GLOBAL EDITION

International Business
The New Realities

FIFTH EDITION

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Procter & Gamble initially considered exporting when it entered Japan. With exporting, P&G would have had to contract with an independent Japanese distributor to handle warehousing and marketing of its soap, diapers, and other products. Instead, P&G chose to enter Japan through FDI for three reasons: (1) trade barriers imposed by the Japanese government, (2) the strong market power of local Japanese firms, and (3) the risk of losing control over its proprietary knowledge. It established its own marketing subsidiary and national headquarters in Tokyo.

In the 1980s, Samsung followed a policy of exporting its products to Europe and North America. Management realized it could improve and speed up international operations by creating its own sales and production facilities in strategic markets. In the 1990s, Samsung internalized much of its production and distribution channels in Brazil, China, Mexico, and the United Kingdom. To ensure product quality, Samsung internalized production of semiconductors and circuit boards for use in making telecommunications equipment. The firm gradually transferred its manufacturing operations from Western to Eastern Europe to profit from lower-cost labor in the East. Samsung also produces various software through its subsidiary, Samsung R&D Institute in India.

Dunning's Eclectic Paradigm

Professor John Dunning proposed the eclectic paradigm as a framework to explain the extent and pattern of the value chain operations that companies should own abroad. He drew from various theories, including comparative advantage, factor proportions, monopolistic advantage, and internalization theory. The eclectic paradigm is often viewed as the most comprehensive of FDI theories.

The eclectic paradigm specifies three conditions that determine whether a company will internationalize through FDI:

- Ownership-specific advantages
- Location-specific advantages
- Internalization advantages

Let's explain each condition in turn.

OWNERSHIP-SPECIFIC ADVANTAGES An MNE should hold knowledge, skills, capabilities, key relationships, and other advantages that it owns and that allow it to compete effectively in foreign markets. To ensure international success, the firm's competitive advantage must be substantial enough to offset the costs that it incurs in establishing and operating foreign operations. It should also be specific to its own organization and not readily transferable to other firms. Competitive advantage may incorporate proprietary technology, managerial skills, trademarks or brand names, economies of scale, or access to substantial financial resources. The more valuable the firm's ownership-specific advantages, the more likely it is to internationalize by FDI.

Alcoa has 60,000 employees in 35 countries. The company's integrated operations include bauxite mining and aluminum refining. Its products include primary aluminum (which it refines from bauxite), automotive components, and sheet aluminum for beverage cans and Reynolds Wrap®. One of Alcoa's most important ownership-specific advantages is the proprietary technology it has acquired through its R&D activities. It has also acquired special managerial and marketing skills in the production and marketing of refined aluminum. The firm has a well-known brand name that facilitates sales. As a large firm, Alcoa also profits from economies of scale and the ability to finance expensive projects. These advantages have allowed Alcoa to generate maximal profits from its international operations.

LOCATION-SPECIFIC ADVANTAGES The second condition that determines whether a firm will internationalize by FDI is the presence of location-specific advantages. These are the comparative advantages available in individual foreign countries that may be translated into firm competitive advantages. These may include natural resources, skilled labor, low-cost labor, or inexpensive capital. Alcoa located refineries in Brazil because of Brazil's huge deposits of bauxite, a mineral found in relatively few other locations. The Amazon and other major rivers in Brazil generate huge amounts of hydroelectric power, which is a critical ingredient in electricity-intensive aluminum refining. Alcoa also benefits from Brazil's low-cost, relatively well-educated laborers who work in the firm's refineries. The presence of these location-specific advantages helped persuade Alcoa to locate in Brazil through FDI.

INTERNALIZATION ADVANTAGES The third condition that determines FDI-based internationalization is the presence of internalization advantages. The firm gains these benefits from internalizing foreign-based manufacturing, distribution, or other value chain activities. When profitable, the firm will transfer its ownership-specific advantages across national borders within its own organization rather than dissipating them to independent, foreign entities. The FDI decision depends on which is the best option—internalization versus using external partners and whether they are licensees, distributors, or suppliers. Internalization advantages include the ability to control how the firm's products are produced or marketed, greater control of its proprietary knowledge, and greater buyer certainty about product value.[20]

With Alcoa, the firm had five reasons to internalize many of its operations instead of letting external suppliers handle them. First, management was concerned about minimizing the dissemination of proprietary knowledge, specifically its aluminum-refining operations—knowledge the firm acquired at great expense. Second, internalization provides the best net return, allowing Alcoa to minimize the cost of operations. Third, Alcoa needs to control sales of its aluminum products to avoid depressing world aluminum prices through oversupply. Fourth, the firm wants to be able to apply a differential pricing strategy, charging different prices to different customers, a strategy it could not implement without controlling distribution. Finally, aluminum refining is complex, and Alcoa wants to maintain control of it to ensure product quality.

