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# 1 Globalisation and the New International Environment

## Chapter Objectives

By the end of this chapter, you should have a better idea of globalisation and how this has made a real impact on modern business. We will look at the following topics:

- The first glimmers of international business and how this process of internationalisation is so different from globalisation.
- Attempts to generate theories of international trade even if trade itself seemed to expand without their help.
- How globalisation serves the interests of developed economies more than it does those of emerging economies.
- The myths surrounding the balance of payments.
- What globalisation means for managers and employability.

## THE HISTORIC ROOTS OF GLOBALISATION

In Lake Mälaren near the Swedish capital of Stockholm lies the unremarkable island of Helgö. Apart from its pleasant location and the pretty eighteenth-century Kageholm Castle, it might be thought that there is nothing there to detain an ambitious student of global management. Yet the island symbolises, not how much the world of business has changed over the centuries, but how little the underlying principles have remained constant. In 1954 an archaeological dig on the island turned up three remarkable Viking possessions: an Indian Buddha statuette, a sacred Irish crozier and an Egyptian scoop (Waller, 1982). The statuette and the scoop are of sixth-century origin, making the eighth-century crozier, an ornamental bishop's crook, almost disappointingly modern by comparison.

Each of the items is exquisite by any standard, but the staggering fact is that together they had travelled over 16,000km to reach their Scandinavian destination. These journeys would have been completed at a time when Vikings were marauding through Europe, Egypt was under Byzantine rule and India was made up of medieval states. Long-distance trade would have taken many months to complete, but essentially this is the same process in which modern international trade operates. Simply, there are specialist producers in distant locations who are able to trade with each other to mutual advantage. It is not known what the Viking buyers were able to exchange for the artefacts, but it was most likely to have been plunder that they had amassed from their numerous raids through Europe.

#### 4 *Managing Global Business*

While the fundamentals of trade may have remained surprisingly constant, there are areas where changes have taken place. The speed that goods can be shipped is certainly faster, reduced to mere hours if they are transported by air. It is also possible to be in direct contact with the originator of the good. If the shirt you wear says it is from India, it would be quite feasible to research its entire supply chain. The great leap forward that international trade represents, then, is not how we can profit from it, we have always done that, but how we can co-ordinate and control it to our advantage. This is where the science of business management steps in, many eons after the benefits of trade were first experienced.

### FROM INTERNATIONALISATION TO GLOBALISATION

Current experience suggests that the pace of international trade has been accelerating, particularly in the past few decades. It has also been spreading to the extent that it can be said with some confidence that no country in the world is now isolated from its influence. Yet even in the past 150 years, the process of international connectedness has not been an inexorable march towards total economic integration but has been a series of advances and retreats. The emergence of the United States as a major economic power in the mid-nineteenth century proved to be a major draw for immigration and capital investment which only served to stoke the furnace of economic expansion even further. The spirit of optimism was then undermined by the financial disasters after World War I and the reversal away from free trade towards the kinds of protectionist policies that are so stubborn to remove (Hirst and Thompson, 2002).

It is because the isolationist doctrine of holding back imports with a protectionist wall of tariff and non-tariff obstacles is mutually destructive that, post-World War II, global economic institutions have been created to unjam the mechanisms of free trade. Chief among them is the **World Trade Organisation (WTO)**, but even it has struggled to liberalise trade. There is still a visceral faith in the idea that exports are good, imports are bad. As we shall see, whatever the intuitive attraction of this one-sided trade doctrine its obstinate blindness to the enlightenment of free trade will continue to suppress trade and hold back global economic development.

International trade being entrenched in human existence over so many centuries means that any theories that seek to explain it are guilty of ex-post rationalisation. Nevertheless, we need their insights if we are to combat the ever-present tendencies for countries to give in to the temptation to safeguard their industries by protecting them from international competition. When international managers know the theories behind trade then they will understand why they should embrace globalisation.

### MERCANTILISM AND THE ZERO-SUM GAME

The earliest attempt to structure our understanding of international trade resulted in the theory of **mercantilism**. Unlike most theories, this has no single inventor and it is instead an approach that emerged over a century or so. Some of the blame is attached to Adam Smith, although he never used the word. Instead, Smith referred to a mercantile system and the necessity for balancing the nation's accounts favourably. Indeed, mercantilism is less a theory of trade and more a rationale for nation building, one that confuses money and wealth as part of a policy for securing a nation's status within the world's flow of trade (Harris, 2004).

It is not difficult to see why this is so since mercantilism has a strong intuitive basis. You can immediately see this even today when you ask a group of people the simple question, 'which is better for your

national economy, exports or imports? Invariably you will find that the vast majority of people will opt for exports. The simple logic of the argument is that if your country is selling more than it is buying, then it must be growing richer. It is what is known as a zero-sum game, meaning that there are absolute limits on what can be gained, and so it is better to grab what you can at the expense of your neighbour. In fact, this is quite wrong; both exports and imports are important: it is trade between the two that brings the most benefits. The key point is that international trade brings mutual benefits, even for the most disadvantaged nations.

Nevertheless, there are certain short-term attractions to the mercantilist approach. It can result in the rapid expansion of particular industries as they gain access to the wider international market. The industrial emphasis is on retaining the skills that add maximum value, which is where the profits lie. Mercantilist policies sanction imports of commodities to feed the domestic industry while imports of rival finished goods are suppressed. The rest of the world, then, is seen as a source of raw material and a market for finished goods. Since countries in the rest of the world have their own economic development agendas for a mercantilist policy to be fully implemented it implies suppression of rival industries in those countries. Inevitably, this created the shameful urge to build empires and thereby control the flow of trade. In response, poorer countries are forced to mount their own trade barriers because their exports face obstacles put up by wealthier countries (Looi Kee et al., 2009).



### CASE STUDY: SPAIN AND THE GOLDEN BANKRUPTCY

The association between mercantilism and the worst aspects of imperialism are most obvious if we go back to the sixteenth century. This was a time when Spain, for example, was expanding its empire and amassing wealth in the form of gold, not all of it earned through fair trade. In Spain this gold was as good as currency, with the effect that the economy was awash with cash. According to monetarist economic theories, the excess cash was chasing the same quantity of goods in the market, with the result that prices climbed and inflation raged.

Those engaged in the mercantilist trade continued to accumulate gold; therefore, they could afford to keep pace with inflation, but for poorer people with no gold the higher prices were intolerable. So while the rich were lavishing gold leaf on religious patronage, the poor in Spain were starving. Corruption is an integral feature of mercantilism and another example of how economic resources can be misallocated. One of the reasons Spain lost the sea battle against England in 1588 was that the Spanish armada was poorly maintained and the sailors were severely malnourished.

It was not only Spain, the mother country, that suffered from its mercantilist policies; the colonies did too. Their nascent economies were tightly controlled in order to maintain their status as suppliers of raw materials to the value-adding industries of the mother country. It could be argued that Spain's colonies were handicapped by this legacy even after they had won their independence.

**Point of consideration:** If Spain had focused instead on developing its colonies economically rather than using them for cheap commodity imports, how would Spain's own economic development have been different?

*Source:* Mahoney (2010)

## NEO-MERCANTILISM IN THE MODERN WORLD

You might well wonder about the point of the history lesson. The fact of the matter is that there is still a strong popular belief in the mercantilist approach. It is particularly tempting for developing countries since it encourages the expansion of export-oriented industries, bringing them up to global standards of scale and technology. With gold now replaced by national currencies, the effects on the economy of amassing wealth are no longer so immediate. Nevertheless, the impact is still just as pernicious and this approach is known as **neo-mercantilism**.

