT costing translates the time sequencing into a costing network, and could be used to monitor performance. The performance is measured by comparing the scheduled time and cost inputs with the actual time and cost inputs.

The Management Information System (MIS), as indicated earlier, is the on-going information system designed to plan, operate, appraise, monitor, control and redirect the total management, or the segmented activities of an enterprise according to pre-determined targets and goals. MIS is all-pervasive, and encompasses the financial and physical budgeting, management audit and control systems and PERT. Performance measurement and evaluation emanates from and converges on MIS.

8.12 PERFORMANCE EVALUATOR :

Performance Evaluation is, or ought to be, based on objective information—generated in the course of business operations or specially collected for the purpose. The data collector is, therefore, the key to performance evaluation. The data processor is an extension of the data collector who uses statistical and logic systems to engineer an acceptable design of the data collected for evaluation.

The data collector and the data processor, however, are not the performance evaluators. The evaluation is made by a person or groups of persons in or outside the organisation. They take or help in taking investment or management decisions. The evaluator could be the Marketing or Production Manager, the General Manager or the lending agency (such as the IDBI, the Industrial Bank of India, and the World Bank), the Planning Commission. Undoubtedly, the decision-maker is frequently assisted by a host of assistants, executives and advisors. The support is essential since in most cases a multi-disciplinary approach is needed involving a mass of information and a diversity of indices, which are not always homogeneous and amenable to decision-making processes.

8.13 PREREQUISITES AND PRECAUTIONS :

1) The objectives of performance evaluation should be defined precisely.
2) The candidate for performance evaluation—an individual, a group or a firm—should be clearly identified.

3) Performance evaluation should be period-specific. Performance can and does vary from one period to another.
4) Assumptions made in making the evaluation should be articulated without reservations.
5) The limitations of the evaluation indicators should be spelt in clear terms.
6) Each performance evaluation should be used for the specific purpose for which it is made. Any evaluation transposed for any other objective should be adjusted suitably.
7) Performance evaluation should be forthright, not open to different meanings or conclusions.

8.14 PERFORMANCE OF TRANSNATIONALS IN INDIA :

A recent study on multinational corporations arrived at the following conclusions:

1) The transnational affiliates in India (ITNs) may not be intrinsically better performers than the indigenous firms, although they make more profits than the Indian firms.
2) Bettér performing ITNs have, however, special niches, which help them earn more profits.
3) The higher profitability of ITNs is secured in spite of the higher resources.
4) The higher ITNs profitability is due to (i) product differentiation (ii) goodwill through advertising, (iii) large sizes leading to economies of scale and superior manpower deployment.
5) ITNs do not invest more in R & D, but have better access to the higher technology.
6) ITNs have better liquidity ratios, which is both the cause and the result of the higher profitability.
7) The export propensity (or performance) of ITNs has been lower than that of comparable Indian firms.

A Reserve Bank study of 326 foreign-controlled rupee companies (FCRs) and 2740 India controlled companies (ICCS) for the three years, 1985-86 to 1987-88, shows that the profits of the foreign companies were consistently higher in all the three years with their average being 10.37 per cent on sale against 7.56 percent for the Indian companies. The variance was larger when the gross profit after tax is related to the net worth. The dividend record of the foreign companies is also better. This corresponds broadly to the profitability ratios.

	FCRCs			ICCs		
	85-86	86-87	87-88	85-86	86-87	87-88
GP to TO	10.9	10.2	10.0	8.2	7.7	6.8
GP to NA	12.9	12.0	12.0	7.9	7.1	6.3
PAT to NW	12.7	11.6	11.3	7.0	3.8	1.0
Dividend to NW	5.2	5.2	5.7	3.0	3.0	3.2

GP = Gross Profit TO = Turnover NA = Net assets NW = Net worth

15 SELF - ASSESSMENT QUESTIONS :

1) Distinguish between 'Parameters of Performance' and 'Indicators of Performance'
2) What is productivity? How is it different from profitability?
3) Distinguish between labour intensity and labour productivity; capital intensity and productivity of capital.
4) Explain why it is necessary for an international organisation to have both, an on-going Monitoring System and **ad hoc** Performance Evaluation exercises.
5) Do you need a separate MIS for performance evaluation? How far can the two be integrated?
6) What is a standard firm? Why is it the bench mark of performance?
7) Explain how productivity is a preferable performance Evaluation coefficient?
8) What is partial productivity? How does it differ from total productivity?
9) Enumerate six performance evaluation indicators, and define third basic concepts and limitations.
10) How is comparative performance evaluation made? Enumerate the steps.
11) What is ratio analysis? Name for important ratios.
12) What are the value-based project monitoring techniques? Apply this technique to the following project case, and evaluate it in terms of the value-based monitoring system:

At audit station 2	
Targeted Civil Works	4000 m^2
Budgeted Cost	Rs 2600/m^2
Construction Completed equivalent of	3900 m^2
Cost incurred	Rs. 10.8 million
Additional work to cost	Rs. 0.4 million

13) Enumerate four causes, which cause cost and time overrun in projects.
14) Explain how project performance differs from the operating performance.
15) Define (i) performance-audit stations (ii) cost over-runs and time over-runs (iii) budget and actual costs.
16) What do you understand by Performance Budget?
17) How does a budge help in performance evaluation? Illustrate it by a *hypothetical* example.
18) Describe the role of PERT and MIS in performance appraisal.
19) Who is the performance evaluator?
20) What is the role of the data collector in the performance evaluation system?

8.16 FURTHER READING :

American Management Association, *Executive Committee Control Charts: A description of Du pont Chart System*, AMA Management Bulletin, No. 6: New York, 1960.

Jorgeson, D.W., *Application of Translog Production Function in Recent Productivity Measurement*, ed by Kendrick and Vaccara NBER, 1980.

Kendricj, J.W & Vaccara, *New Development in Productivity Measurement and Analysis: Studies in Income & Wealth,* NBER, Vol. 44, 1980.

Krishna, K.L., *Industrial Growth and Productivity in India in The Development Process of Indian Economy,* ed by Brahmanada and Panchmuki, Himalayan Publishing House, 1987.

Masse Pierrie, *Optimal Investment Decisions: Rules for Action and Criteria for Choice*, Prentice Hall, Inc., Englewood Cliffs, NJ USA, 1962.

Moris, Sebastian, *Multinational Affiliates in India in Political & Economic Weekly,* Vol. XXVI, Nos 22 and 23, June 1-8, 1991.

Nagesh Kumar, *Multinational Enterprises in India—Indian Distribution, Characteristics and Performance,* Routledge, London and New York, 1990.

Nayyar, Deepak, *Transnational Corporation and Manufactured Exports from Poor Countries, in Economic Journal* , Vol. 88, March, 1978.

Nelson R.R., *Research on Productivity Growth and Productivity Differentials: Deal Ends and New Departures in Journal of Economic Literature,* September, 1981.

Weiss, Johan, *Cost-benefit Analysis of Foreign Industrial Investments in Developing Countries in Industry and Development,* United Nations, New York, 1980.

Vaitsos, C.V., *Inter-Country Income Distribution and Transnational Corporations Calrendon*, Press, Oxford, 1974.

United Nations Industrial Development Organisation (UNIDO), *Guide to Practical Project Appraisal,* New York 1978.

UNIT - 9 MULTINATIONAL CORPORATE CULTURE AND HOST COUNTRIES

Objectives :

After reading this unit you should be able to:

- know the distinct features of Multinational Corporations;
- develop an understanding of the impact of the presence and manage multi-practices of MNCs good and bad, in the host countries;
- critically evaluate the relationship between MNCs and host countries.

Structure :

9.1 Introduction

9.2 MNCs: Nature and Characteristics

9.3 Decision-making

9.4 Intra-firm Trade and Transfer Pricing

9.5 Technology Transfer

9.6 Employment and Labour Relations in Host Country

9.7 Management Practices of MNCs

9.8 MNCs and Host Countries' Government Policies

9.9 Forms of MNCs Collaboration

9.10 Summary

9.11 Key Words

9.12 Self-Assessment Questions

9.13 Further Reading

9.1 INTRODUCTION :

Multinationals operate in different environments and cultures. When the culture of the MNC and that of the host country are similar, there may be smooth sailing. However, problems may arise when the cultures do not mesh with each other. There may be perceptible differences in the values, beliefs and ways of working. The focus of this unit is on such issues. The unit begins with a description about the nature and characteristics of MNCs, and the typical patterns of decision making in them. Thereafter, the issues relating to transfer pricing, technology transfer and labour relations are examined. The business culture of MNCs and their typical management practices are

analysed. What kind of policies are being framed by Government to mitigate or counter the ill effects of MNCs are also described. Finally, the unit discusses the form of MNC collaboration. The usual restrictive trade practices adopted by MNCs are also discussed.

9.2 MNCs: NATURE AND CHARACTERISTICS :

Multinational Companies (MNCs) are also known as Transnational Corporations (TNCs). There is, however, according to some, a difference between the MNCs and the TNCs. According to some experts, MNCs produce commodities/products for domestic consumption of the countries in which they operate. The TNCs. on the other hand, concentrate on producing products/commodities to meet the markets of third countries. This difference is not normally made while referring to either MNCs or TNCs. Therefore, an MNC can also be called TNC. In this paper we refer to these international companies as MNCs.

It is important to understand the nature of these companies, and their main features before undertaking any detailed discussion of their culture in the context of host countries in which they operate. For the purpose of this paper an MNC has been defined as one which has its producing and trading activities in a number of countries and which has a central organisation regulating the activities of its units, across national frontiers, with specific global objectives.

It may be added here that recently some MNCs have decentralised their decision-making. Some large MNCs with a wide variety or products operating in a large number of countries are organising their subsidiaries, branches and affiliates on the basis of regional and product based profit centres. This however, has not radically altered the importance of central decision making in the concerned MNCs. The final decisions on a number of issues of vital importance in such situations still rests with the centre i.e the parent organistion.

It is important in this context to also refer to the recent debate whether MNCs are losing their national character, that is, the parent company does not belong to a country. For, it is argued by some that the parent company sheds its national character and becomes a global one because the ownership of the company is diverse since a large number of share holders belonging to various countries own the equity shares and multinational banks of various countries finance their operations. Moreover, even the boards of directors of the parent companies have different nationals as their members. It is, therefore, argued that there is no such thing as USA's MNCs, Japan's MNCs and the UK's MNCs, etc.

However, the evidence goes against this understanding. It has been found that MNCs do retain their national character because of two important reasons: First, the critical level of ownership of equity shares is still with the original parent. The overwhelming majority of directors on the Board are nationals of the country or origin of the parent company. It is therefore vital to recognise that these companies still retain their national character. Hence even now we have what we can describe as USA's MNCs, UK's MNCs and Japan's MNCs.

It is also important to clarify in this context what one means when one talks of MNC's culture and the host country. In this paper an MNC's culture has been totally identified with its corporate objectives, management practices and procedures. A host country is an independent

nation state where an MNC has established its business operations through either subsidiaries or branches and affiliates. It is also important here to make a distinction between a developed host country and a developing host country. All the countries of the organisation for Economic Cooperation and Development (OECD) are treated as developed host countries and countries treated by the UN as developing countries are treated as developing host countries in this unit. The latter include countries in Asia, Africa and Latin America, excluding ofcourse members of the OECD such as Japan.

The corporate objectives, management practices and procedures of MNCs will differ from country to country. For instance, corporate objectives, management practices and procedures of MNCs from the US differ from those from Japan and Germany. The fact, however, remains that despite a number of variations, MNCs of all major developed countries possess some common elements which cannot be lost sight of. This understanding will help us to generalise about their business culture.

The main features can be classified as follows:

- MNCs are normally very large in size as measured by the value of their total sales. The average MNC has billions of US dollars as its total sales value which is often equivalent to or more than the national income of one, two or three large developing countries. In fact, it has been said that such companies form a 'billion dollar club'. In the eighties, however, there has been growth of small and medium-sized companies which have become MNCs. For instance, 58.4 percent of all MNCs from Canada, 23 percent from Japan, 78 percent from the UK, 43.3 percent form the USA and 80 percent from France are small and medium-sized MNCs. No doubt there is a threshold—a certain minimum size which is required for a firm to become an MNC.
- Many MNCs depend more on their foreign sales than on domestic sales. There has been a steady growth of the share of foreign sales to total sales (Table 9.1).
- The strength of MNCs lies in the fact that they operate in many product lines. Occasionally, we do have MNCs such as automobile giants and the IBM which have confined to a narrow line of products. But such cases are exceptions. Diversification into various product lines was earlier confined to the MNCs from the US in the sixties and early seventies. But now MNCs of all countries have accepted product diversification as a corporate objective (Table 9.2).
- MNCs often preside over a broad range of products with vastly different technical and strategic requirements. This range adds to the complexity of managers' problems. While one line of business may be pressed hard by competition, another may be discovering newer and greener pastures. While some of the activities of MNCs make great demands, as the resource of the network, others may be providing supply of funds. This diversity provides MNCs with extraordinary flexibility in managing their corporations globally.
- The MNCs have yet another advantage, their geographical diversity. When an enterprise takes its first plunge into foreign waters, it normally moves with some caution. Once committed to the international pattern, MNCs expand their geographical reach with great rapidity. This applies to MNCs not only in manufacturing but also in services. For instance, the US-based MNCS were operating in 170 countries and the Europe-based companies in more than 114 countries (Table 9.3).

- Most of the MNCs have great strength in the realm of technology. They spend billions of dollars on research and development. They also possess management and marketing technologies.

Now, we shall discuss the issues related with the MNC's culture and host countries.

Table 9.1 Multinationals: Sales Trends—Ratio of Foreign Sale to Total Sales

Region	No.of MNCs	1976	1980	1985
North America	111	29.7	33.5	25.6
Western Europe	59	36.9	36.2	42.2
Japan	48	5.3	6.2	7.6
Total	218	28.2	30.4	26.1

Source: UNCTC, Transnationals Corporations in World Development: Trends and Prospects (U.N., N.Y., 1988), p.36.

Table 9.2 Principle Industry and Product Lines of 367 Multinational Enterprises (based on a classification system of 158 Product Lines)

Country of parent and principal industry	Number of product lines					
	Inside principal industry			Outside principle industry		
	Skill lines	Advertising lines	Standardised lines	Skill lines	Advertising lines	Standardised lines
U.S. based Enterprises						
63 skill-intensive	219	27	8	219	74	270
53 advertising-intensive	51	140	34	118	79	125
64 standardised	13	15	165	245	62	261
180 total	283	182	207	582	215	656
Europe and U.K based Enterprises						
36 skill-intensive	146	28	9	104	36	141
26 advertising-intensive	6	70	15	30	24	50
73 standardised	9	7	145	206	43	234
135 total	161	105	169	340	103	425
Japan Based Enterprises						
23 skill-intensive	35	6	2	10	3	23
10 advertising-intensive	0	5	2	33	24	81

28 standardised	0	1	50	16	7	29
61 total	35	12	54	59	34	133
All 376 Enterprises in Sample						
122 skill-intensive	400	61	39	342	113	434
89 advertising-intensive	57	215	51	181	127	256
165 standardised	22	23	360	467	112	524
376 total	479	299	450	990	352	1214

Source: Raymond Vernon, *Strom over the Multinationals: The Real Issues* (Macmillan, London, 1977).

Table 9.3 Locations of Foreign Manufacturing Subsidiaries of 391 Multinational Enterprises

Location	180 U.S. based enterprises 1975	135 Europe and U.K. based enterprises 1970	61 Japan based enterprises 1970	All 39 enterprises in sample
In fewer than six countries	10	31	37	87
In six to ten countries	43	30	15	90
In eleven to twenty countries	86	46	8	143
In more than twenty countries	41	28	1	71
In Europe only	0	17	1	19
In North America only	0	1	0	1
In Latin America only	0	0	2	2
In Asia only	1	0	12	15
In industrialised countries only	9	15	0	27
In developing countries only	0	0	30	32
In both industrialised and developing countries	170	114	20	313

Source: Ibid., p.26.

9.3 DECISION-MAKING :

We have earlier noted that decision-making with regard to all important matters is generally centralised in an MNC. Hence, its subsidiary, or affiliate, or a branch in a particular country will depend on the parent company for all its major decisions. This includes finance, technology, choice of products, choice of partner in the case of an affiliate, labour management, exporting and importing etc.

While the company's chairman in the host country could be the national of the host country, he and his Board of Directors will be largely controlled by the parent company.

In some respects the parent company decides about even the quality control of its products. High technology intensive products are extremely subject to the role of central decision making. For instance, in MNCs in the fields of computers, pharmaceuticals and chemicals the role of the parent is very important. This control is normally exercised through regular weekly, fortnightly, monthly and quarterly reportings. The higher the control the greater is the frequency of reporting.

This crucial feature of central decision making raises a number of issues to a host country and its government A few important areas of concern will be discussed.

9.4 INTRA-FIRM TRADE AND TRANSFER PRICING :

The intra-firm trade is defined as trade between two related parties very often situated in different countries and aims at maximising joint profit rather than individual profit as would be in the case of trade between two unrelated parties. The need for transfer pricing arise because of the existence of large intra-firm trade in an MNC's network. it is estimated that infra-firm trade is as high as 60 to 80 percent in some cases. Transfer pricing is defined as a price which is administered by an MNC which is different from the arm's length price or the market price. This transfer price provides adequate scope for the concerned MNC to charge higher/lower prices depending upon its global profit expectation and other corporate objectives. The use of transfer pricing by MNCs is a recognised practice which comes into operation specially under certain circumstances. First, when a host country imposes various taxes which may not be consistent with the objectives of MNCs, then it is expected that the concerned MNC will take advantage of transfer pricing to maximise its global profits and minimise its overall tax liability in the host country. Secondly, in order to avoid declaration of high profits, which may be embarrassing to host and investing countries, an MNC may take recourse to transfer pricing. Thirdly, when the exchange rate restrictions of host country create uncertainties, MNCs may take recourse to transfer pricing. Finally, in the case of the existence of a host country's shareholder who may cut into the profit of MNC, it may take recourse to transfer pricing. Most often in this as is revealed by a number of studies, to host country suffers from the transfer of its resources to the outside world.

9.5 TECHNOLOGY TRANSFER :

MNCs, as has been noted, are keen to innovate. They see a special virtue in innovation which they relate to increase their profits. They guard their technology very much. However, they are not found to be major innovators. But they are major institutions in commercially utilising available innovations to produce products and use processes. It is also important to distinguish major innovations from the run-of-the-mill projects. MNCs tend to place innovational processes close to their headquarters. Hence, the bulk of R & D expenditure is done in the parent company, that is, the investing country. MNCs, however, keep their R & D in a number of host countries as well. For instance, the European owned MNCs have good R & D in the US. To take a specific case, the Unilevers higher priced products were developed in the US. Similarly the US-based MNCs have considerable R & D in Europe and they have not only innovated but also developed products suiting

the European markets. In the context of developing host countries however, such operations are extremely limited.

Differentiation must be made between a developed host country and a developing host country in the context of technology transfer, MNCs are generally reluctant to establish R & D establishments in developing host countries. The R & D unit in developing host countries mainly act as trouble shooting agents and as sources for product adaptation to the needs of local markets. Some times this happened because of an inadequate infrastructure available to an MNC in a developing host country. It is also a corporate policy not to spread its R & D activity in all the countries of its operation.

The host countries local firms do get affected by MNCs' technology power. There are three different types of such an impact. First, in the developed host country, strategic alliances can be built by the national enterprises with MNCs. Second, the MNCs may choose the areas of importance to them and collaborate with national enterprises of the host country. This trend had become quite dominant in the eighties and continued in the early nineties. Such a practice was adopted even by MNCs which were earlier highly protective of their interests and did not want to share ownership and decision making with other important companies. The MNCs, such as IBM and Ford, which were extremely reluctant to joint hands with any other company, have now given up this hesitation. We have now a Ford-Toyota collaboration. (We now have in India even Tata and IBM collaboration). Third, the enterprises in a developing host country may respond in two ways: (a) they may fade out of business, or (b) they may develop distinct product characteristics, adopt appropriate advertising campaigns and reduce price thus competing with MNCs. In India, we do see some of the national enterprises in detergents, soaps and edible oils which have successfully maintained their profitability and are expanding their business.

In the literature on MNCs; entropy is discussed. Entropy, as defined by Raymond Vernon, is the process by which bits of matter lose their inner energy and grow indistinguishable from inert particles that surround them. The established leader in a market tends to see itself as threatened by entropy. If the leader has enjoyed an especially high price or a special degree of stability because buyers think that its products are unique, the entry of new firms is seen as threatening the previous ones or weakening the stability of the leader. The firm may introduce new products, enter into a frenzy of advertising, and it may develop bigger and more capital intensive facilities to keep the competition away.

From the point of view of MNCs one means of coping with entropy may be as good as another provided it works. Yet from the viewpoint of the government of the host country, the means that foreign firms select to hold off the effects of entropy are of considerable importance.

MNCs often dominate the market of the host country. If the number of sellers multiply, smaller firms come into the market, many of them national rather than foreign. In some products, MNCs may not allow the national firms of host countries to come up by various devices. This is typically so in high technology intensive industries. MNCs may join together for not allowing the newcomers. This has happened in electrical equipment and tractor industries.

In many products, the size of the firm and the extent of MNCs' control no longer counts. For much of the competitive race an MNC may walk out of the market by surrendering the old product to the national enterprises of the host country.

9.6 EMPLOYMENT AND LABOUR RELATIONS IN HOST COUNTRY :

MNCs most often do not change their choice of technology of production to a given resource endowment of a host country. This dies not pose a problem to host countries which have a similar resource endowment as the countries of parents of MNCs. For instance, an MNC from the United States does not find a problem in a European country.

The choice of technology becomes a problem when there is a wide difference between the country of the parent and the host country. This is true very often of a developing country. The employment generation by the MNC in a labour surplus host country will be less when it adopts the same capital intensive technology.

If the technology remains labour intensive at the global level, the MNC very often chooses a labour surplus developing country. Then it creates substantial employment occasionally at a slightly higher wage rate than prevailing in the labour market of the host country. This is evidenced in a large number of export-processing zones a well as operation of MNCs in South-East Asian countries.

With regard to labour relations in any host country of either its subsidiary or a branch, the parent of the MNC normally permits its local Board of Directors and Chairman/Managing Director to deal with it, consistent with prevailing practices of the host country. Evidence shows that MNCs do not impose central decision making on them.

MNCs, however, are reputed to assure before entering a host country a flexible regime of labour legislations. They are side to normally shy away form the countries where the labour laws support the collective bargaining of labour. norms to be adhered to by the employer. For instance, MNCs may prefer labour not well organised, and hence seeking lower wages. This can be seen in their preference to employ large number of young women at lower wages in certain export processing zones of South-East Asia.

9.7 MANAGEMENT PRACTICES OF MNCs :

MNCs are known for their efficiency-oriented management systems. When MNCs operate in a developed host country, the influence on the management practices of the host country are often positive. This occurs due to the interaction which can be described as "cross-fertilisation" between the two sets of practices. The interaction may bring about improvement in management technologies and practices.

In the context of developing countries, MNCs most often introduce new efficiency-oriented management practices. Thus a developing host country can learn a good deal from the MNCs in this respect.

MNCs Business Culture :

One of the major areas of controversy is the impact of MNCs on host countries' culture. This has several dimensions which we shall discuss:

Market Promotion and Advertising :

It is known that MNCs rely heavily on advertising and market promotion to retain and enhance their market share. These advertisements and market promotion techniques very often have their basis in the advertisements and market promotion techniques and approaches adopted in home

countries of the parents. Thus, it is argued that the MNCs bring with them to the host country their cultural bias powerfully based in developed country. This, according to some, damages the local culture. This problem may not be serious in host countries which have similar cultural patterns. But in those host cuntries which belong to different cultures, this problem becomes fairly acute. Their advertisements and sales promotions have very often distorted local cultural preferences and thus created substantial confusion in the host countries. It may also happen sometimes that such advertisements may not bring the desired result to the MNC as has been the experience in the fields of food, drinks and clothes.

While the local enterprises are imitating the MNCs in respect of advertisement and market promotion, MNCs are also fast learning the necessity of adapting their promotion campaigns consistent with a host country's culture although the major refrain remains the global market approach of the MNCs where the material differences are expected to be either eliminated or reduced.

MNCs and Social Responsibility :

Modern business is expected not to overlook its social responsibility. While the government's intervention is disliked, there is increasing realisation that modern business must realise its social responsibility. The MNCs may have different perceptions of social responsibility, whereas in the host country, especially in a developing country, it could be less. This tendency is however changing although very slowly. The MNCs are perhaps realising that it is in their long-term interest to acknowledge their social responsibility in the host country also. But the Bhopal disaster cash which was caused by the leak of gas from the Union Carbide Plant, does not give much hope that MNCs would behave with full sense of responsibility. The irresponsible behaviour of the Union Carbide caused misery to a large number of inhabitants of Bhopal. MNCs often sell medicines in developing host countries which have been banned in their home countries.

MNCs and Environment Protection in Host Countries :

MNCs are under increasing pressure by their home governments to give up the technologies which damage the environment. Hence MNCs are choosing countries where environment regulations are weak. It is likely that MNCs are not mindful of the environmental disaster they create in a host country. What is more concerning is an intellectual support to such a shift as has been argued by the Vice-President of the World Bank, Professor Lawrence Summers. According to him, the harm from the shifting of environmentally pollution prone industries to the developing countries will be far less than if these industries were operated in the developed countries for the population of developed countries has lower limits of tolerance of environmental pollution and higher level of health consciousness than in the developing countries.

Restrictive Business Practices :

One of the important aspects of the MNCs' operation has been their restrictive business practices which affect the free operation of their subsidiaries, affiliates and branches in host countries. These restrictive business practices include typing imports to specific sources of interest to MNCs, conditions of technology transfer, price fixation, exports, restrictive use of brand names and trade marks etc.

Efforts at De-stabilisation :

The history of MNCs shows that they have at times taken recourse to de-stabilisation of *inconvenient governments especially in developing countries.*

However, MNCs have been found not to be indulging in political de-stabilisation in the developing countries during the latter half of the seventies and the eighties. The absence of such a phenomenon now can be attributed to a few main factors: (i) The MNCs no longer needed to indulge in political de-stabilisation as the international ideological environment in the eighties had been such that there seemed no basic contradiction between the objectives of the MNCs and the governments of most host developing countries. (ii) The MNCs appreciated the fact of independent governments in the developing countries. These governments have developed the capacity to cope with such situations or contingencies. Similarly, the host developing countries also recognised the need to adhere to the commitments made by them. Therefore, in the eighties one witnessed substantially lesser number of nationalisations and expropriations than had been in the sixties and the early seventies. (iii) The MNCs were not very much interested in raw materials in the eighties. They were steadily withdrawing form these sectors, thus removing the prime cause of confrontation between the host country governments and the MNCs. (iv) The emerging importance of smaller MNCs in their own countries has also contributed to the growth of confidence of developing countries in the MNCs.

9.8 MNCs AND HOST COUNTRIES' GOVERNMENT POLICIES :

One of the most important areas of debate has been the MNCs and host government policies. The objectives of MNCs and host countries' governments have a number of areas where conflicts may occur. First, whose jurisdiction have the MNCs to accept in the event of conflict between the host country and the home country of the MNCs. There are a number of cases where the MNCs have asserted the home government's rights. This had led to conflict among all the three—the MNC, the host government and the home government.

Host government policies may encourage or discourage MNCs. What policies host governments would follow are linked directly with the business objectives and culture of the MNCs.

In the present context, the developed host countries have broadly similar policies that provide relatively free operation of MNCs in their economies. This can be seen in the expansion o foreign direct investment made by the MNCs largely in developed countries with the US receiving nearly 40 percent of foreign direct investment mainly by the MNCs.

The emergence of "Europe 1992' has specific policy orientations to encourage MNCs' operations in European Community. Even Japan is liberalising. The Great Shift has taken place in developing host countries. A large number of developing countries are using their policies to attract MNCs. Before analysing the policy shifts it is useful to identify various elements of developing host countries' policies towards MNCs which were in the centre of the debate in the eighties. It has often been argued that developing countries which has selective foreign direct investment (FDI) and transfer of technology policies create disincentives to MNCs. The selective policies may be manifested in one or more of the following:

- Treatment of MNCs under the laws of the country which may deprive them of national or equal treatment;
- Administrative rules and regulations governing MNCs' ventures may result in a high degree of discretion and lack of transparency in decision making;
- Imposition of management and labour policies;
- Equity restrictions;
- Lack of continuity or uncertainty or FDI and technology collaboration policies; and
- Threat of nationalisation and expropriation and limitations set on remittances of profits and capital.

Many developing countries in the eighties have made a large number of policy changes to attract MNCs. A few chief elements have been highlighted in the following pages.

Many African states have enacted "Investment Codes" designed to promote both domestic and foreign investment. Such codes usually provide for the grant of certain general guarantee against expropriation or nationalisation without fair compensation and non-discriminatory treatment and repatriation of capital and profits. A number of African countries have established investment coordination agencies with a view to promoting investment by TNCs.

It is notable that African socialist countries also appear to be moving, albeit in a manner best suited to their specificities, in the general direction of acceptance of FDI from MNCs.

In Asia several countries have amended to varying extents their foreign investment policies. South Korea which had a rather restrictive foreign investment policy had liberalised by streamlining and simplifying procedures. A foreign investor who does not seek majority ownership seeks no concessions and in fact has less than $1 million investment, gets automatic approval. Service sectors are getting open to MNC s.

Malaysia has postponed the condition requiring participation of Bhumiputras in the equity of foreign ventures. China has also permitted foreign investors and MNCs and simplified procedures and thus emerged as the largest recipient of foreign direct investment. Within seven years of opening its door to foreign investors, China has become one of the largest recipients of foreign direct investment. Among all developing countries China was earlier particularly interested in acquiring advanced technology, management skills and international distribution channels. Between 1979 and mid-1987, the cumulative inflows of FDI to China amounted to about $ 9 billion. Approved investment projects over this period totalled nearly $ 20 billion. It is important to recognise that 2/3rds of the investments has been in the service sector. Since 1986, however, due to certain difficulties, FDI flows to China have, however, declined.

Even the Middle Eastern countries have liberalised the codes concerning foreign direct investment. The Algerian code strikingly illustrates the trend towards liberalization, primarily because it amends an earlier law what that was considerably more restrictive. While equity participation is still subject to restrictive clauses other procedures and restrictions have been relaxed.

The most dramatic changes have taken place in the FDI laws in the Latin American countries. These countries, especially the Andean group of countries, Brazil, and Chile, had predominance of control rather than encouragement in their FDI policies. They have effected a number of changes

in their laws and policies. For example, Columbia, a member of the Andean group, acting within its basic provision of Decision 24, raised the ceiling of profit remittances.

It is important to recognise that some developing countries had nationalised MNCs' subsidiaries in their countries. This measure was taken as a last resort when the conflicts arose with MNCs. The approach of developing countries to the nationalisation issue is an indication of the change that has taken in the attitude of the developing countries to MNCs. it is significant that while during the period 1970-75 nearly 336 companies in developing countries were nationalised, accounting for 58.5 percent of the total nationalisations, during the period 1980-85 only 15 companies 2.6 percent of the total were nationalised.

Apart from relaxation of foreign direct investment policies, a large number of developing countries have entered into bilateral investment treaties. The developed countries in a bid to secure assurance for the protection of investments originating from their respective home countries have sought to negotiate these agreements which provide security to their MNCs. On the other hand, the developing countries, faced with a number of difficulties on foreign exchange account, have themselves resorted to bilateral investment measures.

Some 100 bilateral investment treaties have been concluded since 1980 bringing the total number of these agreements to approximately 270. Majority of these countries are in Africa and South-East Asia. Latin American countries have not concluded such agreements.

These agreements cover issues such as fair and equitable treatment, national treatment and most favoured nation treatment, nationalisation/expropriation modalities of compensation and dispute settlement.

At the multilateral level, efforts are being made to assure protection to MNCs. An important endeavour has been the Multilateral Investment Guarantee Agency (MIGA), a new member of the World Bank group which has a specialised mandate to encourage equity investment and other direct investment flows to developing countries through the mitigation of non-commercial investment barriers especially political risks. To carry out this mandate the MIGA offers investment guarantees against non-commercial risks. A large number of developing countries including India have become its members.

9.9. FORMS OF MNCs' COLLABORATIONS :

In recent years MNCs have changed the approach to their activities in the host countries in many ways. In the earlier phases of their growth they concentrated on establishing subsidiaries in various countries on which they had complete control. In the late seventies and the eighties, they embarked upon using various methods to acquire a market share in the host countries. The methods include joint venture, technical collaborations and licensing (Table 9.4).

Table 9.4 Distribution of Ownership Patterns (1,276 Manufacturing Affiliates of 391 Multinational Corporations Established in Developing Countries)

Home Country and Type and Ownership	Number Established as Percentage of Total				
	Before 1951	1951-1960	1961-65	1969-1970	1971-75

Affiliates of 180 U.S. based corporations					
Total	100.0	100.0	100.0	100.0	100.0
Wholly owned	58.4	44.5	37.4	46.2	43.7
Majority owned	12.2	21.4	19.2	17.8	17.3
Co-owned	5.6	7.9	11.4	11.2	10.4
Minority owned	11.2	18.8	21.7	21.5	28.1
Unknown	12.6	7.4	10.3	3.3	0.4
Affiliates of 135 European and U.K based corporations					
Total	100.0	100.0	100.0	100.0	—
Wholly owned	39.1	31.6	20.9	18.9	—
Majority owned	15.4	20.1	15.6	16.4	—
Co-owned	5.3	6.6	11.1	6.6	—
Minority owned	9.8	27.9	35.8	42.1	—
Unknown	30.5	13.9	16.6	16.0	—
Affiliates of 76 other transnational corporations					
Total	100.0	100.0	100.0	100.0	—
Wholly owned	27.4	16.7	10.7	6.1	—
Majority owned	8.2	26.2	12.6	8.2	—
Co-owned	12.3	7.1	6.3	7.5	—
Minority owned	16.4	42.9	66.7	74.2	—
Unknown	35.6	7.1	3.8	3.9	—

Source: Research Policy Committee for Economic Development, *Transnational Corporations and Developing Countries,* p.34.

MNCs also have the record of buying up profitable enterprises in the host countries. It is estimated that 60 percent of the MNC units, particularly, in developing countries, are bought over firms. Even loss making enterprises are bought over. Japanese investment in the USA and UK partly belongs to this category (Table 9.5)

Table 9.5 Foreign Manufacturing Subsidiaries of 376 Multinational Enterprises (Classified by Whether Newly Formed or Acquired as Going Concerns)

Location and Classification	Subsidiaries of 180 U.S based Enterprises		Subsidiaries of 135 Europe and U.K. based enterprises		Subsidiaries of 161Japan based enterprises		Subsidiaries of all 376 enterprises in sample	
	Number	percent	Number	percent	Number	percent	Number	percent

In Industrialised Countries								
Total Sub-sidiaries	3603	100.0	3207	100.0	46	100.0	6856	100.0
Acquired as going concerns	1974	54.8	1705	53.1	8	17.4	3687	53.8
Newly formed	1385	38.4	862	26.9	38	82.6	2285	33.3
Other and unknown	244	6.8	640	20.0	0	.0	884	12.9
In Developing Countries								
Total subsidiaries	2124	100.0	1454	100.0	516	100.0	4094	100.0
Acquired as going Concerns	757	35.6	465	32.0	72	14.0	1294	31.6
Newly formed	1224	57.6	715	49.2	433	83.9	2372	57.9
Other and unknown	143	6.7	274	18.8	11	2.1	428	10.5

Source: *Ibid.*, p.36.

It is now a known fact that MNC's market power globally and in the host countries is very high. More often it is difficult to counter an MNC's market power by any national enterprise of the host country as also by the host government, especially if the latter is a developing country.

The market power may arise from various factors. Firstly, MNCs preserve their capacity through transfer pricing. This practice enables MNCs to help the loss-making units with the profits of the profit-making units. This gives them the market power to compete with local enterprises for a longer period. Secondly, MNCs have brand names, trade marks, etc. which are popular as also associated with quality. These assets of the MNCs give them the advantage in the marketing of their products. The local and national enterprise generally face stiff competition. It has been revealed that through licensing of their brand names, trade marks, etc., MNCs dominate the market and draw huge profits. Thirdly, MNCs also collaborate with each other for market share. In a situation where a large number of MNCs operate, there is substantial evidence to show that they divide to global market amongst themselves.

9.10 SUMMARY :

Multinational corporations are also known as transnational corporations. An MNC has its producing and trading activities in a number of countries. Such a corporation has a central organisation regulating the activities of its subsidiaries/affiliates across national frontiers with specific global objectives.

MNCs retain their national character despite a number of factors or developments. We may describe MNCs from different countries as US's MNCs, UK's MNCs, Germany's MNCs and Japan's MNCs,etc.

The MNCs culture has been identified with their corporate objectives, management practices and procedures. While there are differences incorporate objectives with respect to the MNCs of the US, UK, Germany and Japan, there are certain basic common features:

- MNCs are very large companies measured by the value of their total sales. However, lately there has been growth of small scale MNCs.
- Many MNCs depend more on their foreign sales than on domestic sales. They are multiproduct companies, something which gives them an extraordinary flexibility and strength.
- They also have a very significant asset: their geopolitical diversity.
- Most of the MNCs have great strength in technological diversity.
- Central decision-making in an MNC makes its subsidiaries, affiliates and branches depend on the parent company for major decisions.
- Intra-firm trade is defined as trade between two related parties with the objective of joint profit maximisation rather than individual profit maximisation. This makes the profitability of a subsidiary, an affiliate or a branch in a host country depend on the decisions of the parent.
- Pricing in the subsidiary, affiliate and branch very often depends on the parent, since transfer price plays an important role in the conduct of business between affiliate parties.
- The bulk of Research and Development (R&D) is done in the parent company. In this respect a developing host country receives less of attention in R & D.
- The local firms in the host country get affected in various ways by the operations of MNCs. Occasionally, an MNC may dominate the market. In some cases of products with an old technology, an MNC may walk out. MNCs do not change their choice of technology to meet the resource endowment of the host country.

With regard to labour relations in any host country of either its subsidiary or a branch, the parent of an MNC normally permits its local Board of Directors/Chairman/Managing Director to deal with it, consistent with the prevailing practices of the host country. The operation of MNCs in developing countries benefits the latter.

MNCs normally introduce in a host country an efficiency-oriented managed system. But there are side effects too. MNCs' advertisement and promotion methods have very often distorted the local cultural preferences in a host country for MNCs go in for a global advertising campaign. MNCs' social responsibility in a host country depends on the power of the host government. It has been observed that MNCs do respond to a host country's governmental policies, especially in the case of export-oriented operations.

9.11 KEY WORDS :

Intra-firm Trade: Trade between subsidiaries, branches and affiliates of the same Multinational Corporation, the objectives being joint profit maximisation.

Transfer Pricing: Price used in an intra-firm trade which is expected to be different from the market price (or arm's length price) with certain corporate objectives.

Host Country: An independent nation state where a foreign MNC establishes its business operations through a subsidiary or an affiliate.

Investing Country: The country of origin of the parent organisation of an MNC.

Market Power: Strength or capacity of an MNC to change prices, financial and marketing policies including advertising which are singularly unique to an MNC.

9.12 SELF-ASSESSMENT QUESTIONS :

1) Describe the main features of Multinational Corporations.
2) Identify the areas in which an MNC and the host country interact.
3) What do you understand by intra-firm trade? In what way does this affect the host country?
4) Do the MNCs have the decision-making power centralised? In what way does the system of decision-making influence the subsidiaries/affiliates functioning in the host country?
5) Elaborate the concept of market power of MNCs, How does it influence the host country?
6) Do MNCs affect the operation of national enterprises? Elaborate your answer with examples, if any.
7) Can a special relationship exist between MNCs and governments of the host countries?
8) Define transfer pricing and assess its effects on the host country.

9.13 FURTHER READING :

United Nations Conference on Transnational Corporations: *Transnational Corporations in World Development: Trends and Prospects* (U.N., New York, 1988).

Chishti, Sumitra and Anees Chishti, *Transnationals and Development Countries: A Monograph* (The World and You Series) (Allied Publishers Ltd., New Delhi, 1990).

Raymond Vernon, *Strom Over the Multinationals: Real Issues* (Macmillan, London, 1977).

Lall, Sanjay and Paul Streeten, *Foreign Investment, Transnationals and Developing Countries* (Macmillan, London, 1977).

BLOCK 4 MANAGEMENT PROCESSES AND PRACTICES

Whatever be its global strategy, a firm in international business needs sound management policies and practices. This Block deals with basic issues that arise in international business, paying particular attention to those aspects that are uniquely international. Management of international business, as we have been underscoring, is in fact multi-cultural management. This block has three units.

Unit 10 is concerned with **Human Resource Management in MNEs.** It begins by examining the approaches to "nationality" problem. The cross-cultural perspectives are discussed. The sources for and stages in recruitment, and selection criteria and techniques are discussed. The role of management development and training, and the various techniques that can be used discussed. Also discussed are cross-cultural transfers and problems. The later portion of this unit deals with issues in compensation policy and human resource management practices.

Unit 11 deals with **Production Management and Logistics.** An international firm needs a well designed strategy on production management and logistics so that it could gain and sustain competitive advantage. At the outset the nature of production management function is examined. The unit then focuses on the issues related to sourcing and procurement, and make or buy decisions. The pros and cons of the various approaches to sourcing are evaluated. The unit explains and then critically examines the "comparative cost advantage principle". The gamut of factors that affect the decision of location of production practices are discussed, citing te research evidence on locational advantage. The unit then takes up for discussion the important questions relating to logistics, technology, plant design and size. New production techniques such as Just-in-Time (JIT), Flexible Manufacturing System (FMS), Total Quality Management (TQM) are also explained.

Unit 12 focuses on **Negotiations in International Business,** a topic which is emerging as of crucial importance in international business operations. It is emphasised that the process of negotiation in reality is a process of communication. The stages in cross-cultural negotiation process are discussed, citing relevant research findings. In view of its growing importance, the international firms have to properly plan negotiations and have to do some homework before actually undertaking negotiations. How could an MNE manage negotiations and how could is sustain its bargaining position are then discussed. The role of negotiating skills and how could the skills be improved are dealt with. The undercurrents in why renegotiations have to be undertaken, and the mechanisms available for arbitration of disputes are discussed. The unit concludes with a discussion on comparative cross-cultural negotiating styles.