Non-FDI-Based Explanations

FDI became a popular entry mode with the rise of the MNE in the 1960s and 1970s. In the 1980s, firms began to recognize the importance of collaborative ventures and other flexible entry strategies.

INTERNATIONAL COLLABORATIVE VENTURES A collaborative venture is a form of cooperation between two or more firms. There are two major types: equity-based *joint ventures* that result in a new legal entity and non-equity-based (project-based) strategic alliances in which the firms' partner, for a finite duration, to collaborate on projects related to R&D, design, manufacturing, or any other value-adding activity. In both cases, collaborating firms pool resources and capabilities and generate synergy. In other words, collaboration allows the partners to carry out activities that each might be unable to perform on its own. Collaborating firms share the risk of their joint efforts, which reduces vulnerability for any one partner.

Collaboration is critical in international business. A firm sometimes has no choice but to partner with other companies to gain access to resources and capabilities unavailable within its own organization. In addition, occasionally a government will restrict companies from entering its national market through wholly owned FDI. For example, the Chinese government prohibits foreign firms from attaining full ownership of ventures in China's health, life, and pension insurance industries, partly because local authorities intend to stimulate the development of Chinese companies in these industries. Where such restrictions exist, the firm may have no choice but to collaborate with a local partner to enter the market.[21]

A collaborative venture can give a company access to foreign partners' expertise, capital, distribution channels, marketing assets, or the ability to overcome government-imposed obstacles. By collaborating, the firm can position itself better to create new products and enter new markets. For example, Starbucks now boasts more than 1,300 coffee shops in Japan. Starbucks first entered Japan through a joint venture with a local partner, Sazaby League, Ltd. The venture allowed Starbucks to internationalize and navigate the marketplace with the help of a knowledgeable local partner.[22]

NETWORKS AND RELATIONAL ASSETS Networks and relational assets represent the economically beneficial long-term *relationships* the firm undertakes with other business entities. Such entities include manufacturers, distributors, suppliers, retailers, consultants, banks, transportation suppliers, governments, and any other organization that can provide needed capabilities. Firm-level relational assets represent a distinct competitive advantage in international business. Numerous emerging markets feature *family conglomerates*—large, highly diversified firms with interlinked ownership. A typical family conglomerate combines numerous firms in diverse industries under the control of a family or an individual owner, within a complex corporate network. In Japan, a *keiretsu* is a conglomeration of businesses linked together by cross-shareholdings to form a complex conglomerate of interlinked associations.[23] For example, the Sumitomo keiretsu comprises the SMBC Bank, Sumitomo Life (insurance), Sumitomo Realty & Development Company, Sumitomo Chemical Company, Sumitomo Corporation (trading company), Sumitomo Electric Industries, Sumitomo Heavy Industries, Mazda Motor Corporation, and numerous others. Like the keiretsu, networks are neither formal organizations with clearly defined hierarchical structures nor impersonal, decentralized markets.

The International Marketing and Purchasing (IMP) research consortium in Europe (www.impgroup.org) has driven much of the theory development on networks.[24] Network theory was proposed to compensate for the inability of traditional organizational theories to account for much that goes on in business markets.[25] In networks, buyers and sellers become bound to one another through continuous exchanges and linkages of products, services, finance, technology, and knowledge. Continued interaction among the partners results in stable relationships based on cooperation and creates value and competitive advantage even among competitors. Network linkages represent a key route by which many companies expand their business abroad, develop new markets, and develop new products. In international business, mutually beneficial and enduring strategic relationships provide real advantages to partners and reduce uncertainty and transaction costs.

The online retailer Amazon has skillfully used network connections to enter various countries. Amazon generates about 40 percent of its sales internationally. The firm entered India, a complex market, through various local connections and a partnership with a local online shopping service, Junglee. Amazon also partnered with the Indian government to facilitate Internet sales, and with digital lender Capital Float to provide loans to online sellers in India. Amazon entered China by developing a relationship with Joyo.com, a local firm highly experienced in online retailing. Amazon collaborated with Beijing Sinnet Technology, an Internet service provider in China. Amazon also partnered with Alibaba, China's largest online retailer, to sell food, kitchenware, wine, shoes and other goods.[26]

Samsung Corporation has many network connections that provide substantial benefits. The firm produces cell phones and telecommunications equipment with various partners in China. It is also well connected in the Korean financial sector. Network relationships with the Korean Industrial Bank and Korea Commercial Bank have provided Samsung with much of the financing it needs to conduct R&D and perform other key value-chain activities. In short, Samsung's network and relational assets have been critical to its success.