Under neo-mercantilism the medium of exchange becomes money. Unlike gold, money can generally only be spent in the country of origin. The principle is still the same, a beggar-thy-neighbour zero-sum game where both sides ultimately suffer. Self-sufficiency and exports are emphasised over imports, while overseas capital investments are restricted. Countries may profess to operate liberal economies but most will protect domestic industries to a degree. As with traditional mercantilism, there is a strong political emphasis on nation building even if that means that the welfare of the domestic population is a lower priority. Rather, goods are sold to overseas consumers who then feel the welfare benefits of the competitive prices, while at home consumers are denied access to imports.

The main beneficiaries, as before, are those that are involved in the export-oriented industry, with the effect that income inequality widens between the rich and the poor. For a developing country this period may be considered part of its growing pains: a few getting rich on the new industries while the rest of the economy gradually catches up. Kröger (2012) argues that Brazil's support of national industrial champions is another example of neo-mercantilism.

In the long term the bias towards exporting creates its own problems. Domestic consumers are not served by the new industries and they have poor access to imported goods. Even if they could find the imported goods they would find that the low value of their currency made imports relatively expensive. Usually, the currency of an exporting nation rises in value as international customers seek it out in order to purchase the goods, but the exporting government works to suppress the value of the currency. It does this by hoarding foreign currency in its reserves, thereby reducing the amounts of that currency in circulation and therefore raising its value.



### MANAGEMENT SPOTLIGHT: NEO-MERCANTILISM FOR MODERN MANAGERS

Neo-mercantilist policies restrict the range of strategies open to business managers. They will find that the government will support strategies that substitute for imports or use basic imports, usually commodities, in value-adding processes. The government is therefore looking for businesses that:

- Reduce the nation's payments for imports
- Improve the national skills base
- Earn foreign exchange through exports.

This is a national strategy that is often employed by developing nations that are looking to accelerate their economic progress, or developed nations that wish to promote a key industry. For developing nations that lack the skill base the shortest route to economic development is to invite **multinational enterprises (MNEs)** from overseas to invest. The MNEs are willing to engage in **foreign direct investment (FDI)** because although it may be substituting imports they are the

imports of rival MNEs. The local government's worry will be that the national skills base is not being expanded by the MNE, so joint ventures are often made compulsory in order to encourage knowledge transfer from the MNE.

Managers will find that whether they work for a local corporation or the incoming MNE, the business strategy needs to be closely aligned with the national strategy. This implies those that can deliver high-value content:

- Electronics
- Fashion clothing
- Complex consumer goods
- Import substitution of high-value goods, e.g. cars, aircraft, trains, defence goods
- National champions upon which other industries depend, e.g. steel production, construction.

Many other industries will be on the losing end of this national trade policy bargain. These include:

- Low-value exports, e.g. commodities
- Domestic agricultural goods
- Importers of high-value components.

There will be some latitude in these policies, such as where high-value imports are necessary for a given type of production to go ahead, but going against government strategy invariably involves overcoming numerous bureaucratic hurdles.

**Point of consideration:** How closely should managers work with politicians in formulating trade policies? Is it better to work within a framework imposed by government rather than attempt to influence the decision making?

## ABSOLUTE ADVANTAGE THEORY

The mercantilist approach to trade is simple to understand and can accelerate the economic progress of a developing country during its formative years. However, the zero-sum game assumes that the global economy as a whole is not expanding. In essence, the world's economy is considered to be static and it is only by exporting that a country can gain a greater share of the wealth.

**Adam Smith**, the famous economist, challenged this negative advancement, arguing that human wealth was not dependent on gold but rather goods and services (Harris, 2004). If a country has an absolute advantage then it is able to produce a particular good with the lowest input of all its trading partners. This means it is the most efficient.



### MYTH BUSTER: CHAMPAGNE AND CONTRIVED ABSOLUTE ADVANTAGE

It might be thought that France holds an absolute advantage in the production of Champagne. Certainly, by reputation it is the very monarch of wines, thanks to the excellent growing conditions that the country enjoys for the grapes, such as Pinot noir. Yet it is not unique in this, and other countries have the potential to produce rival wines of the same type, even the UK with its decidedly

uncooperative climate. The French, though, have created a unique advantage that no competitor can replicate: they have registered the Champagne name so that it is legally restricted to only those white sparkling wines from the Champagne district of France, much to the chagrin of the wine-making village of Champagne in Switzerland.

This is known as Protected Designation of Origin (PDO), a European Union (EU) ruling on where named products can claim a geographical link. In a sense this ensures that France has an absolute advantage in the production of Champagne in perpetuity. Not only have other wine-growing regions sought protection for their particular products, the same approach has created absolute advantages for Greece in the production of feta cheese, as well as many products in other countries.

There is no doubt that PDO is a restriction on free trade. Other EU schemes include Protected Geographical Indication (PGI), where at least one process takes place in the named location, and Traditional Speciality Guaranteed (TSG), which refers to the character of the product or a process.

**Point of consideration:** What are the advantages and disadvantages to the consumer of PDO?

*Source:* European Commission PDO-PGI-TSG, 2014

Adam Smith realised that two trading nations could achieve mutual gains by expanding the total amount of trade, not just taking shares of some fixed global amount. They do this by focusing on those activities where they have an absolute advantage and trading with nations that have complementary absolute advantages. Since both are working at their most efficient then the consumer should benefit through falling prices.

If we take the United States and Canada as examples, both countries have forests for timber and open grasslands for growing wheat. It is clear, though, that the vast forests of Canada indicate an absolute advantage in timber, while the United States would hold an absolute advantage in wheat. Smith would measure these advantages in terms of the labour input, which we illustrate in Table 1.1.

To make the calculations easier, let's assume that equal amounts of timber and wheat are needed by each country. So, from the example above, for the two countries to provide a tonne of each product domestically for their own consumption would require a total of ten units of labour. However, if the countries focus their efforts where they have the advantage, producing one tonne for domestic consumption and one tonne for export to their trading partner, then the total labour input comes to eight units. This breaks down into six units of labour for timber production in Canada, and two units of labour for wheat in the United States. In this imaginary case, international trade saves two units of labour, which can then be employed elsewhere in the economy. In this way, trade is a positive-sum game that leads to an overall economic expansion.

**Table 1.1** *US and Canadian absolute advantages*

Country	Product	Labour input per tonne
US	Timber	4
	Wheat	1
Canada	Timber	3
	Wheat	2

In practice, the theory of absolute advantage fails to explain the complexity of international trade. If a country has an absolute advantage over all its trading partners, then the theory states that it should focus all its energies on the production of that one product and import everything else it needs. You do not have to be a geography expert to realise that the Canadian economy is engaged in far more than simple timber production.

## COMPARATIVE ADVANTAGE THEORIES

**David Ricardo** set down the foundation of the modern approach to international trade with his theory of **comparative advantage**. Roy Ruffin (2002) asserts that it is one of the most important economic theories devised.

In the theory of comparative advantage, attention is now focused on the internal economy of a country. Perhaps a little confusingly, the comparison being made is not between two countries but is between two economic activities being conducted within the country. So, a comparative advantage is the activity that the country is more efficient at than any other activity it might be engaged in. In relation to a potential trading partner, the country may be less efficient at producing both goods but there is one that it is least worst at; in this it has a comparative advantage. This is illustrated in Table 1.2 for trade between the United States and Mexico, this time for the computer software industry and textiles.