UNIT - 10

HUMAN RESOURCE MANAGEMENT IN MNEs

Objectives :

- After reading this unit you should be able to understand:
- why global companies need global managers
- how socio-economic and cultural variables influence HRM philosophies and practices
- how MNEs select, train, develop and reward their human resources
- the role of managers working in foreign subsidiaries
- the attitude of MNEs towards labour force
- HRM practices in MNEs

Structure :

10.1 Introduction

10.2 Approaches to Nationality Problem

10.3 Cross-Cultural Perspectives

10.4 Recruitment : Sources and Stages

10.5 Selection Criteria and Techniques

10.6 Management Development and Training

10.7 Cross-National Transfers and Promotions

10.8 Compensation Policy

10.9 Managing Managers of Foreign Subsidiaries

10.10 Managing Labour force in Subsidiaries

10.11 Human Resource Management Practices

10.12 Summary

10.13 Self-Assessment Questions

10.14 Further readings

10.1 INTRODUCTION :

The success of an enterprise depends largely upon the quality of its people, whether it operates at local, national or international level. When business becomes international it brings some unique problems in human resource management. It needs 'global managers' of very high calibre to play multiple role – integrating and coordinating activities taking place in different cultural environments by people with diverse cultural orientations, formulating strategy in a highly competitive market, identifying opportunities and risks and managing assets world-wide.

For its foreign subsidiaries, MNEs need managers to play the role of boundary or middleman between two sets cultural patterns. They are the 'company' to their subordinates and customers, and local managers to their headquarters which expect them to act as their ambassadors. The recruitment, development and retention of high quality managerial personnel require strategic planning on the part of MNE management so that the human resource could match its global business objectives and strategies. The recruitment of manpower involves a choice among various nationalities involved and examination of cross cultural perspectives. It raises questions concerning desirable qualities, characteristics, aptitude, skills, knowledge, experience and ability to communicate and adapt to different cultures and life styles.

The development of human resources calls for assessing the training needs, chalking out training programmes in cross-cultural setting, transferring knowledge and skills, understanding company goals and implementing them successfully in an environment full of challenges and risks. The retention of top technical am managerial personnel is no easy job due to growing demand for such personnel. The transfer, promotion and compensation policies have to be comparable and favourable to retain them. These and other problems necessitate a clear management strategy on HRM. Michael Deurr has rightly said that having the **right type of people in the right place at the right time** emerges as the key to a company's international growth.

This unit examines the various aspects and issues related to human resource management in the context of international business.

10.2 APPROACHES TO NATIONALITY PROBLEM :

A multinational enterprises may use any one of the following four approaches or a mix of some these to meet its manpower requirements:

1) Ethnocentric
2) Polycentric
3) Regiocentric and
4) Geocentric

These terms, though explained in one of the previous units, need to be discussed in the context of human resource management.

Ethnocentric policy is characterised by an MNEs preference for using home country nationals

for all senior positions and rewarding them more generously over the host country nationals. The discrimination if carried too far alienates and demoralises other country nationals who may feel having (getting) a second class citizen's status and treatment. Hardship may be created for some country nationals also if they have to go on frequent tours to transfers.

In polycentric approach the host country nationals are preferred for local positions. The local units get greater degree of autonomy in recruiting personnel for managerial and other positions. The knowledge of local language, culture and environment on the part of local managers helps create a more favourable attitude among employees of the local organisation and the dealers and customers. The danger from too much localising is that it may alienate the local unit from the mainstream organisation because of the absence of expatriate managers who serve as links in the communication process.

In regiocentric approach, managers are recruited on regional basis. For instance, an American multinational operating, in Europe may prefer to have European managers at regional headquarters in Europe in large numbers instead of sending people from the headquarters. IBM has two international headquarters: one in New York and the other in Paris. This approach helps in reducing the cost of recruitment, maintenance and training and also enables handling regional problems more effectively.

The geocentric approach is based on the philosophy of global outlook of the management. It shows MNEs commitment to employ best brains available from anywhere. The top positions even in headquarters may go to host or even third country nationals. Very few multinationals follow this approach as the culture and tradition of the corporation is built over the years on the basis of certain objectives, philosophies and practices.

Legal Considerations : The laws of most countries require employment of local nationals if available in adequate numbers from within. Immigration visa a pre-requisite to take up any assignment by foreigners. In US and Germany, for instance, the rules for work certificates are very stringent. The European Community countries permit free movement of labour within Europe but require work permit for nationals of non-Community countries. Japan is most reluctant among industrial countries to grant work permit to foreigners. The immigration regulations in most countries permit limited flow of professionals, managerial and highly technical personnel. Migrants get a second class citizen status in most industrialised countries.

Activity 1

Request your Academic Counsellor to initiate in the class a discussion on approaches to Nationality Problem. After examining the pros and cons of each approach, express your views as to what approach would be the most suitable for multi-national subsidiary operating in India (specify the assumptions you make.)

10.3 CROSS-CULTURAL PERSPECTIVES :

Socio-economic and cultural variables influence management philosophy and practices in all countries. It is not easy to transport home country's work culture, boss-subordinate relationship,

decision making process, value systems and techniques in other countries. The issues relating to applicability, transferability and utility of advanced management knowledge and practices therefore, have remained clouded. Cross cultural studios have confirmed variations in management thinking and practices based on social, economic and cultural differences. A few illustrations are given below:

1) Japanese culture places high premium on collective responsibility which is described by the word Shu-jo-hu-on (gratitude to nature and other human beings for one's success). This philosophy requires abandoning the idea of individual power domination in favour of cooperative group action. This is not so in western culture which is based on individualism leading to the goal of self actualisation and fulfilment for individual rather than group as a whole.

   Decision making in Japanese system is considered to be more time-consuming than in American system. Under *ringi seido* the formal process of decision making may start at any level, but it normally starts at middle management level and then works it way both laterally and horizontally. It results reducing the risk. The degree of participation, examination of details and speed of implementation is higher in this system compared to US-European tradition where individual play more important role, and make quick decision, but the accuracy and implementation may not be of that high order.

2) Work is regarded as an end itself in Anglo-American culture, but not so in Mexico. Similarly scientific method is considered to be second nature to US managers while Mexican managers are said to have no such preference.

3) Whether its shortcomings the US management is still considered to be more democratic than the French, German and India management styles, though it is conceded that the autocratic style is not always dysfunctional and may be appropriate in a given situation.

4) Some studies indicate that in the economically backward countries authoritarian style of leadership in business has shown better results in terms of productivity than the democratic style. It has also been found that managers in these countries have a tendency to project their values on others more than most managers in developed countries. Salary differences between average and poor performers in these countries is low as compared to developed countries where performance is an important criteria for determining pay packet. The managers in developing countries are also found satisfied with the usual maintenance of their operations while managers in developed countries stress objectives of growth and competition.

Hofsted in a study (1979) of a large multinational company has attempted to demonstrate the strong influence of soci-cultural variable on authority distribution and the boss subordinate relationship. He used the concept of "power distances" between the superordinate and the subordinate. Power distance according to him is the difference between the extent to which A can determine the behaviour of B and the extent to which B can determine the behaviour of A. His major finding is that **power distance between the boss and the subordinate was larger in developing countries than in developed nations.** The distance was found to be on a higher side in case of Philippines, Mexico, Venezuela, India, Singapore and Brazil while it Sweden, Switzerland, Britain and Germany.

Readings and Martyn Johns concluded on the basis of the theory of cognition applied cross-cultural setting, that oriental companies used less formal planning and control, less programmed training, less objective data in decision making and have shown less precision and urgency in such matters as time keeping, scheduling and completion of programmes than their Western equivalents. But organisations in those countries have been more informal with stress on avoiding interpersonal confrontation than their western counterparts.

These and other studies confirm that there is no single way of doing things or managing enterprises. Similarities may be explained in terms of cultural variables while differences looked into from socio-economic and cultural perspectives.

10.4 RECRUITMENT : SOURCES AND STAGES :

MNEs meet their manpower requirements from three sources (1) home country nationals, (2) host country nationals and (3) third country nationals. The home country nationals are those who belong to the place of origin of the company. The host country nationals are the citizens of the place of location of subsidiaries and third country nationals come from other than the home and host countries of MNEs. In the early phase of internationalisation of business most companies recruited from home office or home country. As the business expanded and activities diversified, managers were recruited from the host country, and if needed, from the third countries. The rationale for using the above sources and the problems faced by MNEs in this regard are given in Table 10.1 below.

Table 10.1: Recruitment Sources: Rationale and Problems

Recruitment Sources	Rationale	Problems
HOME COUNTRY NATIONALS	Familiarity with the company policies, goals, objectives and managerial practices. Technological competence, effective liaison with home office and easier control of operations of subsidiaries	Difficulties in communication due to lack of knowledge of the language of the host country, problems of personal and family adjustments, legal and environmental problems, local pressures. High cost of selection and maintenance.
HOST COUNTRY NATIONALS	Familiarity with the local political, legal, social, economic and business environment, promotion prospects for locals, better motivation and fulfilment of local aspirations. Low cost of selection maintenance.	Problems in controlling the operations of subsidiaries as desired by the head office, communication problems, limited scope of gaining experience from company's operations abroad.
THIRD COUNTRY NATIONALS	More career oriented, professionally qualified and experienced, willingness to adapt to new environment and work away from home.	Host country's hostility towards nationals of certain countries may create problems.

An MNE which starts with export of goods in overseas markets relies heavily on local managers and sales personnel in the first stage of operations. When it starts manufacturing aboard the top and senior managerial and technical personnels are sent form the head office. It may recruit some managers from the host country who may be helpful in obtaining licences, doing liaison work with local politicians, government officials, industry associations, banks and financial institutions.

When entering into manufacturing operations abroad, an MNE may bring technical experts from home. The locals may be recruited for junior managerial supervisory or operative jobs. Their familiarity with local language, culture and environment is helpful in starting and controlling the operations. When the MNE diversifies introduces new technology or wants to penetrate into new markets, it may like to recruit third country nationals with relevant expertise and experience.

Well established MNEs may centralise operational and managerial techniques, manufacturing processes technologies and standards in other countries. This may require transfer from one unit to another, training at head office, creating a pool of expert personnel and making them available to different units on short or long term assignments. On top managerial and technical posts MNEs may prefer to place home nationals. Studies show that 75% of the chief executives in American multinationals are from U.S.A., 92% in European multinationals are from Europe and almost 100% in Japanese multinationals are from Japan. The practice to send large number of expatiate managers overseas to manage the operations of subsidiaries has declined over the years. Host country nationals are preferred for managerial and technical jobs by many companies. American MNEs in Europe for instance have around 70% senior management personnel from Europe. US companies were also the first to allow more locals in their subsidiaries in developing countries. Japanese MNEs, however, prefer their own nationals to fill up senior and in many cases even supervisory positions in their subsidiaries overseas.

10.5 SELECTION CRITERIA AND TECHNIQUES :

An executive who serves abroad not only represents his company but is also viewed as an ambassador without portfolio'. He must have adaptive capabilities in addition to managerial and technical competence. Open mindedness, tolerance and respect for other viewpoint and traditions, and knowledge of the history and culture of the host country are some of the prerequisites of success in overseas assignments. A sense of politics, organisational abilities and overall abilities to achieve company's goals through acceptance and cooperation are other attributes required. The attitude of executives spouses is also a critical factor. A survey of large number of American executives overseas by Gonzalez and Negandhi has shown that adaptability of spouse and children is considered a major source of success. This attributes that contribute to ideal background for overseas manager are listed with rankings, in Table 10.2

Table 10.2: Ideal Background for an Overseas Career

Background	Percentage
Wife and family adaptability	20
Leadership Ability	19

Knowledge of job	14
Knowledge of language of host country	13
Higher Education	13
Respect for laws and people of host country	12
Previous overseas experience	4
Desire to serve overseas	4
Miscellaneous	1
Total	100

The professional capability, knowledge, attitude, communication skills and experience of an executive can be measured easily through past records, personal interviews and psychological tests, etc. The standard of educational institutions from which an executive has obtained degrees, his academic achievements, the companies in which he has served, positions he has held, and performance records often speak about his credentials. For assessing the adaptability of the executives, companies are increasingly using "adaptability screeing" which take into account such factors as its success in handling similar transfers within the home country in measuring suitability for life abroad and its reaction to discussion of the stresses that life in foreign country will entail.

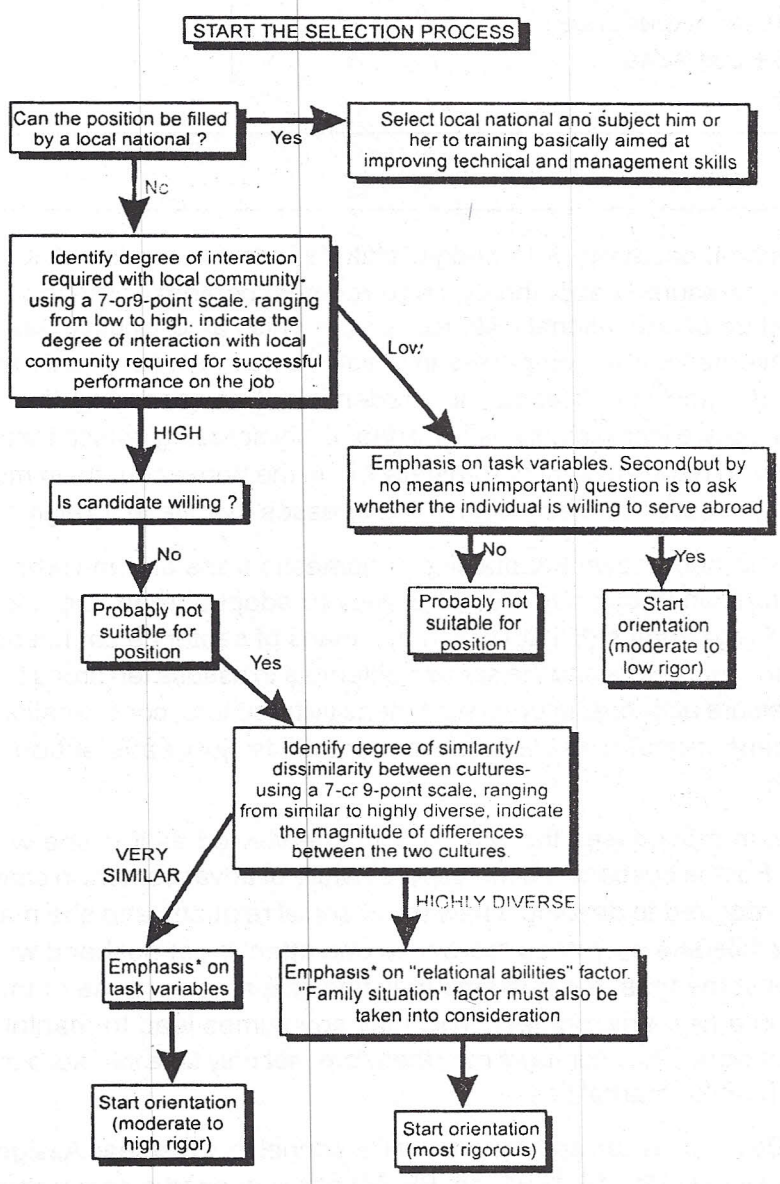
Managers who had shown adaptability in domestic transfers and who are not too tied to their own culture, tradition and family are more likely to adopt abroad. One popular technique is Early Identification Programmes (E.I.D.) which by means of sentence completion, questionnaires and interviews with the managers and the spouse, attempts to assess ten areas for an environmental match. These are: leisure activities, interpersonal sensitivity, culture, consideration, authoritarianism, cultural management, travel and distance acceptability, job satisfaction, motivations and management watch.

The spouse, in most cases the wife, is also interviewed as it is she who has to bear the brunt of the transfer. For the husband it is more in the nature of advancement in career and opportunity to grow. The wife is required to develop a new set of social relations and she may feel lonely in the new environment. While she may need more time and attention of husband who may be her only companion for quite some time, the husband may find little time because of the demands of new job at a new place in a new environment. This may sometimes lead to marital stress which may affect performance at work. The interviews may therefore, not only take into account the adaptiveness but also the strength of the marital ties.

A.L Tung (1981, "Selection and Training of Personnel for Overseas Assignments." Columbia Journal of World Business. Vol. 16. No.1, pp. 68-78) has proposed a comprehensive approach to expatriate selection (See Figure 10.1). It has been suggested that selection decision should be based on answers to important questions asked in relation to expatriate adjustment. The issues of interacting with host nationals, technical competence, culture novelty, family situation, and communication skills are all considered in this decision making framework. This framework also takes into consideration the fact that overseas jobs differ, and that some jobs may require more interaction with host nationals than others. Thus, the criteria need not be the same for all overseas assignments. You will appreciate that the framework is general and does not specify exactly how

candidates can be measured and evaluated on the criteria proposed which are considered important in the selection process.

Fig. 10.1: The Selection Process



Emphasis does not mean ignoring the other factors. It only means that it should be the dominate factor.

The companies which follow a rigorous procedure of selection of assess necessary competences have less failure rate among expatriates. The cost of screening before placement is always much lower than the cost of failure in the new environment.

Activity 2 : Arrange meetings with the Personnel Managers of (i) a multinational subsidiary, and (ii) an Indian company in your town. Gather information on Recruitment, Transfer and Promotion policies

and bring out the differences in their thinking and approaches.

10.6 MANAGEMENT DEVELOPMENT AND TRAINING :

MNEs need managers with a global outlook. Inbreeding and narrowness at the top are harmful in the long run. All those managers who have the potential to work overseas should be prepared for cross national experience. The headquarters should maintain a central inventory of international executives and monitor a continuous career development programme.

There is a no substitute to training in MNEs. The usual objectives of a training programme for international executives may be summed up as: **transfer of knowledge, improvement in communication, understanding company's goals and way of operating, increasing sensitivity to cultural patterns that may be foreign to their own experience and values, improving adaptability to new environment.** The training programmes should have cross national focus. Though training cannot be a substitute for actual foreign living experience, it may, however minimise the painful experience of adjusting to alien culture and avoid the damage that may be caused by the culture shock.

The training programme should be chalked out keeping in view the training needs. In one study Marry Johnston found that the human relations skills, understanding of other cultures and ability of adapt were the most pressing training needs for overseas manager. The conclusions were based on a survey of American Workers overseas and their Asian colleagues as shown in Table 10.3 below:

Table 10.3: Ranking of training needs for American Working Overseas by American Abroad and their Asian Colleagues (Most Important =1)

Training Need	Ranking by Responses of Americans (N=403)	Ranking by Responses of Nationals (N=131)
Human Relations Skills	1	1
Understanding of other Culture	2	2
Ability to Adapt	3	3
Technical Training	4	6.5
Sensitivity Training	5	6.5
A Sense of Politics	6	12.5
Language Ability	7	9
Understanding of Mission	8	5
Understanding of American Culture	9	15
Orientation for Service	10	4

Source: Mary B.Johnston. Training Needs of Overseas Americans as Seen by Their National Co-Workers in Asia. IDR/Focus No. 4 (1974), p.22.

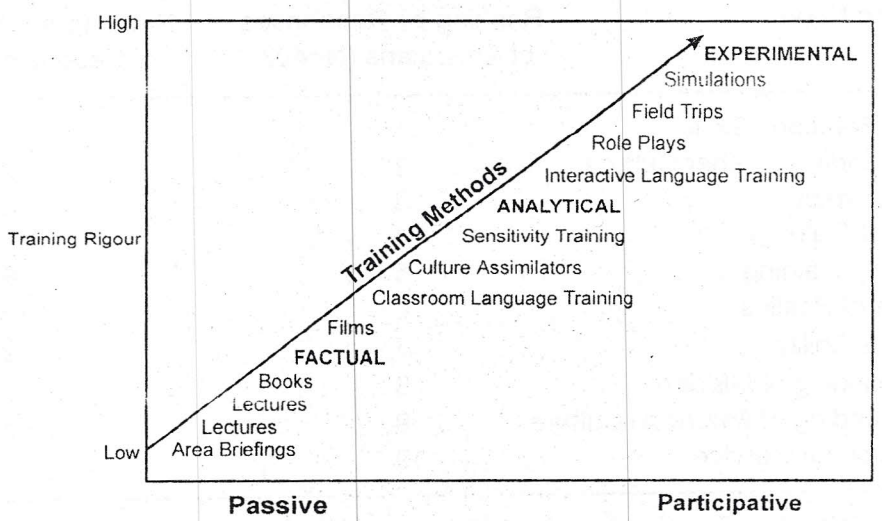
The training programmes to meet specific needs to international managers may be carried out internally as well as externally. The internally-oriented training programmes may be tailored to the specific needs of the company. The topics should have a closer relationship to the executives own work and current issues facing the enterprise. The participants, when brought from subsidiaries located in different countries, come to know each other and understand differing perceptions to

common problems. The impact of such training is also easily identifiable. The internally oriented programmes may also be tailored to the need of specific individuals and their specific job assignment. The executive may be given on-the-job training under the supervision of senior. The learning in such cases is real and not a mere intellectual exercise. It may be an effective way of the understanding the culture as well.

Seminars, conferences and workshops are other important means of training international managers, particularly on specific topics. For instance, a workshop on transfer pricing may be very useful for MNE managers. The externally-oriented programmes aim at broadening the manger's horizon beyond its own organisation and job. Foreign language training, for instance, is given by academic or institutions of foreign languages. The language course may develop a good understanding or say a foreign culture but it may not equip the manager with specific terminology required for business.

Various approaches to cross-cultural training have been used in the multinational enterprises. However, it may be mentioned here that some training approaches as more rigorous than others. Some approaches, e.g. simulation require the trainee to participate directly in the learning experience which others e.g listening to an area briefing simply require the trainee to passively absorb information with little mental and emotional effort on his part. The relationship between training rigor and level of trainees participate is illustrated in Figure 10.2. According to Black and Mendenhall, more rigorous approaches which require the trainee to expert significant cognitive and behavioural effort are more effective than less rigorous approaches. However, to conduct effectively rigorous training programmes require significant amount of time and money, and most companies may not be able to afford to take a manager off the job for one to two months on off-site training.

Figure 10.2: Training Rigorous and Level of Participation



Source: Black, J.S. & M. Mendenhall 1989. "A practical but theory-based framework for selecting cross-cultural training programmes." *Human Resource Management,* 28(4), pp. 511-539.

The Business school in many countries now offer full time or part time course in international management, international living, international understanding etc. Some institutions also offer tailor made orientation programmes of specific countries. There are organisations like Asia Society, Japan Society, Middle East Institute which offer briefing sessions for businessmen from time to

time. In some countries Government Ministries offer training programme for international managers. The Ministry of International Trade and Industry (MITI), Japan has established a training institution at Fuji to train groups corporate executive who are sent by their employers for an intensive year long full time course of study. The training programme of the institute included foreign language courses and a two month's study tour of other countries. Communication skills and understanding (demonstration) of cultural relativism including management policies and practices receive full treatment in the programme.

Activity 3

Arrange a meeting with the Chief Executive of a multi-national subsidiary and enquire about the: (i) objectives, (ii) nature, and (iii) contents of the training programme meant for managerial and supervisory personnel. Ascertain in what ways the training programme is influenced by the parent company (or headquarters).

10.7 CROSS-NATIONAL TRANSFERS AND PROMOTIONS :

All MNEs transfer managers across national and cultural boundaries. In some cases the transfers may be in the nature of permanent postings, in other cases they may be meant to meet some temporary need or they may be designed as a part of the career development scheme of the company.

The transfer decisions are important as the managers who are sent to work in a different environment, culture, language, life and work patterns alien to them must be able to adapt to the new situations. This is besides the requisite technical, managerial and leadership skills in their new jobs. The considerations which guide in recruiting managers for foreign positions would, by and large, be valid for transfers, whether related to promotions or not. The factors which are normally taken into consideration in a transfer decision are: performance in previous jobs, local prejudices, technical competence, adaptiveness and capacity to face repatriation problems. The decision makers, who are usually at the headquarters, prefer the candidates whose performances have been observed personally as that reduces the risk of making a wrong decision. The managers get preference in this process as they are closer to them. The local prejudices may be an obstacle for some executives in foreign postings. For instance, women executives from other countries may not feel at home in many middle east countries; similarly a black manager may not be acceptable easily in a predominantly white locality in certain countries. The transferee must have technical competence superior to those who would be required to work under him, as otherwise there may be resentment against his posting. Job ability is a very crucial factor in success of all foreign assignments. The manager should also be able to adapt to variations in facilities and technologies due to different levels of economic and industrial development at the place of posting. The decision makers have to take the individual's willingness and capacity to take up assignment at job and adapt to new environment. Some managers and their families view such assignments as a disruption in their way of living, particularly when posted in country where the standard of living and facilities are poor. Non-availability of food of one's choice, shopping centers located far off from residence, lack of good schooling for children, unpleasant climatic conditions lack of social support system, communication problems and non-cooperation by the spouse may affect performance at job and

peace at home and may deter some managers to opt for overseas transfers in some cases. Financial compensation is one of the measures which may mitigate hardship of otherwise unwilling executive. But it has to be quite substantial in order to have any appeal.

The number of transfers may be governed by the necessity of subsidiary companies nature of job and training needs. When managerial and technical competence of locals is very low, headquarters may have to send large number of managers to run the subsidiary. In service sector the availability of competent local managers may, be more than in industry which requires more skilled operations. Local pressures and prejudices may necessitate training more local people and placing them on the job instead of transfers at a large scale from the headquarters. Also where conditions favour a country by country strategy, locals may be preferred. But when there is a need to adopt a more global strategy, MNEs use more expatriates.

Performance of executives who join on transfer may not be optimal in the beginning in many cases. This has been confirmed by many studies. The new manager may like to improve his own style or he may try to demonstrate his superiority over locals. This may create resentment among juniors and affect relationship as well as performance at the job. The manger's perception of differences between himself and the subordinate, however, are reduced with the length of time he spend on overseas assignments.

The repatriation problems also need a closer look. The executive may feel that after returning from the job when the tenure is over, he may have to spend more on housing and other amenities of life in his place or origin. Some of his juniors might have risen in hierarchy over time and the social status of family might be affected. If the interest are safeguarded at the time to transfer, the adaptability and performance at the new job may be better. Some of the measures which companies take to smoothen the re-entry of expatriates are mental preparation and advice before return, maximum information about the new jobs, housing assistance, reorientation programmes, bringing expatriate managers to head office frequently and the use of formal headquarters mentors who could look after the manger's interests when they are expatriated.

The promotion policy of an MNE may be national (limiting opportunities for local managers to their own country units) of binational (allowing promotion from subsidiary to headquarters), or global, (promoting without regard to nationality) in nature. US multinationals provide promotion opportunities to non-US nationals to move into top positions in the headquarters, but this is not so with Japanese companies.

Promotion policy is influenced by several factors. Some of these are : legal constraints (emigration and immigration policies), ownership pattern, degree of autonomy granted to subsidiaries, willingness of managers to accept promotion in other counties, size of enterprises and also the size of its market and availability of competent people in local units. As the size of the firm increases, operations diversify or expand, ownership may become more broad based, it may become increasingly difficult for an MNE to lock up its foreign managers within their respective national firms. The managers in mature firms seek new and broader horizons. If it does not materials, some of the top personnel may start looking for more lucrative assignments in other organisations. Such developments may compel the MNE to globalise promotion and create multinational management.

10.8 COMPENSATIONS POLICY :

MNEs have to develop reward policies commensurate with national cultures and managerial expectations. It may be difficult to have the same salary levels for similar jobs in all countries. This is because of diversities in the productivity levels, cost of living, tax rates, supply and demand of certain skills, products and services. The requirements in terms of fringe benefits such as insurance and pension plan etc. may also differ.

When a person is posted overseas, he may have to duplicate his environment as habits are difficult to change. In many developed countries husbands and wives have separate cars, convenience goods and other facilities. When posted abroad they may like to have these at the place of posting where they may cost heavily. Children may have to be sent to very expensive private schools. Food of the type required and housing may also be costilier than the country of origin. In such cases the executive expects a substantial rise in the pay packet and fringe benefits. Most firms use cost-of-living index prepared by U.N. and other known agencies to compute the pay packet for employees going on overseas assignments. But the differences in inflation rates and fluctuations in currency rates pose problems as adjustments may have to be made sometimes too frequently.

Executive posted overseas feel treated inequitably when local employees with similar skills are getting higher emoluments (say, A posting of a European in USA). This needs to be corrected at the time of posting itself. Hardsihp allowances are also paid by many firms to make the employee and his family feel at home in the new environment. The possibility of harsh climate, political unrest, incidence of kidnapping and resultant insecurity and loss of any family member, loss of income of family members accompanying the executives are some of the factors which may call for special allowances. But not a foreign assignments constitute such hardships. The currency in which the employee is to be paid in the overseas assignment is another matter that has to be considered. The practice many firms follow in this regard is that of paying partly in local currency and partly in the currency of employees, home currency. In such plans employees may also gain as at the place of posting only the payments made in local currency get taxed. The restrictions on the transfer of hard currencies necessitate part payment in home currency of the executive. In countries where exchange control exists, there may be differences between official and black market prices. The employees may prefer payment in hard currency.

In construction jobs MNEs usually offer fixed term contract assignments at higher salary to the executives and hire most people from outside the firm.

When an executive returns from overseas assignment, as we pointed out earlier, a cut in salary may be resisted as he starts resettling. Some of the juniors might have gone ahead in hierarchy. This affect his social status. Similarly, when an employees is transferred from higher salary country to lower salary one, downward adjustment may not be easy. Some companies follow a balance sheet approach which assumes home salary as the base and an overseas allowance. The conditions of living allowance, cost of living allowance and residence allowance may be added to the base salary according to the conditions of living in different countries to form the gross salary. Deductions are made on account of taxes, pensionary and statutroy benefits as

per rules to determine the net sum payable to the employees. Table 10.4 below shows Volkswagen's Balance Sheet Approach:

Table 10.4: Volkswagen's Balance Sheet Approach

Salary Component	Sums in DM Per month Place of transfer A	Place of Transfer B
1. Basic Salary, DM	4500.00	4500.00
2. Overseas Allowance (15% of basic salary)	675.00	675.00
3. Conditions of Living Allowance (In % of basic salary depending) on the country		+450.00
4. Cost of living allowance	+600.00	-150.00
5. Residence Allowance	+400.00	100.00
6. Overseas Gross Salary (Before taxes)	6175.00	5375.00
7. Assumed Taxes in Germany on basic salary	-1200.00	-1200.00
8. Contribution to Company Pension Plan	-333.00	-333.00
9. Statutory Payments in country of	-	+200.00
10. Net sum paid out to individuals during overseas assignments (after taxes)	4642.00	4042.00

Source: Peter Frerk,Institutional Compensation: A European Multinational experience, *The Personnel Administrator* May 24, 1979, p.33.

Activity 4 :

Arrange a meeting with the Personnel Manager of a multi-national subsidiary and discuss with him the ingredients and objectives of the compensation policy with regard to (i) managerial personnel, and (ii) labour force. Ascertain the ways in which the compensation policy is different form a large Indian Industrial group company.

10.9 MANAGING MANGERS OF FOREIGN SUBSIDIARIES :

Managers working in foreign subsidiaries play the pivotal role in meeting local customer needs and satisfying the local government's requirements. They have to defend their compnay's

market position against local and international competition. The flexibility required on the part of local managers may sometimes bring them in conflict with global managers at the headquarters. The policy of most MNEs in this regard is not to permit local manager to defend periodical interest as "King of the entrepreneurship and innovation" as put by Professor Chirstopher of Harvard Business School The foreign subsidiary managers in his view play three vital roles:

a) as sensors and interpreters of local opportunities and threats;

b) as builders of local resources and capabilities and,

c) as contributors to and active participants in the global strategy.

As sensors the managers must be good at gathering and shifting information, interpreting the implications and predicting a range of feasible outcomes. They have also to perform the difficult task of conveying the importance of such intelligence to people higher up, especially those whose perceptions may be dimmed by distance or even by ethnocentric bias.

As builders the burden of identifying, developing and leveraging national resources and capabilities falls on subsidiary company's managers, and this include human and financial resources.

While historic position of managers in subsidiaries has been the implementation of headquarters strategy, they are now welding greater influence over the way their organisation make important strategic and operational decisions. They may get a place in product development committees, product marketing task forces and global strategy conferences.

The functional specialists and technical personnel in subsidiaries have yet to gain recognition due to them. They are not considered as part of the corporate mainstream's global activity. There have been cases of corporate misfits or managerial has been to be shifted to functional specialists positions. In an age of information revolution, knowledge explosion and growing expertise the functional specialists can form a world wide network of technical, manufacturing, marketing, financial and HRD expertise. They can "cross pollinate" information and best practices in their areas world-wide, perceive opportunities, analyse market trends, scan their own environments and provide feedback which may help headquarters in formulating strategies and future plans. They can also be a source of innovative ideas. If local developments are viewed in isolation by headquarters, they may seem to be local affairs. However, if a thorough examination reveals that they are part of world-wide emerging trends and this may help policy formulation and action globally. There is thus a need to build formal and informal channels of information between functional managers and provide them opportunities of scanning information and cross pollinating ideas and practices.

10.10 MANAGING LABOUR FORCE IN SUBSIDIARIES :

Most MNEs subsidiaries recruit labour locally and the labour management practices are not standardised in world wide operation. The local labour laws, prevailing wage rates, the extent of unionisation and socio-economic and political factors influence labour management polices and practices. Over-supply and high rate of unemployment in developing countries make labour an object of exploitation not only by the local entrepreneurs but also by the subsidiaries of MNEs which

leave labour force at the mercy of local managers in most cases. MNEs pay much higher emoluments to the labour force in industrially developed countries than in the developing countries.

An argument which is often repeated in management literature is that workers in less developed countries are less productive. In one study of Indian workers, Oscar Omati (1935) observed that Indian workers were not interested in factory work, they resisted adjustment to the type of life which went with industrial employment. Clark Kerr (1960) concluded on the basis of research studies in some underdeveloped countries that the cultural factors (such as religious and ethical values, the family system, class and race) all had a bearing on commitment of labour to industrial life. The greater the influence of extended family, the slower the commitment. Farmer and Richman (1965) following the work of McCelland arrived at the conclusion that the traditional religions were not generally conductive to a high achievement drive in their orthodox followers. Gunnar Myrdal (1968) in his 'Asian Drams' observed that in the absence of simultaneous changes in institutions and attitudes, the effect on labour utilisation and productivity throughout the economy might be still less consequential. Scholars studying the Latin American countries also argued that workers in these countries were less interested in productivity improvement than maintaining and enhancing their family status and fulfilling obligations to their friends and relatives.

But not all scholars agree with the above view. Morris (1965) observed that much of the literature on the subject tended to base interpretation on hypothetical, psychological and sociological propositions which themselves were highly suspect.

McMillan's conclusion about Brazil and Fillol's observations about Argentina show that productivity of labour, motivation and cooperation are primarily determined by the management. Sirota and Greewood have raised doubts over the prevailing theses of the impact of socio-cultural variables on motivation. Empirical studies undertaken in developing countries also confirm this view. Negandhi's enquiry (1971) based on cross cultural study of six developing countries concluded that the employees in these countries were like their counterparts in industrialised countries in regard to their desire for higher wages, opportunity for advancement, job security, fair treatment, better working conditions and welfare and higher standard of living for their children.

The environmental factors which affect labour management in MNEs subsidiaries in developing countries are mainly three:

i) Labour legislation

ii) Oversupply of unskilled labour and lack of skilled and trained workers, and

iii) The nature of labour unions

The labour legislation and the machinery to deal with labour disputes necessitate employment of local managers to handle labour problems. The local managers try to follow local practice in living people, for example giving preference in employment to certain class, caste, community, discrimination on the basis of sex, place of belonging etc., and local norms in matters of wage and fringe benefits, working hours and service conditions etc. The benefits offered to workers may be more liberal than those offered by other local firms, particularly with respect to insurance, medical, transportation, leave, training facilities, etc. The differences in emoluments may however not be large enough so as to be comparable with the wages received by workers for similar jobs in developed countries.

Over-supply of labour and low wages are definite attraction for MNEs to locate their manufacturing and other operations in developing countries as that results in considerable cost savings. A number of Japanese firms have set up manufacturing plants in the last few decades in South East Asian countries primarily because of high labour cost in Japan. As in case of most western multinationals, wages and benefits offered by Japanese subsidiaries outside Japan are much lower than those in Japan. Some Japanese subsidiaries follow Japanese practices of life time employment, seniority-based wages and ringing system (decision making by concensus), but not all. Labour unions in most developing countries are politicised as in India. They play an important role in framing labour laws which are administered through the state machinery. Outside leaders are able to influence bargaining between labour and management. The multiplicity of unions is also common in developing countries.

MNEs subsidiaries in developed countries follow rules regarding employment in their respective countries. Work certificate is required for immigrants in US. Persons with professional training and needed skills are given preference in grant of visas. At the request of U.S. employers limited visas are granted by US government for temporary personnel. The foreign firms right to promote its own nationals against locals has been subject to legal conflicts in US courts. The European Community Countries are required by treaty to permit free movement of labour among themselves, although they may require work permits for nationals of non-community countries who are employed mostly for less pleasant jobs are thus given a treatment of second class citizens. Japan is one of the countries which has exhibited greatest reluctance to the entry of foreign labour. It has reluctantly admitted some Koreans in the recent past with a view to release Japanese workers for more skiller and technical operations.

Employment of foreign labour force may result in lower direct labour cost, but indirect costs may be substantial. Depending on social security legislations, payments on account of health services, community services, training, transportation of workers to and from their native places, documentation and family allowances etc. may be substantial.

Labour management negotiations are mostly localised even in developed countries. It has not yet acquired an international colour. Within EC wage differentials are narrowing on account of converging of social welfare legislation of members states.

Bonus and profit sharing in some countries are statutory requirements such as in India, Mexico, Peru, Egypt, Iran etc. Workers employed in foreign subsidiaries are automatically entitled to minimum statutory benefits if the firm does not have a more attractive scheme.

Workers participation in management has taken different shapes in different countries and these influence management of foreign subsidiaries too in those countries. Co-determination in Germany for instance, requires 50 percent directorship from workers. The scheme covers all enterprises employing 100 or more workers. The matters pertaining to not only routine operations, but strategic issues also fall within its jurisdiction. When the law was enacted, some of the foreign firms, particularly US multinationals, resisted it but they had to adjust to the new situation. In Holland, works councils have a right to nominate and to veto candidates for the Corporate Board of Directors. In France employers and employees are required to form "work committees" to select method by which profits are allocated.

10.11 Human Resource Management Practices :

Human resource is considered crucial for success in MNE enterprise. Though it may be difficult to generalize on the practice followed by all multinationals, the examples given below show the enlightened approach and importance given to human resources:

1) Cummins Engine has set up its highly skilled but low cost Indian engineering group as a world wide drafting resource.

2) NEC headquartered at Tokyo trained engineers working in US subsidiary for development of next generation switches. The US team was allowed to work with original designer and to verify designer's judgment. The US units morale rose considerably

3) P & G formed European technical teams and ran a series of conferences in which like minded experts from different countries could exchange information and build informal communication network. It has this team which is accredited to innovate a new liquid detergent by cross pollinating best practices in detergent manufacturing. The product responded to European needs so well that some establishing brands of other multinationals were driven out of the market.

4) BP established a new European Finance Centre in Brussels with 40 staff of 13 different internationals from BP finance centres throughout the world. An innovative training intervention was developed to deal with communicating across cultures and team working in multi-cultural environment within a climate of major culture change throughout the company. It helped people in understanding their own, culture first before moving on to explore each others assumptions and implications of these for working practices.

5) Komatsu (U.K) Ltd. recruits people through local professional and executive register of jobs and local job centres. Some graduates are also recruited. Shop floor workers undergo skills, numeracy and dexterity tests during the selection procedure. Those with team leader potential undergo psychological tests which explore their ability for team work, flexibility and responsibility. Recruits undergo a ten week induction period and a Japan familiarisation course. The company does not have a life time employment, but long term career development of employees is emphasized. A single status system includes uniforms for all employees, a canteen a gymnasium and morning exercises. Promotion is based on merit. A comprehensive performance appraisal system has been evolved with provision for career development across the country.

6) Volkswagen attempts to ensure that the salaries of its expatriates fit into the social structure of host country. This often obliges the company to offer promotions to expatriate (along with higher corresponding salary classification) to balance off generally lower local salary levels.

7) Lockheed Aircraft has set up its own television broadcasting station in Saudi Arabia for its 4,000 expatriates there.

8) INCO has built schools, hospitals, churches, super markets, a golf course, yatch club, motel and restaurant for its 2,000 expatriates in Indonesia.

9) Bosch in 1991 set up new hi-tech manufacturing operation on a Greenfield site at Cardiff aimed at achieving a blend of personnel strategies adopted by more progressive companies operating in Britain (such as Sony, Nissan, Sanyo and Pirelli) and some strands from German parent company. The package has most of the features of the new model single union agreements found in the other companies but with greater emphasis on the plant consultative council where delegates receive training for their roles. A five year grade top to bottom pay structure included appraisal and performance pay for all.

10) In Europe a French and German joint enterprise adopted a collectively agreed system of board representation has been set up which aims to be a compromise between the statutory provisions applying to its French and German operations. It also clearly mirrors the provision of draft European Company Statute.

10.1 An electrifying exercise

At Philips, president and CEO H.J.J. Rensma meets 15 middle managers a week, just to understand how things are moving. That's over 600 people a year-or half the management staff. In 1994, Rensma is planning to meet with employees at all levels at the company's various locations across the country on a regular basis.

That's quite a number of hand shakes. But Rensma doesn't stop there. Twice a year, the expatriate chief executive gathers Philip's to 60 executives for a powwow on subjects ranging from competitiveness, productivity, performance and market share. "Most companies focus on these issues at the middle-management level. Our rationale is to do it well at the top. The percolation effect will be felt right down, so that all levels are influenced in the change process," says, K. Ramachandran, vice-president for HRD and corporate operational policy.

At Philips, it's called HRM: human resource management. It's a complex multi-pronged approach that works in tandem with a business strategy that hopes to manage rapid change.

Change is not something the Rs. 800 crores turnover Philips Indian is unfamiliar with. In the last few years the electricals and electronic multinational has witnessed a remarkable transformation: turning losses of Rs. 13.6 crore in 1988-89 into profits last year of Rs. 34.3 crore. Many of the problems Philips India faced only mirrored those of its parent company, which saw its market share worldwide eroded by Japanese competitors. Naturally, many of the solutions have also been inspired from those abroad. HRM is one of them, adapted from Philips' international strategy code-named Centurion, instituted in 1991 when Jan Timmer took charge.

Operation Centurion operated on two platforms:

- Personal commitment- the will to win and do things differently; and
- A turnaround project which is profit-oriented, as well as customer and quality driven.

It's implementation was divided into three phases: restructuring, revitalising and entrepreneurship.

Drawing upon that concept, Philips India has adopted an HRM policy in keeping with its business re-engineering process. As Ramachandran puts it: "It is no longer a question of improving things from the way they are, but of taking a completely different approach. Re-engineering questions the fundamentals of things as they exist."