*Table 1.2 US and Mexican comparative advantages*

Country	Product	Labour
US	Computer Software	3
	Textiles	6
Mexico	Computer Software	10
	Textiles	7

Table 1.2 is an example of how the United States might have absolute advantages in production of both computer software and textiles, though it is clearly best at computer software. The strong position in both industries invites a mercantilist response from the United States to produce both products and Mexico will be obliged to import both products.

As before, if we assume both countries want equal amounts of each product, then concentrating all production in the United States will involve labour input of 18 units. The only way Mexico could maintain its industry would be by refusing to trade with the United States, perhaps by applying punitive tariffs that price US goods out of its market. You can think of this as taking Mexico's cost disadvantage and adding it to the price of the imported US goods. The total labour input by both countries after the trade restrictions have been put in place would be 26 units. Since the total labour input has risen, both countries are worse off.

## HECKSCHER–OHLIN THEORY

When the Ricardian theory of comparative advantage was first proposed the industrial revolution had barely started. It was therefore fair to assume that the only production factor of any note was labour and that this was not mobile across national borders. This view became outdated once investments in machinery began to change the commercial landscape.



The work of **Eli Heckscher** contributed to **Bertil Ohlin's** publication in 1933 of his theory on a two factor explanation for trade, adding capital to labour in the scenario of two countries deciding how to produce two distinct products (Baldwin, 2008). This is known as the Heckscher–Ohlin (HO) **factor endowment model** since the country is seen to have capital and labour as inherent qualities, almost as if it was born with them. This is most obvious with a country with a large population where we can readily accept that it must be well endowed with labour resources. Capital is less easy to define. However, it includes those factors that are part of the production process but are not consumed by it, so are distinct from raw materials. Infrastructure, institutions and banking would be examples of capital endowment.

As in all business and theoretical models, the HO model simplifies its view of the world by making a long list of assumptions. It is not that these assumed factors of production are seen as irrelevant, only that their inclusion would complicate the calculations unnecessarily and obscure our view of the two critical factors, labour and capital.

### HECKSCHER–OHLIN ASSUMPTIONS

1. Capital mobility: capital is available freely within the country, but cannot be transferred to other countries.
2. Labour mobility: labour can move freely within the country, but cannot migrate to other countries.
3. Technology: countries enjoy the same access to technology, so their choice of production depends on labour and capital. The two commodities under consideration use unrelated technologies.
4. Law of one price applies: a commodity sells for the same price in all markets, unaffected by trade barriers, tariffs and transportation costs.
5. Constant returns to scale: as production expands there is no additional advantage found in the scale of output, which would then affect costs and prices.
6. Perfect competition: established producers can be challenged by new rivals at any time.

As you look through the assumptions you can probably argue with each and every one of them – just another one of the joys of studying economics for business! Nevertheless, the theory should provide sufficient illumination for us to understand the basic mechanisms of international trade.

The HO model, quite reasonably, states that a country that is abundantly endowed with one factor will use it intensively because the cost will be cheaper. Again, labour is the factor that illustrates this best because we understand that a country that has a relatively large population should have lower labour costs. We understand this because of simple supply and demand: if supply exceeds demand then the price of the supply must fall. The capital factor is less readily identified but the same principle applies: where capital is readily available it will be cheaper, most likely expressed in the form of interest rates.

If we explore this theory with two countries, let us say the United States and China, we can fairly claim that the United States is capital abundant and China is labour abundant. Trade allows them to specialise in their production system where they have the comparative advantage. As they develop their



industries their intensive factor will gradually become scarcer, with the natural consequence that the other factor becomes relatively abundant. So as the United States exploits its capital the demand will begin to outstrip supply, raising its price (i.e. higher interest rates) and labour prices will start to look more attractive.

The same dynamic change will take place in China, except related to the abundant factor input of labour. As factories take on more workers labour prices will rise and it will be capital that becomes more attractive. This sets the two countries on a convergent path until eventually the costs will meet and factor price equalisation will have been achieved. This is the **factor equalisation theory (FET)**. At this point no more gains from trade can be made and volumes between the two countries stabilise (Markusen and Venables, 2000).

## HO MODEL IN PRACTICE

The trading destination implied by the HO model, that countries will specialise in their comparative advantage up to the point where factor prices have equalised, is readily testable. **Wassily Leontief** took the wise decision to use the United States as his subject. Since the United States was a capital-intensive country, and of course still is, the prediction was that it would export capital-intensive goods and import labour-intensive goods. The contrary discovery that in fact it does the opposite became known as the **Leontief Paradox** (Dietzenbacher and Lahr, 2004).

Any number of attempts have been made to explain the paradox, few of them entirely satisfactorily. Leontief argued that US labour was three times more productive than that of other countries, so it should be multiplied by three to make a proper comparison. Casas and Choi (1984) found that in the year that Leontief conducted his study, 1947, the United States was not in the trade balance situation that the HO model demands but was instead in a trade surplus. Thus when a country is export oriented it will export all goods, even those where it does not necessarily have a comparative advantage. This helps to explain why China is currently an exporter of capital, thereby placing it in the Leontief Paradox.

## NEW TRADE THEORY

The **New Trade Theory (NTT)**, advocated by such luminaries as Paul Krugman (Findlay et al., 2002), does not directly contradict the HO model but tries to take a more pragmatic view of how industries might gain some dominance in a country, drawing in national factors of production from other potential candidates. As each country has different industries, there is a reason for international trade. For example, if a country has a very large industry in which there are substantial **economies of scale** then that country will hold a cost advantage over rivals. Not only will other countries want to trade with it to benefit from the lower costs but the specialisation that country has chosen means that it will then need to trade for what it is not producing. Thus trade is based on reciprocal demand.

There are a number of reasons why a country might end up specialising, each with varying levels of predictability. A government may have anointed an industry as a national champion, such as financial services in the tax havens scattered around the world. There may also be a very large domestic market where new technologies can be launched and achieve economies of scale before overseas markets are invaded. This would certainly explain why the United States has come to dominate so many new industries and why the EU was formed to create a European market of comparable power.



## MANAGEMENT SPOTLIGHT: COMPARATIVE ADVANTAGE AND INTERNATIONAL MANAGEMENT

Although the mercantilist approach to trade is economically misguided over the long term it is quite clear in its intentions. Clarity is always the friend of business since it allows planning to be conducted in an atmosphere of reasonably predictable conditions. A major reason why mercantilism can help a developing country rapidly industrialise is that managers can be reasonably sure of the sort of industry to be in, what to produce and who to sell it to.

Comparative advantage and all the international trade theories derived from it are much more difficult for international managers to use in business planning. The assumptions are useful in developing the theories but few managers would recognise them on the ground. Most industries enjoy increasing returns to scale, so there is an incentive in growing a company ahead of rivals in pursuit of economies of scale. The government may also support this expansion with financial aid and training programmes to improve the skills base. Alternatively, the government may not have the political will or the resources to help.

As a consequence, the principles of comparative advantage are not so readily incorporated into management decision making. For MNEs there are company-specific strategies that include analysis of the economic conditions of locations around the world, not the theoretical ruminations on how those conditions came about.

With each company taking a different line on international trade no business consensus emerges except by industry. The advantages for the shipbuilding industry lie in economies of scale and government support to smooth demand fluctuations so, according to the NTT approach, shipbuilding centres can enjoy strong international sales. Textiles, on the other hand, are manufactured labour-intensively so it is the HO model that reigns. As industries seem to be governed by different theories of trade we find that government policy can be short-term and lack coherence. A predictable outcome of this is that rates of internationalisation and globalisation tend to be specific to the industry, and even the company on occasion.

**Point of consideration:** Would it be better for MNEs if all countries had the same policies on international trade?

## INTERNATIONAL TRADE THEORIES AND GLOBALISATION

If the theories seem to be having trouble keeping up with developments in the real world of international trade, then globalisation has thrown everything up in the air. The list of assumptions that made the HO model manageable now seems hopelessly out of date. Capital and labour is increasingly mobile across the globe and while technology can be made available to consumers in all markets, companies will restrict access to their proprietary technologies using laws concerning **intellectual property rights (IPR)**.

The HO model made the assumption that no country enjoyed a technological advantage. This was not because it was true but because it was not considered a core factor of trade, so it was simpler to exclude it from the calculations. This is difficult to justify when countries like China are exporting vast quantities of technical goods, such as computers and mobile phones. Michael Posner (1961) argued that when a country makes a technological advance it gains a new comparative advantage in the product and so exports it. This continues until such time that the competitor countries are able to replicate the technology and close the so-called imitation gap. It is in this sense that technological differences are not

a core feature of international trade, because they are specific to firms. The largest technological firms can become globalised even when their home countries, or compatriot businesses, are not.

It is this firm-specific feature of trade that marks out the shift from internationalisation to globalisation. **Internationalisation** is based on the kind of trade we are familiar with, the swapping of raw materials and finished goods at some agreed rate of exchange. Typically, industrialised countries import raw materials from less developed countries and in return supply them with manufactured goods. The high value-added work is in the manufacturing so the less developed countries have to trade high volumes of raw material for given quantities of manufactured goods. As a consequence, industrialised nations tend to be wealthier than nations that supply raw materials. If we return to our opening example, the three ancient artefacts found in Helgö, Sweden, it is likely that these high-crafted objects were traded for agricultural goods or plunder. This kind of trading relationship has persisted into the modern era and is often seen as an oppressive force on the economic growth of developing countries. It is therefore the basis of drives to bring industrialisation to the developing world.

**Globalisation** is more than just an accelerated version of internationalisation. Globalisation involves an integration of functions so that industries in different countries work with each other to produce the final product. It is no longer possible to characterise one country as the raw material supplier and the other as the manufacturer; they are now integrated into a complex network of suppliers and producers. Of course, those countries that are abundant in commodities will continue to be the chief sources of raw materials, but they can also participate in the value-added work as well.



## CASE STUDY – AUSTRALIA THE GLOBALISED

Australia exemplifies the emergence of globalisation; figures for 2011–2012 from the Department of Foreign Affairs and Trade (DFAT, 2015) showed that 62.8% of its exports were made up of primary goods, with minerals and foods making up 81% of that figure. Of its imports, around 55% is made up of manufactured goods. Even from these figures, inflated by high demand for its commodities, it is clear that the country is far from simply trading raw materials for imports of manufactured goods. Indeed, it is both an importer of primary products (around 18% of total imports) and an exporter of manufactured goods (around 13% of total exports). There is also significant import substitution, with passenger vehicles comprising 5.1% of all imports even as the domestic industry supplies almost a quarter of local demand (FCAI, 2012).

**Point of consideration:** If Australia is rich in raw materials as well as having a vibrant manufacturing industry, why should the country bother to trade at all when it appears to be self-sufficient?

Sources: DFAT, 2015; FCAI, 2012

The international trade picture becomes so complicated with globalisation that an altogether new approach is called for. This should ignore the national perspective and instead focus on industries and even companies.

## MICHAEL PORTER'S DIAMOND MODEL

As international boundaries become porous and open to trade, it makes less sense to quantify a country's in-built advantages. Globalisation shows us that it is possible to acquire resources on the open market as and when they are needed. It is no longer necessary to trade only for the finished goods, as

countries may hold advantages in just part of the production process. If we think of a single product being made up of a number of different components, each sourced from unrelated industries, it is possible for different countries to make contributions to the final product according to their strength in those supplier industries.

Michael Porter (1998) devised the Diamond Model of Competitive Advantage in an attempt to explain a nation's position in terms of its competitive strength in a particular industry. The model encompasses the different factors that drive the competitiveness: not only the factors with which the country was originally endowed but also the historical factors that have helped to build a dominant position. Many of the factors that had to be assumed away by the HO model, but in the age of globalisation have come back to prominence, can be included in the Diamond Model. We can therefore see how a country can develop a highly competitive industry based on the interplay of various stimulating factors.

Interestingly, some factors that would once have been considered inherent to the national advantage, such as labour, in a globalised market can instead be bought in from outside. In this way the model takes account of the seismic shift taking place in migration and the mobility of labour. The four main factors then interact with each other dynamically:

1. **Factor conditions** – we are already familiar with this concept since we have considered it before in the HO model. We can therefore include the availability of natural resources, capital and labour. Porter, though, goes much further and includes the kind of factor condition development that occurs in the modern world. So, labour is not just a passive resource to be used according to its availability; it can also be improved through investments in education and training. New knowledge-based industries, such as the software and electronics companies in Silicon Valley, show how high educational standards can stimulate a fundamentally labour-intensive industry when the nation itself is said to be capital abundant.
2. **Demand conditions** – the model recognises that the characteristics of the market have a significant impact on the viability and strength of a given industry. The UK has a very powerful pharmaceutical industry, much of which can be attributed to the British National Health Service, which operates in near-monopsony conditions. Pharmaceutical companies can enjoy stable and profitable relations with the NHS, which then encourage high levels of business investment.
3. **Firm strategy, structure and rivalry** – over a period of time an industry will mature to a point where the domestic players are in continual and habitual competition. It is not that they are acting and reacting to each other's moves in the market; the sense of competition is raised to a level where they have almost established a culture or a system of competition. If we look at the fashion houses in Paris we see an industry that is shaped by the sense of rivalry that not only maintains the pace of innovation but also creates very high entry barriers to new firms.
4. **Related and supporting industries** – the model includes other industries to show that the links between them help to raise the competitive stature of the industry. This includes the networks of suppliers that are technically members of other industries, but their own competitive dominance is highly supportive. The shipping insurance industry is dominated by Lloyd's, the London insurance market. Surrounded by the huge London financial services industry it is clear that Lloyd's can draw on the local skills and experience. There is also an historical advantage, dating from an age when British merchant shipping was a world force that was insured through the Lloyd's market.

The Diamond Model eschews the definition of a nation, with its arbitrary boundaries, and focuses on specific industries with their constituent firms. The trading advantage is therefore measured in competitive power, either to repel imports or to penetrate foreign markets. The comparative advantage is held by the industry cluster, not the country as a whole. When we say that the United States has

a comparative advantage in aircraft production we are really referring to the industry in its current industrial centres, such as Redmond, Washington, and Fort Worth, Texas. The Diamond Model shows that it would make little sense to establish a new firm in a state like Idaho where there is no supporting industry.

Although Porter's Diamond Model is intended only for evaluating domestic industries, it can be stretched to include aspects of globalisation. This is important when we consider that firms do not operate within a single geographic location but draw on resources around the world. We might want to consider how the international market can broaden demand to allow the industry to achieve economies of scale. Both the Swiss and Japanese watch industries have grown far beyond their domestic strongholds and count the entire world as their markets.

## GLOBALISATION AND DEVELOPING ECONOMIES

All the trade theories, bar one, extol the virtues of international trade for the purposes of enriching both sides in any deal. Even the exception to this rule, mercantilism, with its promotion of domestic industry over foreign industry, is simply being self-centred; it has no interest in whether the trade partner is better off or not.