In arriving at its HRM policy, Philips drew up a set of four perspectives upon which to focus. The

first was the current stage in the evolution of Indian industry, i.e. on the threshold of knowledge intensive phase.

The second perspective was liberalisation and its impact on policy and implementation, as well as social customs, attitudes and ideologies. "While [liberalisation] can be changed with the flick of a switch, bringing about a change in [customs, etc.] is far more difficult," says Ramachandran. "This is the manager's problem. He has to be sensitive to both."

The third perspective was the very purpose of business. While earlier it was assumed to be profit and growth, Philips believed the emphasis had shifted to continuity. This called for an awareness of three major constituents: the customer, the shareholder, and the employee.

The fourth perspective that the organisation mapped out was entrepreneurship. As industry became more knowledge intensive, and the country emerged from its protectionist mindset, Philips management was convinced that fostering entrepreneurship within was not only inevitable, but also essential.

Matching each of these perspectives, the HRM division narrowed its sights on four key areas-what it called operative offshoots. "The offshoot of the knowledge intensive stage must be value addition," says Ramachandran. "That of liberalisation is change management; of continuity, focus; and that of entrepreneurship is empowerment."

Having decided upon its objectives, Ramachandran put four priorities on the HRM agenda in July this year. The first was communication: all Philips' 7,500 employees are to be briefed about the company's policies, and responses are to be invited from both within and outside the organisation. "It is no longer enough to share information", says Ramachandran, "but also to share intent. It is not enough to just put forward expectations to employees but also to explain the why to those expectations.

The second priority was to sharpen the focus on performance, how it was to be recognised and rewarded. The third was to translate training and development into a business-driven exercise. And the fourth was to bring about a more harmonious working environment-particularly with regard to management union relationships.

Explains Ramachandran: "The idea is to link these priorities to our perspectives and offshoots, so as to bring about an effective response to change. Only then will contribution be volitional and an enhancement of skills take place."

In order to fine tune these priorities and increase interaction between employees at various levels, Ramachandran organised a three-day workshop in October for 25 line managers and personnel executives. The workshop in October for 24 line managers and personnel executives. The workshop provided him with quite a few eye-openers. For instance, one line manager commented that the personnel department had been issuing policy statements and was monitoring compliance without examining their rationale.

Besides this, the sessions also yielded a long list of desirables, which would help make working in Philips enjoyable, stimulating, challenging and rewarding. The points included better role clarity, manpower planning, training and development, continuous education of people, and focus on skills attitudes and behaviour. That's not all. Among the other needs identified were performance management, rewards, compensation management incentives and recognition. Staff members also brought up the need for better administrative responsiveness, redress of grievances, counselling and motivation.

Using such feedback, Ramachandran hopes to create an environment at Philips wherein contribution towards change can be come from all quaters. Certainly, it's step in the right direction.

Source: The Economic Times (ET Esquire), 17 December, 1993 page II

10.12 Summary :

MNEs need manager who by playing boundaries spanning roles, can bring about the needed coordination and integration between the subsidiary concerned and the headquarters. For their international operations, they need managers who have global outlook and who can work in more challenging and somewhat unfamiliar conditions. The recruitment and retention of and development of human resources is therefore critical to a multinational enterprise.

In relation to human resource management, an MNE may be guided by any one of the four kinds of policies: Ethnocentric, Polycentric, Rigiocentric and Geocentric. Ethnocentric approach implies managing of all senior positions by home country nationals. This policy however may cause alienation in the country in which a subsidiary operates. In Polycentric approach the host country nationals are preferred for local position—whether senior or junior. Through this approach may be favourably viewed by locals; the subsidiary management may get alienated from the mainstream, especially if this policy is carried to the extreme. Regiocentric approach implies recruiting people from the entire region rather than a particular country. This approach helps in developing a regional perspective especially when the interdependent activities or operations of the MNE extend to a certain region. The Geocentric approach rests on global outlook and no distinction is made between home and host countries, between one region and the other, insofar as selection, placement and promotion of the employees is concerned. While following any particular policy, and MNE has to take into account legal requirements of the country in which it is operating.

Management practices and policies are influenced by the socio-economic and cultural variables of each country. These variables should be considered and examined thoroughly before introducing new ideas or approaches. This would reduce the incidence of failure.

Depending upon the circumstances and the local constraints, MNEs may meet their manpower requirements either from the home country of the host country or the third countries, or from a combination of any of these. It is not uncommon for most of the MNEs to recruit home country people in the early stages of internationalisation. As the business expands and MNEs gain more confidence they may depend more on the local manpower, both for workers and managers. Through a judicious transfer policy with regard to managerial personnel, an MNE can develop a pool of managerial and technical expertise which may be helpful in furthering its objective of globalisation.

In addition to professional competence, knowledge and skills which are required of all jobs, adaptability is the most important most criterion in the selection of managers for foreign assignments/ postings. Other attributes required are: open mindedness, tolerance and respect for the culture and environments of other countries. Some techniques have been devised to assess the adaptiveness of potential candidates. The adaptability of the spouse also matters in foreign posing.

Since the operations of an MNE extend beyond the borders of nations, developing a broader and cross-cultural outlook may be felt necessary. The training programme may, therefore be geared to impart this outlook. And this, of course, would be in addition to sensitising the managerial personnel about the organisational goals and improving their adaptiveness. The training programmes may differ from company to company, and from time to time even within the same company. Further, the training programmes may be internally-oriented or externally-oriented. Internally-oriented

programmes are specific to the needs of the job and the organisation. Externally-oriented programmes focus on broadening the manager's horizon beyond the job and the organisation. The latter types of programmes in International Business Management which may either be of general nature or tailored to the specific needs of a large MNE. The candidates may be sponsored to one of these programmes/courses which may be supplemented from time to time by in-house training programmes.

Transfers from headquarters or home country office to foreign subsidiaries or vice-versa may be felt necessary or desirable. However, this may entail inconveniences of varying nature of the incumbents. Financial compensation is one of the way to mitigate the likely hardships. The magnitude of transfers would depend upon a number of factors, the important one being the need to develop managers who have global orientation. Linked with transfers is the repatriation problem for which also a well thought-out policy is required. Depending upon the objectives and outlook of the MNE, promotional policy may be either country bound or it may extend beyond a national boundary. Several factors, such as legal constraints, ownership patterns, the nature of the enterprise and the availability of competent people would influence promotion policy.

The compensation policy of an MNE is influenced by a number of variables that may be specific to a particular country, though the compensation policy may have an element of uniqueness. Productivity levels, cost of living, supply and demand, compensation offered by similar local firm and MNEs are some factors which may influence the compensation policy.

Most MNEs expect their subsidiary managers to play a pivotal role by interpreting local opportunities and threats, and by building local resources and capability, and by actively contributing and participating in the global strategy. The top managers of the subsidiaries today are planning a far greater role than in the past in the formulation of their organisational policies and strategies.

The labour management policies of the MNEs are, to a large extent, governed by local conditions. By paying somewhat more generous wages and by a more professional management of labour force, MNEs generally have better industrial climate in their companies than most of the local enterprises. In any labour relation policies, local legal framework are important factors reckon with.

10.13 SELF-ASSESSMENTS QUESTIONS :

1) What type of managers do the global companies need? What alternative do they have for meeting their manpower requirements?

2) What are the basic differences between Japanese and Western work cultures and human resource management philosophies?

3) What are benefits and problems in recruiting managers from the home country, the host country and the third country?

4) What qualities are needed to make a multinational manager? What techniques may be adopted to asses the adaptability of managers in new cultures and environments?

5) What are the objective of training programmes for multinational managers? How can the training needs of managers be assessed?

6) What are the merits and demerits of internal and external training programmes for MNEs?

7) Discuss the problems in corss national transfers. In what way MNEs may compensate their employees for the hardships in overseas assignments?

8) What many multinationals do not have common pay and benefits policy for their employees world wide? What is the balance sheet approach to compensation?

9) What role may be played by foreign subsidiary managers in regard to global business of their corporations? How can they be made hot houses of entrepreneurship and innovation?

10) Do you agree with the view that workers in less developed countries are always less productive than their counterparts in developed countries?

11) Why do multinationals favour employment of local workers for operations in subsidiaries?

12) What management practices of MNEs appeal to you most? What are the practices you are opposed to?

10.14 FURTHER READINGS :

Nagandhi, Anant R. 1987: *International Management,* Allyn and Bacore.

Daniels, Johan D. and Radebanch Lee H. 1986. *International Business: Environments and Operations,* Addision-Wesley.

Robians, Richard, D. 1984. *Internationalisation of Business: An Introduction,* The Dryden Press, 1984

Globerman, Stewen, 1986. *Fundamentals of Internationals Business Management*, Prentice Hall.

Rebock, Stephen H. and Kenneth Simmonds, 1989. *Internationals Business and Multination Enterprises* (4th Edn.) Richard D. Irwin.

Bartlett, Christopher A. and Sumantra Ghoshal, 1982. *'What is a global manager?'* Harvard Business Review, Sept.-Oct. 1982

Lallan Prasad, 1993 *'HRD in Transnational Corporations."* Economic Times, Sept. 23,1983, New Delhi.

Paul Vanderbrocck, 1992. 'Long Term Human Resource Development in Multinational Organisations,' *Solan Management Review,* Fall 1992

Simon Gleve and Nick Oliver, 1990, 'Human Resources Management in Japanese Manufacturing Companies in the U.K. 5 cases' *Journal of General Management*, Vol. 16, No. 1

UNIT - 11 PRODUCTION MANAGEMENT AND LOGISTICS

Objectives :

After reading this unit you should be able to understand and explain:

- the nature of international production function
- the issues involved in and management of sourcing of raw materials, parts and components, and finished goods for meeting the demand of international markets
- the factors influencing the location of production facilities for international markets
- the processes and problems concerned with flow of goods across national boundaries
- the nature of production facilities i.e. plant technology, design and size
- the new innovative production (or production related) techniques.

Structure :

11.1 Introduction
11.2 The Nature of Production Function
11.3 Sourcing and Procurement
  Centralised Vs. Decentralised Approach
  Source-Market Matrix
  Sourcing Policies and Practices
11.4 Make or Buy Decisions
11.5 Location of Production Facilities: Comparative Advantage
11.6 A Critique of Comparative Advantage: International Competitiveness
11.7 Other Locational Determinants
11.8 Plant Location Decision
11.9 Evidence on Locational Advantage
11.10 International Logistics
11.11 The Nature of Production Facilities
  Plant Technology
  Plant Design
  Plant Size
11.12 New Production Techniques
  Just-in-time (JIT)
  Total Quality Management (TQM)
  Flexible Manufacturing System (FMS)

11.13 Summary
11.14 Key Words
11.15 Self-assessment Questions
11.16 Further Readings
References

11.1 INTRODUCTION :

In the previous unit we discussed about some aspects of human resource management in international business. You will appreciate that a well designed human resource management system, or for that matter, even a well designed marketing strategy would not yield the desired benefits unless the output is produced to acceptable quality standards and then transported efficiently to the market place. Though, this fact is true for both purely domestic firms and international firms, it particularly applies to the latter because the production conditions are usually more heterogeneous across countries than within individual countries. As a result, firms engaged in international production face more complex tradeoffs between several facets of production and logistics then do purely domestic firms. The more heterogeneous international environment also makes the entire task of coordinating production and transportation more complex; in particular haphazard delays are more common within international transportation network then within domestic transportation system.

The purpose of this unit is to discuss the various issues and tradeoffs involved in international production and to identify specific operating principles that can lead to efficient production management. The unit examines operational decisions from a global prospective. The operational decisions can be both strategic and tactical, strategic part is concerned with long term decisions such as plant location and size of facilities. The tactical decisions are concerned with day-to-day decisions such as production scheduling and delivery time table. The strategic decisions often lock the company into a particular arrangement for many years, while operational decisions often need to be made quickly, keeping in view the needs of the current situation as the paramount consideration. The major topics covered in this unit are: the nature of production management function, sourcing and procurement, comparative advantage, logistical considerations, make or buy decisions, nature of production facilities, plant location and size, and new production techniques.

11.2 THE NATURE OF PRODUCTION FUNCTION :

In order to appreciate the differences between international production and production meant for domestic market, it would be worthwhile to describe the board nature of the production management function. Production management encompasses several critical decisions. One such decision relates to whether specific parts and components, or specific assembly operations, should be contracted out to other firms or carried out in production facilities owned and operated by the firm. This is often identified as the make or buy decision. In a way this decision is also concerned with the important question of sourcing and procurement of various types of materials, parts and components.

Second, a related decision is concerned with the location of the firm's various production activities. In taking this decision the firm would be concerned with balancing the advantages of producing in lower cost sites against any disadvantages of having to transport the output produced over greater distances to the markets served. In otherwords, the management would strive to optimise the firm's logistical network so that the joint costs of producing and transporting output to markets are optimised.

Third, production management decision, also relates to the configuration of the firm's production facilities. The management, among other considerations, must decide whether to have standardised production facilities at all places with respect to technology and design or to have production facilities of varying nature. It is also to determine whether the firm will employ specific production facilities (plant and machinery) the offers lowest unit/cost production or more flexible facilities that can take care of changes underlying demand conditions.

Since international firms face a much wider array of cost conditions and underlying production practices, its choice set is at once rich and complex than that of the purely domestic firms. For example, Attari, the video game affiliate of Warner communication, relocated its production facilities offshore to Hong Kong, which enabled it to dramatically reduce its labour cost. At the same time, the company was also able to expand the geographical scope of its production network. In doing this the company offset the higher transportation cost with some of the benefits of lower wage cost.

The varied production opportunities which an international firm faces are not only related to differences in labour conditions but also to such other factors as differences in the availability of natural resources and access to new technology across countries. An important implication is that the international firm can potentially realise significant competitive advantages often by locating and designing production facilities to match the unique needs of specific production divisions. Thus, where a division produces a labour intensive product of standard design, international firm can locate production facilities in a less developed country where wage rates are low. On the other hand, where a division produce a highly engineered product in small batches, production might be centred in job-shop-type factories located in highly industrialised country.

It is not only the different wage rates, but also the cultural values and industrial relations in different countries which have to be taken into account. The basic production management function of the firm is constrained by the host Government regulations and expectations, and this applies to both advanced and developing countries. The regulations may affect decision about R & D, technology transfer labour relations, capital and marketing practices. Many MNEs wish to centralised R & D in order to retain the firm specific advantages of proprietary knowledge. The host Governments frequently demand that R & D be decentralised to the subsidiary level. MNEs often work under pressures of their host governments to use local sourcing for their inputs, to use local workers, train managers and supervisors and help improve the production environment in the host nation. In a similar manner, other political and social pressures can affect the strategic choice of MNEs e.g. ecological and environmental considerations.

11.3 SOURCING AND PROCUREMENT :

Sourcing and procurement may relate to raw material, parts and components, or semi-finished goods, or finished goods. There are two important issues which are involved in relation to procurement and sourcing strategy:

i) Centralised (concentrated facilities) versus Decentralised (dispersed facilities) approach serving the world market. In other words, to what extent the firm will have integrated manufacturing operations?

ii) Make or buy decisions i.e., whether to buy or subcontract the needed goods, or to manufacture within the firm's own facilities.

Before goods can be manufactured, raw materials must be procured. Procurement of raw materials, for instance, is critical for Japan, since it purchases from abroad 100% of its uranium, bauxite, and nickel; virtually 100% of its crude oil and iron ore; 92% of its copper; 85% of its cooking coal; and 30% of its farm products. Trading companies, discussed in Block 1 and with which we hope you are familiar, came into being to acquire the raw materials that are necessary for manufacturing purposes. Procurement from abroad involves problems that are not present to the same extent in domestic sourcing; for example problems like language, distance, currency, wars and insurrections, strikes, political problems, tariffs, etc.

The importer needs to know how to acquire goods, what duties must be paid, what special laws exist. Sometimes goods are imported into a country and are immediately exported, or are assembled into an intermediate or final product and then exported. When imported goods are exported from a bonded custom warehouse, the entire import duty paid earlier may be refunded. Likewise, when articles manufactured or produced in a country with the use of imported merchandise are exported, a substantial percentage of the duties are refunded as a drawback. In recent years, Foreign Trade Zones (FTZs) have become very popular as an intermediate step between import and final use. We shall revert to this topic a little later.

Managers have to select the best source for the various inputs which are needed for manufacturing a product. They have to decide on the most effective means of obtaining them and have to determine the timing for acquiring them. The firm's overall objective may be to obtain the best inputs from around the world in order to produce the components and products efficiently. Of course, the managers need to modify this objective in the light of constraints of different political and cultural environments.

Centralised versus Decentralised Approach : To procure goods for world markets, the firm may establish a centralised source or sources. This question is directly related to the firm's desire to rationalise its production and marketing processes. The main advantages of establishing a centralised source (or sources) are:

- lower production costs through economies of scale
- elimination and reduction of costly scheduling problem
- rapid start-up on new products
- reduction of inventories

However the centralised system may give rise to the following disadvantages:

- The firm may not be able to meet the host countrie's demand for local manufacturing. The firm therefore runs the risk of loosing such market.
- The firm may have to compromise with the flexibility of responding to changing market conditions and the consumer preferences.
- If production or sourcing is concentrated in one or few countries, this may make the firm vulnerable to socio-economic and political events (e.g. political uncertainty and strikes etc.) in the given country (or countries) in which major plants are located.

All the firms may not like the centralised sourcing activities. The most favourable conditions for a centralised system are where there is *high relationship* between the unit cost and the volume produced (the larger the volume the lower the unit cost) and where production system is using a continuous-process type of manufacturing technology (e.g. any chemicals, and petroleum). Sometimes, larger export incentive offered by a host country may also influence in favour of centralised sourcing facility. Export Process Zones (EPZs) have become major sourcing point for many U.S., European and Japanese firms, partly because of governmental subsidies and partly because of lower labour costs. According to one study, five countries, namely Mexico, Ireland, Taiwan, Hong Kong and Singapore, accounted for 22% of 362 export plants. These along with another five countries (Canada, Belgium, Netherlands, U.K. and Italy) claim 33 % of such plants. All of these countries offer substantial incentives to foreign investors.

Some manufacturers may have what is known as *global sourcing strategy* (a decentralised approach). For example, Nike, which is a producer of sports shoes in the United States, sources more than 90% of its production by contacting with foreign suppliers, mainly from Asia. The company has expanded beyond its home market and increased foreign sales to more than 20% of its total turnover.

It is interesting to note that India is fastly emerging a major sub-contracting source for European companies. (See Box 11.1)

11.1 India fast becoming a major subcontracting source for European cos

India has been steadily emerging as a subcontracting base for Europe. The European manufacturers, particularly the automobile and machinery builders, are keenly looking at India as a base for the supply of parts, subassemblies, castings, forgings and engineering components.

The recently concluded Hanover Fair' 95, the world's largest industrial fair, has brought to the fore the almost compelling need of the European industries to source their procurement from countries outside Europe. India is being considered now as a dependable source for such manufacturers.

According to Indian industry sources, Mahindra Exports Ltd. (MEL) has tied up with the world's biggest tractor manufacturer in Germany for supply of tractor parts and components. The company has also tied up with a Spanish company which will supply MEL the tooling for component manufacturing and will buy back the production on a continuous basis.

Another Pune based company, Pratibha Founders, has received a huge order from the Netherlands for supply of aluminium castings, and the volume is so large that this company will have full capacity utilisation throughout the year with this single order alone

Due to the high cost of production and strict environmental laws, German foundries and forging shops are finding it difficult to cater to their user industries cost effectively. Controlling the costs of inputs is such an overwhelming consideration today that European and American industries are willing to source their component inputs from any part of the world, where they see price advantage.

Since the volumes of orders involved are very large, even the marginal cost advantage spells big overall saving. This kind of a scenario holds precious opportunities for the Indian foundry and forging industry. The technology of most of major foundry and forging companies in India can be rated as the best among all the developing countries.

The industry already has spare capacity to undertake major jobs. Raw materials, power, skilled labour and logistics are no more a problem. With all counts in its favour, the Indian foundry and forging industry is the most ideal sub-contracting partner for European and American industries, sources here say.

The next two to three years would be very crucial for exports of India's foundry and forging industry. During this period, if it can establish itself as a price competitive and reliable source for subcontracting, the industry's hands will be full with business for atleast a decade. Hanover Fair, the world's biggest forum for subcontracting, has provided Indian exhibitors an opportunity to establish worldwide contacts from a single platform.

The Indo-German Chamber of Commerce had organised a joint Indian pavilion in the subcontracting sector at Hanover Fair '95 in order to help medium and small scale companies step into the export market. The IGCC has been organising such joint participation for last three years by offering complete infrastructural support and facilities to the exhibitors. The country level participation organised by the IGCC provides the medium and small scale exhibitors a large image and helps them attract major and serious customers. The Centre for Promotion of Imports from Developing Countries (CBI), Netherlands, had also supported a group participation of 14 companies in the subcontracting sector and power transmission sector.

Reports from Beijing also indicate that the massive modernisation programme of the Chinese railways and the $ 20 billion three gorges multipurpose dam project have opened up possibility for Indian subcontracting jobs in China.

The Chinese authorities have already started making enquiries for Indian participation in the railway modernisation programmes, particularly for purchase of Indian rails form the Bhilai steel plant.

The world leaders in power equipment, Asea Brown Boveri (ABB) and Siemens are to take up big contract jobs in the three gorges power project which is expected to have three billion dollars foreign investment.

The project to be completed by the year 2010 is to have huge 18,200 MW of hydel power generating capacity.

Source: Hindustan Times dated 15th May, 1995.

A company following global sourcing strategy may purchase its requirements from import agents, and negotiations may take place based on home country currency. This is a passive approach. A more aggressive approach may be to have its buyers travelling overseas seeking out sources of supply. Alternatively, it may have purchasing offices located in foreign countries. the personnel overseas may be responsible for quality control, product design, and for supplying materials to foreign fabricators as well as for purchasing and shipping.

The implementation of a global sourcing strategy requires appropriate organisational support, global research on supply sources and personnel experienced in many dimensions of international trade. The buyers of the company must be familiar with foreign exchange risk, tariffs, quotas, international transportation, difference in cultural environment, and many other import issues.

It should be mentioned that the choice between centralised versus decentralised sourcing is not of the either/or type. It has been observed that many firms use both the alternatives. High tariff rates, transportation cost, foreign exchange fluctuations tend to discourage centralised sourcing in certain parts of the world, and for certain products, the firm may use centralised sourcing. In other parts of the world and for other products, it may use a decentralised system. For example, Dow Chemical Company has established larger chemical manufacturing units in West Germany and the Netherlands to supply chemical and petrochemical products for entire European markets, but its consumer oriented products are manufactured in various countries to meet local demands. Such hybrid or mixed strategies involving partial rationalisation of production and marketing facilities and partial local manufacturing reflect the influence of the following factors:

1) **Technology:** Capital intensive industry tend to provide economies of scale on much higher volume through reduction of overhead costs. Capital intensive industries through are more likely to have centralised facilities.

2) **Market competitiveness:** In an industry where there is a intense competition, there is considerable pressure to reduce unit costs. Consequently, production and marketing rationalisation become almost a necessity.

3) **Interchangeability of parts:** Rationalising the production facility for manufacturing parts etc. is quite difficult unless the products are standardised. Consequently, products which are at the mature stage of their product life cycle are more likely subject to production rationalisation.

4) **Government demands and pressures:** Many developing countries require multinational companies to manufacture locally. The objectives behind this requirement are to achieve self sufficiency and to generate economic and industrial growth. Countries such as India, Indonesia, Malaysia, Brazil and Peru have required local manufacturing, and until recently have imposed stiff duties and penalties on goods imported from other countries. It may be pertinent to make a distinction between *global sourcing strategy* and a *global strategy* (or *global logistic strategy).* A multinational enterprise following the latter strategy would normally like to have the sourcing for its target markets from a centralised system perspective. Rather than determining supply sources independently for each market, the enterprise can seek to strengthen its competitive position by considering all the markets simultaneously and by designing a least cost supply strategy for the system as a whole. It may rationalise its manufacturing operations by having an integrated network of plants, each plant may specialise in one or more products or components,

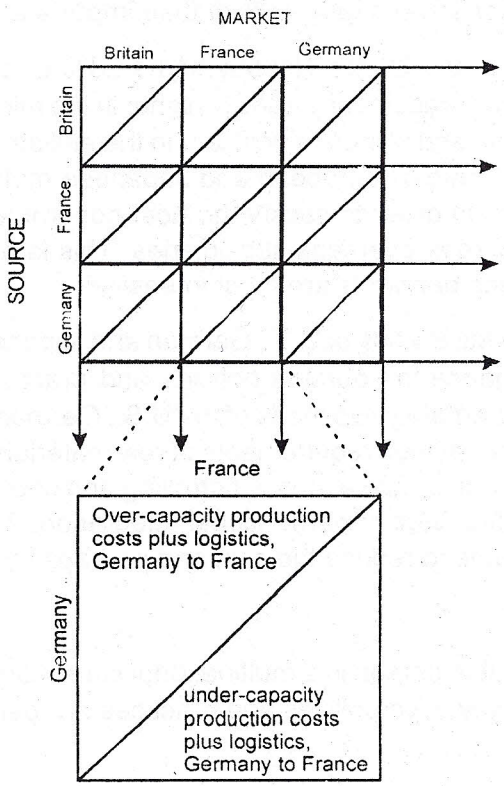
and each plant may serve a world or a regional market. Plants may also specialise by stages in the production process and can be located in different countries according to location advantages. Extensive trans-shipment of components and finished products between subsidiaries in different countries is usually the result of such global (or global logistic) strategy.

The global strategy can reduce unit cost in industries where economies of scale are significant and not fully exploited within the size of national market. Once each subsidiary no longer manufactures a full product line, the management of export activities becomes extremely important. Export orders have to be directed to the centre and then allocated to the appropriate subsidiary. Needless to mention the implementation of such a strategy requires the use of export/import expertise, and this capability must be exercised includes harmony with the management of foreign production.

Source-Market Matrix :

To help plan production management, the MNE following a global strategy can gainfully employ a source-market matrix. The matrix relates the supply of products of various subsidiaries to the demands for these products in various markets. Each cell in the matrix, as shown in Figure 11.1, contains information about the incremental costs of producing on extra unit output and the logistics costs of transporting that unit from one subsidiary (source) to another market.

Figure 11.1: The Source-market matrix



The production costs of the various subsidiaries will differ because of country specific factors, such as local wage rates. Logistics costs may also vary because of environmental factors, such as optimal transport mode and level of tariffs. The purpose of the matrix is to provide a

framework for the MNE to evaluate production and logistics costs in relationship to market demand. The usual objective of the MNE is to avoid both excess production and under production, as the former builds up inventory costs and the latter can lead to stockouts. The MNE has to optimise production by many subsidiaries across many markets. The source-market matrix is a device to focus attention on the integrated nature of its production management.

The source-market matrix shown in Figure 11.1 is a simple matrix which is limited to focusing on the relationships between three nations. Some MNEs may have operations by having subsidiaries or affiliated companies in 50 or more countries. The matrix could be further sub-divided into major regions within the host nations. Each cell in the matrix is further divided into over-and-under-capacity production cost, as this will differ significantly between plants. The matrix should be updated periodically to reflect other changes in production of logistics costs in the various countries in which the MNE operates.

Sourcing Policies and Practices : One study indicates that European and Japanese companies have rationalised their production systems more than the United State companies. Japanese firms, until recently, had a preference for exporting from Japan or their off-shore facilities in low wage countries. the ability of the Japanese firms to achieve economies of scale and lower unit cost largely explains their success in the international market place. Competition from the Japanese and European firms has compelled many United States firms to rationalise production and marketing systems. Nearly 40% U.S. exports and nearly 45% of their imports are intrafirms transactions[1]

According to statistics of the United Nations some 23% of sales by U.S. affiliates were intracompany transactions. Such intracompany trade is higher in the mining and petroleum industries than in the manufacturing sector, and is more significant in the affiliates located in developing than in the developed countries. In context, European and Japanese multinational firms claim to use local inputs in large proportions in order to satisfy the host government's demands and to grant higher degrees of autonomy to their overseas subsidiaries. This is particularly true in relation to developing countries where such demands are most intensive[2].

The result of the comparative study of U.S., German and Japanese multinational companies show a great deal of convergence in sourcing policies and practices of these three types of multinational companies. Approximately two thirds of the U.S., German and Japanese subsidiaries purchased more than one quarter of their requirements of raw materials, semi-finished and finished goods from their respective parent organisations. Controlling and coordinating the sourcing for the required input is perhaps the first step towards global integration. Through integrated sourcing policy the firm may indeed be able to reduce the cost and perhaps the price of the goods.

Activity 1 :

Approach a knowledgeable person in a multinational subsidiary and ascertain the sourcing policy and practices. Discuss why such policies and practices are being followed. Note down the salient points that emerge.

.....

.....

.....

11.4 MAKE OR BUR DECISIONS :

Make or buy decisions in away are related to vertical integration. At one extreme a firm can seek to make all of its own inputs (called backward integration) and be its own supplier. At the other extreme it can choose to buy virtually all the needed inputs it needs and thus depend on others for its supplies. Partial integration is also possible with some inputs being bought, while others being made. In this context an MNE may consider three options:

1) A subsidiary itself can be vertically integrated i.e. it makes its own inputs.

2) A subsidiary can be vertically integrated with the other parts of the company, i.e. it purchases inputs from other subsidiaries or from the parent.

3) No backward integration occurs, i.e. its supplies are obtained outside of the company.

Each of the above options can have different consequences for the subsidiary, its associated subsidiaries, and the company as a whole. For example, consider a British wire producer with one subsidiary in Indonesia that assembles cellular phones, and the second subsidiary in the U.S. that produces wire used in assembling the phones. The British company could supply the Indonesian subsidiary with wire from the U.S. subsidiary, its British headquarters, or external sources. The decision has consequences for each of the parties, and the "best" decision can be different for each party.

Besides commercial and financial factors, other factors may also have to be taken into account in making a decision. Therefore the final decision becomes quite complicated as sometimes there may be political implications of the decision as well. The guidelines and regulations in many countries encourage or specify the use of local supplies or give preference to suppliers from favoured trading partners. Such considerations need to be planned in making the final choice. The company's political risk-management strategy may promote or discourage the use of certain suppliers. This occurs when certain nations are hostile to each other.

Once fundamental decision that a firm must make is whether it could be cheaper to sub-contract out specific production and assembly operations to other firms or internalise those operations within the firm i.e. produce and assemble entirely within the firm. There are significant advantages to the sub-contracting option. The greatest advantage lies in the gains from economies of the scale that can be realised by the firm acting as the sub-contractee which, presumably, would be shared with the firms doing sub-contracting. In other words, the sub-contracting firm might be able to realise lower costs on specific production and assembly operations by 'buying' rather than 'making'. If there are a number of different potential users of components, each using relatively small quantities, production ranges of run would be relatively short if individual user produces the component independently. However, if each user sub-contracted the production of the component to a small number of common supplier the later could justify operating much longer production runs. Needless to say, there are a number of economic advantages to operating with longer lengths of run. These advantages centre around the 'experience curve' effect which, as you would recall, were discussed of length in block 3 of MS-11. The relationship between costs and cumulative production has been observed in various industries including automobile, semi-conductors, petro-chemicals, synthetic fibers, an airline transportation among others. According to the experience curve effect, each time cumulative volume of a product doubles, total value-added costs, including

administration. sales, marketing, distribution and so forth, plus manufacturing costs fall by a constant and predictable percentage.

Make or buy decision involve cost-benefit analysis. If the cost of acquiring inputs or goods form outside is cheaper than to manufacture in the firm's own facilities, the economic choice will be to buy from the outside. However, beyond economic rationality the firm must take into consideration some non-economic factors. By internalising the production of specific components and assembly operations, the company is able to benefit from enhanced quality control. The management has more direct control over the quality and supply reliability of critical components. This advantage would be especially relevant when it is difficult to establish the quality of a component prior to its use or when failure of a component can lead to widespread breakdown in production activities.

Firms operating in capital intensive industries and using continuous process technology e.g. chemical industry, are more likely to use internal sources to obtain critical inputs, because any disruption in supplies can create major bottlenecks. In many developing countries, MNEs have integrated their operations vertically and horizontally to ensure constant supplies of inputs, especially in those cases where such supplies are critical to a firm's survival and profitability. Off shore plants in export processing zones (EPZs) in Mexico, Taiwan, South Korea, Hong Kong, Malaysia, Singapore have been established to secure local supplies of critical inputs and finished goods to serve the world markets.

While a firm must weigh carefully the pros and cons of make versus buy decisions, there are certain things that a firm can do to mitigate the potential for supply and quality control problem among sub-contractors. One approach is to use a variety of sub-contractors. This way the firm can spread the risk among a number of alternatives. Whi.. this approach is practiced by MNEs of several countries, Japanese companies seem to be an exception. The latter generally rely on one or at the most two-main suppliers for specific components. To ensure the supply of quality components, Japanese firms adopt rigorous inspection procedures at the supplier's plan. They not only insist on inspecting the supplier's plant but also demand that suppliers implement easy-to-see and measurable standards of quality.

11.5 LOCATION OF PRODUCTION FACILITIES: COMPARATIVE ADVANTAGE :

Why production costs of specific products vary across countries may be explained in the **concept of comparative advantage.** In a sense, all countries have a comparative advantage in specific economic activities. There are certain activities in which a particular country is advantageously placed.

It goes without saying that the comparative advantage concept is relative one. A country may have absolutely higher costs of production for all economic activities compared to other countries; yet there will be atleast one activity in which the country is least disadvantaged in a relative context. A country's comparative advantage therefore will reside in that activity in which its cost relative to the costs of its potential trading partners are lowest.

Theatrically, an important implication of the comparative advantage principle is that under free trade, production activities will be distributed geographically according to relative cost differentials. The cost differential in turn will depend upon the relative availability of different factors of production and other characteristics of national markets, including size and technological advancement. For international managers, an implication of this concept is that production of goods will be located in those countries which are relatively rich in the skills and other attributes which are intensively required in the production of those goods.

You might be familiar with the product life cycle. In the early stages of a product life cycle, non-conventional factors of production, such as scientific, engineering and research and development expertise, industrial designs and quality control, will often be the critical inputs that are in short supply. Countries which are relatively well endowed with these inputs will therefore enjoy a comparative advantage in technology-intensive activities. As products become older and their production technologies become more widely understood, conventional costs of production, for example unskilled and semi-skilled labour, become increasingly important factors in determining the best production location for any given set of products.

The various input factors whose costs influence location decision are listed in Table 11.1. For putting up factories, and for storage and distribution facilities, land is required. Similarly, water will be required to support special cooling for effluent removing processes. Though land costs may have significant impact on specific activities, land input is not usually a critical locational determinant in international business. You might be aware increasing proportion of international business is taking the form of service.

In a similar vein, finance or capital is also a relatively unimportant locational determinant of economic activity, since finance capital tends to be quite mobile internationally. Most large and credit worthy companies can obtain financial capital on a world wide basis. However for smaller or less well-established companies, local source of financing may be very important. For example, location of many high technology businesses in the U.S., is partly attributed to the availability of venture capital on easy terms than elsewhere.

Table: 11.1 Major Inputs Required in the Production Process.

1) Land
2) Financial capital
3) Fixed capital equipment
4) Materials and components
5) Sources of power
6) Labour
7) Government services (state and local taxes)
8) Enterprises
9) Technology

Physical capital, materials and components should, in principle be available anywhere in the world either through local production or through imports. For obvious reasons, the availability of raw materials is a major determinant of plant location in resource extraction and primary manufacturing industries, such as wood products and metal smelting. Similarly access to economical sources of power is important. Electricity is the main source of motive power in most industries today. The availability or cheap water power may also become a source of advantages for certain locations, especially in energy intensive activities, such as aluminium and copper processing.

The availability of different categories of labour perhaps is most important single determinant of industrial location. It would be advantageous to locate a business which requires large labour force with a wide range of skills in countries where abundant, cheap and skilled labour power is available.

In recent years, off-shore manufacturing has gained considerable ground because of comparative cost advantages. Off-shore manufacturing activity increased sharply in the 1960s and 1970s in the electronic industry world-wide, as one firm after another set up production facilities in the far east, particularly in Taiwan and Singapore. These locations were chosen because of low labour costs and the availability of cheap materials and component. Over the recent past, some other "low-cost" countries of Asia (Indonesia, Thailand, Malaysia, South Korea) and Latin America have emerged as popular choices. Mexico has become one of the most popular for off-shore production for the U.S firms. U.S - sourced components are shipped to Mexico duty free, assembled by Mexican workers and re-exported to the U.S. under favourable tariff production. U.S. duties are levied on the imports only to the extent of value added in Mexico. Since labour is cheap, the value added is not much. This way the U.S. industry has been able to assemble products more cheaply than what would have been the case in the U.S. At the same time, off-share production has provided employment by creating 2,30,000 jobs for Mexicans.

11.6 A CRITIQUE OF COMPARATIVE ADVANTAGES : INTERNATIONAL COMPETITIVENESS :

Let us now examine the comparative cost principle. It should be stated that the production of specific goods in specific locations may not always be based on comparative advantage principles. The firms based on countries which enjoy certain location advantages can still be unsuccessful in the international market if they waste those advantages **through inefficient management.** Even if a company faces certain country specific disadvantages, it can offset those disadvantages through its unique proprietary skills in such a manner that it has a competitive advantage in the world markets. To the extent the firm specific advantages outweigh country specific disadvantages, production location decisions may depart from the pattern predicted by the comparative cost principle. In other words, production activity may be carried out in relatively high cost countries, and yet the company may be quite competitive in international business. For example CAE Electronics, a Canadian manufacturer of aircraft simulators and power station control system, was able to capture in 1982 approximately 30% of the world civil aviation market in flight simulators while exporting 25% of its total production. With a technically more advanced than production system its larger country rivals and by stressing personal contacts with customers, the company

was able to manage this position. These competition advantages are largely transportable from one geographic region to another. A number of researches have noted that entrepreneurial skill can enable a firm to operate in otherwise high cost locations.

A question arises as to why do firms not rent or licence their specific proprietary skills for exploiting their other firms that are located in areas enjoying lowest conventional cost of production? You would recall that this question was discussed at some length in Block 1. Prof. Johan Dunning suggests that ownership advantages largely take the form of intangible assets such as technical knowledge and market expertise. The firm often likes to exploit these intangible assets itself rather than license them to other firms because of imperfections in the market for such assets. As was pointed out in Block 1, imperfections may relate to difficulties in establishing a selling price for the assets or in monitoring[3] and enforcing terms of licensing agreement. In some cases, the relevant expertise may be so embedded in the organisation of the firm that it cannot be effectively transferred unless firm seeking to acquire much expertise becomes a part of the organisation itself. As you might be aware the process of exploiting competitive advantages internal to the firm through self production (rather than by renting or selling the underlying intangible assets) has been identified in the literature as the "internalisation" process.

It may also be mentioned that patterns of comparative advantage are not fixed for all the time. For example, new ways of producing a product may be developed that emphasis the use of certain factors of production to a greater extent than do more traditional methods of production. In this case, the locational advantage of producing in a given geographic region may change. It may also be mentioned that there are usually more than a single way of producing a product or service, e.g. more capital and less labour, more energy and less labour, etc. Hence, there may often be no single 'most preferred' location for an activity. A given product can often be economically produced in a number of locations, provided that **production activity can be carried out efficiently.** The qualification, i.e. "efficient production" is a relevant one.

As we shall discuss a little later in more detail, MNCs frequently locate production facilities abroad in order to gain access to a low cost factor of production used intensively in a specific production activity. At the same time it has also been observed that MNEs tend to use production technology that is more appropriate in the home country rather than the host country. An MNE from a developed country may set up an automated overseas plant which may not be appropriate keeping in view that the firm could reap by locating plant in a low-waged market. Such inappropriate behaviour can largely dissipate cost advantages associated with location in specific regions.

Michael Porter, in his recent incisive has examined and analysed the factors that can give rise to competitive advantage of nations (See, Box 11.2)

11.2 Sustaining advantage requires a global approach to strategy.

A firm cannot sustain competitive advantage in international competition in the long run without exploiting and extending its home-base advantages with a global approach to strategy. German chemical companies employ extensive foreign production and worldwide marketing networks to solidify their leadership, as do Japanese consumer electronics firms.

A global approach to strategy involves a number of important elements. First, it clearly means selling worldwide, not just in the home market. However, international sales are viewed not

as incremental business but as integral to strategy. The firm builds an international marketing channels it controls. Second a global strategy involves locating activities in other nations in order to capture local advantages, offset particular disadvantages, or to facilitate local market penetration. Third, and most importantly, a global strategy involves coordinating and integrating activities on a worldwide basis in order to gain economics of scale or learning, enjoy the benefits of a consistent brand reputation, and serve international buyers. Simply operating internationally does not equate to a global strategy unless this sort of integration and cooperation takes place. Advantages drawn from the global network add to home-based advantages and make them more sustainable. The scale from selling globally, for example, may allow a higher rate of R & D spending to take advantage of sophisticated home buyer and suppliers.

A company must move towards a global strategy as soon as its resources and competitive position allow if it is competing in a global industry. A high domestic cost of capital, high domestic factor costs and a strong currency are not excuse in global competition. With global strategy, these sorts of disadvantages can be circumvented. Yet competing globally is not a substitute for improvement and innovation at home.

Adapted from Porter, Michael, E. The Competitive Advantage of Nations.

11.7 OTHER LOCATIONAL DETERMINANTS :

In addition to the comparative advantage a firm may generally be guided by some other consideration as well in taking a decision on location of its production facilities. One such important consideration is **risk diversification**. By locating production facilities in a number of different countries, a firm can hedge against production disruption that may occur at one production site. Of course, there are other ways to tackle the problem of production disruptions e.g., carrying larger inventories of parts and finished products. However, the costs of diversifying through multi plant operations must be carefully weighted against the costs of other viable alternatives.

The least cost approach implicit in the doctrine of comparative cost advantage may sometimes be misleading when demand itself is a direct function of location. It has been seen that local competitors are often hostile to import. They may get together and in actively lobby to prevent imports. However, they may adopt a softer attitude of "live and let live" if competition takes the form of domestic production. Similarly goods imported from abroad may run the risk of being changed with 'dumping' from local producers.

The perception of being a local company may also enable the MNE to increase demand for its products in specific foreign markets. A local plant may be perceived by customers and local leaders as a commitment to performance. "Its perceived commitment may make local buyer more willing to attach themselves to the firm's products. Governments may also respond more favourably to a firm that sets up local production facilities". Sometimes, some governments may encourage the establishment of local plants by delaying permits to other entrants for a specified number of years. This is besides import protection from inputs and investment incentives which have been offered by many countries. Firms that produce at home and export abroad create benefits only for the home country in terms of jobs, foreign exchange earnings etc. importing countries frequently like to have share of the benefits accruing to the exporting country by adopting import substitution

policies that restrict imports and encourage local production. Firms desiring access to such foreign markets have to locate part of their production processes abroad. In some cases such local production will only be the assembly of imported components or the packaging of imported bulk materials. Local production may not be cost effective, yet it may be profitable because of higher local prices that can be charged as a result of tariff or quota protection.

In countries where imports complete with nationally owned industries, protectionist laws (or the threat of protectionist measures) may cause foreign firms to establish local production operations. Japanese automobile firms began to produce cars in the U.S. during 1980s while continuing to supply the U.S. market mainly through exports from Japan. The creation of jobs in the U.S. and the reduced pressure on the U.S. balance of trade by having significant amount of local content were expected to moderate protectionist tendencies which otherwise would have manifested. Many oil producing countries require that some petroleum refining be undertaken locally, though the international firms would have found it more economical to locate refineries near the main markets. As was noted earlier the movements across national boundaries by many MNEs largely consist of the movement between different units of the same enterprise rather than traditional exports between unaffiliated parties.

Activity 2 :

Approach a manager of the General Manager level in a multinational subsidiary which has production facilities in India. Discuss with him as to why and how the decision was taken to locate plant facilities in India? What factors influenced the decision?

.....

.....

11.8 PLANT LOCATION DECISION :

In general, as we have discussed in earlier sections, location decisions are influenced by various factors; proximity of consumers, cost of production factors (e.g. labour, capital, land), tariff rates, availability and of (or restrictions on) foreign exchange, government subsidy, infrastructure development in a given country, (e.g. telephone, transport, power, water), availability of raw materials, availability of skilled and unskilled labour, availability of technical and managerial personnel and political and economic conditions.

Some leading multinational firms not only take into account the above factors but also assign appropriate weight to each of the determinants. However, ultimate choice of a particular country is a matter of judegment which also rests on overall assessment of the economic, social and political situation in that country.

It must be pointed out that many multinational companies do not make a detailed evaluation before deciding the location of overseas plants. One study suggests that the plant decisions are ad hoc, unsystematic and subjective. For instance, Schollhammer's study of 140 U.S., European and Japanese companies indicated that location decisions were made randomly. According to him, location decisions were made on "incomplete and pre-conceived investigation of the consequence of a particular locational choice rather than on the decision of a comprehensive and systematic evaluation of locational alternatives on a global scale".[4]

Another study indicated that few market-related factors dominated decision making whereas other environmental factors such as governmental subsidies, infrastructure in a country, political and economic stability played only a minor role.[5]

According to one classical study at Aharoni on the foreign investment decision making process is rather subjective and unsystematic.[6] Another study indicates that the managers spend more time and effort in selecting a site within a country that in selecting the country "... while the decision to invest in a country is often unstructured, the selection ... of a specific location is formalised since it is embedded in the formal procedure for approval of funds. Funds do not seem to be granted merely for an investment opportunity, but only to a specific project at a specific location."

After a particular country has been selected for location of production facilities in keeping with the overall strategy of the international firm, a decision has to be made with regard to location of facilities in a particular site for location of plant is much than same as one entrepreneur in the country selected would follow. The check list method can be used for site selection.

11.9 EVIDENCE ON LOCATIONAL ADVANTAGE :

Several economists have studied the phenomenon of location of industry across countries based on the traditional indicators of comparative advantage. In one major study, (through an old one)[7] Balassa calculated the comparative advantage for a group of 73 manufactured products as 'revealed' in the export by patterns of 13 industrial countries. Revealed comparative advantage (rca) was calculated by dividing a country's share in the exports of manufactured goods of the sample countries. Balassa found that the U.S. had a comparative advantage in research-intensive industries. The research intensity was defined in terms of the share of research and development expenditures in total sales or the ratio of R & D Scientists and engineers to all employees. Among individual countries, aircraft manufacture occupied first place in the U.S. comparative advantage scale over the entire period of 1953-1971. Other prominent research intensive industries in which the U.S. enjoyed a comparative advantage included office machinery, electrical power equipment, organic and inorganic chemicals, Scientific and professional equipments. It was also found that U.S. had comparative disadvantage in non-durable goods which have low research intensity, such as woolen yarn, synthetic yarn, textile fabrics, blankets, furniture, clothing and footwear. Balassa found that Canada's comparative advantage, within the manufacturing sector, lay in the processing of its abundant raw materials. Paper enjoyed the higher (rca) value over the entire sample period. The next higher values in 1971 were for fertilisers and fur clothing. Canada also enjoyed a comparative advantage in fabricated metals.

The U.S. comparative disadvantage in non-durable consumer goods contrasts with the comparative advantage in these products enjoyed by France, Italy and Japan.

Germany's comparative advantage appeared to lie in machinery and metal products. The comparative advantage of U.K. showed no clear cut pattern. Apart from processed non-ferrous metals, it showed no clear cut pattern. The comparative advantage of Austria, Norway and Sweden, as with Canada, lay in research-based products.

11.10 INTERNATIONAL LOGISTICS :

Many of the MNEs have evolved fairly sophisticated production systems in which they produce and/or assemble components in one or several countries for markets all over the world. The virtual explosion of this form of business operations over the last few decades has increased the complexity of logistic function dramatically. Several of the world's largest multinationals have a significantly higher proportion of their production outside their parent countries because of the small size of the home market or lack of local resources.

As was mentioned in Block 1, international trade is becoming a more important part of the GNP in the industrial advanced countries. Several firms in these countries are beginning to integrate their operations worldwide in a production sense. The General Motors of U.S. in one instance in point Japanese firms are becoming large investors worldwide.

Business logistics is a comprehensive system that can be defined as follows:

> Business logistics is the planning, organising and controlling of all move-store activities that facilitate product flow from the point of raw material acquisition to the point of final consumption, and of the attendant information flows, for the purpose of providing a sufficient level of customer service (and associated revenues) consistent with the costs incurred for overcoming the resistance of time and space in providing the service.[8]

There are several logistics activities that firms must get involved in. While it is difficult to develop a comprehensive list of logistics activities, the major activities are transportation, storage, packaging, materials handling, order processing, forecasting, production scheduling, purchasing and site location. The cultural, social, political, and economic environments of international business are important in determining how much of the different logistics functions are carried out. Logistics network can range from simple to complex. Where inputs are close to production facilities and production takes place close to the market, logistics are likely to be relatively simple. Where production is distant from both sources of supply and markets, the network is likely to be more complex. A system's approach that recognises the trade-offs will be useful to apply.

The issues associated with international transportation of finished goods from production site to market are essentially the same as those that apply to domestic production and transportation to domestic markets. However, there are important differences between the two. In International operations, the goods can be out of exporter's control for longer period of time, more documentation is required, packaging may be more costly, shipping insurance is more costly. The transportation alternatives include ocean shipping and containerisation as well as air freight, air express and parcel post. The basic activities involved in the flow of goods are: transportation, warehousing and inventories, all of which, as we have emphasised, should be integrated in a system's approach. From the overall cost perspective, all these activities are interrelated. If the number of warehouses is increased, transport costs can be decreased because of short distance, but inventory cost will be increased because inventory may be duplicated at more places. Similarly, if an attempt is made to decrease inventory costs by reducing number of warehouses and inventory levels, transportation cost will go up. The system's approach would recognise the trade-offs and may often lead to the use of more expensive air freight rather than less expensive ocean shipping because of savings in warehouse and inventory costs.

Managing Logistics :

The specific regulations and requirements that apply to finished goods may be different from those that apply to raw materials or components. For example, shoes imported into Canada at one point of time were not considered finished goods if they did not have laces and, without laces they qualified for a lower import duty. One manufacturer discovered this and took advantage of the provision by quickly hiring local high school students to remove the laces at the U.S.-Canada border from a shipment of shoes before brining them into Canada.

It may also be noted that transport systems in developing countries are generally not as efficient as in the industrially advanced countries. Transportation in many such countries are inefficient and unreliable. It is, therefore, important for the international firms to examine and identify the potential problems and bottlenecks before developing logistical systems. The development of logistical networks has become an integral part of doing international business and these networks can be designed and their costs worked out by trained operation research specialists so that efficient choice can be made by global companies.

As mentioned earlier transportation is often considered to be the most important single determinant of plant location. Where an international firm locates production facilities outside and at places other than the markets where it sells, it obviously accepts higher transportation costs as the quid pro quo for production cost is advantageous. In this case the firm has to choose both its reach and the method of transport. The overall cost of transporting goods from a central factory to a foreign consumer or sales affiliate is the sum of a fairly lengthy list of items, some of which are noted in Table 11.2. The items are fairly self-explanatory.

Table 11.2: Costs of Logistics between Two points

1) Extra Inventory at the factory
2) + Packing
3) + Transport to dock and loading fees
4) + Paperwork
5) + Transportation charge of ocean liner or airline
6) + Inventory en route and waiting to clear customs
7) + Customs broker charge and other paper work
8) + Import duty
9) + Repackaging if necessary
10) + Inspection at the sales outlet
11) + Delivered inventory
12) – Export incentives
13) – Duty drawbacks
14) + Quotas
15) + Customer uneasiness about imported products

Source: David Rutenberg. Multinational Management (Boston: Little, Brown, 1982) pp. 153-54. Copyright © 1982 by Little, Brown and Company. Reprinted by permission.

The shipping factory has often to carry inventory to meet unexpected deviations from planned shipment or it has to accumulate enough product stock to fill a shipping container. Financial capital is tied up in this inventory which has a cost and is reflected in the foregone interest. As you might be aware, most cargo today is packed into metal containers to reduce the breakage, spoilage or theft. Since the shipping charges are usually based on volume rather than weight, firms have to stuff in largest number of units into a container. International firms also try to reduce that amount of unnecessary product packaging since packaging material can account for almost 40% of the weight of the products shipped. A company can reduce inland transportation charges by locating its distribution facilities adjacent to container ports or airports.

The forms required to document exports can impose a formidable burden of paper work on an MNE. The burden of documentation can be eased through computerisation and by using intermediaries such as export brokers or trading companies. Most of the overseas transportation typically involves shipping by ocean going vessels. Ocean liner charges are set by price cartels called conferences. All conferences have rules that set uniform rates for various classes of cargo and limis on international competition. Different types of cargo classifications may be used depending upon the bargaining power of shippers. The larger shippers, with transportation alternatives, may be able to negotiate lower rates by obtaining a unique and (lower price) classification for their cargoes.

Goods in transit also mean the blocking of financial capital for the duration of transit sometime since the shipper is ordinarily not paid until delivery is taken. Foreign goods also get delayed on arrival due to custom procedures etc. Besides, unloaded cargo accumulate storage fees until all necessary paper work is completed. Ordinarily, companies hire custom brokers to expedite paper work. The import duty depends upon custom classification and may either be in the form of ad valorem or specific tariffs. While payment of import duty is the direct responsibility of the importer, the exporter may indirectly bear some or all of the tax in the form of a lower price, depending upon the competition the latter faces in world markets.

Repackaging and shipment to the importer's site, inspection on site and the value of lost or damaged goods represent cost that are born directly by the importer. But again, where there is strong local competition to imports, foreign sellers may need to absorb some or all of these additional costs, implicitly, by charging lower FOB (free on board) prices.

All the costs identified in Table 11.2 are potentially relevant when exploring the economies of establishing production facilities in alternative geographical regions to serve specific markets. All other things being equal, the higher the logistic costs the greater is the incentive to locate production facilities close to major products markets.

Activity 3 :

Arrange a meeting as required in activity 2 and discuss about the Logistics policy on i) subsidiary level, and ii) on global MNE level.

.....

.....

.....

11.11 THE NATURE OF PRODUCTION FACILITIES :

The nature of production facilities would include plant technology, design, size and plant location decisions.

Plant Technology :

Once a decision has been taken to manufacture products abroad, the firm has to answer the critical question regarding the nature of technology that is to be transferred to overseas operations. In earlier sections we have emphasised that one of the main motives for going overseas is to exploit their specific advantages in technological managerial spheres. This rationality prompts an MNE to transfer firm's **existing technology** to overseas operations. Several of the MNEs from USA, Europe and Japan have done this, and successfully.

The Dilemma : It is common knowledge that MNEs do not face any critical problems in transferring their home based technology to industrially advanced countries. However, in transferring the technologies to less developed countries, the MNEs are sometimes confronted with a sort of dilemma as they come across contradictory public statements. On the one hand, the LDCs require the multinationals to bring in the most advanced/modern technology because they are very much interested in hastening their industrial and economical progress.

On the other hand, faced with the grim reality of high level of unemployment and surplus labour, the LDCs also expect the MNEs to generate employment and thus absorb surplus labour. The developing countries often make ambivalent and contradictory demands from the MNEs for generating employment and for deploying sophisticated technology (which is often capital intensive). The public figures concerned with economic and industrial development in LDCs expect the foreign investors to bring in world class technology, whereas public figures concerned with labour and employment issues expect them to bring in labour intensive technology.

The MNEs therefore face conflicting pressures. Typically, however, their response has been to go ahead with the kind of plant they prefer to operate i.e. one usually more automated than their domestic counterparts. [9]

It may also be pointed out that some of the MNEs have risen to the challenge of LDCs in a laudable way. For instance, Razor blade manufacturing involves capital-intensive technology. The Gillete company, threatened by the Malaysian government's policy of import restrictions, designed a "mini" plant that was less automated than the company's plants elsewhere. In doing so, the company satisfied the need of the Malaysian Government to employ more workers. In such a mini plant much of the packing is done by hand. Labour costs in Malaysia are cheap enough to keep costs comparable to larger plants even with less automated operations. The company's experiment in Malaysia was so successful that the firm was encouraged to put up similar plants in the Philippines, Indonesia, Morocco and Kenya. Similarly the Dutch electronic giant, Philips designed a pilot plant for its foreign subsidiaries, which is small and less automated, meant to accommodate smaller markets and higher unemployment.

It has been found that the subsidiaries of the MNEs heavily rely upon their respective headquarters for technology. They not only initially borrow the technology from their headquarters but also depend on the headquarters for new technological knowledge. Minimal research and

development activities are carried out at the subsidiary levels. It may be mentioned however that some MNEs form the U.S. and other countries have begun to decentralise their R & D activities. Overall, however, it must be stated that MNEs by and large, would be using the home-based capital intensive technologies in spite of the fact that the costs of labour in the host countries are much less than their home countries. It is also expected that for quite sometime the LDCs would continue to make ambivalent and contradictory demands regarding acquisition of technologies. In other words, the LDCs want to have their cake and eat it too.

For developing countries, perhaps, it is not the question of either or between automation and handicraft technology. The technology should be viewed as a continuum of production techniques, with the choice depending upon the scale and precision of production, and the wage rates relative to capital costs.[10]

What is appropriate technology for developing countries is very difficult to determine. There can be no generalisable principles for determining the appropriateness of a technology. Appropriateness depends upon the priority of objectives, whether they be maximum employment, technical efficiency, income equality, in export development, national autarky or whatever. The phrase that "appropriate technology" can not be isolated from politically determined priority of objectives is a truth and the management must be mindful to this reality.[11]

Plant Design :

What is the appropriate design for production facilities would depend upon the firm's choice of production strategy. If the firm believes in a centralised strategy, it would naturally have large, efficient, standardised, and probably, automated design for its plants. On the other hand, if the firm believes in decentralised or dispersed strategies, in all probability, it will have facilities that are similar and unique in design to meet the special needs of a particular location and production adaptation.

The distinctive characteristics of the design of facilities would also be affected by the climatic and cultural conditions of the place where production facilities are to be located. For example, in the tropics, particularly in developing countries where air-conditioning is expensive and unusual, facilities need to be designed to take advantage of cooling breezes. Similarly, different cultural conditions can affect appropriate design of facilities. For example, in certain Muslim countries men and women are not permitted to work together. As such facilities have to be designed in such a way that the tasks done by women are separated from those done by men.

Different physical characteristics of people have also to be taken into account in designing appropriate facilities. People in the Far East are, on the whole, relatively short in height compared to North Americans. Facilities that are comfortable for North American employees may not be suitable for the employees of Far East. Government regulations can also affect the appropriate design of facilities.

Decisions concerning the nature of plant design are directly related to the nature of technology a firm intends to use in overseas manufacturing facilities. Usually, in capital intensive industries and processed-type manufacturing (e.g. petro-chemicals, synthetic fibres, chemicals), the nature of technology used will be more or less the same as is being used in the home country. There will thus be few variations in plant design and layout between the home country and the subsidiaries

abroad. However, if the facilities were built up in the home country sufficiently long ago, the technology and 'consequently' the plant design might have changed. Under such conditions there will be a greater tendency to use more modern technology in the overseas plants.

Plant Size :

Plant size is basically a function of the market, the firm's policy with regard to centralisation versus decentralisation of production facilities and its concern for achieving economies of scale, and governmental attitude and policies. The countries with smaller markets, will require smaller plants then in countries with basic markets. Some examples of first type of countries are Singapore, Srilanka, Malaysia and Columbia, and some examples of the second type of countries are China, India, Mexico, Brazil and the United States.

However, as we have pointed out earlier, smaller countries may be used as "export platforms" for exporting goods to the home or third countries. In such cases the plants even in these countries may be larger than those in the bigger markets such as China or United States. In the 1960s, many of the electronic firms from the United States, Europe and Japan actively used many of the low waged countries in South East Asia and Latin America as export platforms. The tendency is in fact on the increase. Many electronics MNEs from U.S.A., Europe and Japan, such as General Electric, General Instruments, Sony, Matsushita, and Telephonica (West Germany), have plants in South East Asian countries as large or even larger than those in their home countries.

11.12 NEW PRODUCTION TECHNIQUES :

Severe competition in the international arena has led to the development of several innovative manufacturing techniques. Some such techniques are Just-in-time system (JIT), Group Technology (GT) and cellular manufacturing, Flexible Manufacturing System (FMS), Total Quality Management (TQM), and Computer Aided Design/Manufacturing (CAD/CAM). Moreover, recent advances in computing (hardware and software) have resulted in several important manufacturing applications; robotics, NC machines etc. Several of these new production (or production related) techniques, which have come to the fore, have been initiated and successfully experimented by Japanese firms. Such techniques have now come to be adopted by several firms all over the globe. We shall briefly describe some of these new techniques.

Just-in-time (JIT) : The essence of just-in-time is to produce and deliver finished goods just-in-time to be sold, sub assemblies just-in-time to go into sub-assemblies, and purchased material just-in-time to be transferred into fabricated parts. The overall objective of JIT system is to minimise the costs of inventory at all stages of the production process. All materials are thus intended to be in active use as elements or work in process. They are never at rest as that would mean tying up of working capital which has a cost. Since the focus is on minimising carried inventory, the manufacturers have to prepare utilise production-line schedules which closely match the market demand.

An implication of JIT approach is that there could be frequent starts and stops in the production process for specific product models. We have discussed earlier in "make versus buy decisions" that long product lengths of run have certain advantages. JIT practices, with frequently production line switch overs to accommodate short lengths of run, may therefore give rise to certain disadvantages.

It is worth noting that Japanese companies have successfully attempted to minimise the problem arising from short lengths of runs by cutting setup cost. A glaring example is that of Toyota which was able to cut down the setup time from one hour to only 12 minutes in a particular case (800 ton presses used in auto hoods and fenders).

JIT production system is a way by which many Japanese companies have been able to minimise inventory levels.

A related approach involving any JIT is the extensive use of sub-contracting. "Specifically, small companies utilise more or less intensively, depending upon business cycle conditions, either to overcome short-term capacity constraints faced by the large companies or to absorb the impact of slow-down in general economic conditions.

Total Quality Management (TQM) :

Total quality management has been described as "continuous improvement of every output, whether it be a product or a service, by removing unwanted variation and by improving the underlying work processes". By implementing the concept of total quality management, several companies, particularly in Japan, have been able to gain a competitive edge in the international markets.

One particular TQM model proposes there basic ways of achieving competitive advantage. They are: customer focus, process improvement and total involvement. **Customer focus** means the firm needs to know its customers and what they want in order to provide quality goods and services. Though it may sound simple and self-evident, it is not always so in reality. The model identifies both internal and external customer and makes the point that within the organisation. The employees serve others and that these "internel customers must be part of the quality process"

Process improvement is defined as "the sequential integration of people, methods and machines in an environment to produce value added outputs for customers". In order to achieve customer satisfaction, effective process management is vital. The key process in the firm have to be identified and analysed in order to devise ways of improving them and maximising their usefulness.

Total involvement indicates that customer satisfaction and process improvement depend on the efforts of those within the organisation as well as those who interact with it. Not only all the people who contribute to the firm's product or service have to be totally involved but their attributes also integrated. The points of focus in total involvement are **senior management leadership, empowering work force, and establishing quality suppliers.** It should be emphasised that quality cannot be achieved without clearly understanding why the firm should exist by identifying how it can achieve its objectives. Needless to say, this understanding is of greatest importance to an international firm which faces a more complex internal and external environments.

Table 11.3 lists some of the items which are essential for TQM. Item 1 of the table identifies an important distinction between Japanese and North American factories which in the former, the personnel directly involved in the production process are responsible for quality control, in the latter the primary responsibility rests with quality control department. The second item refers to emphasis on the **explicitness** of the objective of many Japanese companies to strive for continuous improvement in the production process. Items 3 and 4 signify that every process is to be controlled by **checking quality during production** using measurable standards of quality. Item 5 identifies the readiness of Japanese managers to enforce compliance with quality control standards. Generally, the work group that made the bad parts performs the necessary rework (item 6). Item 7 indicates

that the Japanese believe in checking all output produced. This is in contrast to the practice in North American plants where inspectors test the quality on sampling basis. Finally, item B recognises that small lot sizes are more relevant for assuring that defectives are caught early.

Table 11.3: Essentials of Total Quality Control

1) Production people have primary responsibility
2) Instill goal of perfection
3) Total process control
4) Make quality measures apparent
5) Insist on compliance
6) Principle of rework
7) 100% check
8) Small lot sizes

Sources: Richard J. Schoenberger *Japanese Manufacturing Techniques* (New York: The Free Press, a Division of Macmillan Inc., 1982) p. 61.

Flexible Manufacturing System (FMS) : One of the methods that many of the MNEs have used to increase production efficiency is the flexible manufacturing system (FMS). An FMS is a production system in which the MNE uses sub-assemblies of components from several subsidiaries. This permits the MNE to source from the lowest cost factory, depending upon the country specific costs of each nation. Worldwide production and sales can give the MNE an opportunity to use FMS to realise economies of scale if relatively a few barriers have been imposed by the host governments.

The recent achievements in communication and management information system have increased the abilities of the MNEs to control and monitor production around the world. This permits the MNE to reduce inventory levels and costs and simplifies control of scheduling of inputs and output. Standardisation of parts can be increased and their interchangeability improved. The Standardisation of production enables to realise the economies of scale. With flexible manufacturing technologies the MNE can remain responsive to changing market conditions. It can make a centralised decision to adopt a basic sub-assembly quickly to new conditions in a host market, while still optimising its overall production system. The improved communication networks today provide the necessary information which makes the internal market work more efficient.

The flexible factories allow an MNE to respond rapidly to new market demand as niches open up in host country markets. The MNE can provide customised production at low prices after it has organised itself with a flexible manufacturing system. It is often found that MNEs believing in the flexible manufacturing methodology have highly customised plant, use computer aided manufacturing design (CAD) and computer aided control processes. They may also use robotics on a large scale and they may have **modular production techniques.** All these techniques permit the MNE to produce standardised sub-assemblies which result in benefits arise from the economies of long production runs, while retaining the flexibility to adapt shorter batches of product outputs to cater to the local markets with specific tastes. This overall dual advantage in economic and management jargon is called **economy of scope.**

In short, it must be said that Japanese have an edge in product design and innovative use of sub-assemblies, flexible manufacturing systems and so on. The Japanese have superior product and process technology. The product strategy of Japanese is based on manufacturing excellence, low labour costs, and high productivity. The focus is on **process yield,** a combination of management practices and systems connected with production planning and control. The management and operation of the production process itself is the source of the Japanese advantage. "It does not just occur because of a better culture, quality circles, life time security of employment, or other macrofactors in the socio-economic and cultural environments. Nor is it all due to better high technology equipment and computer assisted robotics. All these are important, but the key characteristics is the ability of Japanese firms to manage them effectively"

11.13 SUMMARY :

Due to diverse environments which the international firm faces in different countries, the task of managing international production is by no means an easy task; the trade-offs between the various choices in production and logistics are more complex.

The production management function includes several critical decisions, the main ones among them being decision on make or buy, decision on sourcing of raw materials, parts and components or sub-assemblies, decision on location of production facilities, decision on the nature of production facilities i.e. plant technology, plant design, and size, and decision on logistic aspects.

Apart from economic considerations the international production decision is affected by socio-political and cultural factors. In the matter of sourcing of raw materials, components, etc., the firm may follow either a centralised or a decentralised or a mixed approach. The potential advantages of centralised (or concentrated) approach are scale economies and need for lower inventories. However, in the centralised approach flexibility and adaptability of products of local tastes may have to be sacrifised. The firm is likely to incur greater cost on transportation and also runs the risk of becoming vulnerable to unexpected developments in one or two locations. This approach is suitable for low volume high value products of standardised nature. The decentralised approach takes care of the negative aspects of the centralised approach but carrying costs of inventories may increase, and the overall quality of the product may suffer. It should be pointed out that it is not necessary for a firm to follow one of the two approaches. Several firms in fact follow both the approaches, one in relation to some other products or regions. The overriding consideration is optimisation of benefits for the firm. The Source-Market Matrix can be a helpful tool in relating production form various subsidiaries of the firms to the demand in various markets.

The make or buy decision in fact is closely related to sourcing decision. Though basically an economic decision, it has to be based on careful assessment of the pros and cons of each side and subjective judgment of the supplier weigh a lot. Japanese firms maintain a close liason with one or two main suppliers (or sub-contractees). A close and consistent watch on the quality of the items sub-contracted at the premises of the vendors is the hallmark of the Japanese sub-contracting.

The concept of comparative costs has dominated the thinking of economists and managers alike in production location decisions. The decision, however, in real life may not be based on comparative cost advantage alone, other factors like new market opportunities, risk diversificatio

incentives offered by government of other countries, and sociopolitical factors influence the decision on location of production facilities. Besides, any country specific disadvantageous (from the view point of comparative cost advantage principle) may be set off by production efficiency as a result of managerial and entrepreneurial strengths.

Logistics is concerned with flow of goods, and basic activities involved are transportation, warehousing, and inventories. All these activities should be integrated in a system approach by recognising vital trade-offs.

What would be the technology used, and what would be the design and size of the production facilities to be built in the host countries are important questions to be tackled by a global firm. The decision on the nature of technology to be used may prove to be quite difficult or even a ticklish decision because of the contradictory pressures often being brought on the MNEs by developing countries. Here the firm would mainly be guided by its global or overall strategy. The plant design is directly related to the nature of technology a firm intends to use. Over the last two decades or so, many new or innovative production techniques, mostly initiated by Japanese firms, have appeared on the production management horizon. Some of these techniques are: Just-in-Time (JIT), Total Quality Management (TQM), and Flexible Manufacturing System (FMS). While Just-In-Time is mainly aimed at lowering the inventory levels. The TQM is an overall management philosophy which, through customer focus, process improvement, total involvement of all employees, attempts to upgrade the overall quality environment at the work place. Flexible manufacturing systems aim at making the whole production system more market (or customer) oriented, flexible and adaptive.

11.14 KEY WORDS :

Appropriate Technology : Technology considered appropriate from the point of view of economic, social and political points and objectives of a nation.

Centralised (concentrated) Production : Production of output concentrated in one or small number of facilities located in one or few countries. Main benefits being efficiency and standardisation; and main drawbacks being that it needs more time, is expensive and creates complexity.

Comparative Advantage : The cost advantage to a country over other countries due to endowment of national resources or accumulation of intangible assets e.g., managerial skills etc.

Decentralised (Dispersed) Production : Large number of facilities in many locations. Benefits being ease of adaptation (customisation) and flexibility. Negative aspects being higher per unit costs and greater administrative complexity.

Flexible Manufacturing System (FMS) : A production system in which the MNE uses sub-assemblies of components from several subsidiaries or centres within the same plant which are linked together by an automated material handling system, directed by a central computer.

Just-in-time (JIT) : A production planning system aimed at reducing the work-in-process inventories to the bare minimum level.

International Logistics System : The means by which inputs get to the production site and output to customers in the course of international trade and business.

Source-Market Matrix : A matrix that relates the supply of products of various subsidiaries to the demands for these products in various markets.

Total Quality Management (TQM) : A philosophy aimed at continuous improvement achieved through customer focus, process improvement, and total involvement.

11.15 SELF-ASSESSMENT QUESTIONS :

1) Describe the nature of production management function. What decisions are involved?
2) Discuss the pros and cons of various approaches to sourcing in international production.
3) What new trends do you observe over the last one decade or so in sourcing of materials, components or sub-assemblies? Offer your comments.
4) What is meant by "rationalisation of production"? What factors play a part in such rationalisation?
5) What are the factors that should be considered in a "make or buy" decision? Discuss the role of sub-assemblies in international business.
6) What is the concept of comparative cost advantage? Critically examine the concept.
7) What factors influence the decision regarding location of production facilities? What complexities and trade-offs might be involved?
8) What activities are involved in international logistics? How could an international firm optimise its logistics?
9) Why is a decision about technology and design of new production facilities to be built in a host country important for the MNE? What factors might influence the decision? Discuss fully.
10) Write short notes on the following and critically examine them:
    i) Source-Market Matrix
    ii) Just-in-time (JIT)
    iii) Flexible Manufacturing System (FMS)
    iv) Total Quality Management (TQM)

11.16 FURTHER READINGS :

Davidson, William H., 1982. *Global Strategic Management*, John Wiley, New York

Dunning, J, 1981. *International Production and the Multinational Enterprise,* George Allen and Unwin, London.

Mascarenhas, B. 1984. "*The Coordination of Manufacturing Interdependence in Multinational Companies",* Journal of International Business Studies, 17(1), pp. 63-82.

Schoenberger, Richard J., 1982. *Japanese Management Techniques,* Free Press, New York.

REFERENCES :

1) Hood, Neil, and Stephen Young, 1979, *The Economics of Multinationals Enterprises,* Longman. London , P. 173

2) Ibid

3) Dunning, John H., 1981. *International Production and the Multinational Enterprise,* George Allen & Unwin, London, Ch. 1 to 4.

4) Schollhammer, Hans, 1974, *Locational Strategies of Multinational Firms,* Centre for International Business, Los Angles, P. 32.

5) Kobrin , Stephen, "The Environmental Determinants of foreign Direct Investment: An Ex-post Empirical Analysis", *Journal of International Business Studies*, Fall 1976, pp. 37.

6) Aharoni, Yair, 1966. *The Foreign Investment Decision Process,* Harvard Business School (Division of Research), Boston, Mass.

7) Balassa, Bela, Dec. 1977. "*Revealed Comparative Advantage Revisited:* An Analysis of Relative Export Share of the Industrial Countries, 1953-1971", quoted in Globerman Steven, "Fundamental of International Business Management", Prentice Hall, New Gersey, P. 337-38.

8) Coyle, John J. and Edward J. Bardi, 1980. "*The Management of Business Logistics,*" West. New York, P. 4.

9) Wells, Louis T., 1974. "*Do not Over-automate Your Foreign Plant,*" Harvard Business Review, Jan-Feb., P. 111.

10) Baranson, Jack 1971. "Automated Manufacturing in Developing Countries," *Finance and Development*, No. 8, Vol. 4, pp. 10-17.

11) Robinson, Richard, 1978. *International Business Management,* Dryden Press, Hinsdale P. 156.

12) Schoenberger, Richard J., 1982. *Japanese Management Techniques,* Free Press, New York.

UNIT - 12

NEGOTIATIONS IN INTERNATIONAL BUSINESS

Objectives :

The objectives of this unit are to familiarise you with:

- the linkage between negotiations and communication
- the process of c ross-cultural negotiation
- the steps required for planning and preparation for negotiation
- the effective management of negotiations
- comparative cross-cultural negotiating styles.

Structure

12.1 Introduction
12.2 Negotiations and Communication
12.3 Cross-Cultural Negotiation Process
12.4 Planning and Preparation for Negotiations
12.5 Managing Negotiations
12.6 Negotiating Skills
12.7 Re-negotiation
12.8 Arbitration of Disputes
12.9 Comparative (Cross-cultural) Negotiating Styles
12.10 Summary
12.11 Key Words
12.12 Self-assessment Questions
12.13 Further Readings
References

12.1 INTRODUCTION :

Negotiations involves discussions and presentation of the viewpoints by two or more parties in an attempt to reach a mutually acceptable or beneficial relationship. Discussions may range from a couple of hours to a couple of years, or even more in some cases. Though the objective in all negotiations is to reach an agreement, perceived to be beneficial by the parties (otherwise there would be no agreement); yet every negotiation may not necessarily lead to agreement. Circumstances, situations and perceptions may change.

According to one author, "Negotiation is a process for resolving conflict between two or more parties whereby both or all modify their demands to achieve a mutually acceptable compromise." Another author says "Negotiation is a process of adjusting both parties' view of their ideal outcome to an attainable outcome". Another defines "Negotiations as the use of common sense under pressure to achieve objectives".

Negotiations have increasingly been used as a means to decide the terms on which a company may begin or terminate its operations in a foreign country. Negotiations may relate to (foreign) direct investments, licensing agreements, strategic alliances, establishment of joint ventures, exporting etc. Negotiations may be conducted with a host country firm, a group of firms, or a host country government (through its officials), or all of them simultaneously or in a phased manner.

Negotiation is not a one time activity, rather it is an ongoing activity. New problems may emerge in MNE relations with different governments. Hence, specific information about the environment is to be gathered in order to better understand and forecast emerging government priorities. This enable the management to position itself to take advantage of the opportunities or to mitigate threats.

It may be felt necessary by an MNE to generate support for its actions from key decision makers in the host country. The firm has to demonstrate that it is promoting the board public interest. Sometimes the firm may have to dispel false impressions about how it is conducting its international business activities. All these activities call for negotiations.

With increasing globalisation, the ability to conduct successful cross-cultural negotiations cannot be overemphasised. Failure to negotiation productively will result in lost potential alliances and lost business at worst, and confusion and delays at best.

Ignorance of native bargaining rituals may often be responsible for unimpressive results. Important differences in the negotiation process from country to country include: (i) the amount and type of preparation for a negotiation, (ii) the relative emphasis on tasks versus interpersonal relationships, (iii) the reliance on general principles rather than specific issues, and (iv) the number of people present and the extent of their influence.

This unit deals with all relevant aspects of international negotiations. Cross-cultural negotiation may be seen as cross-cultural communication. The barriers in cross-cultural communication are briefly explained. The various steps in cross-cultural negotiations are discussed, with relevant underlaying cross-cultural beliefs and philosophies. The role of planning and preparation and managing negotiations effectively is underscored. The unit concludes with a discussion about comparative cross-cultural negotiating styles.

12.2 NEGOTIATIONS AND COMMUNICATION :

All business communications, whether domestic or international, should be seen in the context of human communication. The process by which verbal and non-verbal language is shared is communication. Communication has no determinate beginning or end; it is an ongoing exchange of messages between two or more people. Human communication travels through a variety of signals, not just words, and depends on the **context** for its meaning. Context means the degree to which the communicator and listener share a common background of knowledge and experience.

This occurs when both individuals have a common history or, at least, a shared understanding of each other's lives, intentions and experiences. Additionally, communication depends on the competence of the communicators. If a person is able to send or express messages clearly and receive and interpret them clearly, communication is enhanced.

This dimensions of human communication assume particular importance in the cross-cultural context. To communicate with someone from a different culture, one must learn not only the language but also the rules regarding how the languages is used in different context and situations. Culture is a factor that influences to a large degree how people do what they do. Culture Influences hand gestures, tones of speech, clothing and so on. A negotiator must understand the barriers so that effective communications can take place with someone from a different culture. He should have a fairly good understanding of the gestures, facial expressions, body movements in relation to communication, otherwise misunderstandings can occur. Perceptual biases and mindsets based on those biases may adversely affect the ability of a negotiator to effectively interact with people from other cultures. "The more we consider our views and experiences (our categories of their world) to be absolute and universal, the less prepared we are to deal with people who have different backgrounds, experiences, cultures and their views (categories) of the universe." To overcome this kind of barrier, some MNEs have gainfully used the services to former government employees of the host countries for dealing with government in relation to sensitive negotiating positions.

Faulty attributions to others' action or behavior and stereotyping, i.e. categorising a group of people (or a society or a nation) based on some feature they hold in common such as nationality, race or religion, can also cause barriers in cross-cultural communication. Stereotyping can be a powerful barrier in cross-cultural communication because interactions with people from groups other than their own, are categorised on a variety of issues such as intelligence, industriousness, education, level of authority and responsibility, integrity, honesty etc. If a community is classified as being dishonest, for example, whenever one interacts with a member of that community, it will be difficult for the holder of the stereotype to trust whatever the outsider does or says. Box 12.1 provides an interesting insight in connection with this phenomenon.

Box 12.1 Foreign Perceptions of Americans

Mexican Perceptions	Taiwanese Perceptions
Americans are:	Americans are:
Reserved	Friendly/Outgoing
Rushed/Time conscious	Relaxed/Easygoing
Realistic/Hardheaded	Optimistic
Team worker	Independent
Quality-concscious	Output-oriented
Unemotional	Emotional
Serious/ Businesslike	Fun-loving/joking
Self-controlled	Self-indulgent

Source: *Newsletter,* National Council for International Visitors. 1981

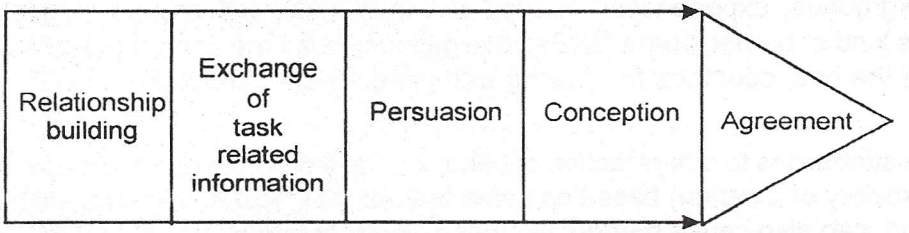
12.3 CROSS-CULTURAL NEGOTIATION PROCESS :

Whether business would or would not occur depends on whether negotiations have or have not been successful. The negotiations would be on a firm group if the negotiators understand and appreciate the barriers to and complexities of cross-cultural communication.

Research on cross-cultural communication indicates that within any culture, people go through four stages in the negotiation process[1]. These stages (depicted in Figure 12.1) are:

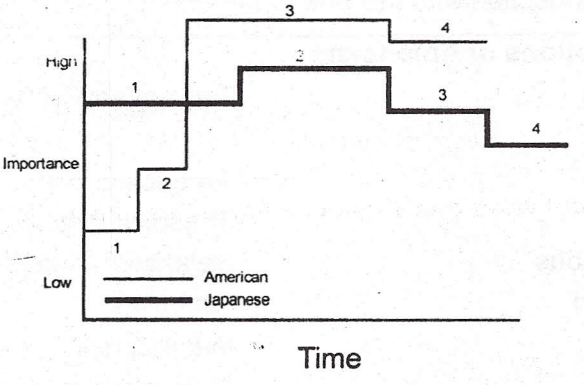
- Relationship building
- Exchange of task related information
- Persuasion
- Making concessions and agreement

Figure 12.1: Cross-Cultural Negotiation Process



It may be pointed out that cultures differ in the degree to which value is placed on each stage of negotiation relationship. Figure 12.2 shows the importance of each step in negotiation between U.S. nationals and Japanese. Importance is also reflected by the amount of time spent on each stage of negotiation

Figure 12.2: U.S/Japanese Stages of Negotiations



Negotiation Stage Legend

1= Non-task Time (Building Relationship)

2= Information Exchange

3= Influence Bidding

4= Conclusion and Contact

Source: Mendenhall Mark, et al. (1995) Global Management, Black Weel Publishers, p 552

Relationship Building :

The first step in negotiations involves building interpersonal relationships between the negotiating parties. This step is crucial in the negotiation process. Japanese realise the importance of this step and, therefore, spend considerable time in building relationships with the other party, as would be clear from Figure 12.2. On the other hand, Americans in general consider this aspect of the negotiating process as less important and thus spend much less time on it than do the Japanese. Japanese spend considerable time in informal interaction with the members of the other party in going round the town, eating and drinking. In this way formal barriers are broken down between the parties and a sense of trust and respect slowly develops which becomes the basis for negotiating contracts. In fact, looking from Asian angle, developing a mutually trusting relationship is the cornerstone of negotiated agreements. While Americans tend to get down to business in their very first meeting, Japanese like to talk in general, having in their minds that the preliminary sessions are meant simply to know each other well. Japanese thus desire to build a trusting relationship before doing business so that frustration and failure do not occur later.

In many countries, personal commitments to individuals, rather than the legal system, from the basis for the enforcement of contracts. Effective negotiations, therefore, allow plenty of time in their schedule for relationships building with bargaining partners. As mentioned above, this process may usually take the form of social events, tours, ceremonies alongwith much light conversation of general nature, while both sides get to know one another.

Information Exchange :

The second phase of the cross-cultural negotiations involves information exchange. In this phase the parties make presentations and state their positions. A question-and-answer session usually ensues, and alternatives are discussed.

It is often difficult to understand the other party's situation, intents and needs even if the latter belongs to one's own culture, but understanding these matters is even more difficult when the other party is from another culture. People from differing cultures may view problems, realities, and business operations in different ways. It takes a more sincere and sustained effort to clearly articulate one's own situation and understand other party's situation.

As would be clear from Figure 12.2 the Japanese rate this step as important and spend a fair amount of time on the issues involved. Americans, on the other hand, rate this as a moderate importance and spend relatively little time on this phase. Therefore, misunderstandings and problems may occur based on different ways these cultures value this phase.

From an American viewpoint, this stage is one which is straight forward objective and efficient. However one study[2] points out that negotiators from other countries countinue to take a more indirect approach at this stage. Mexican negotiations are usually suspicious and indirect, presenting little substantial material and more lengthy, evasive conversation. French negotiators enjoy debate and conflict and will often interrupt presentations to argue about an issue even if it has little relevance to the topics being presented. The Chinese also ask many questions and they delve specifically and repeatedly into details at hand. The Chinese presentations contain only vague and ambiguous material.

Persuasion :

Persuasion involves influencing the other party to adopt one's viewpoint position, or beliefs. Outcome in any negotiation very much depends upon the persuasive abilities of the parties. It is

during this stage that the hard bargaining starts. Typically, both parties try to persuade the other to accept more of their position and to give up some of their own.