By allowing countries, and therefore industries and companies, to specialise in their strengths, the advantages are not only compounded through learning effects and economies of scale, consumers also benefit from access to better products at lower prices. A natural consequence of this focus on national strength is that the country will also have to relinquish those industries where it is weak and so import the products and services instead. This adjustment period, when companies are wound up and industries disappear, can be difficult for the public to stomach, so there are often cultural and political obstacles to the formation of perfectly free trade. Nevertheless, the mutual benefits of globalisation for all involved are feeding through at a sufficient pace for the basics of international free trade to be broadly accepted.

However, this may not be the case in many developing economies. Many economists, most notably Joseph Stiglitz (2002), argued that the liberalisation of trade was being foisted on developing economies before they were ready for it. While developed economies had created their national and government institutions centuries before globalisation, and so were able to respond to it in an organised fashion, developing countries had no way of accommodating the vast changes being forced on them. Without a strategic approach the apparent advantages of incoming investment were frittered away on domestic corruption and the enrichment of foreign multinational enterprises (MNEs).

These problems were exacerbated by supranational institutions, such as the **International Monetary Fund (IMF)**, which supported the imposition of market structures that were seen to be effective in developed economies that had the institutions to contain them. The market structures being imposed on developing economies included liberalisation of financial services and the privatisation of strategic industries. Such dramatic prising open of markets was viewed as an open invitation to MNEs to exploit the weak and vulnerable economies.

Not only could globalisation suppress the economic growth of developing nations, it could even lead to them being worse off. Jagdish Bhagwati (1958) demonstrated that when a developing country is the location for a large export operation, not only may the rest of the economy lose out on any possible economic benefits but it may actually be worse off. This is due to the distorting effect the operation has on the country's terms of trade. This has been called **immiserising growth** and it is a phenomenon that is considered to be unfair on the poorer countries because the richer countries have centuries of economic development underpinning their advantage.

Although the weight of argument is still in favour of international trade, it is the suffering of poorer nations at the margin that has led to attempts to defend them from the worst effects of globalisation. For example, the **WTO** allows developing economies to use tariffs as trade barriers to defend their new-born, **infant industries**. This is quite distinct from that enemy of free trade, **protectionism**. The WTO allows infant industries to be defended for only a limited period until such time that they should be able to stand up for themselves against the global competition, at which point the permitted tariffs should be dropped. In contrast, protectionism is the use of trade barriers to defend domestic industries for the long term, despite the fact that they may already be strong enough to withstand exposure to globalisation.

Protectionism is not only seen as being contrary to the tenets of free trade, it is also counterproductive. Safe from the full competitive forces of globalisation, managers are under much less pressure to develop the business. Instead of honing their management skills and innovating, managers have little incentive to progress. The result can be a depressing amalgam of inefficient production, high costs, low quality and poor product design. This can become so entrenched that if at some point the government is obliged to remove its protectionist policies the pampered industrial champions simply collapse in the face of the global competition.

## ANTI-GLOBALISATION REBELLION

Globalisation is often believed to benefit only large MNEs, which, due to their economic importance, are able to wield undue economic influence. This influence is considered to be most pernicious when it comes to developing nations, which are obliged to accept the conditions imposed by the MNE or risk losing the promised investment. It is argued that these MNEs can play one developing country off against the other, driving down conditions of employment and hoarding any economic benefits. This is perceived to imbue the MNEs with a power that exceeds that of the sovereign government and its citizens. A social movement has emerged in, often violent, rebellion against the power of MNEs, a movement that has become known as anti-globalisation.

The rebellion against globalisation can often become chaotic, obscuring the rational argument. Noam Chomsky (2002) has attempted to return the conflict to that of a reasoned debate, pointing out that it is not globalisation *per se* that is so objectionable but rather the kind of economic globalisation that has diminished the power of self-determination of ordinary people. Other forms of globalisation, such as internationally agreed human rights standards, represent international integration of a form that should be welcomed.

On the basis of Chomsky's criticism, we can see that 'anti-globalisation' is not an accurate term since it describes the resistance against abuse of economic power, not globalisation in its broadest sense. Nevertheless, it is the term that is now accepted for the overall protest movement. Neither is anti-globalisation a new argument: misgivings about large corporations have a long history, including the concerns about monopoly powers. We are therefore familiar with the various rules and regulations that are put in place to corral the larger corporations before they become too dominant, and the anti-globalisation critique taking this same argument to the international level.

Although the focus of anti-globalisation is economic the movement is fragmented across a number of organisations. For example, the anti-capitalists have directed their ire against the global institutions of the IMF, World Bank and WTO. Although there may be some justification in pointing out that these institutions are founded on Western concepts of economic progress through capitalism and free trade, it seems that the protest movement's fundamental grievance is against those institutions as symbols of political power. The protests staged in Seattle during the WTO summit in 1999, the so-called Battle of

Seattle, comprised a wide spectrum of participant groups such as trade unions, environmentalists and anarchists (Gillham and Marx, 2000). Although ultimately ineffectual, these protests around the world underline the irony of the globalised anti-globalisation movement.

Given the disparity of forces ranged against globalisation it is probably inevitable that they will fail in their purpose of diminishing the power of big business. Supporters of globalisation point out that no matter how wealthy a corporation might be, and some are richer than the poorest countries, their income is always dependent on political co-operation. Even if the benefits to a developing country of allowing an MNE to invest are marginal, as the economy progresses on a broad front the influence of that one MNE will proportionately weaken as other MNEs enter the market.

Perhaps the best example of a state that has developed economically on the back of globalisation, all the while maintaining a strong political framework, is Singapore. For Hobson and Ramesh (2002) the city state represents a happy middle ground between the structuralist theory of an omnipotent globalisation and the agentic-centric argument that states are agents that can control the institutions of globalisation to their own designs. The authors call this new view a structurationist approach, an awkward sounding phrase that denotes Singapore's success at both benefiting from globalisation and its institutions while also participating in how globalisation is continually shaped. It is because globalisation is dynamic by nature that it keeps one step ahead of its detractors.

## COUNTING TRADE

The huge volumes of international trade cannot go uncounted. Governments, and their electorates, like to know whether they are making money off the rest of the world or, heaven forbid, the rest of the world is making money off them. This is not as easy to assess as one might imagine since trade volumes can fluctuate wildly year-by-year and even more so month-by-month. This can affect countries that export big ticket items that have high value in comparison with the total national trade volume. Finland, for example, may book the value of a number of ship exports one month that give a false indication of rising trade in its favour; the next month the figures might show the reverse. Other countries can labour under persistent trade deficits as they import more than they export year after year, alarming the electorate but apparently to no ill effect on the economy.

## TRADE AND THE MYTHICAL BALANCE OF PAYMENTS PROBLEM

As we saw earlier, the mercantilist approach to trade, where the government encourages exports and discourages imports, has long been superseded in the text books by much more effective theories, yet it still clings to life in the political and business worlds. Mercantilism has some practical value to developing countries that are building up their economies under the menacing shadow of established industries in developed countries. Once developing economies are up to speed they can switch to a free-trade approach, where it is the exchange of goods and services that brings the greatest mutual benefit. We should not just blame politicians for stoking the mercantilist argument in order to gain popular support; some of the responsibility also lies with those that give that popular support, the people of the country.

At the heart of the matter is something that is often known as the balance of payments problem. You might want to ask yourself the following question: 'what does it mean if the balance of payments does not balance?' Actually, it is a trick question because the only possible answer is this: 'you have not done the calculations correctly'. By definition, the balance of payments must always balance so a loss made



in one area is made up in another. The balance of payments shows that an export strategy may seem to lead to gains being made, but it is inevitably balanced by losses elsewhere. We can see this if we look at the components of the equation:

$$\text{Current Account} + \text{Capital and Financial Account (+ Balancing Item)} = 0$$

The balance of payments expresses all the financial transactions that a country has made with all other countries of the world. Since these transactions form many different types of payment they are allocated to different categories. Not all institutions use exactly the same categories but there is enough commonality to ensure sufficient consistency. Historically, the **IMF** had used a set of definitions peculiar to itself, which was the source of some confusion, but it has now consolidated its definition into just two major categories: the first is the current account; the second is the capital and financial account (IMF, 2012). The new definitions bring the IMF into harmony with the **System of National Accounts (SNA)**.