Americans view this phase as the most important part of the negotiation process and spend quite a bit of time in the use of persuasive tactics. However, as indicated in Figure 12.2, American take up the persuasive part rather too early in the process and expect the party to agree to their offer, bit, contract, etc. The Japanese also rate this phase as important and spend a fair amount of time on it as well. However, for the Japanese, persuasion should take place only after mutual trust has been built up. For Americans, persuasion can take place quickly with appeals to logic and rationality. They do not consider the need for warmth in personal relationships as a prerequisite for fruitful negotiations.

Table 12.1: Differences in negotiating behaviour among Japanese, North Americans and Brazilian negotiators

Behaviour (Tactic)	Japanese	Brazilians	North Americans
	55	0	5.5
(Number of periods greater than 10 seconds, per 30 minutes)			
Conversational Overlaps	12.6	28.6	10.3
one person speaking number per			
Facial Gazing	1.3	5.2	3.3
(Minutes of gazing other party's face per 10 minute period)			
Touching (Not including handshaking	0	4.7	0
Per 30 minutes periods)			

Adapted from Graham, J.L. 1985. "The influence of culture on the process of business negotiations: an exploratory study". *Journal of International Business Studies*, Spring, pp. 81-96.

International managers usually find that this phase of bargaining fraught in with difficulties because of the different uses and interpretations of verbal and non-verbal behaviours. Studies of the negotiating behaviour have revealed the use of certain recognisable tactics, Which skilled negotiations should take note of. Table 12.1 shows the results of a study comparing the use of various tactics (promises, threats, and so forth) by the Japanese, Americans and Brazilians. The results indicate that the Japanese and Americans tend to be more alike in the use of these behaviours, whereas the Japanese and Brazilians are less alike. For example, the Brazilians use fewer promises and commitments than the Japanese or the Americans, but they use commands far more often. Just in any other negotiation, dirty tricks or rough tactics may also be used by international negotiations. In a survey of 18 U.S. –Korean joint ventures, U.S. executives reported that the behaviour of the Koreans during the course of negotiations was often "abusive", resulting in shouting matches, desk pounding, and chest beating.[3] International managers, therefore, must keep in mind that what seem like dirty tricks to the negotiators of one nation may simply be the way some other culture conducts negotiations. In some South American countries, for example, it is common to start negotiations with misleading or false information.

The messages emanating from non-verbal behaviour are often most difficult to deal with— the use of voice intonation facial and body expressions, eye contact, etc. Non-verbal behaviours are ingrained aspect of culture used by people in their daily lives; they are not specifically changed for the purposes of negotiation.

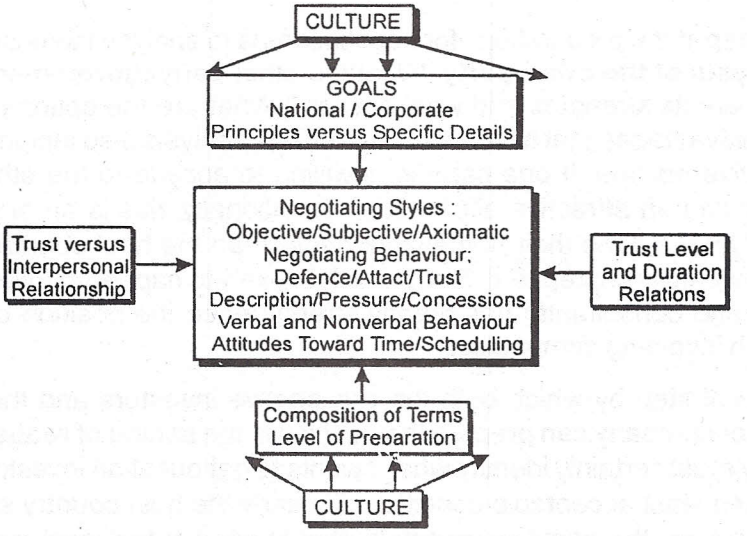
Concessions and Agreement :

Giving concessions and arriving at an agreement is, in fact, a logical consequence of persuasion process and rests on the principle of mutual give and take. As shown in Figure 12.2 the Japanese value this phase lesser than the Americans do (in relation to other phases), though they spend about the same amount of time as Americans do. Americans in general negotiate sequentially i.e. they discuss and attempt to agree on one issue at a time. They attempt to separate the issues into pragmatic parts. Throughout the bargaining process they make many small concessions, and expect the opposite party to reciprocate. They then finalise the list of concessions to be incorporated into the overall agreement.

The Japanese do not like to spend a lot of time and energy in making small concessions in reciprocation to the opposite party's concessions. Instead, they like to view the process holistically, trying to accept each others' views and needs, build trust and then make concessions, if any, at the end as a form or warping up the negotiations.

As far as concessions are concerned, tactics vary greatly across cultures. Well-prepared negotiators are usually aware of the various concession strategies of the other country's negotiators, and therefore, decided ahead of time what their own concession strategy should be. It is known that the Chinese and the Russians generally open their bargaining with extreme positions, asking for more than they hope to gain, where as the Swedes usually start with what they are prepared to accept. The relationship between culture and negotiations is vividly portrayed in Figure 12.3.

Figure 12.3: Cross-Cultural Negotiation



Source: Deresky, Helen (1994) International Management, Harper Collins, p. 170

Activity 1

Arrange a meeting with the Chief Executive of a Company which has been involved in a major international negotiation for the last 3 to 5 years. (It may be either your company or some

other co :ipany). With which country's citizens the negotiations were conducted? discuss. Gather detailed information on the process involved. How did the negotiations go about?

.....

.....

.....

12.4 PLANNING AND PREPARATION FOR NEGOTIATIONS :

The importance of careful preparation for cross-cultural negotiations cannot be overstated. The managers in any negotiation need to familiarise themselves with the cultural background and underlying motivations of the negotiators and the tactics and procedures they use to control the process By doing this they can make progress, and therefore maximise company goals. For long-term positive relations, the goal should be to set up **win-win** situation—that is, to bring about a settlement beneficial to all parties concerned. In preparing for negotiations, it is critical to avoid what is known as **projective cognitive similarity**—that is, the assumption that others perceive, judge, think, and reason in the same way when in fact they do not because of differential cultural and practical influences. "Instead, astute negotiators emphathetically enter into the private world or cultural space of their counterparts, which willingly sharing their own view of the situation. "

The successful negotiations depend on thorough understanding of each other's position. The first step in that direction is that each party should assess not only its own strengths but also weaknesses i.e. **self analysis**. Each party to the negotiation should consider: what options it has available. Should negotiations fail, what is the fall back positions? How many concessions it is willing to make for the negotiations to succeed? What is the cost of failure? What are the benefits of the possible alternatives?

The second step in the preparations for negotiations is to analyse the positions of anticipated counterpart i.e. **analysis of the other party**. What the other party (government or a company) is likely to seek? What are its strengths and weaknesses? What are the options that will be sought and what are the disadvantages that it will try to avoid? The analysis also includes determining the other party's alternative options. If one party is unwilling to accede to the other's demand, how readily can the latter find an attractive alternative? Traditionally, this is an area where investing companies practically have done their home work better than the host countries. Host countries have frequently been woefully unprepared. But, this is less likely to happen in future. The proliferation of experts (advisers and consultants) has greatly strengthened the position of host countries in their negotiations with investing companies.

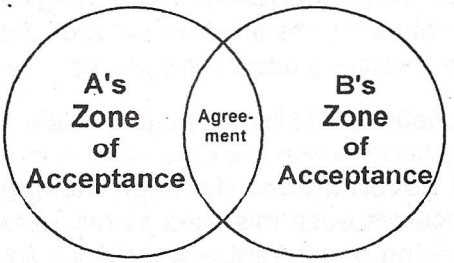
The third logical step by which both the prospective investors and the prospective host country government or company can prepare themselves is the setting of **realistic or reasonable goals.** The company must certainly identify what it wants to get out of an investment. It should also decide what can be the least acceptable condition. Similarly the host country should evaluate the proposed relationship from the same perspective, that is what is the least acceptable condition under which the country would be interested in the investment. Both the parties must determine their zones of acceptance and non-acceptance. As portrayed in Figure 12.4 (A and B), if the acceptance zones overlap, there is a possibility of coming to an agreement; if they do not, there is little hope of agreement The stating of goals must be realistic. It must take into account the goals

that the other party is likely to set for itself, otherwise a lot of time can easily be wasted in fruitless discussions. Besides, opportunities for potential attractive partnership may be lost.

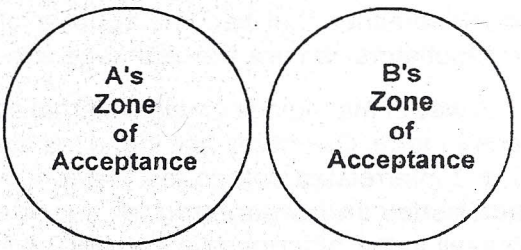
The fourth logical step is to understand cultural differences in negotiating styles. The managers first need to know their own styles and then determine how their styles differ from the norms in other countries. Keeping in mind the nature of the negotiations and all other relevant factors the top management must decide about the size and composition of the negotiation team. The age, experience, expertise and mastery on human relationship are important qualities that the members are expected to possess. For instance, patience, respect and experience are necessary prerequisites for anyone negotiating in China. For best outcomes older (or more) experienced people are more acceptable to the Chinese in cross-cultural negotiations. Section 12.9 on comparative Negotiating Styles should prove interesting and informative in this context. Studying these differences in negotiating behaviours can help the managers in recognising what is happening in the negotiation process. Adept negotiators do some research to develop a profile of counterparts so that they know in most situations what to expect, how to prepare and how to react. After developing thoughtful profile of the other party or parties, managers can plan for actual negotiation meetings. Prior to the meetings, they should find out as much as possible about the kinds of demands that might be made, the composition of opposite team, and the relative authority that the members posses. After this, the managers can gear their negotiation strategy specifically to the demands of the situation and the other party, allocate roles to different team members, decide on concessions and prepare an alternative action plan in case a negotiated solution cannot be found.

Figure 12.4: Zones of Acceptance

A: Zones of Acceptance overlap: Hence agreement



B: Zones of Acceptance donot overlap: Hence no agreement



Bargaining and Compromise :

Bargaining is a process of give and take. Negotiations, therefore, are seldom a one-way street. Negotiations take place in the context of goals and are a function of the personalities involved. Neither party will get everything it wants. And no bargaining opportunity can offer each party its maximum goals. Therefore, compromise in many situations is inevitable. In any positive-sum relationship there is likely to be a wide variety of combinations of the distribution of both the gains and disadvantages resulting from relationship. If the expectations of each party have been realistic and if the bargaining has been carried out with careful awareness of the mutual advantages and disadvantages, then a successful conclusion to the negotiations may often be possible. Even under these circumstances, some negotiations may fail. This is to be expected. Neither party should therefore make the mistake of relaying excessively on the successful outcome of a particular negotiation, especially where both or even one of the parties have options available. By the same token each party should weigh the cost of an excessive prolongation of the negotiations, which in the final analysis might fail anyway.

12.5 MANAGING NEGOTIATIONS :

The objective in any negotiation is to reach an agreement which is seen as advantageous by both the parties. From the view-point of this objective, negotiation is both an art and a science. The science implies systematic analyses for problem solving. The "art" includes "interpersonal skills the ability to convince and be convinced, the ability to employ abasket-full of bargaining ploys, with wisdom to know when and how to use them." [4]

On a conceptual plane, the negotiation process can be said to be occurring within the context of four C's: *common interest, interest conflicting, compromise and criteria* (or Objectives)[5]. For example, any developing country would be interested in the setting up of a new enterprises. Both the parties have a common interest in so far as the establishment of the enterprise is concerned. However, the extent of import duties imposed on the technology and material brought in by the foreign venture may create a situation of conflicting interests. This aspect involves reaching a decision which is advantageous to both parties even though it may not be ideal to both. The criteria (or objectives) for the foreign investor may be satisfactory profits with low risk and few restrictions. The objective for the host country is attractive net social benefits. Thus, international business negotiations are concerned with the balancing of freedom and restrictions, benefits and costs, and profits and risks between the host country and the foreign investor.

In a particular situation, many other characteristics may become important. For instance, in a joint venture, apart from the foreign investor and the Government, a local business firm may be involved as a third party in the negotiation. The negotiation may create significant precedents for either party. The outcome to negotiations reflected in a particular agreement may have important implications for other agreements which the foreign investor might be thinking of entering into with governments in other countries. There may also be linkage effect if the project results in encouraging new local industries that become supplier of material or distributor of the finished product. An astute negotiators can use these linkage effects to improve the investor's bargaining position.

A way of managing complex international business negotiations is to list the major mistakes commonly made. One study has identified at least 19 major mistakes which are organised in four broad and interrelated categories, namely, **empathy, role of governments, decision making characteristics and organising for negotiations.** The list includes such mistakes as failure to put yourself in the other person's shoes, insufficient understanding of different ways of thinking, insufficient recognition of or the perceptions of the host country about the role of multinational home government in negotiations, insufficient allocation of time for negotiations, and insufficient recognition of loci of decision making authority[6].

Bargaining Power :

What would be the outcome of the negotiated agreement will depend upon the respective bargaining power of the parties. As we had discussed in the previous units, you are aware that multinationals, in general, have considerable bargaining power which mainly arises from their access to resources and possession of specific advantages. Multinationals also posses considerable bargaining skills as compared to the skills of the developing countries. The deal that is struck between the foreign investor and the host government reflects the need for and scarcity of the resources offered by the two parties. A very important element of the bargaining power is whether or not the parties have alternatives available to them. If no alternative is available with one of the parties, practically speaking, its bargaining power can be said to be nil.

The foreign investor who can offer capital, technology marketing know-how, managerial skills and new jobs would relatively be in a stronger bargaining position, particularly when alternative sources for these benefits are not readily available. A country with a large market, such as India (if the multinational is a market seeker) or with attractive human and natural resources (if the foreign investor is a production efficiency or resource seeker) would relatively be in a strong bargaining position. Just as an international firm may posses bargaining power due to its hold on the scarce resources or the skills available with it, a host government may also derive its bargaining power form the control it has on the market access. However, as far as foreign investor is concerned, the country's bargaining position would be viewed by him in the light of the attractiveness of opportunities in other host countries.

The main findings of a study on bargaining power are as follows:

- The bargaining power of host governments is likely to be weak when negotiating with high technology firms. This is quite understandable. Skilled scientific and technical resources are in scarce supply in most countries. As a result host governments are often in a take-it-or-leave-it positions, if they want to develop a domestic technological infrastructure.
- Firms with well-known brand-name products that enjoy success in export markets also possess stronger bargaining positions in negotiating with foreign governments.
- Firms that produce a wide range of products are able to secure above-average success in international negotiations. This probably could be attributed to the fact that multi-product firms better fit into a host government's import substitution strategies.
- The greater the number of firms competing in an industry, the weakert he bargaining power of any individual firm in that industry.

We need to appreciate the time dimension of the bargaining power. The bargaining power of the multinational is likely to be greatest before it makes its initial commitment to investment. However, once the capital has been sunk in a country, its bargaining power may considerably decline. If the technology for the project is required to be periodically improved or upgraded, the bargaining power of the foreign investor may stay strong, especially when the host country views competitiveness of the project as being of crucial importance. The host country in its assessment, may consider the continuous flow of product and process innovation by the parent firm as essential for maintaining competitiveness of the project. On the other hand, if the technology is old and static, or it is not required to be periodically upgraded, it may be easier for the host country to acquire or develop technological capability locally. The bargaining power of a foreign investor in such a situation would diminish over time.

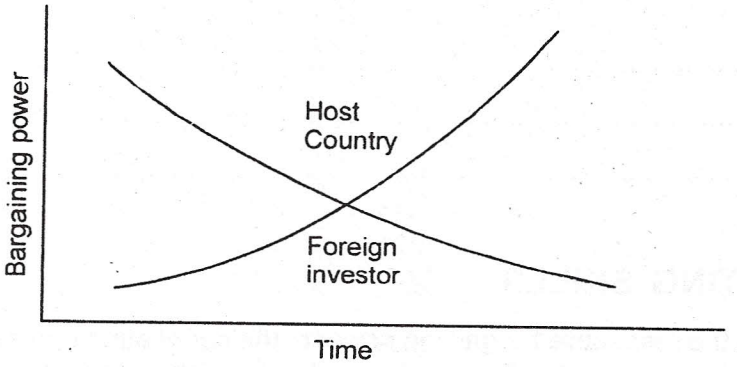
The negotiating process between the multinational enterprises and the host country can be seen as a function of not only the relative strengths and weaknesses and the goals of the two parties but also of the perceptions held by each of the relative strengths and weakness and goals of the other, together with the appropriate negotiating skills of each. Given the reasonableness of the conditions that each party brings to the bargaining table, an acceptable agreement may be possible. However, if the alternatives available to the other party seem more attractive, the negotiations may fall through. Sometimes irreconciliable difficulties may develop. Both the MNE and the host country firm need to be realistic about their minimum conditions. A potentially attractive agreement may fall through because of unrealistic demands and failure to give adequate

consideration to cultural differences. The investor, or the host country, or both may be responsible for this. For example, Citibank, which has been well established in Nigeria by the mid 70s refused to accept the demand to sell 60% of its Nigerian operations to local interests. The Bank was fearful that yielding to the government demands in Nigeria would have repercussions in Columbia and South Africa, the countries in which Citibank was more deeply entrenched than in Nigeria. As a result of its refusal, Citibank was forced to withdraw from Nigeria. And this was much to the satisfaction of the other foreign banks who were able to pick up the business of the former. However, Citibank later yielded to the Government demands in both Columbia and South Africa anyway. It belatedly regretted its Nigerian decision and was subsequently anxious to return to Nigeria but was unable to do so. The Nigerian Government was not very favourable toward a bank which had earlier withdrawn from the country rather than accept its demands.

The governments, particularly in developing countries have been concerned about the same types of issues, viz., domestic employment, exports, technological development, balance of payments, local participation in management, use of local resources/inputs ownership and tax revenues; but priorities change and different criteria become more or less important over time. Many countries over the recent past have given incentives to attract foreign investment. (These incentives may also be available to local firms). The various incentives, apart from full or majority ownership, may include tax holidays, accelerated depreciation, low-interest loans, loan guarantees, subsidised energy and transportation, construction of roads, etc., By signaling changes in priorities, a structured or systematic approach to issue identification can give international managers an important advantage in negotiating with government officials. Management can tailor concessions to suit the circumstances of individual business proposals.

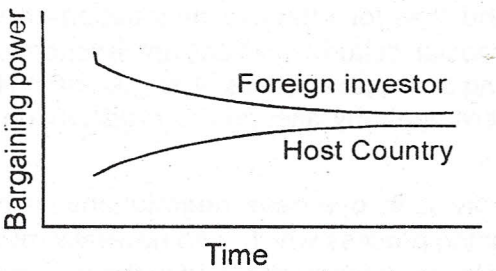
As was mentioned earlier the related bargaining power of the two parties changes over time. Generally, the foreign investor's bargaining strength is greatest before the investment is actually made. Once the investment has been committed, the bargaining strength generally shifts to the advantage of the host country/company. In other words, once the facilities have been constructed and run for some crucial period of time and local nationals trained, the need for foreign firm may be less felt. It might be thought that the operations are well within the abilities of the host country's nationals who could manage without the help of the foreign investor. In a sense, the firm becomes a hostage to the host government authorities. Knowing the "captive" nature of capital assets involved, host government may be tempted to change the terms of existing agreement unilaterally on the premise that the international firm would accept a modest reduction in profitability, in preference to a large write-down of its assets. This position is vividly portrayed in Figure 12.5. After the facilities have been completed and have been there for some period of time, there might be a strong temptation for the host government to utilise its relatively stronger position to demand renegotiation of the investment contract to the government's advantage. Knowing the potential for this pattern in advance, management should try to negotiate the initial agreement that embodies a safety margin for the firm's profit in the event of further unilateral unfavourable decisions by governments. Management might also consider actions designed to reduce the risks arising from opportunistic behaviour on the part of foreign governments. One way is to include local investors in the international activity. This encourages the host government to maintain a favourable attitude towards initial agreement. Another way is to establish and nurture an infrastructure of local suppliers which may enhance the company's long-term relationships with host governments. Through these ways the company can manage its political risk, above and beyond the negotiation strategies, over the life of an international business venture.

Figure 12.5: Relative Bargaining Power: A



Since the host government has sovereign authority and since the governments relative strength increases once the investing company has committed its resources, the company needs to demonstrate that it continues to bring net advantage to the country. A continuing infusion of capital or technology, plant expansion, export markets and purchases from within the host country or sales to affiliated organisations abroad (i.e. vertical integration) are excellent means (or bargaining weapons) to demonstrate its continuing usefulness to the host country. This is especially effective if there are no other sources or customers for the subsidiary. Thus the bargaining power of the company may remain above that of the country for extended period as shown in Figure 12.6.

Figure 12.6: Relative Bargaining Power: B



Several efforts have been made in the past towards drawing a **code of conduct** to guide foreign investors in their operations in host countries. Two of the many codes of conduct were designed, one by the United Nations (basically reflecting the host country's perspectives) and the other by the International Chamber of Commerce (reflecting the corporate viewpoint). These codes of conduct, elaborately discussed in unit 17 (block 5), can serve as useful guidelines for helping foreign investors avoid "inappropriate" behaviour. They can also guide host governments in terms of what to expect from foreign investors. However, these codes cannot insure an investor against all troubles with the host country. Moreover, the codes themselves may not be completely applicable in many investment situations. Although they can be useful guidelines, they must be used with discretion.

Activity 2

Try to find out if your organisation has been involved in negotiations on international level over the last few years. How did your organisation prepare itself before entering into the negotiations? What strategy has your company evolved to manage the negotiations?

After discussions with the concerned people, mention the salient points on how negotiations were managed.

.....

.....

.....

12.6 NEGOTIATING SKILLS :

In addition to the respective bargaining power of the negotiating parties, the decisive factor in determining the outcome of a specific bargaining situation is the negotiating skills of the persons involved in the negotiation process. The understanding of psychology and sociology of negotiations is therefore extremely important. The question: how people perceive each other, how they interact, how the ambience of interaction can be altered, how confidence and trust can be established are relevant and determine the outcome of negotiations. In the negotiation process, as we have noted earlier, even threats and intimidating tactics are used.

The psychological and social dimensions mentioned above affect all types of business negotiations. However, the problem can be more serious in international business negotiations due to conflicts arising from different economic, political and social environments, different cultural influences, and in many cases, different languages.

It is in this background that for effective negotiations one author has laid stress on understanding the underlying social, cultural, political, and economic systems as well as expertise in technical, financial, accounting and legal analyses. Any international firm can enhance its leverage in negotiations with host governments by altering the organisation and behaviour of the firm in specific ways.

Before becoming involved in overseas negotiations, a manager should have some experience of handling bargaining process which is somewhat similar to the future experiences in the foreign sphere. For example, experience obtained in the process of acquiring or taking over a domestic company would prove to be a source of strength while acquiring a local firm in a foreign country.

The development of negotiating skills require instructions, training and guided experience in actual negotiation situation. There has been a widespread belief in the Third World that host countries are at a sharp disadvantage as to the negotiation skills in dealing with multinationals. However, the learning experience of host countries, on the whole, has improved over time. Besides, several international agencies have been providing technical assistance to the developing countries in their negotiations with foreign governments. In some cases host country government and firms have sent officials abroad to learn more about how multinationals operate and for improving their negotiation skills. Multinationals have also become increasingly sensitive to the needs of the developing countries and have trained their international managers for negotiating under cross-cultural situations.

Simulation and role playing exercises, based on actual case histories, have been used as valuable devices for training negotiators, especially for projects requiring approval of a foreign government. By practicing their own roles and those of the governments negotiators and by

researching the culture and history of the country to determine its attitude towards foreign investors, business executives can be in a much better position to anticipate responses and plan their own actions. Instead of limiting to one's own pre-conceived static positions, negotiators can prepare for their meetings by practising role rehearsal.

A number of Indian firms are endeavouring to reach beyond the borders. Why and how they are preparing their corporate executions to overcome barriers of culture and etiquette, see Box 12.2.

12.2 : Cross - Cultural Training : New Tricks of the Trade

When executives at Texas Instruments-India (TII) first met their counterparts from Japanese electronics giant Hitachi, the Indians made it a point to squeeze in their age along with the preliminary introductions. No, it was not part of a brave attempt to embellish their credentials, but a deliberate strategy to play on a cultural nuances of the Japanese who set great store by the age of the person they are dealing with.

And when they got down to business, the Indians relied more on charts an figures than the usual sales spiel. They had been fore-warned that long discourses would not catch the Japanese attention. No, thumping of desks to make a point, they were told, because the Japanese would see it as a display of aggression. The subtle game continued till the excessively polite and Patient Japanese decided to unwind after the discussions were concluded. The upshot of these negotiations is that the two companies are now involved in a project to develop memory-integration circuits. Says BM senior product-development manager, TII: "The customs in japan were far removed from Indian or western practices. But we could still fit in very easily.

The trouble TII took to keep the Hitachi team at ease underscores a subtle shift in corporate thinking towards equipping executives with cross-cultural inputs that can help them avoid gaffes while dealing with the diverse attitudes and life-styles of overseas negotiators.

Several companies are now impressing upon executives that in the esoteric world of international trade negotiations, an out-of-turn eye contact could derail a deal in one environment, and the lack of it could equally leave them in the lurch elsewhere. Among the first to focus on cross-cultural inputs. TII has put several employees through a specially designed cultural diversity programmes that helps participants know better the country and the people they are doing business with.

BM whose job involves constant interaction with foreign clients, can now hold his own with the Japanese, deal with the highly individualistic style of the Americans and settle down to the laid-back pace of the Italians. In fact, infotech players such as TII and the Bangalore-based software from Infosys, are leading the race to equip managers with cross-cultural skills. Infosys has roped in foreign as well as Indian trainers and evolved a system which teaches employees how to converse and negotiate with foreign clients and conduct themselves in alien cultures as different nationalities have different ways of doing busir ess. "The employee becomes that much more effective and productive with such in puts." says NN deputy managing director, Infosys, explaining that the extra focus is needed to succeed in the competitive global market. Venturing beyond mere etiquette and language skills, companies are exposing employees to the finer points of clinching deals abroad and driving home the message that even seemingly minor details count. Those in the know say the Indian penchant for interspersing conversations with "fine" could land a negotiator in trouble if he happens to be in America. And in Scandinavia, eager-beaver executives will do well if they manage to suppress the irresistible? "Do you understand?" poser which often leaves clients annoyed. Similarly, you have to brace yourself for lenghty and detailed meetings while in Japan, but learnt to be brisk and precise in Germany.

As boardroom behaviour abroad is laced with such subtleties, companies are understandably keen to ensure that their representatives do not collapse with egg on their faces. Says AS, who moved from Tata Consultancy Services to Smith Newcourt, Hong Kong; "Multicultural training helps build an employee's self-confidence. You know how to react to a particular situation without ending up looking like a fool."

Even in remote Tirupur in Tamil Nadu, the hub of the knitted-garments export industry, the exports' association provides its members with extensive tips on how to conduct business abroad, including making appointments, starting discussions, negotiating techniques, picking business gifts and even using the telephone.

Eager to wrest the maximum advantage, several corporate advantage, several corporate bodies are now chalking out training programmes to bridge the difference between cultures and to help understand the nuances of how business is done beyond the borders. Says PK, organisation development consultant and human resource development (HRD) manager at Alpic Finance: "Doing business within --say, Asia--is a complex thing. Despite the cultural similarities, there are subtle differences which have to be considered." And Alpic Finance, which plants to open an office in Bahrain, is doing exactly that. Before it sets up shop there, its Indian staff will be familiarised with Arabian culture.

But cultural awareness alone is not enough. It has to be conveyed across the table through body language. ABB's programme on negotiation skills for its domestic and international supply managers lays a accent on body language and behaviour in different cultures. Says ABB General Manager (HRD) YS. "If a Frenchman brings his thumb and index finger to form a circle, he means thing are perfect. But in certain other cultures, the same gesture would mean a zero." YS adds that even if companies do not have structured training programmes in cross-cultural skills, frequent international exposure provides managers with a global perspective. :" Most of them learn to listen, observe and understand before responding."

Meanwhile, the stress on cross-cultural inputs has spawned numerous training programmes. Delhi-based RM's Corporate Arms conducts 'Globetiquette' RM's started off by training executives on etiquette and soon the programme was expanded to cover issues such as how to overcome cultural barriers. Some of the companies that have tapped these inputs in RM's programmes include HCL-HP, Ranbaxy and ANZ Grindlays Bank.

RM says several executive who participated in her programme had abundant job expertise but were making their debut on the international stage. "Knowing about the culture you are dealing with ensures that extraneous factors do not negatively affect the outcome of a business negotiation, "she says. Another player, the Hyderabad-based Centrax Services, which organises workshops on contemporary management practices, is planning a series on multicultural management with experts from the US. Centrax's AK warns that cultural insensitivity could destroy a business relationship. "Multinationals such as Sony, Nissan and Motorola place tremendous emphasis on cultural-sensitivity training. This awareness is spreading in India. AK says companies such as Bombay Dyeing and Bakelite Hyelam have shown a keen interest in equipping their managers to be more effective in negotiations with foreigners.

Most companies are culturally sensitising employees who interact with their counterparts of other nationalities. Infosys, for instance, trains all sales and software engineers who are on projects abroad, who account for 50 percent of its 800 employees. The company even provides a foreign-travel manual which list the basics on travelling and doing business abroad. Says HR vice-president (HRD): "Often, language is not a barrier but other less obvious things are."

However, opinions differ on whether the companies can reap tangible benefits from the move, Sceptics point out that, at best, the exercise may help managers set the right stage for starting negotiations, but the outcome will depend on the inherent strengths of the firm and the credibility of its plans. But, as companies expand business borders, Indian managers can no longer afford to ignore the differences in customs and traditions of various societies. Ignorance about the naunces of a particular culture build up prejudice and lack of tact could show the company and the country in poor light. Ranbaxy's HRD chief PKS says: "When people poorly trained to recognise cultural differences are sent to do business it undermines the very objective of their work."

Adopted from India today, April 15, 1995 pp-102-103.

12.7 RE-NEGOTIATION :

Normally in commercial relations a contract between two parties is a legally binding agreement for the duration of the contract. However it is not unusual for the parties to renegotiate or rebargain contracts even before their expiry. Renegotiations may take place when market conditions shift substantially against one of the parties to the contract. For example, a borrower may be able to renegotiate a fixed term loan when interest rates have fallen. These situations are especially likely when the party in the more favourable position. (i.e. the lender in our case) is anxious to do more business with the party in further.

Investment contracts with a host government are sometimes renegotiated. The changes in the objectives or goals of the government or the objectives of the new government that comes into power in the host country may necessitate retrospective changes in the contract. One of the most common cases of demand for renegotiations may relate to the governmental perception that the foreign investment is no longer making significant marginal contributions to the host country. What the government likes to see is that the foreign investment continues to make marginal contribution over and above what domestically owned company can make. The government's perception may be that the advantages are far fewer than the disadvantages arising from the investment, for example, a continual drain upon the balance of payment in the form of outflows of profits, fees, and even capital. As discussed earlier, it is therefore in the interest of foreign investor that it continues to provide a unique contribution via continual inflows of new technology, such as in electronic or computers, via expanded local investments, or via providing continuing access to captive foreign markets. Renegotiation may also be resorted to by a host government or company when it learns that the bargaining power of the MNE has substantially declined. This was elaborated in Section 12.5.

12.8 ARBITRATION OF DISPUTES :

Despite all the efforts of the parties, disputes may sometimes arise. The differences can occur even when two parties otherwise wish to continue working together. The contracts entered into as a result of negotiations often provide for legal alternatives which would be open to the parties. The local courts may be accepted by a foreign company as having the appropriate jurisdiction. However, the legal system in the other country may be considered by the investing company as not being sufficiently independent of governmental influences, or may be viewed, philosophically, biased against the company. Accordingly, the investing company may not deem it as an appropriate avenue for setting its dispute with the country. The company may insist on the legal system of its home country if the same is acceptable to the other party. However, it is also possible to select a neutral jurisdiction, noted for its efficiency and independence. In addition to the

use of usual legal channels, there are three multinational channels that might also be of assistance. One is to seek the intermediation of some third party or agency, including one of the several organisations available for international arbitration, such as the Geneva Arbitration Tribunal. In 1969 the World Bank created the International Centre for Settlements of Investment Disputes (ICSID) to provide a channel for binding arbitration between an investor and a host country. The host country must be a member of ICSID (only Governments can be members). One final legal avenue is the International Court of Justice in The Hague in Netherlands. Only governments can represent cases to the International Court. Therefore, a company could only utilise this channel if its host government is willing to present its case.

Support from home country's governments :

Frequently, the home-country government plays an intermediary role, either by applying informal pressure on the host government or by challenging host-government policies in the international court. In extreme cases such as refusal of a host government to negotiate of in the case of outright confiscation (or expropriation) the government of the investing company, (i.e. home country) may take direct action against the host country. This is a very unfortunate situation. However, whether action would be taken or not depends on the sensitivity of the home country's government, magnitude of the problem and its long term outlook.

All investment one risky whether made domestically or internationally, Governments should tend to avoid the temptation to bail out a home company's investments abroad. A government has responsibilities that are far greater and more important than protecting individual or a group's international operations. Though the days of gun-boat diplomacy seem to be behind us, instances can still be seen on international horizon when the interest of the home country's companies are aggressively backed up or supported by the Government. International power politics is still very much with us. Only the weapons have been updated. They are now generally economic or political. It would be ideal for governments to remain aloof from the international activities of their companies. Private business problems in fact should not become the basis for international relations. However, in reality governments are willing to be involved especially if the investments are made in developing countries in support of governmental policies. Also since the other countries are doing the same thing to encourage and protect their own companies, competitive pressures between governments encourage them to offer comparable protection to their companies.

12.9 COMPARATIVE (CROSS-CULTURAL) NEGOTIATING STYLES :

We had discussed four phases in the cross-cultural negotiation process and had noted the differences in styles and behaviours of negotiators from different cultural backgrounds. Why negotiators behave the way they do? The answer probably lies in the underlying values and philosophies of different cultures. We suggest that you carefully go through tables 12.2 and 12.3 which would reveal some very interesting facts. It is, important for a negotiator to understand the underlying beliefs, values and philosophies of different cultures. The understanding of the cultural norms would enable him to manage the negotiator appropriately.

The following observations are based on the various research findings that have been undertaken on this subject. However, these findings, which are general in nature, should be taken with a pinch of salt. Firstly, because some of these research studies were conducted long ago. Things might have changes. Secondly, because of the policies of liberalisation and globalisation pursued by many countries, developed and developing, over the past decade or so, countries, are trending to come closer to each other. The interaction among nationals of different countries has

substantially increased. The cross-cultural differences might, therefore, be sinking. The world seems to be moving form greater cultural heterogeneity to lesser heterogeneity or lesser homogeneity to greater homogeneity.

Table 12.2: Comparison of Negotiation Styles – Japanese, North American, and Latin American

Japanese	North American	Latin American
Emotional sensitivity highly valued	Emotional sensitivity not highly valued	Emotional sensitivity valued
Riding of emotions	Dealing Straightforwardly or impersonally	Emotionally passionate
Subtle power plays; conciliation	Litigation not so much as conciliation	Great power plays; use of weakness
Loyalty to employer; employer takes care of employees	Lack of commitment to employer; breaking of ties by either if necessary	Loyalty to employer (who is often family)
Face-saving crucial; decisions often made on basis of saving someone from embarrassment	Decisions made on a cost benefit basis; face-saving does not always matter	Face-saving crucial in decision making to preserve honor, dignity
Decision makers openly influenced by special interests	Decision makers influenced by special interest but often not considered ethical	Execution of special interests of decision maker expected, condoned
Not argumentative; quiet when right	Argumentative when right or wrong, but impersonal	Argumentative when right or wrong; passionate
what is down in writing must be accurate, valid	Great importance given to documentation as evidential proof	Impatient with documentation as obstacle to understanding general principles
Step-by-step approach to decision making	Methodically organised decision making	Inmulsive, spontaneous decision making
Good of group is the intimate aim	Profit motive or good of individual intimate aim	What is good for group good for the individual
Cultivate a good emotional social setting for decision making; get to know decision makers	Decision making impersonal; avoid involvements, conflict of interest	Personalism necessary for good decision making

Source: Pierre Casse, *Training for the Multicultural Manager: A Practice and Cross-Cultural Approach to the Management of people* (Washington, D.C.: Society for International Education, Training and Research, 1982)

Table 12.3: Comparison of Negotiation Style – North Americans, Arabs, Russian

Primary Negotiating	North Americans	Arabs	Russians
Style and Process	Factual: Appeals made to logic	Effective Appeal made to emotions	Axiomatic Appeals made to ideas
Conflict: Opponents Arguments Countered with...	Objective facts	Subjective feelings	Asserted ideals
Making Concessions	Small concessions made early to establish a relationshipp	Concessions made throughout as a part of the bargaining rocess	Few, if any, small concessions made
Response to Opponent's Concessions	Usually reciprocate opponent's concessions	Almost always reciprocate opponent's concessions	Opponent's concessions viewed as weakness and almost never reciprocated
Relationship	Short-term	Long-term	No continuing relationship
Authority	Board	Board	Limited
Initial Position	Moderate	Extreme	Extreme
Deadline	Very important	Casual	Ignored

Adapted from E.S Glenn, "Cultural Styles of Presuasion," International Journal of Intercultural Relations 1 (1984)

We shall now briefly summarie the styles and underlying value, and philosophies of negotiators from same countries.

United Sates of America :

A successful American negotiator knows when to compromise. He takes a firm stand at the beginning of the negotiation and refuses to make concessions before hand. He often keeps his cards close to his/her chest and accepts compromises only when the negotiation is deadlocked. He sets up the general principles and delegates the detailed work to his associates.

An American negotiator keeps maximum options before negotiations. He operates in good faith and respects the opponent and states his position as clearly as possible. He is usually briefed about the issues of negotiation. He has a good sense of timing and is consistent. He attempts to make the other party reveal his position while he keeps his own position hidden as long as possible.

Americans often plunge straight to the matter on hand, whereas negotiators particularly from the East want instead personal rapport to develop over a period of time. Americans are business-like in negotiations. Their factual appeals are based on what they believe in objective informatior presented with the assumption that it is understood by the other side on logical basis.

Arabian Countries :

Arabian Countries, following Islamic tradition use mediators to settle disputes. The Arab negotiators are very much concerned about their honour, self-respect and dignity. They try to avoid putting themselves into situations where they have to show weakness or admit defeat. They like to avoid direct confrontation and attempt to come up with honorable solutions for all parties. They would try to resist all kinds of pressure that the opposite party might try to exercise on them. In their conversation, they would often refer to people who are highly respected by the opposite party with a view to persuade them to change their minds on the issues.

Brazil :

Brazilians negotiators use a "receptive" style of influence which is a blend of "linking" and "seducing" approaches. Linking involves the desire to understand the frames of reference of the other party by searching for points of agreement, listening and empathetic behaviours. The other party is encouraged to participate in the discussion fully. Seducing involves the desire to win the opposite party over to one's side. This is achieved by ensuring influence, admitting mistakes, motivating others, praising them and raising their spirits through gracious behaviour. As revealed in Table 12.2, Brazilians talk more, touch more and look directly at the other party more than the Japanese or the Americans do. This **non-verbal** behaviour reflects active linking and seducing activities.

Unlike Americans, Brazilians do not value persuasion in the negotiation process. They depend on personal relationships because they know that they cannot depend upon the legal system to iron out disputes which might crop up later. The linking and seducing behaviours are aimed at engendering trust, obligation and friendship between negotiating parties.

Overall, it may be stated that Brazilian negotiators are open minded, cooperative and receptive, while they believe less in direct persuasion and exertion of pressure.

Peoples Republic of China :

In the initial stages of negotiations Chinese negotiators prefer to seek agreement on generalities with the other party. They try to avoid dealing with specific details altogether and prefer to leave them for later meetings. It is perhaps due to the Chinese cultural values. The approach of agreeing on general principles allows the Chinese to adopt a mental framework for the negotiation process from which to work. Many Westerners are not able to appreciate this approach of the Chinese. After the Chinese establish a cordial relationship with foreign negotiators, they use this relationship as a basis for give-and-take in business discussions. The Chinese expect Western firms to sacrifice corporate goals to Chinese national goals and principles, such as meaningful friendship, Chinese national development, and the growth and enhancement of Chinese people. Misunderstandings occur when Americans show polite acceptance of these general principles without understanding their significance. The experience shows that the Chinese put pressures on Americans by shamming them, thereby implying that the Americans are trying to renege on the friendship – the basis of implicit contract.

Chinese put much greater emphasis than American on respect and friendship, on saving face, and on group or national goals. Their emphasis on social obligations and their belief in the interconnection of work, family and friendship underlies their strong orientation toward collective goals.

Two major problems usually confronted by businessmen with Chinese are that they want great amount of detail about product characteristics, and that they are insincere about reaching an agreement.

Chinese negotiators frequently have little authority which frustrates the other who have authority and are ready to conclude a deal.

The Chinese negotiating team is usually about twice as large as the Western team.

The Chinese are said to be among the toughest negotiators in the world. They use various tactics, such as their delaying techniques and their avoidance of direct, specific answers. all these plays are meant to exploit the patience of the other party.

While American negotiators tend to approach negotiations sequentially, i.e. they divide the issues into parts and settle them one at a time. The Chinese negotiators do not make any concessions in the course of negotiation. The concessions come only at the end. The Chinese thus follow a holistical rather than a sequential approach. The style of the latter is more cognitive. They would not concede on things which do not fit into their total mental framework. Once the perception of the final settlement is in place in their minds, only then would they make the concessions.

Because of the emphasis on harmonious personal relationships. The Chinese try to avoid confronting the other party in negotiations at all costs. The confrontation tactics may create a feeling of deep personal shame in the Chinese minds.

Japan :

Much of the Japanese culture and the basis of Japanese working relationships can be explained by the principle of **was** meaning "Peace and harmony". This principle is one aspect of the value they attribute to **amae** meaning "indulgent love", a concept probably originating in the Shinto religion which focuses on spiritual and physical harmony. The Japanese identify strongly with their working groups, where the emphasis is on cooperation, participative management, consensus on problem – solving and decision making based on patient and long-term perspective. Open expression or conflict is discouraged, and it is of utmost importance to avoid embarrassment or shame i.e. to lose face as a result of not fulfilling one's obligations. The culture of collectivism and shared responsibility underlines the Japanese **ringi** system of decision making.

The Japanese are calm, quiet, patient negotiators and are accustomed to long detailed negotiating sessions. They want to get to know those on the other side and spend sometime in **non-task** sounding i.e. general polite conversation and informal communication before meeting. Because of Japanese culture of politeness and hiding of emotions, they are unable to get straight-forward eye contact but maintain smiling faces even is serious situations. The persons negotiating with the Japanese should avoid anything that resembles boasting because the Japanese value humility and like to avoid physical contact. They would like to leave the room rather than give a direct negative answer. They view decisions carefully in the light of long-term consequences, and are objective and analytic and take time for reflection.

India :

Indian negotiators generally exhibit firmness for a good cause. This approach combines with strength with the love for truth. Successful Indian negotiators look for and say truth and are not

afraid of speaking up. They generally exercise self-control, seek solutions which will please all the parties involved. They respect the other party and do not use any violence or insult. They are ready to change their minds and may even differ with themselves at the risk of being seen inconsistent and unpredictable. They are generally humble and trust the opposite party, and are tenacious, patient and persistent.

Italy :

Italian negotiators, in general, have a sense of drama and do not hide their emotions. They read facial expressions and gestures very well and usually do not trust anybody. They believe in the individual initiative and not so much in team work. They feel good when they have to oblige. They generally do not have definite opinions. They are quite capable of giving up with new ways to immobilise and eventually destroy the opposite party. They in general have flair for intrigue and flattery.

Russia :

Russia is a country where negotiating style has been considered confrontational by Westerners. (Here, we are talking about undivided Russia, i.e. before its break up into CIS).

Historically Russian negotiators have been secretive about themselves, their motives and their goals for negotiations. This could be attrib .ted to the type of economic and social system that prevailed in the Russia which kept them isolated from the international business community. They have a general distrust of foreigners.

The negotiating behaviour of the Russian has been variously described by Westerners as rigid, stubborn, inflexible, confrontational and competitive. Within the Western ethical systems, it is considered positive to seek compromises in order to resolve conflicts and come to an agreement. However, within Russian ethical system the very word "deal" has negative connotations, and any one seeking compromise is considered cowardly, week and unworthy.

Because of historical reasons, the word "profit" has a negative connotation and implies exploitation. The Russian negotiators do not view negotiation as a means of achieving higher profits for their organisations, nor as a vehicle for furthering personal goals. "Instead they view the negotiation process as an opportunity for "right" to succeed over the American perspective.

Historically, Russians have been extremely reliable in honouring their contractual agreements. Although they drive a very hard bargain in contract negotiations, they faithfully abide by its provisions and expect the other party to do the same. They have an excellent record of honouring their financial commitments.

Russians enter into negotiations well prepared. They are well-versed in the specific details of the matter being presented. They put a lot of emphasis on protocol and expect to deal with top executives.

Sweden :

Swedish negotiators are very quiet, thoughtful, punctual and extremely polite. They are straight-forward and get straight down to business, and tend to be productive and efficient. They adopt down-to-earth approach, and are quite good at holding emotions and feelings. They are informal and afraid of confrontation. However, they are quite slow at reacting to new (unexpected) proposals.

Activity 3

Arrange a meeting with the Chief Executive of the Company with which you have been associated and ascertain if the company had entered into any major negotiations at international level on any aspect e.g. collaborations, technology transfer, strategic alliances, licensing agreements etc.

After detailed discussions with him, list the salient features relating to the negotiating parties.

.....

.....

12.10 SUMMARY :

Negotiations have increasingly been used as a means to arrive at important agreements which become the basis fro starting a new business activity. The managers therefore must prepare themselves for certain cultural variables, including the relative emphasis on task versus interpersonal relationships, the use of general principles versus specific details, the number of people present and the extend of their influence.

All negotiations are a part of the communication process. Therefore, effective communication skills are very important.

The negotiation process typically progresses through the stages of preparation, relationship building, the exchange of task related information, persuasion, and concessions and agreement. The process of building trusting relationships is a pre-requisite for doing business in many parts of the world. The culturally based differences in verbal and non-verbal behaviour and tactics influence negotiation process at every stage. Such tacties and actions include promises, threats, initial concessions, silent periods, interruptions, facial gazing, etc. Some parties may even resort to various dirty tricks.

The effective management of negotiations requires an understanding of the perspectives, values and agenda of the other party and the use of problem solving approach.

Sometimes, due to unexpected developments, agreements or contracts may have to be renegotiated.

It is in the interest of multinationals to adopt policies which are seemed to be contributing to the national welfare of the host country. They may sometimes have to dispel false impressions created by the media regarding their international business activities.

Despite all the efforts of the parties, disputes may sometimes arise. The company has to take a decision on which one of the several mechanisms available it could rely upon. One such mechanism is the agency created by the World Bank, viz. International Centre for Settlement of Investment Disputes.

In the concluding part of this unit, we attempted a comparative review of the cross-cultural negotiating styles with a view to familiarise the prospective negotiators with the typical traits of the negotiators from different countries so that they could plan and prepare themselves well before undertaking negotiations.

12.11 KEY WORDS :

Arbitration: Settlements of disputes by recourse to a third independent agency. The arbitrator may be an individual or a body of individuals.

Bargaining Power: The power that one or both the parties in negotiation derive from the ownership of the resources—technology, financial, manpowers managerial capabilities, etc.

Projective Cognitive Similarity: Assumption that other perceive, judge, think and reason the same way as we do.

Ringi: The bottom-up approach of Japanese wherein a proposal may first be circulated to the concerned persons throughout the organisation for their approval. It represents a culture of collectivism and shared responsibility.

Self Analysis: Analysis of one's own personality characteristics, attributes or strengths and weaknesses.

Stereotyping: Categorising a group of people, or a society, or a nation based on some common features, such as nationality, race or religion.

12.12 SELF-ASSESSMENT QUESTIONS :

1) "Negotiation should be seen in the context of human communication; managing negotiation is in fact managing communication". Explain and discuss the barriers to cross-cultural communications.

2) Identify some specific non-verbal aspects of communication that are important for negotiations in India. Discuss how these non-verbal aspects affect the effectiveness of negotiations.

3) Discuss the stages in cross-cultural negotiation process, citing relevant research findings in relation to each stage.

4) Highlight the importance of planning and preparation for negotiations. In what way can the negotiators plan and prepare themselves well before undertaking negotiations?

5) Explain the concept of bargaining power of the parties. What are the sources which give rise to bargaining strength? How can a party maintain its bargaining strength over the entire period of the contract?

6) How can a company manage its negotiations effectively? Explain fully.

7) What role do negotiating skills play in the process of negotiations? Suggest some ways and means by which a company could enhance the negotiating skills of its managers.

8) What is renegotiation? What might be the causes for renegotiating contracts?

9) What is arbitration of disputes? What channels for arbitration of disputes might be available to a multinational enterprise? What role, if any, the government of the home country of the company could play in setting disputes?

10) Write an essay on the cross-cultural aspects of negotiating styles of three countries of your

choice.

12.13 FURTHER READINGS :

Brooks, Earl and George S. Odiorne, 1984. *Managing by Negotiations*, Van Nostrand Reinhold: New York.

Casse, Pierre, 1985. *Managing Intercultural Negotiations: Guidelines for Trainers and Negotiations,* Society for Intercultural Education, Training and Research: Washington, D.C. Fisher, G. 1980. *International Negotiation: A Cross-Cultural Perspective,* Intercultural Press: Chicago.

Graham J.L. & R.A. Herberget, 1983. "Negotiations Abroad—Don't Shoot from the Hip," *Harvard Business Review*, July-August, pp. 160-168.Graham John L., 1983. "Brazilian, Japanese and American Business Negotiations", *Journal of International Business Studies*, Spring – Summer, pp. 47-61.

REFERENCE :

1) Alder, N.J., 1991. *International Dimensions of Organisational Behaviour*, PWS-Kent Publishing Co., Boston, PP. 195-200.

Graham, J.L., 1985. "The influence of Culture on the Process of Business Negotiation: An exploratory Study", *Journal of International Studies,* Spring.

Graham, J.L. and R.A. Herberger, 1983. "Negotiations abroad - Don't shoot from the hip", *Harvard Business Review* July - August, pp. 160-168.

2) Copeland, Lennie and Lewis Griggs, 1985, *Going International,* Random House, New York, p. 85.

3) Tung R, 1971. "Handshakes across the Sea: Cross-Cultural Negotiating for Business Success", Organisational Dynamics, Winter, pp. 3-40.

4) Raiffa, Howard, 1982. *The Art and Science of Negotiation*. Harverd University Press, Cambridge, Mass, p. 8.

5) Fayer weather, Johan and Ashok Kapoor, 1976. *Strategy and Negotiation for the International Corporation,* Ballinger Publishing Co., Cambridge, Mass, pp. 29-45.

6) Ibid, pp. 47-49.

BLOCK 5 MULTILATERAL ARRANGEMENTS

In today's environment, an international manager operates in a world system of nation states and international agencies. These two types of bodies may have conflicting roles and objectives. While nation states frequently regulate trade and business (including international trade and business) to achieve domestic goals, the objectives of international organisations or agencies are to promote trade and business and generate a movement towards world economic integration.

The environment of international business is affected by international organisations or agencies who, ever since the conclusion of World War II, have been attempting to promote a liberalised trading system. The General Agreement on Trade and Tariffs (GATT), whose objectives have been to reduce tariffs and encourage non-discrimination and settle disputes has been particularly influencing the liberalisation of international trade. While GATT embodies multinational negotiations, several nations have entered into regional trade cooperation agreements. Though these agreements have lowered trade barriers amongst the member nations, they have broken the GATT's non-discrimination rule. There are three types of agreements : free trade areas, custom unions, and common markets. The best known example of trade groupings, as you might be aware, is EEC(now renamed as the European Union). Since its establishment, EEC has been able to eliminate tariffs, reduce non-tariff barriers, eliminate restrictions on labour movement between countries, reduce restrictions on movement of capital, and develop common policies.

Block 5 examines the major institutions involved in the regulation of international trade, international financial investment, foreign direct investment, technology flows and regional groupings and cooperation. Since these agencies affect the strategies, tactics and operations of a firm engaged in international business, it is necessary that the international manager familiarises himself with the roles, functions and the nature of agreements or arrangements that have been brought about as a result of the efforts of these agencies or organisations.

This block has four units.

Unit 13 : International Business and Developing Countries has its focus on the less developed countries (LDCs), and the place they occupy in international business. It begins with discussing the motivation of the MNEs for doing business in and with LDCs. The unit then examines the issues relating to foreign direct investment (FDIs) in LDCs, and their determinants and impact on the latter. Whether and to what extent the MNEs can play a role in the establishment of new economic order is discussed.

Unit 14 deals with **Regional Trade Groupings and Cooperation.** The dynamics of regional trade groupings are examined. The regional groupings among developed and developing countries are discussed. What has been the experience of these groupings during the 80s is examined. The objectives, scope and functions of some particular trade groupings are then described. An 'Annexure' to this unit gives brief particulars about the main regional groupings among developing countries.

Unit 15 : International Intervention and International Business examines the need for international intervention. It then describes the types of international intervention. The objectives, scope and role of various agencies of the international organisations such as UNO are examined.

Unit 16 : Multilateral Negotiations is in fact an extension or elaboration of the previous unit (i.e. unit 15) and supplements the material with regard to matters relating to the codes of conduct on Transactional cooperations and on transfer technology. It gives detailed historical account of multilateral negotiations relating to these two subjects.

UNIT - 13 INTERNATIONAL BUSINESS AND DEVELOPING COUNTRIES

Objectives

After going through this unit you should be able to comprehend the

- motivations for MNE entry in the developing countries; the patterns and role of MNE investments in developing countries; determinants of domestic market-oriented and export-oriented FDIs in developing countries;
- impact of MNEs on different parameters of development in the host countries; and
- the patterns and nature of foreign investments undertaken by the developing country enterprises.

Structure :

13.1 Introduction
13.2 Motivations for MNE Operations in LDCs
13.3 FDIs in LDCs
13.4 MNEs and New International Economic Order
13.5 Determinants of FDIs
13.6 Impact of FDIs on LDCs
13.7 FDIs from LDCs
13.8 Summary
13.9 Self - Assessment Questions
13.10 Further Readings

13.1 INTRODUCTION :

The role of multinational enterprises (MNEs) in the less developing countries (LDCs) has been a subject of much controversy. The advocates of MNEs emphasise their role in transferring a package of much-needed resources to the LDCs and thus helping accelerate the process of development. Their antagonists argue that MNEs are profit-seeking corporations, and that they perpetuate the dependence of the LDCs on their home countries.

The activities of MNEs are heavily concentrated within the industrialised countries themselves. Less than twenty percent of the FDI flows find their way into the LDCs. Yet affiliates of MNEs enjoy an important place in the economy of most developing countries. They account for 70 percent of the manufacturing output in Zimbabwe, 63 percent in Venezuela, 32 percent in Brazil, and about 23 percent in India.

13.2 MOTIVATION FOR MNE OPERATIONS IN IDCS :

The MNEs operate in the LDCs for one or more of the following reasons.

i) **To feed the LDCs local markets:** The MNEs seek world-wide markets including those in the LDCs. These markets are served through exports in the first instance. Market defensive local production is undertaken, if the host country policies restrict imports. Examples of this type of operations are virtually all large MNE affiliates in India from Hindustan Lever and Philips to the drug MNEs, such as, Glaxo, Sandoz, Bayer or Pfizer, or engineering giants as Siemens, ASEA Brown Boweri, and so on. Developing countries with large and expanding markets, like India, Brazil, and China, are generally attractive for MNEs to set up manufacturing facilities to tap the local market.

ii) **To obtain access to natural resources and raw materials:** Quite a large proportion of MNE investments in the LDCs are in the extractive and primary commodity producing sectors. These operations are designed to secure an access to the natural resources for their worldwide operations. Examples of this type of investments are the British tea plantations in India and Sri Lanka, IIT's copper mines in Chili, Sesa Goa's (an affiliate of IRI, Italy) iron ore mining activities in India, Unilever's palm oil plantation in Malaysia, and Firestone's rubber plantations in Liberia. Such investments are concentrated in natural resource rich countries.

iii) **To exploit cheap labour:** Advances in product design, transport and communication facilities enable the MNEs to rationalise production across countries to minimise costs. The labour intensive portion of manufacturing processes are relocated into cheap labour developing countries, while capital intensive portions are retained at the home country bases. This phenomenon is called **international division of labour.** In this case an MNE affiliate in an LDC is integrated with its parent and associate companies, vertically. Since the early 1970s, there has been a growing evidence of this pattern of MNE operations in the LDCs. Examples include numerous garment and leather goods factories in Thailand, India, Bangladesh and Sri Lanka that produce for the western MNEs like Motorola's semiconductor chip making facilities in Southeast Asia, and so on.

Relocation of production in the LDCs may not only be to obtain access to unskilled or semi-skilled cheap labour but also to tap cheap skilled technical manpower. For instance, MNEs like Texas Instruments setting up software development plants and Astra (Sweden) setting up a laboratory for biotechnology research in India to tap cheap and abundant supply of skilled manpower. Sometimes, highly polluting industries are relocated in the developing countries to avoid the enormously high pollution abatement costs in the industrialised countries. Examples of this type of investments are many, and include shifting of asbestos, pesticides and other agrochemical factories by a number of MNEs from the industrialised to the developing countries.

Thus the MNEs' operations in the developing countries could be motivated to tap the domestic market, to obtain access to either natural resources, or cheap (unskilled or skilled) labour and technical manpower, or to avoid high costs of pollution control in the industrialised countries. The MNE activity, in the first case, are oriented to the domestic market of the host country, and are export-oriented in the rest of the cases.

Activity 1

Indicate the areas of operations and main motivations of the following MNEs that have entered India recently.

MNE	Area of Operation	Motivation
a) Bausch & Lomb	.....	.....
b) 3M	.....	.....
c) IBM	.....	.....

13.3 FOREIGN DIRECT INVESTMENT IN LDCS :

The magnitude of global flows of FDI has grown at a rapid pace over the past two decades. The growth has been particularly steep since the mid 1980s. Table 13.1 shows that FDI flows have grown from US $ 11 billion in 1970 to $ 225 billion in 1990. FDIs originate almost entirely in the industrialised countries. An increasing proportion of these flows is also destined towards the industrialised countries.

Table 13.1: Magnitude of World-wide FDI outflows, 1970-90

Year	World-wide FDI flows billion US $
1970	11.2
1979	35.6
1985	53.3
1987	135.0
1989	196.1
1990	225.0

Source: United Nations Centre on Transnational Corporations.

The distribution, according to the source countries, shows that five major home countries, viz., the U.K., the U.S.A., Japan, France, and Germany accounted for 70 percent of total outflows of FDI (see Table 13.2). The U.K. has been the largest home country of FDIs for the overall 1980-89 period with annual outflows of $ 17 billion (20 percent of the world flows). However, outflows from Japan have exceeded those from the U.S.A. since 1986 and surpassed those from the U.K. in 1989. Thus, in 1989, Japan emerged as the largest source of FDIs, accounting for 23 percent of the total world-wide outflows.

Table 13.2: Outflows of Foreign Direct Investment (from five major home countries); 1985-1989

	1985	1986	1987	1988	1989	1980-1984	1985-1989
Home country	(Billion of dollars)					(Percentage)	

France	2.2	5.4	9.2	14.5	19.4	6.0	8.0
Germany, Federal Republic of	5.0	10.1	9.2	11.2	13.5	7.4	7.8
Japan	6.4	14.5	19.5	34.2	44.2	8.9	18.8
United Kingdom	11.1	16.5	31.1	37.0	32.0	19.4	20.2
United States	8.9	13.8	28.0	13.3	26.5	28.1	14.3
Total	33.7	60.2	97.1	110.2	135.6	69.8	69.1
Developed countries	52.1	84.7	132.6	155.4	187.1	98.4	96.8
Developing countries	1.2	1.7	2.4	5.9	8.9	1.6	3.2
All countries	53.3	86.5	135.0	161.3	196.1	100.0	100.0

Source: United Nations Centre on Transnational Corporations

FDIs represent flows of resources, which can be instrumental in expediting the developmental process in LDCs. However, the distribution of FDI inflows between the industrialised and developing countries is increasingly uneven. The bulk of the FDI inflows are hosted by the industrialised countries themselves. Table 13.3 shows that the share of developing countries in average annual FDI inflows has actually declined steadily from about 35 percent during the 1960s and 1970s to 16.9 percent during 1988-89.

Thus developing countries are being gradually marginalised in the distribution of the FDI flows. In the coming years, this trend is likely to intensify further in view of the emerging developments in the world economy, such as, Single European Market, formation of the North American Free Trade Area, Pacific Rim Community, and reform of East European countries.

The distribution of whatever little FDI that flows to the developing countries itself is highly uneven across countries. The bulk of these flows are destined towards a handful of middle income Newly Industrialising Economies (NIEs) in South-east and East Asia and Latin America. As is evident from the Table 13.4, nearly two-thirds of the FDI flows from the developing countries are accounted for by the ten largest host economies.

The least developed countries, for the development of which FDIs could be of critical importance receive only a marginal proportion of FDIs. The Table shows that proportion of the least developed countries in annual FDI flows to the developing countries actually declined from 1.52 per cent, during the early 1980s, to 0.58 percent, in the late 1980s. Further, the least developed countries are the only group of countries, which have lost, not only in terms of shares, but also in absolute terms. The average annual flows to them were of the order of US $ 190 million during the early 1980s, which declined to $ 170 million during the late 1980s.

Table 13.3: Distribution of Global FDI Inflows, 1960-89

(Value in billion $)

Year	Total Global Inflows	Industrialised Countries			Developing Countries		
		Values	%	Share	Values	%	Share

Annual Average 1960-79	13.002	8.473	65	4.529	35
Annual Average 1980-84	49.700	37.200	74.8	12.500	25.2
Annual Average 1985-89	119.000	96.800	81.4	22.200	18.6
Annual Average 1988-89	173.000	143.800	83.1	29.200	16.9

Sources:

1. UNCTC, **Salient Features and Trends in Foreign Direct Investments,** New York: UN, 1983.
2. Group of Thirty, **Foreign Direct Investment, 1973-87**, New York: 1984.
3. UNCTC, **World Investment Report 1991: The Triad in Foreign Direct Investment,** New York: UN, 1991.

The sectoral distribution of FDI flows suggests that manufacturing has attracted only on small proportion of FDI flows. Table 13.5 shows the manufacturing accounts for only about 35 per cent of the total FDI stocks owned by the four major home countries of FDI, viz., the United States, the UK, Japan and Germany. Further, the share of manufacturing shows a declining trend in all the cases over the 1977-84 (from 42 to 36 percent in the case of the U.S., from 45 to 43 for the U.K.; from 34 to 32 for Japan, and from 48 to 43 percent in case of Germany). Extractive sectors and services account for nearly two-thirds of the FDI. Service sectors, especially trading and banking, finance and insurance, account for increasing proportion of FDI. The figures given in the Table relate to the overall FDI stocks. In the FDI stocks in LDCs, it can be expected that the proportion of the primary sectors (petroleum, mining, agriculture and plantations) would be considerably higher, and that of the manufacturing sectors would be even lower.

Table 13.4 Distribution of FDI Inflows Among Developing Countries

(Values in US $ billion)

Host Region and Economy	Average Annual Flows					
	1980-84		1985-89		1988-89	
	Value	%	Value	%	Value	%
Developing Countries	12.50	100	22.20	100	29.20	100
Africa	1.20	9.6	2.60	11.71	3.20	10.96
Latin America and the Caribbean	6.10	48.8	8.30	37.38	10.00	34.25
East, South and South-East Asia	4.70	37.6	10.70	48.20	15.20	52.05
Others	0.54	4.32	0.57	2.57	0.79	2.70

The MNEs are even more selective about the choice of location of export-oriented investments, which are relocated abroad to exploit cheap labour and raw materials. A recent study of the pattern of relocation of production by the American MNEs found the distribution of such investments to be highly uneven across 40 countries. An analysis of the determinants, revealed that the extent of export-oriented production attracted by a country depended, besides cheap labour, on the presence of mineral deposits, industrial capability and infrastructure, and the presence of the free zones, giving them free trading environment. Further, the exports generated from relocation were heavily dependent upon imports from the multinational parent.

Activity 2

Examine the prospects of attracting domestic market-oriented and export-oriented FDIs by India, Bangladesh, Sri Lanka and Singapore, given the determinants of FDI.

.....

.....

13.6 IMPACT OF FDIs ON LDCs :

FDI inflows, generally, have important direct and indirect implications for the national income (output), employment, balance of payments, technological capability, market structure, and other parameters of development in the host economies.

Direct Impact :

FDIs comprise inflow of productive resources, such as, capital and foreign exchange are, generally, accompanied by flow of entrepreneurial and managerial skills and technology. FDIs complement the domestic savings in financing the capital formation in the host country. Thus FDIs contribute to the generation of output and employment. The foreign exchange inflow augments the supply of foreign exchange, which is often scarce in the developing countries. In most cases, however, the projects being set up with FDI is dependent upon imported plant and machinery, and technology. The foreign exchange inflow takes care of these import requirements, partially or fully.

The direct cost of FDI to the host country comprises remittances made on account of dividends on the equity held abroad, interest on loans or suppliers' credits extended by the foreign investors, royalties and technical fees, for transfer of technology and other services provided by the foreign partner.

Unlike foreign borrowings, servicing remittances, viz., dividends in the case of FDI begin after the project starts making profits. However, the servicing burden of FDI builds up very fast, and consumes considerable foreign exchange resources of the host country. Further, these remittances have the tendency to grow over time as the enterprise consolidates and prospers.

Thus, the direct impact of FDIs on the host country includes both positive and negative aspects. The favourable impact is by way of generation of output and employment by complementing the domestic savings and bringing in the much-needed entrepreneurial skills and foreign exchange resource for the developing countries. The adverse impact is on account of growing remittances of

13.4 MNEs AND NEW INTERNATIONAL ECONOMIC ORDER :

The Declaration and the Programme of Action on the Establishment of a New International Economic Order was adopted by the United Nations General Assembly on 1 May 1974. It calls for a restructuring of the world economy with imbalances in world economy with imbalances in world production and trade between the developed and developing countries. To pursue this objective the Second General Conference of UNIDO, held in March, 1975, adopted the Lima Declaration and Plan of Action on Industrial Development and Cooperation. The Lima Declaration stipulates that the share of the developing countries in the world industrial production should be increased to the maximum possible extent, and, as far as, possible, to at least 25 percent of the total world industrial production by the year 2000, while making every endeavour to ensure that the industrial growth so achieved is evenly distributed among the developing countries.

It has been estimated that these targets could be reached only if the industrial output in the developing countries grew at a rate of at least 10 percent year during the entire 1975-2000 period. This endeavour would necessitate a vigorous concerted effort on the part of both the developed and developing countries. The MNEs could play an important role in achieving these targets by restructuring the global pattern of production and relocating labour intensive industries in the developing countries for global sourcing.

The experience of the past 17 years indicates that the Lima Target will remain elusive. The economic prospects of the developing countries considerably worsened in the 1980s due to the debt crisis, negative transfer of resources, sharp fall in commodity prices, resulting in fall in terms of trade of the developing countries, and the new wave of protectionism in the industrialised countries. As indicated earlier, the share of the developing countries in global FDI flows declined steeply. The growth of relocations of production by the MNEs from the industrialised countries has also slowed down considerably. The emerging trends of the formation of regional trade blocks and protectionism in the industrialised world would further intensify these tendencies. In any case, such relocations benefited only a handful of the developing countries in East and Southeast Asia and Latin America.

13.5 DETERMINANTS OF FDI :

FDIs are almost entirely associated with the operations of the MNEs. As indicated earlier the MNEs are attracted by prospects of markets, natural resources and infrastructure.

The empirical studies analysing the determinants of FDI flows across countries found per capita income, growth rate, extent of urbanisation, availability of infrastructure, and political uncertainty to be important factors influencing them. Therefore, countries with higher levels of economic development and urbanisation are more likely to attract FDIs than the agrarian low income developing countries.

A recent empirical study of 46 countries suggests that foreign 'investors' response is strongly influenced by the size and growth of the host nation's economy than by changes in the government FDI policies. Therefore, the economic strength of the nation, and not necessarily the openness of investment regimes, is the primary determinant of where foreign investors will locate. Removing investment restrictions can be effective only when there is economic growth or underlying development potential.

Ten Largest						
Host Economies	9.01	72.08	14.31	64.46	19.26	65.96
Argentina	0.44	3.52	0.73	3.29	1.09	3.73
Brazil	2.10	16.8	1.59	7.16	2.53	8.66
China	0.53	4.24	2.49	11.22	3.29	11.27
Colombia	0.40	3.2	0.56	2.52	0.39	1.33
Egypt	0.56	4.48	1.23	5.54	1.40	4.79
Hong Kong	0.68	5.44	1.65	7.43	2.04	6.99
Malaysia	1.13	9.04	0.83	3.74	1.28	4.38
Mexico	1.50	12.0	2.02	9.10	2.42	8.29
Singapore	1.39	11.12	2.50	11.26	3.29	11.27
Thailand	0.29	2.32	0.72	3.24	1.40	4.79
Least Developed Countries	0.19	1.52	0.15	0.67	0.17	0.58

Source: Adapted from UNCTC (1991) as cited in Table 13.3.

Table 13.5: Sectoral Composition of Outward Direct Investment Stocks of Selected Industrial Countries

(Percentage Share)

	Industry	US		UK		Japan		Germany	
		1977	1984	1971	1981	1977	1984	1976	1984
1.	All Industries	100	100	100	100	100	100	100	100
2.	Petroleum and Mining	23	27	35	29	25	16	4	5
3.	Manufacturing	42	36	45	43	34	32	48	43
4.	Wholesale and Retail Trade	11	11	10	10	14	16	19	20
5.	Banking, Finance and Insurance	18	23	d)	d)	8	10	8	13
6.	Other Industries	5	4	10	16	19	26	21	19

Source: US Department of Commerce, **International Direct Investment: Global Trends and the US Role**, Washington, D.C., G.P.O., 1988, Table 6, p. 98.

dividends, royalties and technical fees in the foreign exchange, which affect the balance of payments. It has been contended, however, that the direct remittances represent only a minor part of the total cost of FDIs on the developing host countries. More significant costs are indirect costs as discussed below.

Indirect Impact :

The indirect impact of FDIs on LDCs also has both favourable and adverse elements as follows:

Among the indirect favourable effects of FDI one could include improvement in the access of the host country to the international markets through association with the MNEs, exposure to new technologies and organisation and management systems. The MNEs can help their developing host countries to expand the manufactured exports with their captive access to marketing outlets in the industrialised countries. They can also help in saving scarce foreign exchange by substituting imports of the host countries. A predominant proportion of FDIs in India has gone into import-substituting projects. Some studies for the Latin American countries have found evidence of favourable spill-overs of the presence of foreign enterprises on local enterprise in terms of improved labour productivity.

FDI can have adverse effects on different parameters of development, such as, balance of payments, local technological capability, employment, market structure, etc.

Balance of Payments :

Besides remittance of dividends, royalties, and fees, as discussed above, operations of the MNE affiliates can affect the balance of payments of the host countries through their import dependence and export performance relative to that of their local counterparts, and through manipulation of transfer prices.

Import Dependence :

The dependence of foreign controlled enterprises on imported capital goods, raw material, components and spares is, generally, higher than that in the case of their local counterparts. This could be because of the greater familiarity of the foreign investors with the foreign sources of goods, and to provide a market for the products of the other group companies. A number of studies of different countries confirm the tendency of the foreign firms to buy a lesser proportion of inputs from the local markets than their local counterparts.

Export Promotion :

It is argued that the foreign enterprises are better equipped to undertake the manufactured exports because of their captive access to information and marketing outlets in the industrialized countries, and their ability to use internationally renowned brand names. The experience has shown, however, that the MNEs are very selective about using the developing countries as platforms for exports. Except for a few countries in the Southeast and East Asia, the experience of the developing countries has been disappointing in this regard. The studies from a number of countries have shown that export performance of foreign affiliates has not been any different, if not worse, than that of their local counterparts. Further, a considerable proportion of agreements concluded between the MNEs and their local affiliates include clauses restricting exports of the latter.

Transfer Pricing :

The MNEs also use manipulation of transfer prices to covertly transfer surpluses of the affiliates to the headquarters. The transfer price is the price at which intra-firm (i.e., between two affiliates of a MNE) trade takes place. Hence, imports of raw materials, spare parts and capital goods of the affiliates from the parent or other associates (and exports of affiliates to them) take place at transfer prices. Since the transfer prices are determined by the foreign parent, there is ample scope of their manipulation to their advantage. There is considerable evidence from India and other developing countries of indulgence of the MNEs in manipulating transfer prices to the disadvantage of the host nations. The extent of manipulation in certain cases exceeded 100 per cent.

Thus, FDIs affect balance of payments of the host countries, not only through initial capital inflows, foreign exchange spent on capital goods imports and servicing remittances, but also through foreign exchange generated through exports or saved through import substitution, imports of raw materials and components, which could be unreasonably high, and through possible manipulation of transfer prices.

Technology Transfer and Local Technological Capability : FDI is considered to be a vehicle of technology transfer. It is contended, therefore, that the FDI flows provide their host countries access to sophisticated and complex technologies. But the theoretical propositions and empirical findings suggest that FDI by itself does not necessarily improve the access of the host countries to more complex technologies.

Over the past four decades, arm's length licensing has emerged to be a viable and increasingly significant alternative to FDI for technology acquisition. Internalisation theory is presently used to explain the FDI flows and foreign operations of firms. According to this theory, FDI is likely to be preferred as a mode of foreign production, if goodwill assets like brand names are included in the transfer (because of the need of maintaining quality) or where knowledge is idiosyncratic and, hence, its transfer requires movement of the personnel. New proprietary process technology, or process technologies that are standardised, and which can be written down and transmitted objectively, can be transferred easily through licensing.

The recent empirical studies confirm that it is not the more complex of sophisticated technologies that are transferred most through FDI. It is the technology for production of differentiated goods, sold under brand names with high advertising and marketing outlays, that is most likely to be transferred through FDI. It is because of these tendencies that most developing country governments have evolved entry regulations to screen proposals of FDI and licensing collaborations according to the national priorities and technological gaps.

In any case, FDIs or licensing agreements envisage transfer of production know-how. The know-how, or design capability is rarely provided by the foreign collaborators to the recipient enterprises, and that is the most important component of building local technological capability. The know-how is to be absorbed through learning by doing, reverse engineering, or during the process or product adaptations and R & D activities. In the case of FDI, the foreign collaborator is also participating in the management controlling the technical functions. In these cases, therefore, the chances of the importing enterprise learning though processes, such as, reverse engineering are very limited. In-house R & D activity of the MNEs is usually centralized on a global or regional

level, feeding all the affiliates. Several surveys have confirmed the MNE's tendency to concentrate R & D activity near headquarters or in the developed countries.

A recent study found the foreign controlled firms in India to have lesser propensity to undertake in-house R & D than their local counterparts, who obtained technology on a licensing basis. This tendency has been explained in terms of three factors. Firstly, through the foreign collaborators often restrict any changes in the original specifications/designs supplied through restrictive clauses inserted in the collaboration agreements, the propensity to adhere to these restrictions may be less in case of a locally controlled firm than in the case of a firm controlled by the foreign collaborator itself. Secondly, unlike the MNE affiliates, the unaffiliated licensees do not enjoy continued and captive access to the research laboratories of the technology supplier. Hence, they have to set up their own laboratory. Finally, the technical collaboration agreements are of a finite duration (up to 5-10 years), while FDI entails a life-long relationship. Due to restrictions placed on the renewals of technical collaborations by the government, the local licensees may be anxious to absorb the technology before their expiry. Besides, independence of decision-making in the case of licensing collaborations or outright purchases allows the local firm to selectively delink and diversify the sources of technology resulting in cost effectiveness and greater technological competence.

Thus, FDI makes only a limited contribution to local technological capability building in the host countries. They appear to be inferior to licensing or outright purchases of technology (purely technical collaborations) as a channel of technology acquisition in terms of contribution to local technological capability.

In this context, there is a lot to learn from the experience of South Korea, which succeeded in building local technological capability and climb the technology ladder very fast. South Korea imported technology selectively on licensing or contractual basis, and absorbed it through reverse engineering. FDIs were restricted only to the export-oriented or to cases where closely held nature of technology would not allow it to be obtained on a contractual basis. The Korean enterprises promoted their own brand/trade names and trading houses instead of depending upon the western multinationals. Therefore, the Korean enterprises enjoyed independence of decision-making from the foreign collaborators, enabling them to absorb and adapt technologies with reverse engineering and in-house R & D activity.

Choice of Techniques and Employment :

It is widely believed that, because of relative scarcity of labour and abundance of capital, the technologies developed and employed by the western MNEs are progressively labour displacing and relatively more capital intensive. An excessive induction of such technologies in labour surplus economies may, therefore, create distortions like growing capital scarcity and unemployment. A number of studies comparing factor proportions of technologies employed by the foreign and local firms in a number of developing countries have found evidence of the higher capital intensity in the former case. Therefore, FDIs create fewer jobs per unit of investment than other investments in LDCs.

Market Structure :

Entry of the MNEs can affect host country market structures adversely. Possession of intangible assets, such as, globally known brand names and their reliance on non-price mode of rivalry, viz., through product differentiation and advertising and heavy market promotion raise barriers

to the entry or potential local entrants. Besides, the MNEs sometimes engage themselves into restrictive practices (RBPs), which are aimed at eliminating the existing or potential competition by mergers and acquisitions or by forming cartels. Hence, the presence of the MNEs generally leads to market concentration. Empirical studies of a few countries have confirmed a correlation between FDIs and market concentration even after controlling for common factors.

The possession of rent-yielding intangible assets and non-price mode of rivalry enables the foreign affiliates to earn higher margins of profit on sales and higher rates of return.

Empirical evidence on higher profitability of the foreign firms, compared to their local counterparts, is now available from several countries.

Political and Cultural Impact :

Inflows of FDIs can also have considerable political, social and cultural dimensions. Since key decision-making in the case of FDIs is concentrated at the MNE headquarters, it is argued that excessive dependence on FDI reduce the controllability and, hence, sovereignty of the host country. The high-pressure making and advertising techniques employed by the MNEs can affect consumption patterns and tastes in the developing host countries.

Thus FDIs can have a wide-ranging impact on the national incomes of host countries, employment, balance of payments, local technological capability, and market structures. Impact on these parameters of development of individual FDI projects can vary widely, depending upon several factors such as its place in the host country's development priorities, organisational structure, extent of local participation, choice of technique, location, size of market relative to that of the project, etc. Host country policies and regulations can play an important role in maximising the positive impact and minimising the negative impact.

Activity 3

Indicate the direct and indirect impact of Pepsi Cola's entry in India. Show how the conditions imposed by the Indian government on the MNE at the time of entry tend to increase its positive impact on the country.

.....

.....

13.7 FDIs FROM LDCs :

Since the 1970s, a growing number of firms in some developing countries have tended to become international by investing abroad. The FDIs associated with the developing country firms, through small in magnitude, are increasing at a faster rate than total FDI flows. Table 13.2 above shows that the share of the developing countries in the global outflows of FDIs increased from 1.6 percent during 1980-84 to 3.2 percent during 1985-89. The developing country firms that undertake FDIs are sometimes called the Third World MNEs. Much of FDIs originating in the LDCs are from newly industrialising economies, such as, Singapore, Hong Kong and Taiwan. But a significant proportion of these flows has also originated in Argentina, Brazil, Mexico, India and South Korea.

The Indian enterprises, for instance, had set up 186 joint ventures (JVs) in 37 countries by March, 1989, of which 152 were already in operation and 34 were in different stages of implementation. Total Indian investment in these JVs exceeded Rs.100 crores.

FDIs associated with the developing country firms appear to be similar to those undertaken by the western MNEs. However, FDIs from the LDCs are markedly different from their western counterparts in several respects. As these differences have important implications for the impact of FDIs on the host countries, we review them briefly.

In terms of geographical distribution, the bulk of the developing country FDI flows are destined to other (generally poorer) developing countries while the bulk of those from the western MNEs are shared by the industrialised countries themselves. Further, a greater proportion of the developing country FDIs has gone into the manufacturing.

Developing country enterprises have hardly one or two affiliates, and are, therefore , unlikely to have a global strategy or optimisation of global opportunities as their goal. Their main advantage in foreign operations is not to promote globally known brand names or proprietary new technology but to gain experience in operating rather mature technology plants under the conditions prevailing in the developing countries, which might require certain adaptations, raw material substitution, and scaling down.

Joint venture is the major form of participation in the case of the developing country firms and the propensity to control the affiliates tightly is much less. The developing country firms are more willing to share control and ownership with local partners.

Comparative studies have shown that affiliates of the developing country MNEs have a much smaller scale of operation than of those affiliated with the western MNEs. Due to the small size of markets in the developing host countries, the smaller scales are more appropriate, and enable them to achieve higher levels of capacity utilisation. Further, the affiliates of the developing country were found to be having much lower capital intensity and hence, were more appropriate to the endowments of the host countries than their counterparts from the western MNEs. The competitive strategy of the LDCs MNEs is more dominated by price competition than by high pressure advertising and product differentiation in the case of the western MNEs.

Furthermore, there is some evidence of the lower dependence on imported raw materials and the lower remittances in the case of the LDC MNE affiliates than the western MNEs. These imply relatively higher domestic linkages and lower foreign exchange burden for the host countries.

Another welcome feature of joint ventures among the developing country firms is that they promote South-South Cooperation and the collective self-reliance of the developing countries, and reduce their dependence on the industrialised countries.

Activity 4

Indicate a few Indian enterprises that have set up joint ventures abroad.

.....

.....

13.8 SUMMARY :

In this Unit, we have discussed various issues relating to the MNE activities in the developing countries. The unit has indicated motivations for the MNE operations, discussed trends in international investments, and has touched upon the role of the MNEs in fulfilling the targets fixed for achievement of the new international economic order. The unit has also indicated various determinants of FDIs, has discussed the impact of FDIs on the LDCs, and has examined the patterns of FDIs from the LDCs.

13.9 SELF ASSESSMENT QUESTIONS :

1) Discuss the motivations for export-oriented investments by the MNEs in the developing countries.
2) Summarise the recent trends in distribution of FDI flows and reasons of growing marginalisation of the LDCs in their global distribution and prospects of fulfilment of the Lima Target.
3) Discuss the impact of the MNE operations on major parameters of development of the developing host countries.
4) Indicate the distinctive features of operations of the developing country MNEs.

13.10 FURTHER READINGS :

Caves, Richard E. *Multinational Enterprise and Economic Analysis*, Cambridge University Press, 1982 (especially chapter 9).

Kumar, Nagesh, *Multinational Enterprises in India: Industrial Distribution Characteristics and Performance*, London: Rutledge, 1990.

Kumar, Nagesh, "Cost of Technology Imports: The Indian Experience", *Economic & Political Weekly,* August 31, 1985, pp. M 103-114.

Kumar, Nagesh, "Foreign Direct Investments and Technology Transfers Among Developing Countries", in V.R. Panchamukhi et al. *The Third World and the World Economic System,* New Delhi: Radiant, 1986, pp.139-165.

Lal, Sanjaya and P. Streeten, *Foreign Investments Transnationals and Developing Countries,* London: Macmillan, 1977.

Wells, L.., *Third World Multinationals: The Rise of Foreign Investments from Developing Countries,* Cambridge, MA, U.S.A: MIT Press, 1983.

UNIT - 14 REGIONAL TRADE GROUPINGS AND COOPERATION

Objectives :

After going through this unit you should be able to:

- Explain the concepts of free trade area and customs union.
- Discuss the differential performance of regional economic groupings among the developed and the developing countries.
- Describe the features of cooperation within and between trade groupings.
- Describe the progress made in SAARC in terms of economic cooperation.
- Draw lessons for individual countries and trade groupings for their future operations.

Structure :

14.1 Introduction
14.2 Dynamics of Regional Trade Groupings
14.3 Regional Groupings: Developed and Developing Countries
14.4 Experience During the 1980s
14.5 Latin America
14.6 Asean
14.7 APEC and EAEC
14.8 SAARC
14.9 Summary
14.10 Self-Assessment Questions
14.11 Notes
14.12 Further Readings
Annexure 1: Select Regional Trade Groupings Among Developing Countries

14.1 INTRODUCTION :

Regional economic blocs have proliferated in the world in recent years. To name a few, the European Community and the North American Free Trade Agreement (NAFTA) among the developed countries; and Association of Southeast Asian Nations (ASEAN), South Asian Association for Regional Cooperation (SAARC) and Latin American Integration Association (ALADI)[1] among the developing countries.

Compared with economic cooperation and integration schemes among the industrial countries, those among the developing countries are somewhat less successful due to lack of political will on national and regional issues; the pattern of economic management; and the impact

of external political and economic influences over which, by and large, the members of such regional economic groupings have little control.[2]

It is sometimes argued that South-South economic cooperation is a realization on the part of the individual developing countries of their mistake of being inward-oriented and is a step towards their opening up. This is not entirely so. The thrust towards greater South-South economic cooperation increased when the North, as the engine of world economy slowed down and protectionism in the North towards the South's exports to the North increased. This should not be interpreted as a confrontationist posture between the North and the South. In fact, it will be beneficial for both the North and the South to envisage South-South cooperation as complementary to North-South cooperation.