The **current account** is the one that tends to get the media excited as it measures the trading record of the country with regard to goods and services. If a country holds a competitive advantage in these two areas, then it is likely that its exports of goods and services will exceed its imports and it will want to boast of having a trade surplus. Also included in the current account are income from overseas, in the form of wages, and transfers, such as insurance payments but excluding capital transfers such as ownership changes.

It might be useful to think of the national current account as being analogous to an individual's personal current account at a bank, and indeed this is why it has become such a useful political device. Just as your own account receives your wages and pays your bills, you feel richer if you have a surplus at the end of the year. Politicians play on this analogy for political gain by suggesting that a current account surplus in trade means the country is richer.

The **capital and financial account** is the other side of the story that either spoils, or restores, the impression given by the current account. In the IMF definition, the capital and financial account provides information on the investment position of the country. It is not concerned with the flows of money but with transfers of ownership and flows of investment funds. This account is less easy to understand than the current account because it does not really fit our homely personal spending analogy. Instead, we need to understand that any result from the current account must be balanced by an equal and opposite result from the capital and financial account.

The reason why national accounting is different to personal accounting is because a country is identified with its own currency. It is the same when several countries share a single currency, although it does complicate the picture somewhat. Taking the one country view, the currency it releases can only be spent within its borders, where the currency has legal tender status. Outside its borders it may be acceptable but only at the discretion of the receiver and for the reasons that the money will eventually find its way back to its home country where it can be legally spent. The money can only be created and spent within its home country. This means that when a country spends its money on imports, that money is not lost but must return to it in some form.

The money returns because the exporting country is earning money but in the form of a foreign currency. One use of the money is to buy goods from the trading partner, creating reciprocal trade. Another route is to invest in the importing country, buying property or lending it money. These funds are measured in the capital account. In this way, whatever money is spent on imports in the current account must either return through reciprocal trade shown the current account or through investment shown in the capital account. Either way, the money must return and the balance of payments must sum to zero.



## TRADE AND THE FOREIGN CURRENCY PROBLEM

When the current account is in balance, two countries, A and B, are paying each other in their own currencies. When Country A pays for imports from Country B the money is used by Country B to pay for imports from Country A. Neither country is accumulating the other's money and each national currency is finding its way back home through the current account. In the case where there is a trade imbalance, foreign currency will begin to accumulate in the country that is doing more exporting than importing. The imbalance is addressed in the capital and financial accounts for both countries.

It is the balancing act by the capital and financial account that demonstrates there is no particular advantage to being a mercantilist, export-oriented country. The exports are being paid for in the currency of the importing country, the only currency that it has authority over. While it may seem obvious to simply state that this money can be exchanged for that of the exporting country, this can only be done if there is a complementary trader who wants to buy that currency. So the problem of two currencies is not solved; it is only being shifted onto someone else.

When an exporting country is running a current account surplus it will accumulate the foreign currency that it is receiving in payment. Even if it does nothing with it, the funds will build up in its foreign currency accounts, which then show up in the capital and financial account. More curiously, the funds can be lent back to the country of origin. The importing country then uses them to purchase yet more goods. The exporting country is perpetuating its export drive by becoming a creditor country lending back currencies to the importers so that they can carry on importing.

This strategy means that the exporting nation is effectively taking production responsibilities away from the importing nation, promoting its own industrial development at the expense of its importing partners. Conversely, though, the market in the importing nation benefits from cheaper foreign goods, while consumers in the exporting nation are denied. Furthermore, foreign currency reserves can grow out of control. Table 1.3 shows the accumulation of foreign currency reserves, how they relate to the total output of the economy (% of gross domestic product, GDP) and the current account position. The table provides the figures for the top four biggest hoarders of foreign currency, as well as the United States and India for reasons of comparison.

From the table we can see that the top three holders of foreign currency, China, Japan and Russia, confirm our suspicions that they are doing this as part of their export drive. This view is further supported by the United States, which holds low quantities of foreign reserves relative to its gross domestic product, while also running the largest current account deficit in the world. At the same time, India

**Table 1.3** *Foreign currency reserves and the current account – 2014*

Country	Reserves (US\$billions)	Reserves/GDP %	Current Account
China	3948.1	39.4	224.3
Japan	1282.8	26.5	57.2
Russia	472.3	22.6	44.9
Switzerland	548.9	79.1	68.8
India	311.9	15.6	-47.5
US	143.5	0.8	-391.1

Sources: IMF (estimates), 2014; Bank of Korea, 2014



**Figure 1.1** *China and India Current Account/GDP 2007–2011*

Source: IMF (estimates), 2014

stands out as a contrarian, with strong reserves and a current account deficit. Indeed, Figure 1.1 shows how India compares with China on trading strategies as the two great developing economies make their rapid advances.

Although the two countries are well known to be exhibiting impressive rates of growth in GDP, sometimes exceeding 10% per annum, they are funding themselves in contrasting ways. China is using a mercantilist approach, exporting to drive the growth of its industries and providing importing countries with much of the financial credit. In contrast, India is a debtor nation using overseas credit to invest in its economic development. There are pros and cons to both approaches, but China will have to undergo a challenging economic restructuring when it needs to shift out of its mercantilist policies. This will then impact on the managers of companies that operate in or with China.



### MYTH BUSTER: GREECE AND THE EUROZONE BALANCE OF PAYMENTS PROBLEM

Some might argue that Greece's problems within the Eurozone have been brought on by itself. Certainly, Greece has been suffering a litany of financial problems recently, but at the bottom of it all is a balance of payments crisis.

Before it joined the single European currency, the euro, Greece would have paid for its imported goods in its own currency, the drachma. If you imagine a situation where it was buying goods from China, paying in its own currency would have left the Chinese holding drachmas. There is only one place in the world where this money can be spent, namely Greece, so China would have been obliged to buy goods from Greece. How much it wanted those Greek goods would have effectively decided

the exchange rate between the two currencies. As a result, China would have spent its drachmas buying a variety of goods from Greece, including manufactured goods.

Once Greece had joined the euro it would have paid for its imports from China as before, but this time using euros. China is now free to pay for goods made anywhere in Europe, not just Greece. When it comes to manufactured goods Germany holds a substantial competitive advantage and so has attracted the Chinese buyers. Where Greece was previously able to compete with Germany on price by devaluing its currency, now that they share the same currency Greece must compete by way of an internal devaluation in the form of wage reductions.