The predominance of political factors over economic ones led to the argument that until the political questions are settled first, no meaningful South-South economic cooperation is possible. This need not necessarily hold. For, progress in economic cooperation can and did sometimes ease political constraints as in the case of the Economic Community in the run-up to 1992.

14.2 DYNAMICS OF REGIONAL TRADE GROUPINGS :

All over the world, economic centres of gravity are emerging—the US-Canada Free Trade Agreement (with possible extensions to Mexico and others in the region), the EC 1992, the Asia-Pacific Economic Co-operation (APEC) and so on.

Regional economic cooperation schemes have achieved varying degree of success depending on the dynamics of political economy in the region and their bilateral and multilateral economic relation with the rest of the world.

In addition to the efforts for economic cooperation at the sub-regional, regional and inter-regional levels that are being witnessed in several parts of the world, two new forms of cooperation are emerging—(a) inter-subregional, and (b) extra-regional.

In the former, example may be cited of the growth triangles that are emerging within the ASEAN region. e.g., the projects that are contemplated jointly by the Johor state in Malaysia, Singapore, and Indonesia's Riau islands. Under this scheme, all three countries are expected to benefit. Singapore is to increase its water purchases from Johor against payment of US $ 118 million for land on which a dam is to be built. Singapore is to obtain water from Sumatra also. The growth triangle is envisaged to attract MNCs as the triangle is to be developed by telecommunication skills and management expertise from Singapore and skilled labour and land supplied by Johor and Batam (the latter in Riau archipelago). Batam was originally conceived to be developed as a free trade zone by Indonesia, but the growth triangle concept seems to have appealed more to Indonesia than that of a free trade zone.

The benefit to Malaysia from the growth triangle is a planned US $ 755 million bridge as a second land link between Singapore and Malaysia. The costs of the growth triangle concept have already been felt: as reflected in the 40 times increase in land prices in Riau Islands after the signing of the Singapore-Riau economic cooperation agreement.

Examples of extra-regional cooperation attempts are the APEC comprising the ASEAN, Japan, Australia, New Zealand, South Korea and the US with extension to the three Chinas. As against this is the Malaysian proposal of the East Asian Economic Grouping (EAEG), now called the East Asian Economic Caucus comprising the ASEAN, Japan and he newly industrialising economies (NIEs). Several forms of cooperation are under discussion or are underway between the European Community on the one hand and the EFTA and East European countries, on the other.

Regional trade groupings include: (a) free trade areas where partners abolish duties on mutual trade, but retain tariff schedules on extra-regional trade; (b) customs union which have free trade between members but also have a common external tariff; and (c) common markets which are essentially customs unions, but with additional provisions for labour mobility and the harmonisation of trading standards and practices.

Activity 1

Think of the possibility of growth triangles in the SAARC region. For example in the field of tourism and fishing, which sets of three countries in SAARC do you think could join in these activities?

.....

.....

.....

14.3 REGIONAL GROUPINGS : DEVELOPED AND DEVELOPING COUNTRIES[3]

The main motivating force behind the trend towards regionalism in the industrial countries appears to be the need to reduce non-tariff barriers to trade and to diffuse trade tensions, which is perceived to be easier to achieve on a regional than on a global basis. The expected gains are increased productive efficiency through the achievement of economies of scale, the adoption of cost-reducing technologies, and a reduction in market segmentation which creates monopoly rents and imposes administrative costs.

A different set of reasons seems to underly the trend towards preferential trading among developing countries. Tariffs continue to be more important than non-tariff barriers in these countries. The elimination of tariffs among a group of partner countries is thus viewed as a means of achieving industrialisation through regional import substitution by "swapping' markets for each other's products. Regional integration among developing countries has also sometimes aimed at economising on foreign exchange by setting up clearing accounts for intra-area trade. Such internal clearing accounts exist for most regional trading groups among developing countries, including the Latin American Integration Association, the Central American Common Market, and the Caribbean Community. This objective also underlies recent integration initiatives in Africa. Most recently, there has been increased focus on opening markets in a broader way and thus integrating members of preferential trading arrangements into the global trading system.

14.4 EXPERIENCE DURING THE 1980s[4] :

A major objective of these groupings has been the promotion of trade and other forms of economic co-operation at the regional and subregional levels, and from the outset the economic integration process has focused on the unification and expansion of regional and subregional markets by means of trade liberalisation programmes. Although during the 1960s and 1970s some progress was achieved in this sphere, in the 1980s there have been substantial setbacks in intra-grouping trade which show the need for new initiatives to revive and strengthen the integration process.

The importance of intra-regional trade in the evolution of the integration process cannot be over-emphasized. In fact, it is one of the most relevant yardsticks of the success and extent of economic integration. However, the extent to which market integration through trade liberalization schemes actually contributed towards stimulating and expanding intra-grouping trade has generally been modest.

In 1985 the share of intra-grouping trade to total exports in each region were as follows: 7.1 percent for the West African Economic Community (CEAO) in Africa; 15.9 percent for the Central American Common Market (CACM) in Latin America and the Caribbean; and 17.9 percent for the Association of South-East Asian Nations (ASEAN) in Asia. In addition, value of intra-trade exceed $US 1 billion in a minority of the integration groupings.

During the early years of economic co-operation and integration, the reciprocal reduction of tariff and non-tariff restrictions and the adoption of preferential trading arrangements stimulated trade. Between 1970 and 1980, the value of intra-grouping trade grew annually at the dynamic rate of over 20 per cent in the Economic Community of West African States (ECOWAS), the Latin American Integration Association (ALADI), the Andean Group, ASEAN and the Bangkok Agreement; and by over 10 per cent in almost all other integration groupings. In fact, South-South trade as a whole expanded dramatically during the 1970s. Nevertheless, during this period, the share of intra-grouping trade of most integration groupings rose only marginally, if at all.

In the 1980s, as with South-South trade as a whole, the intra-trade of most integration groupings of developing countries suffered substantial setbacks, due chiefly to serious international financial problems and the recessive adjustments deriving therefrom. Many member States, facing a severe and persistent deterioration in their external debt and payment positions, adopted various national adjustment measures to compress overall and restrict access to domestic markets. Such actions, in addition to existing internal obstacles to economic integration which became particularly difficult to tackle in the wake of the crisis, precipitated a reversal in the market integration process. In most cases, the mutual trade of integration groupings stagnated or contracted considerably. The impact of the crisis varied.

In the Latin American region where there are several highly indebted middle-income countries, the overall trading capacity of most groupings was drastically reduced. Their intra-regional trade suffered heavier setbacks and declined more rapidly than external trade. Intra-trade of ALADI, the Andean Group, and CACM went down by over 20 percent in current value terms between 1981 and 1985. In ALADI, the largest group in the region, the share of intra-trade to total exports during this period fell from 12.6 to 9.6 percent, in the Andean Group from 3.4 to 3.1 percent and in CACM from 20.7 to 15.9 percent.

In Africa, adjustment of balance-of-payments difficulties, debt crises and natural disasters had a similar contractionary effect on intra-grouping trade. Between 1981 and 1985, the intra-trade of the Central African Customs and Economic Union (UDEAC) and ECOWAS declined by over 40 percent, and in CEAO by more than 20 percent in current dollar terms. The share of mutual trade of these three African groupings also contracted. In the Economic Community of the Great Lakes Countries (CEPGL) and Mano River Union (MRU) intra-trade did grow, although in value terms intra-trade in both groupings remain quite small—less US $ 10 million. Moreover, intra-trade comprises less than 1 percent of each of the two groupings' total exports.

In Asia, where the debt and payment crises affected a limited number of countries, the intra-trade of groupings reflected a different trend which followed more closely the movements in prices of commodities and oil-products which feature prominently in the exports of the region. ASEAN's intra-trade, which rose sharply in current value terms from $ US 12.7 billion in 1981 to $ US 17.1 billion in 1983, declined to $ US 12.7 billion in 1985. The proportion of intra-ASEAN trade to total exports in the 1980s, however, has remained mostly constant at around 18 percent, except in 1982 and 1983 when it rose to 23 percent.

In the Co-operation Council for the Arab States of the Gulf (GCC)—the major grouping in the West Asian region—the share of intra-trade grew from 3 percent in 1980 to 4.6 percent in 1985. The value of intra-trade, however, declined from $ US 4.8 billion to $US 2.5 billion during this period. This reflects, to a large extent, the drop in oil prices as the bulk of GCC intra-trade is comprised of fuel exports.

In the Bangkok Agreement, the value of intra-trade has risen substantially (from $ US 0.6 billion to $ US 1 billion) but the share of intra-trade, which rose only from 1.9 to 2.5 percent, remains very small.

Activity 2

Categorise regional groupings according to the available information on the share of intra-regional trade in their total trade.

Category	Grouping
Less than 5%	
5% - 10%	
11% - 20%	
Above 20%	

What are the common and distinguishing characteristics among the groupings?

14.5 LATIN AMERICA :

Andean Pact :

Venezuela, Colombia and Bolivia entered into a free-trade pact in January 1992. Peru and Ecuador were expected to join this pact by June 1992. Over the past few years, the three countries effected independent tariff cuts.

Mercosur :

In 1988, Brazil and Argentina entered into a free-trade pact. In March 1991, Uruguay and Paraguay joined this pact. It is envisaged that by the end of 1994, there would be completely free flow of goods, services and labour between Argentina and Brazil and by the end of 1995, Uruguay and Paraguay are expected to join this free market.

Central American Common Market :

This was set up in the 1960s but became non-functional in 1969 when war broke out between Honduras and El Salvador. In July 1991, the five members, viz., El Salvador, Honduras, Gautemala, Nicaragua and Costa Rica decided to re-establish the common market by 1994.

Caribbean Community (Caricom) :

In 1991, and attempt was made to create a customs union among the English-speaking Caribbean countries under the auspices of Caricom. However, they could not agree on a common external tariff which is an integral element of a customs union.

Intra-regional Trade :

Intra-regional trade in Latin America, i.e trade of Latin American countries with other Latin American countries as percent of their total trade, was 22% in 1980 and this share went down to 15% in 1990. However, between some individual Latin American countries, trade was on the rise e.g. between Brazil and Argentina total trade doubled to about $ 2 bn from 1985 to 1990.

USA and Latin American :

In 1990 there was a call by the USA for a Pan-American free trade area. Since 1987, the USA signed 16 'framework' agreements with Latin American countries in the field of trade.

In 1992, negotiations on the North American Free Trade Agreement (NAFTA), linking the US, Canada and Mexico moved at a rapid pace. According to a recent study, NAFTA is expected to create 600,000 jobs in Mexico and 130,000 jobs in the USA and lead to an improvement of about $ 10 bn a year in the US trade balance.

Though new jobs are expected to be created, a study has pointed out that some existing jobs must be lost. Therefore, there is need to facilitate new skills. This study suggested the creation of a new development bank to develop skills, physical infrastructure, to finance environmental improvement projects and supports expansion of social infrastructure such as education and health care.

Following Mexico, other Latin American countries wish to join NAFTA. Venezuela supplies oil to the US and considers itself as a 'strategic' partner. Panama also considers itself as a 'strategic' partner because of the Panama canal. Chile already entered into a free-trade agreement with Mexico in September 1991.

14.6 ASEAN :

The Asean Summit in January 1992 in Singapore is considered a watershed compared to the first Asean summit in Bali in 1976. The central focus of the 1992 summit was economic. The

'Framework Agreement on Enhancing Asean Economic Cooperation' covers cooperation in trade, industry, finance and banking, as well as transport and communications. The agreement also recognises the development of sub-regional growth areas, both within Asean and non-Asean states.

The most important outcome of the 1992 summit was the agreement to establish Asean Free Trade Area (AFTA) within 15 years beginning January 1, 1993. Presently a preferential Trading Arrangement (PTA) is in operation but it covers only a very small portion of intra-Asean trade (viz., 3.2% in 1989).

The agreement on the common effective preferential tariff (CEPT) scheme is restricted to products with an ASEAN content of at least 40 percent and cover manufactured, processed agricultural and capital goods. In all 15 product groups have been identified for the reduction in tariffs.

While the above exemption is expected to be made use of quite frequently by the member countries, what is limiting the importance of the tariff cutting agreement in a more serious way is that agricultural raw materials, which are important components of the trade of most countries in ASEAN, have been excluded from the tariff cutting exercise.

Beginning from January 1, 1993 tariffs are to be reduced to 20 percent within five to eight years preferably year by year. The aim is that the tariffs should fall below five percent in the subsequent years. The Government of Thailand has announced that its tariffs for the manufactured products imported from other ASEAN nations will be no more than 30 percent from the beginning of 1993 and has further promised to try and cut them to 20 percent by the beginning of 1994.

The groups of products identified for inclusion in the CEPT scheme are vegetable oils, cement, chemicals, pharmaceuticals, fertilisers, plastics, rubber products, leather products, pulp, textiles, ceramic and glass products, gems and jewellery, copper cathodes, electronics, and wooden and rattan furniture.

14.7 APEC AND EAEC :

The Asia Pacific Economic Cooperation (APEC) forum consists of 15 nations, viz. the 6 ASEAN countries, the three Chinas (Mainland China, Hong Kong, and Chinese Taipei), South Korea, Japan, Australia, New Zealand, the USA and Canada.

The APEC forum, in its November 1991 meeting in Seoul, endorsed the aims of the GATT Uruguay Round. The meeting also discussed the issue of agricultural liberalisation.

Parallel to the APEC forum was the emergence of the East Asian Economic Caucus (EAEC) proposal of Malaysia which envisages an informal consultative grouping including most Asian members of APEC, but not the US, Canada and Australia. The USA was unhappy with this concept. Japan's reaction to the EAEC was unsympathetic, as Japanese economic success depended on global presence and particularly access to markets in North America and Europe. Japan's direct investments and trade links with southeast Asia have been perceived by some as the emergence of a 'yen bloc'.

14.8 SAARC[5]

The Research and Information System for the Non-aligned and Other Developing Countries (RIS), New Delhi, made a comprehensive study on identifying the potential areas of cooperation, the constraints and policies to be adopted to improve economic cooperation in SAARC.

Some of the major recommendations of this study are as follows:

i) The setting up of SAARC Trade and Technology Information Centres to maintain a liaison with the other trade and technology information organisations such as the Asian and Pacific Centre for Transfer of Technology (APCTT).

ii) The formation of SAARC Federation of Chambers of Commerce and Industry as a regional apex body of the national chambers of commerce and industry. Specialised panels have been suggested to promote exchange of business information and contacts by sponsoring trade missions and delegations, trade fairs and exhibitions.

iii) SAARC Trade Fairs could be organised every year with the venue rotating among the capitals or other business centres of the member states and concessional rates could be charged for space from the member countries.

iv) A SAARC preferential trading arrangement supplementing the Bangkok Agreement and the Global System of Tariff Preference (GSTP) and granting of greater tariff and non-tariff concessions to lesser developed countries in the region.

v) Extension of regional tariff preference to regional joint ventures, technology transfers, project exports, and trade in services.

vi) Extension of the Bangkok Agreement and the Asian Clearing Union (ACU) to other SAARC members. The experience of other developing countries' regional arrangements shows that to support and increase intra-regional trade, regional trade and payment arrangements should go together.

Through seminars, conferences and meetings involving traders, bankers, and government officials dealing with the ACU, the present and proposed activities of the ACU need to be familiarised more fully and measures adopted to remove constraints in the functioning of the ACU. For example, streamlining of procedures is required to speed up the time taken for settling transactions involving commercial banks and central banks in the member countries.

vii) The setting up of a Regional Council of Development Financial Institutions (RCDFI) which could conduct feasibility studies on regional projects, assist in strengthening of DFIs in member countries and raising of funds on competitive terms for regional projects.

viii) The formation of a task force to evolve a harmonized system of procedures and documentation. This would require conducting in-depth studies in different aspects of export/import procedures in each country such as export/import licensing, quality control and pre-shipment inspection, export/import finance and letters of credit, excise and customs duties. Among the documents that will require standardisation and alignment are tender documents and proforma invoice; bank documents such as LCs; handling, transport, and insurance documents; forwarding instructions; and miscellaneous certificates.

ix) Harmonization of standards and specifications in the region especially in the fields of drugs, agrochemicals, processed foods and select engineering goods.

SAARC's Male' Summit Declaration of November 1990 welcomed the suggestion of a Fund for regional projects which could make available credit on easy terms for the identification and development of regional projects. This Fund could act as a catalyst in the activities of the Regional Council of Development Financial Institutions (RCDFI), proposed in the RIS study, and other organisations involved in regional projects.

The Joint Press Release at the end of the Male Summit included the decision to establish joint ventures in the field of cottage industries and handicrafts, setting the stage for collective self-reliance. For achieving this goal, in addition to joint ventures in cottage industries and handicrafts and the proposed regional fund, there are several other product and fucntional areas in which there could be regional cooperation as discussed earlier.

As part of SAARC regional cooperation, the following new initiatives show the potential for further regional economic cooperation in SAARC:

i) The workshop on 'Agricultural Produce Markets' in February 1990 in New Delhi which recommended the setting up of market intelligence network for the benefit of other member countries. Free exchange of technical and scientific information in the field of agricultural marketing and setting up of a regional marketing centre to cater to the needs of the whole region was also recommended.

ii) The proposal for setting up a SAARC Documentation Centre to collect information on all important and relevant matters and to assist various south Asian study centres in their research work in interdisciplinary and allied aspects and to assist work arising out of the activities of the various technical committees of SAARC.

iii) The proposal for setting up a South Asian institute to coordinate and study the policies and economies of member countries and suggest areas for cooperation or joint venture projects, with initiative to be taken by the private sector.

iv) SAARC shipping is still dependent on foreign shipping lines in the absence of strong national lines. Multimodalism is still to develop procedures for common documentation acceptable to all regional members, and avoiding of delays. The formation of the Association of Shippers Councils of Bangladesh, India, Pakistan and Sri Lanka (ASCOBIPS) is a good beginning, but has to go much further.

v) Peoples' participation for sustainable development in programmes like 'linkage, exchange, animation and partnership' (LEAP) held in Nepal in May 1990 organised by the South Asian Partnership (SAP) is a welcome step on the part of SAARC exhibiting its awareness and willingness to take action on major issues such as sustainable development that are facing the world economy.

vi) A suggestion had been made some time back for the establishment of a South Asian Free Trade Association leading to a South Asian Common Market. With the present status of the economic and political relations obtaining in SAARC and the need for establishing complementary measures like industrial cooperation, payments arrangements and trade finance mechanisms, it may be difficult to envisage the formation of a Free Trade Association in SAARC at the present time. Therefore, a formation of a Free Trade Association in SAARC at the present time. Therefore, a SAARC Preferential Trade Arrangement (PTA) may be an appropriate starting point. As SAARC PTA progresses it should be possible to aim at further trade cooperation arrangements

A synthesis study was undertaken by the SAARC secretariat in consultation with the National Coordinators and was finalised at the meeting of national Coordinators held in June 1991 in New Delhi organised by the RIS and the Ministry of External Affairs, Government of India. The synthesis study is entitled, **SAARC Study on Trade, Manufactures, and Services.** Many of the major recommendations made in the RIS study found place in the SAARC study. The proposals made in these two studies which have already taken concrete shape are: SAARC Fund for Regional Projects (SFRP), Regional Council of Development Finance Institutions (RCDFI), SAARC Chamber of Commerce, and Committee on Economic Cooperation.

SAARC Fund for Regional Projects (SFRP) :

The Vth and VIth summit meetings of the Heads of State of Government of SAARC Member States welcomed the setting up of the SFRP. Accordingly a Council (of designated Development Financial Institutions (DFIs) from each of the member countries) for SFRP was constituted and it held its first meeting in Bombay in February 1992. RIS, India, has provided background notes to this meeting and participated effectively in it.

The size of the fund is to be equivalent to US $ 5 million and is to be utilised for pre-feasibility and feasibility studies, and preparation of detailed project reports on a sharing basis with the sponsors.

SAARC Chamber of Commerce and Industry :

The members of the SAARC Chamber of Commerce and Industry met in Kathmandu during March 1992 and it is understood that they agreed upon the Constitution for the Chamber. Shortly, the Chamber is expected to be launched formally.

Committee on Economic Cooperation (CEC) :

The high level Committee on Economic Cooperation was established following the recommendations of the 9th session of the Council of Ministers, July 3-4, 1991 to identify measures for immediate action and oversee their implementation arising out of the SAARC regional study.

The CEC supported the recommendations of the SAARC study. Many other ideas contained in the RIS study and the SAARC report are being pursued further. For instance, it was suggested in these documents that SAARC should set up a preferential trading arrangement (SAARC PTA) and this is being pursued through a Sri Lankan proposal of SAPTA.

Activity 3

Select some of the initiatives taken up in SAARC economic cooperation and comment on the possibilities of further progress in each of them. Think of the constraints and give suggestions for removing them.

.....

.....

.....

14.9 SUMMARY :

The world trading system is presently characterised by trading blocs both among the developed and the developing economies. New groupings are emerging with membership comprising

of countries belonging to more than one existing grouping. These groupings throw up both opportunities as well as challenges for individual countries. SAARC, though of recent origin, has made some progress in several areas of trade, manufacturing and services. It is necessary to identify the constraints and steps for further economic cooperation within the region and links with other economic groupings.

14.10 SELF-ASSMESSMENT QUESTIONS :

1) Describe the distinguishing characteristics of different trade groupings.
2) What are the objectives of trade groupings? Discuss the success achieved by individual groupings in realising the objectives.
3) Discuss the progress made in SAARC so far and the scope for future economic cooperation.

14.11 NOTES :

1) See Annexure 1 for a listing of the regional groupings among developing countries.
2) This and the following paragraphs are from Rao (1991).
3) UN, **World Economic Survey**, 1990, p.69
4) UNCTAD, **Recent Developments in the Economic Integration Process of Developing Countries,** TD/B/C.7/AC.3/4, pp.1-2.
5) This section is based on Rao (1991), Panchamukhi, et al. (1990) and press reports on recent developments in SAARC.
6) Panchamukhi, et. al (1990).

14.12 FURTHER READINGS :

V.R. Panchamukhi, et al, *Economic Cooperation in the SAARC Region,* (New Delhi, Research and Information System for the Non-aligned and Other Developing Countries, 1990)

V.L. Rao, "Emergence of Regional Economic Blocs: Imperative before SAARC", *South Asia Journal,* Vol.4, No. 3, 1991.

ANNEXURE 1

Select Regional Trade Groupings Among Developing Countries

Association of South-East Asian Nations (ASEAN) :

ASEAN established in 1967 comprises Brunei, Darussalam, Indonesia, Malaysia, Philippines Singapore and Thailand. Since 1984 members have applied a 20-25% tariff preference to other members, subject to national exception lists and have agreed to enlarge these preferences to up to 50%.

Caribbean Community (CARICOM) :

CARICOM was formed in 1973 and replaced the Caribbean Free Trade Association of 1967. It consists of Antigua and Barbuda. The Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, Montserrat, St. Kitts-Nevis, St. Lucia, St. Vincent and The Grenadines, and Trinidad

and Tobago. All expect the Bahamas participate in the Common Market although Belize and Montserrat have been granted longer to phase in the common external tariff.

Central American Common Market (CACM) :

CACM was established in 1961 and comprises Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua. It applies a common external tariff to all but a few gods from third countries.

Economic Community of West African States (ECOWAS) :

ECOWAS was formed in 1975 and comprises Benin, Burkina Fasco, Cape Verde, Cote D' Ivorie, The Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Mauritania, Niger, Nigeria, Senegal, Sierra Leone and Togo. It provides for free trade in unprocessed goods and the gradual elimination of tariff and non-tariff measures.

Gulf Cooperation Council (GCC) :

The GCC was established in 1981 and consists of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates, Intra-trade has been liberalised since 1983 and a common external tariff has been adopted by most members.

Latin American Integration Association (ALADI) :

ALADI was formed in 1981 and replaces the Latin American Free Trade Association of 1960. It comprises Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay and Venezuela. It has implemented regional tariff preferences and aims to establish a common market.

Latin American Group of Three :

It was announced in April 1991 that Colombia, Mexico and Venezuela plan to establish a free trade zone by July 1994, subject to the exclusion of certain goods. (Mexico is also negotiating free trade agreements with Chile, Costa Rica and certain other Central American countries, as well as with the United States.)

Preferential Trade Area for Eastern and Southern Africa (PTA) :

The PTA was established in 1982 and comprises Angola, Burundi, Comoros, Djibouti, Ethiopia, Kenya, Lesotho, Malawi, Mauritius, Rwanda, Somalia, Swaziland, Tanzania, Uganda, Zambia and Zimbabwe. It intends eventually to eliminate all trade restrictions and establish a common market.

Southern Cone Market (MERCOSUR) :

MERCOSUR was established in March 1991 and comprises Argentina, Brazil, Paraguay and Uruguay. Its main aim is to achieve a common market with a single external tariff and free trade among members by the end of 1994. Other objectives include the coordination of policies on agriculture, industry and transport.

(**Source:** Commonwealth Secretariat, **Global Change and Economic Development**, London, August 1991).

UNIT - 15 INTERNATIONAL INTERVENTION AND INTERNATIONAL BUSINESS

Objectives :

After going through this Unit you should be able to comprehend the

- need for international intervention;
- types of international intervention; and
- initiative taken under the aegis of the World Bank affiliates, different organs of United Nations, OECD and GATT etc. in the area of international business and their status.

Structure :

15.1 Introduction

15.2 Need for International Intervention

15.3 Types of International Intervention

15.4 World Bank Affiliates and Promotion of International Business

15.5 UN Commission on Transnational Corporations

15.6 UNCTAD, Technology Transfer and RBPs

15.7 ILO Tripartite Declaration

15.8 OECD Guidelines

15.9 GATT and International Business

15.10 Summary

15.11 Self Assessment Questions

15.12 Further Readings

15.1 INTRODUCTION :

In Unit 13 it has been emphasised that host country policies and, regulations, play an important role in determining the impact of multinational or transnational corporations (TNCs) on a host country specially a developing one. The international business such as the operations of the TNCs transcend national barriers. Hence, national governments' ability to deal with them is limited. The role of international intervention in promoting foreign direct investments (FDI) flows to developing countries

and regulating the operations of TNCs has increasingly been recognised over the past two decades. Over the 1970s, a number of initiatives were launched to provide a framework for international regulation of international business. Not only have these attempts been resisted by industrialised countries, but there have been moves to curtail even the ability of national governments to regulate operations of TNCs in the late 1980s. This Unit provides a description of various initiatives taken by the international community in this regard.

15.2 NEED FOR INTERNATIONAL INTERVENTION :

It is recognised that transnational corporations have the economic power and resources to act as effective instruments of development. Yet the pervasive role attributed to these corporations in the world and the disclosure of certain instances of corporate misconduct have given rise to serious concern about their negative impact on economic development and political and social affairs. The attempt to regulate their corporate conduct in developing countries has been accompanied by the desire to establish an international regime of minimum standards for the treatment of TNCs. The objective of these endeavours, has been to create an international framework that would minimise the negative effects of the activities of these corporations while maximising their positive contribution to development. This is because it is increasingly realised that national regulation and control are inadequate to deal effectively with the global strategies of TNCs. Many states, particularly small developing countries, have encountered difficulties in regulating transnational corporate conduct to ensure conformity of TNCs' activities with domestic laws, regulations and policies, adequate disclosure of information, and consumer protection; and to prevent tax evasion, restrictive business practices, illicit payments and abusive transfer pricing. It is for this reason that a multilateral approach to international intervention has been emphasised by developing countries. The developed countries have likewise seen merit in the multilateral adoption of common standards of transnational corporate behaviour. A multilateral approach is also helpful in settling intergovernmental disputes as to the treatment of TNCs within national jurisdictions, particularly where such jurisdictions impose conflicting requirements on various entities of TNCs. Further, multilateral intervention can play an important role in promoting flows of foreign direct investments to developing countries by providing investment guarantees and finance to TNCs.

The international intervention in the arena of international business has evolved over the past two decades with the growing expansion and complexity of operations of TNCs. Not only have the existing multilateral organisations such as UNCTAD, World Bank, GATT, started their activities concerning international business gradually in consonance with their mandate but new ones were created just to deal with international business. The most prominent example of the latter is the United Nations Commission on Transnational Corporations.

15.3 TYPES OF INTERNATIONAL INTERVENTION :

Broadly, the international intervention in International Business area can be classified into two groups viz., promotional and regulatory. The former could cover the initiatives taken by the international community to promote FDI flows and globalisation of business by creating favourable

climate such as by providing financing and protecting against non-commercial risks. The latter includes the initiatives to protect the interests of host countries by evolving norms of corporate conduct and control of restrictive business practices.

The promotional role has been played by the World Bank affiliates viz. IFC and MIGA and ICSID sponsored by the Bank. The regulatory initiatives include attempts to evolve norms and codes of conduct of TNCs by different United Nation agencies (viz. UN Commission on TNCs and UNCTAD), ILO and OECD. Further, multilateral trade negotiations in the framework of GATT that are currently in progress have attempted to include certain provisions having a bearing on the operations of TNCs.

15.4 WORLD BANK AFFILIATES AND PROMOTION OF INTERNATIONAL BUSINESS :

The two affiliates of the World Bank viz., International Finance Corporation (IFC) and Multilateral Investment Guarantee Agency (MIGA) have the mandate of promoting international business. Together they have sponsored a Foreign Investment Advisory Service (FIAS). In addition the Bank has sponsored the International Centre for Settlement of Investment Disputes (ICSID), which provides arbitration facilities for international business.

International Finance Corporation (IFC) :

The International Finance Corporation (IFC) was established in 1956. Its aim is to promote the economic development of its developing member countries through private sector investment. It is the world's largest multilateral organisation providing both loan and equity finance directly to private companies in developing countries. It provides loans to private companies without government guarantees. Membership in the World Bank is a prerequisite for membership in the IFC, which presently totals 146 countries.

Since it started its operations, IFC has been associated with more than 2000 companies and financial institutions in supporting over 1000 business ventures in more than 80 countries. In 1992 IFC approved financing of $ 1.8 billion ($ 1.5 bn in 1991) for 167 projects (152 projects in 1991). The IFC sees its role as a catalyst, mobilising substantial amounts of private capital from other investors and lenders, with relatively small outlays of its own funds. For instance, the projects approved by IFC in 1992 had total investment costs of $ 12 billion. IFC also provides technical assistance and advisory services to businesses and governments. It has been advising companies and governments all over the world on corporate restructuring and privatisation. IFC provides technical assistance to governments of a number countries on various aspects of capital market development such as the development of stock exchanges and security market regulations, the restructuring of commercial banks and establishment of other types of financial institutions, the use of vouchers and mutual funds for privatising state enterprises, and the drafting of leasing legislation.

IFC's Technical Advisory Service provides advice and assistance to companies and governments on such matters as technical restructuring, marketing and feasibility studies, and

strategic planning. IFC also finances activities related to project preparation, such as project identification, prefeasibility studies, pilot operations, sector studies, training, and short-term management support through its Technical Assistance Trust Fund. IFC supports four facilities that provide advice to small-scale entrepreneurs on developing project proposals and raising finance for them. These are: the Africa Project Development Facility, the Business Advisory Service for the Caribbean and Central America, the Polish Business Advisory Service, and the South Pacific Project Facility.

In addition to its project finance activities, IFC also seeks to help developing countries create the conditions conducive to productive private investment, both domestic and foreign. Towards fulfilling this objective IFC set up a Foreign Investment Advisory Service (FIAS) jointly with MIGA.

Multilateral Investment Guarantee Agency (MIGA) :

The Multilateral Investment Guarantee Agency (MIGA) was established in 1988. It seeks to promote economic development by encouraging the flow of private FDI to developing countries. MIGA aims to achieve this objective by insuring such investment against loss due to political risks such as expropriation, blocked currency transfers, breach of contract, and war, revolution and insurrection. By June 1992, the Convention establishing MIGA had been singed by 115 countries and 85 countries had become members of MIGA. India has also recently decided to join the MIGA.

MIGA insures new investments, including the expansion of existing investments, privatisation, and financial restructuring. Project must be registered with MIGA before the investments are made or irrevocably committed. MIGA can insure up to 90 percent of the investment amount, subject to a limit of $ 50 million of coverage per project. Eligible investments include equity, loans made or guaranteed by equity holders, and certain other forms of direct investment. MIGA's standard policy covers investments for fifteen years; in exceptional cases, coverage may be extended up to 20 yrs. MIGA also cooperates with national investment insurance agencies and private insurers to coinsure or reinsure eligible investments. In 1992 MIGA issued 21 guarantees with a maximum contingent liability of $ 313 million representing a total of $ 1.0 billion in direct investment.

MIGA also provides promotional and advisory services to its developing member countries to support their efforts to attract foreign direct investment. These services include organisation of investment promotion conferences, executive development programmes, foreign investment policy roundtables, research and specialised advisory assistance to governments.

MIGA's advisory assistance includes significant work on the legal frame work for FDI in member states. MIGA has worked with a number of countries as they have liberalised the laws applying to foreign investments. Several developing countries have enacted new statues that provide for international arbitration to settle investment disputes and many have entered into bilateral treaties for protection and promotion of foreign investments. MIGA also concluded legal protection agreements with six member countries that will make it easier for MIGA to issue investment guarantees. The advisory functions consist of improving investment policies, programmes and institutions to facilitate direct investment. This function is entrusted is entrusted to FIAS set up jointly with IFC. The consultative functions, covering investment promotion and applied research are undertaken by MIGA's Policy and Advisory Services.

Foreign Investment Advisory Service (FIAS) :

As indicate earlier FIAS has been sponsored by the two World Bank affiliates viz. IFC and MIGA. It provides advice to developing countries on how to adjust policies, regulations and institutional arrangements to attract more foreign investment in priority sectors, while at the same time safeguarding national interests. The advisory projects undertaken by FIAS, for instance, include formulation of policies and programmes that would facilitate and promote backward linkages between foreign investors and local suppliers; helping governments to develop an investment policy statement, investment guidelines, and the statutory basis for launching an investment promotion agency; identification of policy issues that retard foreign investment flows.

International Centre for Settlement of Investment Disputes (ICSID) :

The World Bank sponsored the Convention on Settlement of Investment Disputes between States and Nationals of other States which come into force on 14 October 1966. The International Centre for Settlement of Investment Disputes (ICSID) was set up under the Convention at the World Bank headquarters in 1966 to facilitate the flow of funds from industrialised to developing countries by providing arbitration facilities equipped to deal with dispute between States and nationals of other States particularly multinational firms.

A large number of countries including the major capital importers, however, have not signed the Convention on the ground that the Convention gives preference to foreign over domestic investors. They contend that investments within their boundaries like domestic investments should be subject to domestic jurisdiction equally. In 1992, the membership of ICSID comprised 99 countries.

Activity 1

List three enterprises in India having IFC's participation and indicate their activities.

.....

.....

.....

15.5 UN COMMISSION ON TRANSNATIONAL CORPORATIONS (UNCTC) :

The creation of the United Nations Commission on Transnational Corporations in 1974 itself was a product of the conflicts that characterised relations between developing countries and TNCs in the 1960s and early 1970s. These conflicts were inevitable because the sensitivities of developing countries in the immediate post-independence era coincided with an unprecedented expansion of FDIs spearheaded by TNCs based in the developed market economies. The commission was conceived as a forum under whose auspices, measures could be taken to strengthen the host country's position vis-à-vis TNCs. Among the measures envisaged were the formulation and implementation of an effective code of conduct on transnational corporations, strengthening of the bargaining position of developing countries, and a system of information on TNCs. The later two objectives have been entrusted to the UN Centre on Transnational Corporations (UNCTC) set up to provide secretariat to the Commission.

The UN Commission on Transnational Corporations has been established as an intergovernmental subsidiary body of one of the major organs of the United Nations, the Economic and Social Council (ECOSOC). It has 48 members. Election of member States to the Commission is based on geographical distribution. 12 members are from Africa, 11 from Asia, 10 from Latin America, 10 from the developed countries of Western Europe, North America and Oceania, and five from the socialist countries of Eastern Europe. Members serve a three-year term and are eligible for re-election. The main home countries of TNCs (e.g., the United States, the United Kingdom. the Federal Republic of Germany and Japan) have always been members of the Commission.

The Commission's main functions are to discuss and keep under review all issues related to TNCs, to draft the UN Code of Conduct on Transnational Corporations and to advise ECOSOC in all matters relating to TNCs. In addition, it determines the priorities and the programmes of work of the UNCTC which has been set up to develop an information system and to provide technical support to developing countries. Sixteen Expert Advisers are elected by the Commissions to assist it in its deliberations. The Advisers, from developed, developing and socialist countries, are drawn from trade unions, business, public interest groups and universities. They act in their private capacity.

UN Code of Conduct on Transnational Corporations :

Given the importance of TNCs in the world economy, there has been a general agreement that standards need to be established to govern the relationship between host governments and TNCs. These standards seek to establish the basic general rules for the conduct of TNCs and their treatment by governments. Accordingly, the formulation of a Code of Conduct on Transational Corporations has been the Commission's highest priority since its inception. Negotiations began in 1977 in an intergovernmental working group and have continued since 1983 in a series of meetings of a special session of the Commission; the special session is open to all States. Therefore. the Code is being negotiated with the active participation of countries from all geographic regions. This process receives input from the Expert Advisers, the business community, trade unions and other organisations as well.

The negotiations have succeeded in preparing a draft text in which about 80 percent of the provisions were agreed to. Compromise formulations exit for all the remaining principal outstanding issues, although these are yet to be agreed upon.

When adopted, the Code is expected to be the first multilaterally agreed framework governing all aspects of the relations between States and TNCs. The Code has two fold main objectives which are as follows:

Firstly, it seeks to establish standards for the conduct of TNCs from all countries to protect the interests of host countries, strengthen their negotiating capacity and ensure conformity of the operations of TNCs with national development objectives. These standards would apply in such areas as the general and political aspects of the activities of TNCs, the economic, financial and social aspects of the activities of TNCs and the disclosure of information.

Secondly, it proposes to set standards for the treatment of TNCs by countries to protect the legitimate interests of investors, create a stable, predicable and transparent framework for the activities of TNCs and create a climate for foreign direct investment which is beneficial to all parties

in the investment relationship. These standards would apply in such areas as national treatment, transparency, nationalisation and compensation, dispute settlement procedures, fair and equitable treatment and jurisdiction.

Thus, the Code will define the rights and responsibilities of States and TNCs in a balanced manner. It will help to minimise any negative effects and maximise the positive effects associated with activities of TNCs. The Code will thereby contribute to a reduction of friction and conflict between host governments and TNCs and enable the flow of foreign direct investment to realise its full potential in the development process. However, because of the rigid attitude adopted by the industrialised countries on certain contentious issues such as the applicability of international law and national treatment, the prospects of the successful conclusion of the Code negotiations are remote. In fact the intergovernmental group convened by the UN General Assembly in 1992 to finalise the code recommended alternative methods to encourage global FDIs and strengthen the investor-host country relationships. More about the negotiations on the code of conduct on Transnational Corporations are discussed in the next unit.

UN Centre on Transnational Corporations (UNCTC) :

The United Nations Centre on Transnational Corporations (UNCTC) was set up in 1975. It acts as the secretariat to the UN Commission on TNCs and also serves as the UN Secretariat's focal point for all matters related to TNCs. The objectives of the UNCTC are to further the understanding of the nature of TNCs and their economic, social, legal and political effects on home and host especially developing countries and on international relations; to secure effective international agreements aimed at enhancing the contribution of TNCs to national development goals and world economic growth while controlling and eliminating any negative effects; and to strengthen the negotiating capacity of host countries, in particular developing countries, in their dealings with TNCs.

The studies prepared by UNCTC include major surveys of the role of TNCs in world development (published every five years), analyses of laws and contracts, the impact of TNCs on the environment and the role and impact of TNCs in selected industries.

UNCTC information system collects, processes and analyses information on many aspects of the activities of TNCs. The data are continually updated and supplied on request interested parties, especially governments of developing countries. Some areas covered by the system are; statistical data on flows and stocks of foreign direct investment; financial and other statistical data on individual TNCs; information on contracts and agreements between TNCs and host country entities; national legislation, policies, laws, administrative practices and regulations related to TNCs; and annual reports of TNCs and other sources of information on TNCs.

UNCTC assists governments of developing countries in the evaluation and negotiation of specific foreign direct investment and technology projects. Assistance in provided to governments in evaluating financial, fiscal, economic, legal and other technical issues contained in feasibility studies, proposals and contracts prepared for particular projects involving TNCs. Technical support for the negotiations of such contracts is also provided. It also assists in the formulation and revision of foreign investment and technology regimes and in the structuring of contractual relations between TNCs and host countries.

UNCTC has set up five Joint Unit at the United Nations regional Commissions for Africa, Asia and the Pacific, Europe, Latin America and the Caribbean, and Western Asia. The Joint Units serve as the focal points for the UNCTC's activities in each region.

As a part of the restructuring of the United Nations, UNCTC was merged into the Transnational Corporations and Management Division of the Department of Social and Economic Development of the United Nations in 1992.

15.6 UNCTAD, TECHNOLOGY TRANSFER AND RPBs :

The United Nations Conference on Trade and Development (UNCTAD) was set up by the United Nations General Assembly in 1964 as one of its permanent organs, mandated to promote international trade, particularly that of developing countries with a view to accelerating their economic development. UNCTAD is composed of 183 Member States including 179 members of the UN. One of the areas of work of UNCTAD since 1970 has been international technology relations in view of the important bearing it has on trade and development. UNCTAD's studies showed that the gap between industrialised and developing countries in the area of technology had been vast and had been widening with technological advances in the twentieth century. The technological superiority of the developed nations has been protected jealously by the industrial property system and the exchanges of technology between developed and developing countries have been prone to restrictive practices and exploitation. UNCTAD has attempted to propagate a wider understanding of the issue concerning technology and its transfer with the help of in-depth studies particularly focusing on building up national technological capacity, reducing external dependence, and strengthening the bargaining position with transnational corporations. UNCTAD help developing countries in adoption of national policies, plans, strategies, laws, regulations etc. concerning technology consistent with their development plans. To restructure international technological relations UNCTAD spearheaded the initiative towards establishment of an International Code of Conduct on Transfer of Technology.

International Code of Conduct on Transfer of Technology :

The UN General Assembly vide its Resolution 32/88 of December 1977 decided to convene a United Nations Conference on an International Code of Conduct on the Transfer of Technology under the auspices of UNCTAD to negotiate the draft of the Code.