**Point of consideration:** If Greece were to leave the Eurozone but stay in the EU, how would this impact on Germany?

*Source:* Chen et al., 2013

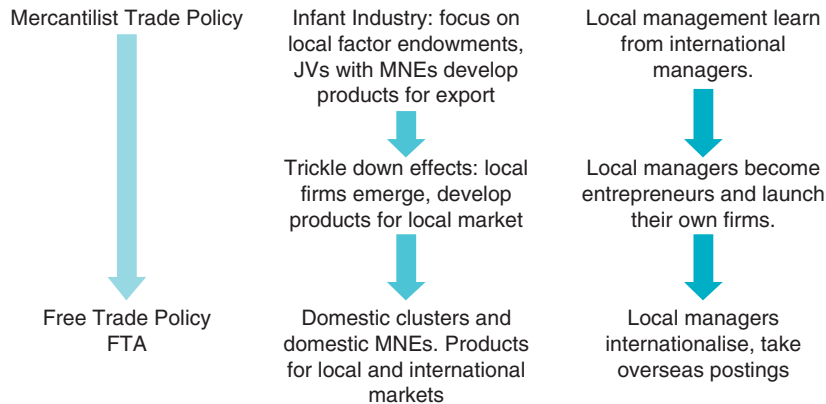
## THE EVOLUTION OF INTERNATIONAL BUSINESS WITH TRADE POLICY

Governments interfere in their nation's trade to differing degrees, with consequent implications for domestic businesses. In neo-mercantilist countries, like China, it is important for a company to become an exporter because that is the most buoyant sector of the economy. At the same time, the strategy brings with it a number of challenges. Any foreign earnings must be exchanged with the government at the official rate, which then determines the profitability of any transactions. The government may also choose to nominate certain industries for special attention, which can help them to grow but may also force them into consolidation or joint ventures. For example, the automotive companies in China require government licences to build new plants, and this policy pushes growing companies to acquire smaller companies for their production rights when they wish to expand their output.

In economies that are structured around free trade and the principles of comparative advantage, firms enjoy greater liberty for pursuing the opportunities that they perceive. We have seen that the Heckscher–Ohlin theory suggests that companies dependent on factors of production that are abundant in the country will expand to make use of those factors, with a clear potential to export. However, the Leontief Paradox has shown that the opposite can be the case, with the United States famously exporting from labour-intensive industries when capital is the abundant factor. The **gravity equation theory** of trade suggests that the practicalities of economic dominance and geographic proximity are the main drivers of trade (Chaney, 2013).

There is empirical support for the gravity equation but it seems to have little to say about Free Trade Agreements (FTAs), which can occur between countries in close proximity or geographically separated. However, research by Baier and Bergstrand (2007) found emphatic evidence that FTAs do have a very positive impact on trade if the gravity equation calculations are adjusted accordingly. This seems to tie in with Michael Porter's Diamond Model, which argues that trade is not national or international but occurs between industrial clusters. These clusters give economic 'mass' to the gravity equation. The purpose of the FTA, then, is to render the concept of nationhood irrelevant in the process of removing the trade barriers and allowing clusters to develop links.

The problem for developing countries is that they do not yet have those industrial clusters, and so they are in a poor position to trade. They can do this, though, through mercantilist trade policies to build up their economic strength even at the expense of the rest of the world. During this period the infant industries can enjoy the support of the WTO and World Bank. Once the industrial clusters have matured, the country can enter into FTAs and join the movement towards global free trade.



**Figure 1.2** *Evolution of trade policy, industry and management*

For international business this evolution of the trading position from protectionism to free trade represents a destabilising shift in its environment. For this reason managers need to be prepared to develop their corporations in step with the evolving trade policy. Figure 1.2 illustrates how industries, and the corporations that comprise them, should adapt in step with trade policy guided by increasingly experienced managers.

## RAISING EMPLOYABILITY: THE GLOBAL MANAGEMENT STUDENT

Matters of international trade seem to be aggregated far above individual businesses and outside the influence of managers. Yet trade comprises the same business–customer relationships as exist in domestic commerce, only greatly more complicated by the acts of transacting across borders. This does not mean that the international manager is a different breed of professional, but they do need to be operationally sharper and more sophisticated. This requires education, training and experience.

Taking education first, it is common these days for managers to have a degree in business. There is a myriad of these courses around, including international business, business psychology, business law and so on. Kim et al. (2002) found that students were certainly focused on their future careers, rather than the reputation of the institution. This was all the more so as the degree specialisation narrowed; accounting students, for example, placed the highest emphasis on the employability their degree would provide. Students of general management were the least convinced of the direct applicability of the degree, although this may reflect their own lack of conviction and subsequent choice of the broadest degree topic. Across all topics, though, the perception of the business degree being a direct step towards a business career underlined the importance of offering related extracurricular activities like work experience and internships.

The career focus of business students may be laudable, but they may be specialising unnecessarily early in their lives. Other degree topics can provide, somewhat counter-intuitively, the same basic skills. One of the most surprising is a degree in music. It may appear to be the very antithesis of the kind of commercial ambition that seems to characterise the business world, but music is nevertheless a highly disciplined practice. While a mediocre business student can bluff their way through assignments, the music student is compelled to identify and fix problems as they occur, or risk being publicly exposed.

Indeed, one university in the UK found that its music graduates were amongst the most employable in the jobs market, including business management (University of Nottingham, 2015).

At graduation, students like to think their education ends there. It does not. All businesses operate in a dynamic environment and this is all the more true of those operating internationally. Training that is made available within the organisation should be embraced at all opportunities. If it is not available then the ambitious manager should seek the training elsewhere. Ultimately, this can involve returning to college for a formal course. There is a wide variety of postgraduate courses to choose from but most likely it will be a Masters of Business Administration (MBA), given that in countries like the United States it is the most popular graduate degree. Yet the promises of higher financial rewards flowing from the higher value degree are not always supported by the evidence. The course may aim to compress experiential learning into the academic timetable, but the success of a business depends on human passion, not textbooks (Hann, 2014).

Yet all this education pales into insignificance behind the most important managerial asset of all: experience. Whatever impression textbooks may give, even this one, the true business skills are learnt in the execution, not the academic exercise. It is therefore crucial that anyone with a plan to succeed in international business acknowledges that first that they must embrace opportunities to experience international business for real.

## THE STORY SO FAR: THE BIRTH OF GLOBAL BUSINESS

There is nothing new about the attraction of people trading with each other; indeed, trade is probably a basic human characteristic. It took a long time for theorists to wake up to it, though, and the early obsession with mercantilism, with its short-sighted protection of domestic industry, did more harm than good. Some countries still benefit from mercantilist principles in the short term but over the long term comparative advantage encourages trade that can benefit all sides. Starting from internationalisation, importing raw materials and exporting high value manufactured goods, we have progressed to full globalisation. This means a complex global web of importing and exporting with corporate operations integrated worldwide. Yet despite the theory of an economic promised land some developing countries appear to have become victims of international trade. Even if they are not exactly getting poorer they are certainly not getting richer very fast.

For international managers globalisation offers a massive expansion in business opportunities. There are new markets to sell to and greater varieties of suppliers to source from. All businesses can then specialise in their strengths, giving rise to learning benefits and the cost advantages of economies of scale. There are also greater risks, and international managers need to sharpen their skills as they compete with the best of their peers around the world. It is not just a global business; it is global management as well.



### WEB SUPPORT

1. 'The Silk Road: Connecting the ancient world through trade'. A video from TedEd with a rapid fire historical review of trade routes from ancient times to the present day. Consider carefully, though, whether ancient trade is simply the slower equivalent of modern globalisation.

[www.youtube.com/watch?v=vn3e37VWc0k](http://www.youtube.com/watch?v=vn3e37VWc0k)

2. 'What was mercantilism?' A fascinating article from *The Economist* putting mercantilism into perspective. Includes a handy reading list for those who want to dig deeper.  
[www.economist.com/blogs/freeexchange/2013/08/economic-history](http://www.economist.com/blogs/freeexchange/2013/08/economic-history)
3. 'Rigged rules and double standards: Trade, globalisation and the fight against poverty'. A 2002 report from the international charity Oxfam with an excoriating critique of rich countries and how they, according to some, manipulate the rules of trade to their advantage. Available in various languages.  
[www.policy-practice.oxfam.org.uk/publications/rigged-rules-and-double-standards-trade-globalisation-and-the-fight-against-pov-112391](http://www.policy-practice.oxfam.org.uk/publications/rigged-rules-and-double-standards-trade-globalisation-and-the-fight-against-pov-112391)

### Project Topics

1. How would Porter's Diamond Model explain the Leontief Paradox?
2. To what extent do you think that Switzerland enjoys an absolute advantage in watchmaking?
3. What are the limits to growth in China's foreign currency reserves? What will happen if the reserves are allowed to continue expanding unchecked?
4. If the world 'rebalances', meaning that each country becomes more self-sufficient in manufacturing, services and agriculture, do you think this will reverse globalisation? Will the world be better or worse off?
5. As a management consultant, if you were asked by a developing government to advise on promoting economic growth, which theory or theories of international trade would you find most useful?



### CASE STUDY – SWITZERLAND AND THE INTERNATIONAL WATCH INDUSTRY

Watchmaking is literally and figuratively globalisation in miniature. Boasting mechanisms of exquisite ingenuity, watches are also dependent on the industrialisation of their national economies for technological progress. In the pre-industrial medieval era, clocks were massive pieces of ironmongery, each part hammered into shape in the blacksmith's forge. Their sheer scale demanded robust structures to house them, such as church towers and civic buildings. Clock mechanisms known as verge and foliot were an advance over the ancient water clocks, but they were hopelessly unreliable by today's digital standards and could not be shrunk to the size of a watch.

It was in Britain that the first practical, and reliable, watches began to appear. With scientific progress being made in all areas the country had luminaries such as Robert Hooke, the seventeenth-century polymath, who developed the delicate hairspring. This powered the steady oscillations of the balance wheel, the watch equivalent of the clock's swinging pendulum. The supply of innovations received its impetus from the Royal Navy, which demanded accurate timepieces in order to safely navigate around the British Empire. Building on the work of John Harrison and Thomas Tompion, the British watchmaking industry came to global dominance in the eighteenth century, with Coventry emerging as the centre of gravity for production.

Britain, though, failed to embrace the logic of factory production and its promises of economies of scale. The United States, with its vast domestic market, was a zealot for mass production even in the nineteenth century, and watchmaking factories brought the global focus across to their side of the Atlantic. Yet even as American brands stole the mantle from the British craftsmen the Swiss were waiting for their opportunity. Although it is a small country, it has long been wealthy and politically stable. Its position at the heart of Europe also meant it could learn from French watch designers, famed for their innovation but never for their industrial levels of output. Then in the twentieth century the Swiss learnt from the US companies how to manufacture efficiently. From then on the world belonged to the Swiss watch brands.

To be a little more precise, what the Swiss owned was the world of mechanical watches. Even the finest chronometers, the pinnacle of the watchmaker's art, can only manage to be accurate within a few seconds a day. True accuracy needed a technological innovation and it came in the form of a tiny vibrating crystal: quartz. Passing a current through this minuscule piece of rock induced it to oscillate at an entirely reliable 8192 Hz. This could be harnessed as an electronic timekeeping device in place of the mechanical balance wheel. The Swiss industry was well aware of the technological possibilities of quartz but it was the manufacturers in the Far East that understood the production and marketing potential. By the 1970s the Quartz Crisis had the Swiss industry reeling, as rates of production rocketed on the other side of the world.

This should have spelt the exit of the Swiss from watchmaking and the death of noble brands like Omega, Rolex and Patek Philippe. Figures from the Federation of the Swiss Watchmaking Industry (FH, 2015) confirm that global production is dominated by China, from where 669 million units were exported in 2014. In comparison, Switzerland exported a miserly 28.6 million. Money, though, tells another story. The Swiss earned US\$24.3 billion, or around US\$803 per watch, while all those Chinese exports earned just US\$5.3 billion, representing approximately US\$4 per watch. Clearly the Swiss watchmaking industry is far from dead.

International trade theories like the HO model would not have anticipated the international fame achieved by watchmakers in Switzerland. It is a labour-intensive process, yet the country is not labour abundant; indeed, it is home to a banking sector with international standing. Porter's Diamond includes additional factors that help us to see the complete picture. Labour may not be especially abundant in the country but it is well educated, useful for a skilled craft like watchmaking.

These skills have long been present throughout Swiss industry, so the watchmaking industry can rely on supplies of components that match the high product standards. Many of these are exported as sub-assembly ebauches, basic watch mechanisms that are then included in the models of non-Swiss manufacturers. Furthermore, there is international input into the Swiss watch designs, such as British master watchmaker George Daniels and his co-axial escapement for Omega. The famous Swiss brands may like to portray themselves as survivors of an ancient tradition, but in reality they form an industrial cluster with global impact.

**Point of consideration:** Theories of international trade tend to identify national strengths and assume that this will drive the exports. Yet we often find that countries develop leadership in unexpected industries. Think about how India, for example, has found a comparative advantage in the development of computer software and suggest which international trade theory might have predicted it. Can you use that theory to predict a future comparative advantage for a country of your choice?

Sources: Glasmeier, 2000; Sobel, 2007; FH, 2015





## MULTIPLE CHOICE QUESTIONS

1. The Silk Road is the ancestor to modern globalisation because:
  - a. It specialised in the transport of silk.
  - b. It was a network of routes for the international exchange of goods.
  - c. It eventually became a hard surface highway for modern cars and trucks.
2. Why is mercantilism still practised by some developing countries?
  - a. They can use the short-term export advantages to establish their new industries.
  - b. They have not yet learnt about the advantages of Porter's Diamond Model.
  - c. They have no absolute advantages.
3. Does Greece enjoy an absolute advantage in feta cheese?
  - a. No, feta cheese can be made anywhere.
  - b. Yes, all feta cheese comes from Greece because no one else can make it as well as they do.
  - c. Not quite; feta cheese can be made anywhere in the world to the same quality, it just cannot be called feta because the name is protected.
4. Germany is a top exporter because it has a comparative advantage in what industry?
  - a. Cars.
  - b. Banking.
  - c. Olive oil.
5. Which is better, to export or to import?
  - a. Import; it provides access to a global range of products at various specifications and prices.
  - b. Export; it brings cash into the country and so increases national wealth.
  - c. Both; it is trade that permits access to imported global products while allowing the country to specialise in its comparative advantage for exports.
6. Which theory best explains American exports of rice?
  - a. Absolute advantage; the United States is better at growing rice than any other country.
  - b. Comparative advantage; the United States is better at growing rice than it is at any other economic activity.
  - c. No theory does; it is the Leontief Paradox.
7. Why is Japan a large exporter of cameras?
  - a. Michael Porter's Diamond Model shows that a supporting industrial cluster has evolved in the country.
  - b. The Japanese people have small, nimble hands that are suited to the production of small, complex products.
  - c. The Japanese are very skilled at innovating in high technology.
8. Does the WTO ever permit protectionism?
  - a. No, the WTO stands for free trade.
  - b. Yes, when a developing nation is nurturing an infant industry.
  - c. Yes, when a wealthy country has a long-established industry employing many people.
9. How can exporting countries prevent damaging rises in the value of their currencies?
  - a. They reduce the circulation of their own currency.
  - b. They raise domestic interest rates.
  - c. They accumulate foreign currencies in their reserves.



10. How does India sustain its long-term deficit in the balance of trade?
- It borrows money from its trading partners.
  - It allows the value of its currency to rise.
  - It invests in overseas operations.

**Answers**

1b, 2a, 3c, 4a, 5c, 6c, 7a, 8b, 9c, 10a

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