The draft Code tries to remedy the unfavourable position of developing countries in any international transaction of transfer of technology by providing general and equitable standards as a basis for the relationship between parties. It seeks to facilitate and increase the international flow of technological information and making available alternative technologies to developing countries. It specifies the restrictive business practices (RBPs) from which parties to a technology transfer transaction should refrain and sets forth an appropriate set of responsibilities and obligations of parties to transfer of transactions. It recognises the right of each State to employ all appropriate means to facilitate and regulate transfer of technology within the principles of sovereignty, political independence and sovereign equality of all States.

The Code negotiations have proved to be cumbersome. Despite the convening of six sessions of the UN Conference between 1979 and 1985, the negotiations on the International of Conduct on

Transfer of Technology are yet to be completed due to the rigid attitude adopted by the developed countries. Their staff attitude has not only prolonged the negotiations but has also made sure that the proposed Code if ever implemented would not be effective. For one thing, they have opposed the legally binding character of the Code; and as a result, the code is now reduced to a set of "universally acceptable recommendations". For another, it will also not apply to the transactions between a resident but foreign (owned and) controlled entity and a local one; the TNCs which control and supply bulk of the technology can, therefore, easily side track the Code. Besides, the definition of what constitutes a Restrictive Business Practice, has also been diluted; the industrialised countries maintain that the restrictions for the purpose of rationalisation of functions amongst affiliated firms should not be considered contrary to the Code. Because the bulk of technology transactions is of intra firm nature, the scope of the Code as far as RBPs are concerned, stands substantially reduced.

Set of Multilaterally Agreed Equitable Principles and Rules for Control of RBPs :

The concern about the market power exercised by developed countries' enterprises in domestic and international markets and their increasing resort to RBPs to strengthen that power by suppressing protectional competition. Led developing countries to press for international action in this area. Through the Havana Charter had a chapter dealing with RBPs, it was not included in the GATT. The efforts of the United Nations Economic and Social Council in the early 1950s to adopt an international code had been thwarted by the industrial countries. Despite the opposition of developed countries, UNCTAD initiated work in the area of RBPs in 1968 under the resolution 25 (II) adopted by roll-call vote. The work was steadily pursued and developed over the subsequent years, through studies and expert and intergovernmental discussions culminating in the unanimous adoption of the Set of Multilaterally Agreed Equitable Principles and Rules for the Control of RBPs in 1980. The set specifies voluntary recommended norms both for enterprises, including TNCs, and for States. It is not a legally binding instrument. Though it can be hailed as the first decisive step in international efforts to control RBPs, it is yet to be effective. The Intergovernmental Group of Experts on RBPs established by the Trade and Development Board of the UNCTAD to monitor the application and implementation of the Set has repeatedly expressed its concern about the persistent resort to the use of RBPs in international trade transactions.

We shall discuss the subject of code of conduct on Transfer of Technology in more detail in the next unit.

Activity 2

Indicate various types of restrictive business practices (RBPs) that have been resorted to by TNCs in India with specific examples.

.....

.....

15.7 ILO TRIPARTITE DECLARATION :

The Tripartite Declaration of Principles on Multinational Enterprises and Social Policy was approved by the Governing Body of the International Labour Organisation on 16 November 1977.

The Declaration is voluntary in character. It concentrates on employment, training, working conditions and industrial relations and is addressed to TNCs, employers' and workers' organisations and governments.

15.8 OECD GUIDELINES :

The OECD Guidelines on International Investment and Multinational Enterprises adopted in 1976 lay out a rather comprehensive set of voluntary norms of behaviour for transnational corporations A number of these guidelines deal in part with issues which are causes of concern to the Governments, including their fiscal authorities, and to the international labour movement. In a sense, the OECD Guidelines cover the behaviour both of Governments and transnational corporations; it is comprehensive from the point of view of coverage of substantive issues, but it is limited geographically to developed countries. Although the OECD Committee on International Investment and Multinational Enterprises is not empowered to reach conclusions on the conduct of individual enterprises, its interpretation of principles embodied in the Guidelines has already influenced decisions of transnational corporations in certain cases.

15.9 GATT AND INTERNATIONAL BUSINESS :

The General Agreement on Tariffs and Trade (GATT) came into existence in 1948 following the Havana Conference. The International Trade Organisation (ITO) as proposed at the Bretton Woods Conference and a charter of which was established at the Havana Conference failed to come into existence. The principal aim of the GATT is the "substantial reduction of tariffs and other barriers to trade." GATT has 102 contracting parties (Countries) that take part in trade negotiations (called Rounds). The basic principle of GATT is of nondiscrimination. Countries that belong to GATT accept the so-called most-favoured nation (MFN) clause. This means that a country agrees not to give better treatment to any single nation than it gives to all the contracting parties of GATT. The MFN clause in principle rules out any preferential treatment among nations as far as trade policy is concerned. However, GATT has made exceptions from the principle of non-discrimination. Formation of custom unions and free trade areas are thus permitted among groups of countries. As a result today a large part of world trade is carried out within custom unions or free trade areas which as EFTA, Single European Market, NAFTA.

The Uruguay Round :

The Eighth round of multilateral trade negotiations was launched in the GATT Framework at a Ministerial Meeting in September 1986 in Punta del Este, Uruguay. The prominent feature of Uruguay Round, as it has come to be called is the attempt of developed countries to extent GATT type rules and principles applicable to trade in goods to services, international flows of capital and technology. Services, investment and technology had never been a focus in the GATT negotiations which have mandate to cover goods trade. In this respect Uruguay Round represents a point of departure. The Objective is to evolve a multilateral system with built-in provision for the elimination of regulatory measures that host country governments may adopt. These have been sought to be covered through parallel negotiations on the General Agreement on Trade in Services (GATS),

Trade Related Investment Measures (TRIMs) concerning restrictions on international capital flows, and Trade Related Intellectual Property Rights (TRIPs). These attempts of developed countries to extend the domain of GATT to services, investments and technology were resisted by developing countries though without any success because of domination of GATT decision making by major trading countries. Acceptance of these proposals especially TRIMs can have far reaching implications for international business. Because of special relevance of TRIMs for international business it deserves a discussion.

TRIMs :

The developed countries led by the United States, moved to include TRIMs in the Uruguay Round of GATT negotiations, with the objective of phasing them out. Host governments use a variety of performance requirements such as local content requirements, phased manufacturing programmes, export-obligations to orient the operations of multinational enterprises in conformity with their public policy. These performance requirements are called TRIMs as they affect the international trade (exports and imports) resulting from the operations of an enterprise. Both developing and developed host countries have used TRIMs as policy tools. In the recent period the European Community (EC) countries have imposed rules of origin, screw driver regulations and voluntary export restraints (VERs) among other, on Japanese exporters of automobiles and electronics to force them to produce locally for the EC markets.

TRIMs have become a major source of North-South contention in the Uruguay Round Negotiations. The countries of the North or the industrialised countries argue that TRIMS cause distortions in patterns of trade and investment because business decisions on the part of transnational corporations come to be made on the basis of considerations other than market forces. The developing countries, argue that TRIMs can be useful policy tools to promote development objectives and strengthen trade balances. According to developing countries, TRIMs, TRIMs are also restored to offset the trade restrictive and distorting effects of restrictive business practices adopted by TNCs such as export restrictions imposed on their affiliates. Acceptance of TRIMs proposals in the Uruguay Round will, thus, seriously curtail the ability of host developing countries to regulate the operations of TNCs in accordance to their policy.

The GATS provides for liberalisation of service markets and national treatment to be given to foreign enterprises. This provision if implemented would again curtail the ability of the developing countries to protect their service industries. The TRIPs mandate seeks to evolve a stricter intellectual property regime in relation to chemical and pharmaceutical products, extension of patent system to cover living organisms and plants and universal recognition of patents sealed in any member country. These proposals if accepted, will again strengthen the position of TNCs by giving them a more complete monopoly over their technology and innovations. They are likely to further widen the gap between developed and developing countries in the area of technology.

The Uruguay Round Negotiations are yet to reach a conclusion as these have been deadlocked on a number of issues including the US-EC conflict pertaining to agricultural subsidies. Depending upon the conclusion of negotiations on trade in services, TRIPs and TRIMs the Uruguay Round may have taken away from developing countries the freedom to use a number of development policy instruments to guide the operations of TNCs.

Box 15.1: The Final GATT :

After a prolonged and tortuous negotiations lasing over a period of seven and a half years, 124 nations, including India, finally signed the GATT agreement on 15th April 1994 at Marrakesh, Uruguay. The two main documents signed were:

i) the final Act embodying the results of the Uruguay round talks, and

ii) the agreement on World Trade Organisation (WTO) which is to replace GATT.

Mr. Pranab Mukherjee, the Commerce Minister who went to Marrakesh to sign on behalf of India, said that "though India may have reservations on some parts of the Uruguay Round deal, on balance it was in India's interest to go along with the deal." The new vastly empowered WTO and detailed rules on multilateralism, he hoped, "would make unilateralism by powerful nations a difficult proposition." The 22,000-odd pages that comprise the various agreements and annexures seem to be more legal in character than economic and cover new areas as subsidies on agriculture, textile, trade related intellectual property rights and services, and vastly strengthened provisions relating to anti-dumping and countervailing measures. Agriculture for the first time has been brought strongly under the discipline of GATT.

The Marrakesh declaration underscores the strive for greater global coherence on policies in the field of trade, money and finance, including cooperation between the WTO, the IMF and the World Bank.

The following are the main elements of the final Act:

Market access: This is the backbone of the act. Countries pledge to cut tariffs on industrial and farm goods by an average of about 37 percent. The US and European Community agree to trim tariffs between them by one half.

Services: For the first time, rules will govern an estimated $4 billion in annual trade in services like banking, insurance and travel, as well as the movement of labour.

But only minimal market liberalisation commitments have been made, largely because Washington and Brussels could not iron out disagreements over audio-visual products like television programmes and films, financial services and shipping.

The US reserves the right to deny other countries favourable access to the lucrative US financial services market but will hold off for at least 18 months. Washington has threatened to challenge EC curbs on audio-visual goods.

Countries could demand an exemption from the obligation to offer Most Favoured National (MFN) treatment fo service trade partners.

Agriculture: Agriculture for the first time has been folded into the GATT. The blueprint is the 1992 Blair House Accord reached between the US and EC as amended in talks last December. It converts all non-tariff barriers like quotas into tariffs, which are reduced 36 percent for industrialised countries, 24 percent for poor nations. The cuts will be implemented over six years for rich countries, 10 for others.

Activity 3

Indicate various types of performance obligations of TRIMs that have been imposed by the Indian government on foreign collaborations before the current liberalisation policy.

.....

.....

.....

15.10 SUMMARY :

This unit has focussed on international intervention in the area of international business. The need and relevance of international intervention for regulating cross border economic activity has been highlighted. The intervention has been both promotional as well as regulatory. Three World Bank affiliates have been promoting FDI flows by providing finance, investment guarantees and arbitration facilities.

The regulatory intervention includes initiatives taken by the UN Commission on TNCs. UNCTAD, ILO,OECD to evolve norms and codes of conduct of TNCs during 1970s. Most of these initiatives though well intentioned were crippled or rendered ineffective by the resistance and stiff attitude adopted by industrialised countries at the negotiations. In the late 1980s industrialised countries infact made an attempt to curb the ability of even national governments to regulate the operations of TNCs through multilaterial trade negotiations. The need for an effective multilateral framework to regulate the operations to TNCs assumes even greater significance now in view of the increasing globalisation of business.

15.11 SELF ASSESSMENT QUESTIONS :

1) Indicate why a multilateral approach is required to deal with operations of TNCs.
2) Describe the international mechanism available for financing private FDIs and for investment guarantees.
3) What attempts have been made to evolve international norms for conducting international business? How far have these initiatives been effective?
4) Discuss the implications of Uruguay Round proposals for international business.

15.12 FURTHER READINGS :

UNCTC, *Transnational Corporations in World Development: Third Survey,* New York; United Nations, 1985.

World Bank, *Annual Report* 1992, Washington D.C.

UN, *Impact of Trade Related Investment Measures on Trade and Development: Theory Evidence and Policy Implications,* UNCTAD/UNCTC, New York, 1991.

RIS, *UNCTAD VII and Globai Challenge,* New Delhi, Research and Information System for the Non-Aligned and Other Developing Countries, 1987.

UNIT - 16 MULTILATERAL NEGOTIATIONS

Objectives :

After reading this unit, you should be able to:

- appreciate the need for a globally negotiated code of conduct on transnational corporations and on technology transfer,
- understand and analyse the issue and objectives on the code of conduct of Transnational Corporations.
- understand the origin, role and relevance, structure and major features of the code on technology transfer.

Structure :

16.1 Introduction: Background
16.2 Control of Transnational Corporations over Global economy
16.3 Framework of Negotiations
16.4 Basis for Negotiations
16.5 Negotiations on the Code of Conduct on Transnational Corporations
Issues Involved in the Negotiations
Objective of Negotiations
16.6 Major issue on Negotiations
Definition and Scope of Code
General Treatment of Transnational Corporations
16.7 Structure of the Draft Code
General Principles
Economic and Financial issues
16.8 Negotiations on Code of Conduct: An Evaluation
16.9 Negotiations on Code of Conduct on Transfer of Technology
16.10 Origin of Code Negotiations
16.11 Role and Relevance of the Code
16.12 Structure of the Draft Code and its Major Features
16.13 Major Features of the Code
Restrictive Licensing Practices
Applicable law and Dispute Settlement Procedures
16.14 Comments on the Outcome of Negotiations on Code of Conduct on Technology Transfer.
16.15 Summary
16.16 References

16.1 INTRODUCTION :

A Brief Background :

The global economy in the second half of the present century, has been witnessing increasing tendencies towards internationalisation of business. This phenomena has been in sharp contrast with the situation prevailing in the immediately preceding phase, where protectionism and internecine trade wars between countries was the order of the day. Beggar-thy-neighbour policies epitomised this economic rivalry among nations which resulted in severe economic strains in the 1930s, and in the immediate post-World War II phase. The predominant thinking in the post-war period, therefore, was one of evolving mechanisms that could increase economic cooperation on a global scale to the common benefit of all.

Restoration of economic order was sought through a multilateral system of decision-making, involving sovereign states that started to take shape around the middle of the 1940s. It was maintained that multilaterally established rules of economic behaviour were the only way in which the global economy could be put back in shape so that it could function effectively. Sovereign states were expected to negotiate their economic space keeping in view interests of one another.

Contributing to this process of economic cooperation among countries in the past few decades were the international business interests, represented most characteristically by the transnational corporations or the multinational enterprises, as they have often been referred to. The emergence of these conglomerates in the global economy had been seen earlier, but it was only in the phase that we are discussing here that they assumed importance. The strength of the transnational corporations brought them to a point where the corporate interests of the corporations came into conflict with the interests of the sovereign states in whose territories they were operating. This gave rise to a situation where sovereign states were compelled to negotiate with the transnational corporations in an effort to bargain for the economic space.

In order to understand the process of negotiations and what these negotiations involved, in the first instance, try to understand briefly the extent to which the transnational corporations control the global economy.

16.2 CONTROL OF TRANSNATIONAL CORPORATIONS OVER GLOBAL ECONOMY :

The significance of the transnational corporations can be gauged from the fact that in 1980, 350 of such conglomerates and their subsidiaries accounted for 28 percent of the gross Domestic Product of all the developed countries taken together. In terms of size, the largest transnational corporations had sales which exceeded the total Gross Domestic Product of most developing countries in the mid-1980s.

Not only were the transnational corporations accounting for a sizeable proportion of the global production, they were also in control of a major part of all direct foreign investment. According to one estimate, 500 transnational corporations were controlling 80 percent of all direct foreign investment at the beginning of the 1980s. A sizeable proportion of world trade was controlled by the transnational corporations. In the early 1980s, the exports from the home base of 500 transnational

corporations were valued at US $350 billion, or about 28 percent of exports of all developed countries. If exports by their subsidiaries were included, the transnational corporation-linked trade would have been significantly higher. In case of the United States it has been estimated that in the late 1970s, about 90 percent of all trade was generated by the transnational corporations, both of US and non-US origin.

Domination of the transnational corporations was seen in the market for technology as well. It has been seen that although the transnational corporations have not been instrumental in developing technology, they have had a sizeable control over the process of commercializing new technology in most of the post-World War II phase.

The characteristics of the transnational corporations stated above indicate quite clearly that these business entities can exercise a fair degree of control over the countries in which they operate. Transnational corporations have been able to control not only the smaller developing countries which have sought capital and technology from them, but they have also used the countries where they originated from, for maximising their returns. It was found that the transnational corporations paid scant attention to the requirements of their host countries and were exploiting these countries for increasing their profits. The exploitation of countries by the transnational corporations was seen to be more acute in case of developing countries most of which, as stated above, were economically far weaker than the transnational corporations. The multilateral institutions like the United Nations took cognisance of this inability of the developing countries to protect their own interests in the face of the profit seeking transnational corporations. In the seventies a series of initiatives were taken to put an order in the global economic system. The negotiations held were aimed at evolving Codes for the conduct of international business and had two major variants. One was focused on the Code of Conduct for Technology Transfer and the second was a more general Code of Conduct for transnational corporations that was to encompass all areas of operations of the transnational corporations. At the same time, developed countries that were home to most of the transnational corporations had their own valid interests in ascertaining that these business entities which were critical to their economic prosperity got the right treatment of the countries they operated in. We would discuss the main features of the negotiations in the sections below.

16.3 A FRAMEWORK OF NEGOTIATIONS :

Relations between governments and the transnational corporations follow a bargaining pattern. This follows from the fact that both governments and the transnational corporations seek to purse their own goals and since each is contained by the other, negotiating process are called for.

The bargaining relationship has the two obvious components, namely the benefit that each side seeks and the concession each side is willing to offer. In concrete terms, the benefits that governments seek from the transnational corporations are in terms of positive contribution to the process of economic development that they have initiated while the transnationals would seek to maximise their profits through better market access opportunities in their host countries. More generally, the parties involved in the negotiations seek to gain from the each other's strengths. This phenomena can be explained by using the table 16.1 below.

Table 16.1 Bargaining Resources of Transnational Corporations and Host Governments

Strengths of Transnational Corporations	Strengths of Host Governments
1) Assistance in Improving Host Country Internal Balance	1) Control over access to Host Country Market
a) Proprietary technology including product, process and management	a) Control over access to the market in general
b) Access to funds for investment in the host Country	b) Ability to offer on important market to transnational corporations when the government itself is a customer
c) Managerial/ marketing skills	
d) Access to information	
2) Assistance in Improving Host Country External Balance	2) Control over Access to Factors of Production
a) Access to low-cost inputs from abroad	a) Natural resources such as minerals and metals, farmlands, forests, fishers
b) Access to foreign markets for export	b) Low-cost production inputs such as Labour

Source: Behrman, Jack N. and Robert E. Gross, *International Business and Governments: Issues and Institutions,* University of South Carolina Press, Colombia, 1990, p.8.

The table indicates that the two fundamental bargaining resources possessed by host governments arise from the control over the two usual targets of the transnational corporations, namely, (1) the host country market, or (ii) the host country factors of production, such as raw materials or inexpensive labour. Only when countries have the above mentioned attributes, do the transnational corporations get into the act of investing in these countries.

Correspondingly, transnational corporations usually have at least two attributes that the host governments seek: (i) assistance in raising host country income through manufacturing or other activities, such as extractive industries or service-providing enterprises, which use the corporations' proprietary technology, and, (ii) providing access to markets abroad which help in increasing the foreign exchange earnings of the host countries.

Based on these perceptions about the issues involved in the bargaining, the processes and institutions through which negotiations take place are determined. Most of the negotiations involving governments and the transnational corporations in recent decades, have taken place through the multilateral institutions under the United nations system.

These multilateral negotiations brought out, in clear terms, the conflict of interests between the host Governments and the transnational corporations. The examinations of the process of

negotiations between these contending interests provides important insights into the changing nature of the global interplay of forces. Since the negotiations began in the 1970s, there has been a perceptible change in the relative bargaining positions of the sovereign states and the transnational corporations and this determined the eventual outcome of the negotiations as we shall see shortly.

16.4 THE BASIS FOR NEGOTIATIONS :

The reason for considering an international framework for setting the norms of behaviour of transnational corporations was the growing realisation that national regulations and controls were inadequate to deal effectively with global strategies of the transnational corporations. Two parallel processes were initiated to regulate these corporations. The first sought to formulate a broad structure of Code of Conduct on Transnational Corporations. The second was more narrowly focussed on the technology transfer transactions involving the transnational corporations and it tried to provide an International Code of Conduct on Transfer of Technology.

The effort to formulate the Code of Conduct was induced by two main perceptions about the role of the transnational corporations in the global economy. On the one hand, it was recognised that the transnational corporations played a positive role as effective instruments of development in both developed as well as the developing countries and that this dimension needed to be strengthened. On the other hand, there was the realisation that given their all-pervasive nature of operations, the transnational corporations needed to be controlled by setting effective guidelines for their conduct. The result was an effort to establish a balanced Code that prescribed standards of corporate conduct and principles for the treatment of transnational corporations.

For the developing and the socialist countries, the main objective in the Code negotiations was the establishment of international standards for the conduct of transnational corporations. Many Governments, particularly the small developing countries, had encountered difficulties in ensuring that these corporation met such objectives as, consistency of their activities with domestic laws, regulations and policies; adequate disclosure of information; environmental and consumer protection, and further that they did not indulge in such negative activities as tax evasion, restrictive business practices and abusive transfer payments, among other things.

In addition to strengthening their regulatory and negotiating capacities with respect to the transnational corporations, a multilateral regime was seen by some developing countries as contributing to increased capital flows to the developing countries, by establishing conditions of stability, predictability and transparency that would encourage such capital flows. In approaching this problem of regulating the transnational corporations, developed countries also saw merit in adopting a multilateral approach for formalising the norms and standards for the behaviour of the corporations. This was owing to the fact that they had been not only the leading home countries transnational corporations, but had been the largest host countries as well. Thus, it was not surprising that the developed countries had already taken initiatives within their own fora, in the main, the Organization for Economic Cooperation and Development (OECD) and the European Economic Community (EEC), for promulgating some instruments for controlling the operations of the transnational corporations. The OECD Council had adopted the Guidelines for Multinational Enterprise in 1976, for regulating and treatment of such enterprises in the OECD countries and the EEC introduced its own Code of Conduct for companies operating in South Africa in 1978.

At the multilateral level too, initiatives were taken in the 1970s to establish Codes of Conduct relating to specific areas of involvement of the transnational corporation. The more important among these have been the Tripartite Declaration of the Principle concerning Multilateral Enterprises and Social Policy, adopted by the Governing Body of the International Labour Organisation (ILO) in 1977 and the set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices negotiated under the auspices of the United Nations Conference on Trade and Development (UNCTAD) in 1980.

We would discuss the two processes of negotiations involving transnational corporations below. At the outset we would discuss the negotiations on Code of Conduct on Transnational Corporations. Subsequently we would discuss the negotiations on the International Code of Conduct on the Transfer of Technology.

16.5 Negotiations on the Code of Conduct onTransnational Corporations :

Issues Involved in the Negotiations :

The main concern of the developed countries in the Code negotiations was the establishment of a regime of minimum standards for the treatment of transnational corporations. Increased reliance on foreign investment flows was promoted consistently by the developed countries as a means to achieving efficient allocation or resources world-wide and contributing to economic growth. Some developed countries made promotion of foreign investment though the transnational corporations as a major component of their foreign economic policies. In view of the emphasis on the promotion of the transnational corporations, these countries argued for a favourable climate for foreign investments as a means of advancing and promoting economic development, and hence the need for a balanced Code which established standards of fair and equitable treatment for transnational corporations, in addition to standards for their conduct.

Given these diverse perceptions about the purpose the Code was expected to serve, the multilateral negotiations that took place had the important task of providing a stable, predictable and transparent framework that could facilitate the flow of resources across national boundaries and thereby enhance the role of foreign investment in economic and industrial growth. The Code that was to evolve was also meant to minimise any negative effects associated with the activities of transnational corporations. In having this twin-focus on the operations of the transnational corporations and their treatment by Governments, the concerns of both home and host countries, as well as the transnational corporations were to be met.

That a Code for Conduct having these twin-objectives, as referred to above, was felt imperative because of the inadequacies of the earlier efforts which were made to deal with the various issues relating to transnational corporations. The OECD countries, in particular, had promoted bilateral investment protection treaties which were important policy instruments of developed countries. A large number of developing countries had also entered into such treaties primarily to secure foreign investment. The most significant limitation of these treaties was that while the standards of treatment of transnational corporations by their host governments were specified, no mention was made of the corresponding set of standards to govern the behaviour of

the transnational corporations. Thus, the bilateral investment treaties, while remaining a part of the international regime governing transnational corporations, fell short of providing a balanced and comprehensive international framework essential for fostering the predictability and stability required for mutually satisfactory relations between transnational corporations and the Governments. The multilaterally evolved Code was expected to fill this lacuna and to contribute to a reduction of the friction and conflict between the transnational corporations and their host Governments.

Objectives of Negotiations :

The Code of Conduct was a major endeavour of the world community towards evolving a broad set of rules and regulations governing the operations of transnational corporations. This came as a part of the effort that took place in the 1970s to improve the functioning of the international economic system and building on the initiative of the international business community to prescribe norms for foreign direct investment, as expressed, for instance in the "Guidelines for international Investment" adopted by the international Chamber of Commerce. The Code was to provide instrumentalities for regulating the whole range of relations between the governments and the transnational corporations and covering a set of issues that were all encompassing.

The negotiations centering around the Code took place under the auspices of the Commission on Transnational Corporations, the organisation which took shape within the United Nations system in the mid-1970s. It envisaged a global mechanism that was to be opened to participation by all States.

A draft Code, formulated by the Intergovernmental Working Group, a subsidiary body of the Commission established in 1975 and covering 48 States, was considered in the negotiations. The first session of this Intergovernmental Working Group was help in 1977. In the course of the deliberations of the Working Group it was emphasised by the developed countries that the Code ought to be balanced by the establishment of standards for the treatment of transnational corporations in their host countries (implying thereby the developing countries), in addition to the standards for their conduct. This suggestion was made keeping in view the interest of the transnational corporations most of which had their home bases in the developed countries as referred to earlier. The suggestion was accepted by the Economic and Social Council of the United Nations, which stated in its Mexico Declaration of July 1980 [Resolution 1980/60, para 6(f)] that the Code should, among other objectives, "include provisions relating to the treatment of transnational corporations, jurisdiction and other related matters". In substance, the resolution, affirmed that the Code should fulfil the following objectives:

a) Be effective, comprehensive, generally accepted and universally adopted,

b) Associate effectively the activities of transnational corporations with efforts to establish the New International Economic Order and their capabilities with the developmental objectives of developing countries,

c) Reflect the principle of respect by transnational corporations for the national sovereignty, laws and regulations of the countries in which they operate, as well as the established policies of those countries and the right of states to regulate and accordingly to monitor the activities of transnational corporations,

d) Encourage the contribution that tansnational corporations can make towards the achievement of developmental goals and established objectives of the countries in which they operate, particularly the developing countries.

The Intergovernmental Working Group submitted its report to the Commission in its eighth session in 1982. This report, though arrived through a consensus, had several unresolved issues which were central to the Code. The unresolved issues related mostly to the treatment of the transnational corporations. The next phase of the negotiations was consequently entrusted to a special session of the Commission on Transnational Corporations, which began its deliberations in 1983 and it was made open to the participation of all States.

16.6 MAJOR ISSUES IN THE NEGOTIATIONS :

Definition and Scope of Code :

The scope of application of the Code was a key issue in the negotiations. Negotiating countries had serious differences over the definition of a "Transnational Corporation". OECD members, representing the developed countries, were of the opinion that the Code should also apply to the State enterprises in the Socialist countries. In view of such differences, it was decided to seek the widest application of the Code to all enterprises from all countries operating transnationally, irrespective of the nature of their ownership patterns, field of activity, the perceptions of their home countries or a qualitative assessment of their role in international economic relations. Accordingly, enterprises were to be considered as transnational corporations irrespective of the fact whether they were classified in any country or not.

General Treatment of Transnational Corporations :

a) The negotiations revealed a broad agreement on the issue that the States would have the right to regulate the entry and establishment of transnational corporations in their territories. This was in keeping with the basic principle of national sovereignty. What was however disputed was the issue of standards to be observed by the host Governments in their treatment of transnational corporations. The developed countries had sought to introduce the clause that called for "fair and equitable" treatment to be given to the transnational corporations.

b) Related to this issue was the national treatment standard, the main thrust of which would have required the host countries to accord to transnational corporations the same treatment that domestic enterprises in similar circumstances enjoyed. Within the framework of this principle of national treatment, it was agreed that the standard of treatment should be subject to national requirements for maintaining public order and protecting national security. It should also be in conformity with national constitutions and should be without prejudice to measures specified in legislation relating to the declared development objectives of the developing countries. In this context, the developed countries, argued that the provision should be flexible enough to allow preferential treatment for transnational corporations if the host country considered it appropriate.

c) The other issue of contention in the negotiations related to the free transfer by the transnational corporations of payments relating to their investments. While the transnational corporation's primary objective was free transfer of earnings on their investment, many Governments of ho[illegible]

countries were unwilling to give up their power to regulate the use of their foreign exchange resources, particularly in light of the fact that these resources were scarce. Any provision providing for free transfer of resources by transnational corporations was therefore opposed by the developing countries. The developed countries, on the other hand pressed for the acceptance of the principle of free transfer of resources in general and as a compromise they were willing to provide an exception from this principle for countries that were temporarily in balance of payment difficulties.

The developing countries, on the other hand, argued that while the question of preferential treatment to transnational corporations was within the sovereign discretion of individual states, it should not be made a general international standard.

16.7 STRUCTURE OF THE DRAFT CODE EMERGING OUT OF THE NEGOTIATIONS :

The Draft Code of Conduct assumed the following broad structure:

i) General principles enunciating the political and legal basis for the regulation of transnational corporations by the host States and the basic norms of general economic import in the relations between the Governments and the transnational corporations.

ii) Specific standards dealing with discrete economic and financial issues

iii) Norms addressing selected social issues, and

iv) Prescriptions on disclosure of information.

We would elaborate on the specific features of the Code under each of the broad characteristics described above.

i) General Principle :

The draft Code re-emphasised the well-established principles emanating from the premise that the transnational corporations are required to respect the national sovereignty of the countries in which they operate.

A related obligation on the transnational corporations underlined in the Code related to their making endeavours to the achievement of the developmental goals set by the host Governments and thereby to contribute to their economic progress.

ii) Economic and Financial Issues :

To reinforce the above mentioned standards on adherence to the economic and development goals of the host states, the Draft Code provided that the transnational corporations would make every effort to allocate their decision making powers among their subsidiaries and affiliates, operating in different countries so as to enable them to contribute to the social and economic development of the host countries. This provision was included to ensure the grant of appropriate autonomy by the parent companies to their foreign subsidiaries and affiliates. The need for such a provision flowed from the widespread empirical evidence that acquisition

of majority equity in a joint venture set up in a developing country by the State or a local private entrepreneur did not necessarily ensure the control of the venture by the majority partners.

An important element of the regulatory mechanism that the Draft Code underlined was relating to control of abusive transfer pricing by the transnational corporations. The Code provided that the transnational corporations would seek to desist from applying pricing policies that are not based on relevant market prices, or the arms-length principle in carrying out the transactions, which may have detrimental economic effects such as evasion of exchange control measures and the consequent loss of foreign exchange that the host countries may suffer.

16.8 NEGOTIATIONS ON CODE OF CONDUCT : AN EVALUATION :

The negotiations leading to the formalisation of the Draft Code of Conduct laid down the standards that were needed to regulate the Transnational Corporations. The framework for regulating the corporations was provided in unambiguous terms as we discussed above, but there remained several major weaknesses. The exact legal force, or more precisely, the extent of the binding force of the standards laid down in the Draft Code has remained an open issue since the Draft was presented in the middle of the 1980s.

It can thus be said that the process of negotiations involving conduct of international business was not able to deliver the goods in so far as the host countries, constituting the developing countries, are concerned.

The process of negotiations we described in the earlier pages had another complementary set of negotiations in which developing countries were trying to secure better terms in technology transfer transactions with the transnational corporations. This process is discussed below.

16.9 NEGOTIATIONS ON CODE OF CONDUCT ON TRANSFER OF TECHNOLOGY :

Technology transfer to the newly independent developing countries from the transnational corporations had been on an increase from the 1950s. While the beneficial effects of the technology that the developing countries were getting were recognised for furthering their progress towards a greater degree of industrialisation, the national authorities of some developing countries pointed to the fact that certain practices associated with technology transfer operations were abusive of, or contrary to, the national development needs. They indicated that these negative aspects of transfer of technology arose either because of the imbalance in the respective bargaining powers of the licensees and the licensor of technology i.e. receipt countries and the corporations selling the technology in these transactions, or because of insufficient regulation involving the sale of technology. In order to remedy this situation the recipient countries took measures to adopt national legislation for regulating technology transfer transactions and thereby to control the perceived ill-effects of such transactions. At the same time, these countries took initiatives at the multilateral level to evolve a multilaterally agreed upon framework underlining the Code of Conduct on the Transfer of Technology.

16.10 THE ORIGIN OF THE CODE NEGOTIATIONS :

The formal initiative towards formalising an International Code for the Transfer of Technology were made in 1972, through the adoption of Resolution 33 (iii) at the third session of the UNCTAD. The main thrust to the negotiations, however, came in 1974 when the General Assembly, in its Programme of Action for the Establishment of a New International Economic Order (Resolution 3202 (s-vi)), referred to the adoption of an International Code of Conduct on the Transfer of Technology, responsive to the needs and conditions prevalent in the developing countries. The Code was seen from its inception as primarily dealing with an aspect of the North-South economic relations which was critical to the process of industrialisation of the South.

An intergovernmental group of experts was established by the UNCTAD for preparing a draft Code of Conduct that was to form the basis of negotiations towards evolving the International Code on Technology Transfer. The intergovernmental group, in six sessions between 1976 and 1978, prepared the draft. The General Assembly decided to convene a United Nations Conference on an International Code of Conduct on the Transfer of Technology under the auspices of the UNCTAD. Formal negotiations on the Code of Conduct were initiated in 1978 and in the course of six sessions the last being held in 1985, the negotiated draft was developed.

16.11 ROLE AND RELEVANCE OF THE CODE :

The relevance of the Code of Conduct on the Transfer of Technology in a continuously changing global environment was also considered from the point of view of both the Governments and the parties involved in the transfer of technology. The suppliers of technology sought ways in which they could attract minimum regulation and obtain conditions for safeguarding their commercial interests. Not withstanding this pressure, there existed sufficient common ground to warrant creation of a global framework of norms and standards for transfer of technology.

These norms and standards were such so as not only to influence the behaviour of technology suppliers, but also to establish universally acceptable standards by which the treatment of technology suppliers may be judged, as well as a common framework for the transfer or licensing of industrial property rights, which include among other forms of rights, patent rights and copyrights. It was felt that in the context of an inter-dependent global economy, such a common framework should greatly enhance the stability and predictability needed for the free flow of technology among nations. The necessity of this framework stemmed from the recognition of the fact that national regulations might grow even more diverse in the absence of international standards. Therefore, adoption of a common frame of reference for national regulatory regimes would in itself constitute a positive development even from the point of view of technology suppliers.

It was commonly held that with an agreed Code, the flow of technology to developing countries would be encouraged to the extent that regulatory standards are not only harmonized but are also reasonable.

16.12 STRUCTURE OF THE DRAFT CODE AND ITS MAJOR FEATURES :

The negotiations till 1985 resulted in the Draft International Code on the Transfer of Technology. Nine chapters of this Draft Code provided the details of the Code and these covered substantive

issues like national regulation of transfer of technology transactions, restrictive business practices, dispute settlement machinery, machinery to oversee the implementation of the Code.

With the exception of two chapters, which we would discuss in greater details below, the Draft Code of Conduct reflected a broad agreement of views between the negotiating States. However, on two issues central to the Code, (appearing in Chapters 4 and 9 of) the Draft marked the beginning of detailed negotiations which have continued till recently. The centrality of these issues lies in the fact that they underlined the regulatory dimension of the Code and were thus the points of contention between the developed and the developing countries. In the following discussion we would highlight some of its major features.

16.13 MAJOR FEATURES OF THE CODE :

Major features of the code relate to the following:

i) Restrictive Licensing Practices :

From the beginning of the negotiations a centre-price of the proposed Code had been a list of restrictive licensing practices to be avoided. Most of the practices listed in the early drafts of the Code came from regulations of some developing countries.

In course of the negotiations it was possible to reach nearly full agreement on a common list of practices, but it was difficult to formulate a little for the Chapter dealing with the restrictive business practices (Chapter 4 of the Draft Code) and a "chapeau" or the introductory section which would set forth an analytical framework for determining when certain practices would be acceptable rather than objectionable.

The developing countries, based on their own experience, viewed regulation pertaining to technology transfer, as an attendant policy to the control of foreign investment, or more specifically, the transnational corporations. The purpose of such regulation, as commonly perceived, was not so much to preserve competitions as to balance bargaining strength, encourage national development and promote exports.

The developed countries, on the other hand, had generally not regulated transfer of technology using specific legislation. But most of these countries had legislated very effective anti-trust laws with the developing countries lacked. The anti-trust legislation gave rise to well developed jurisprudence regarding anti-trust and licensing. This jurisprudence considered licensing to be a useful, legitimate activity under this system. A licensing restriction would be regarded offensive only if the limitation of competition goes beyond the need of the licensor to protect and exploit its intellectual property rights and would significantly lessen competition in the relevant market. In view of this, the developed countries emphasised that only those practices be listed in the Code that are to be prohibited or controlled on the grounds that they restricted competition. The conflict between autonomy of private transactions represented by the position of developed countries and the emphasis on the development objectives and consequently the larger public interests, was clearly visible in this difference over the formulation of Chapter 4 of the Code.

ii) Applicable Law and Dispute Settlement Procedures :

The juridical dimension of the Code of Conduct, the choice of the legal system for arbitration procedure and the settlement of disputes were to be set out in Chapter 9 of the Draft Code. However,

in its textual rendering in the draft, the Chapter remained as a set of proposals requiring further negotiations.

The original text proposed by the developing countries provided that technology transfer arrangements be governed with regard to their validity, performance and interpretation by the laws of the technology receiving countries. It was further proposed that these countries should exercise legal jurisdiction over the settlement of disputes pertaining to those arrangements. Arbitration in disputes, it was suggested, would be permitted only if the laws applicable to the technology transfer agreements do not exclude recourse to arbitration. The developed countries, on the other hand, stressed that the contractual agreements should not be bound by any national legislation. Thus, while developing countries as recipients of technology took the position that the dispute settlement procedures should follow their legal system, the developed countries argued against any particular system acting as a framework for settlement of disputes.

16.14 COMMENTS ON THE OUTCOME OF THE NEGOTIATIONS ON CODE OF CONDUCT TECHNOLOGY TRANSFER :

The negotiations on the International Code of Conduct on the Transfer of Technology yielded little in terms of results. The failure of the process was epitomised by the inability of the negotiating States to agree to a common Draft Code prior to its formal acceptance.

The protracted negotiations on the Code have seen an evolution in the positions of the negotiating States in respect of the scope and content of the provisions. The conflict between autonomy of private parties involved in the technology transfer transactions and the public interest assumed insurmountable proportions since no acceptable position could be found in the negotiations.

This underlying conflict that formed the basic framework for the Code negotiations has often been pointed as the reason for the failure of the process to meet the objectives. Regulation of transnational corporations was seen as the major function of the two Codes, namely, Code of Conduct on Transnational Corporations and the International Code of Conduct on the Transfer of Technology, but the changing international scenario in the past two decades and particularly, the weakening of the bargaining position of the developing countries at whose behest the Code negotiations were initiated, however, provided impediments to even the formalisation of the Codes.

16.15 SUMMARY :

With the global spread of international business and the increasing domination by transnational corporations over the global economy, there have emerged areas of conflict between the sovereign States and the corporations, over the economic space each one can control. Negotiations between the States and the Transnational corporations for defining their respective domains have gained increasing prominence as a result.

The scheme of bargaining that has been adopted has been to secure maximum from within the resources that the other is endowed with. For instance, the transnational corporations have the advantages of the modern technology, surplus funds for investment and managerial and marketing skills that are essential ingredients for a successful commercial venture. The host countries, on the otner hand, have the control over their respective domestic markets and some factors of production. Negotiations between the transnational corporations and the host country government

were aimed at developing mechanisms through which the resources of the two parties could be easily exchanged.

The negotiations on Code of Conduct on Transnational Corporations were to provide a framework wherein the Corporations were obliged to participate in the development processes of their host countries. The host countries, on the other hand, were expected to provide conditions for the transnational corporations to function effectively.

The negotiations on the International Code of Conduct on the Transfer of Technology were to provide a mechanism for technology transfer where the interests of both parties involved in the technology transaction could be protected.

Both the sets of negotiations had set the objective of developing regulatory frameworks, which the developing countries, who were also the host countries to the transnational corporations, were arguing for. The developed countries, representing the interests of the transnational corporations, were arguing against such regulations and were pushing for a system where the rights of the corporations could be enhanced.

The negotiations threw up some areas where the parties involved were arguing from two extreme positions as a result of which there was no agreement. Negotiations on the Codes of Conduct have consequently remained inconclusive.

16.16 FURTHER READINGS :

Behrman, Jack N. and Robert E. Grosse, *International Business and Governments: Issues and Institutions*, University of South Carolina Press, Colun . a.

Jenkins, Rhys, *Transnational Corporations and Uneven Development: The Internationalization of Capital and the Third World*, Methuen & Co. Ltd., London, 1987.

UNCTAD, *Draft International Code of Conduct on the Transfer of Technology: A Note by UNCTAD,* TD/CODE TOT/47, June 1985.

UNCTAD, *Draft International Code of Conduct on the Transfer of Technology: Report and notes by experts on the outstanding issues.* TD/CODE TOT/52, August 1988.

UNCTAD, *Consultations on the Draft International Code of Conduct on the Transfer of Technology: Report by the Secretary-General of UNCTAD,* TD/CODE TOT/50, October 1986.

UNCTAD, *The Relevance of Recent Developments in the Area of Technology to the Negotiations on the Draft International Code of Conduct on the Transfer of Technology:* Study by the UNCTAD Secretariat, TD/CODE TOT/55, October 1990.

UNCTC, *Transnational Corporations in World Development: Third Survey,* UN, New York, 1985.

UNCTC, *The United Nations Code of Conduct on Transnational Corporations, Current Studies Series A,* No. 4, New York, 1986.

UNCTC, *The New Code Environment, Current Studies Series A,* No. 16, New York, 1990.

UNCTC, *Transnational Corporations in World Development: Trends and Prospects UN,* New York, 1988.