As we'll see later in this book, in the contemporary global economy, many firms have shied away from making permanent, direct investments in host countries. Instead, many firms now opt for more flexible collaborative ventures or other relationships with independent business partners abroad.

CLOSING CASE Unilever's Comparative and Competitive Advantages

Unilever is a multinational enterprise in the fast-moving consumer goods (FMCG) industry, with headquarters in Rotterdam, Netherlands. Unilever has 170,000 employees worldwide and generated revenue in 2017 of more than 50 billion euros (about $60 billion). Top competitors include Nestlé and Procter & Gamble. Unilever emerged in 1929 through the merger of Dutch food company Margarine Unie and British soapmaker Lever Brothers.

Today, Unilever's products fall into four main categories: personal care, food, beverages, and cleaning agents. Personal care accounts for about 38 percent of total sales and includes such products as deodorants, cosmetics, lotions, toothpaste, soap, and shampoo. Unilever's food group contributes 24 percent to total sales and comprises snacks, soups, margarines, mayonnaise, and salad dressings. Beverages and cleaning agents each contribute 18 percent to total sales. The firm's 400 brands include Ben & Jerry's, Best Foods, Dove, Flora, Knorr, Lipton, Lux, Magnum, Noxzema, Pepsodent, Vaseline, and many others.

Unilever has research and production operations in more than 100 countries. It sells products in almost 200 countries. Emerging markets—especially Brazil, China, India, Mexico, and Russia—account for more than half of total sales.

Comparative and Competitive Advantages

Unilever's headquarters in the Netherlands, and its longstanding connection to the United Kingdom (UK), provide numerous *comparative advantages* to the firm. For example, the UK market is highly developed, sophisticated, and diversified. The Netherlands is well located to serve the world and is a key entry market for continental Europe. The Netherlands and the UK are leading platforms in new technology development, with a high concentration of knowledge workers who drive innovation in product development and operations. The UK is one of the world's leading banking centers, with an active stock market, which provides a ready supply of capital. Rotterdam is Europe's largest port. The Netherlands has leveraged its location to establish advanced infrastructure for transporting goods, people, and electronic data. Strong and stable economies in both the Netherlands and the UK ensure steady demand for Unilever products. The wide range of countries where Unilever operates provides numerous other comparative advantages.

Unilever possesses many *competitive advantages*, including thousands of patents, superior R&D capability, high-quality products, innovative technologies, economies of scale, cross-business synergies, deep distribution channels, excellent marketing capabilities, well-known brand names, customer loyalty, and access to lower-cost and superior labor through factories worldwide. Several of these strengths also provide Unilever with *monopolistic advantages*, capabilities that few other firms have. Such advantages give Unilever a degree of monopoly power over local firms in international markets.

Consistent with the Porter Diamond Model, the Netherlands and the UK are strong locations for R&D due to the presence of highly demanding consumers; superior production factors, especially in capital and labor; and numerous strong competitors that pressure Unilever to innovate. For example, Europeans are demanding consumers and push Unilever to produce high-quality products. Related and supporting industries in Europe—especially suppliers of key ingredients for food, personal care, and beauty products—provide additional advantages. Intense rivalry in the FMCG industry constantly pressures Unilever to launch new products and improve existing ones. Europe is home to numerous *industrial clusters* in the FMCG industry. Consistent with *new trade theory*, Unilever obtains massive economies of scale by selling its products throughout the world.

Internationalization and FDI Advantages

Unilever long has pushed *internationalization* throughout its value chains, including R&D, procurement, manufacturing, distribution, and marketing and sales. The firm utilizes a full range of foreign market entry strategies, including exporting and foreign direct investment (FDI). The firm has used FDI to establish factories and marketing subsidiaries around the world. FDI allows Unilever to control international operations and reduce the risk of dealing with outside partners. For example, the firm spent $2.7 billion to acquire South Korean skin-care brand Carver Korea to extend its presence in Asia. In Colombia, Unilever acquired Quala to better target personal and home care products to Latin America. Major factories are located in Brazil, Canada, China, Indonesia, Mexico, Ireland, and Turkey. Unilever's R&D centers—in India, China, the Netherlands, the United States, and the UK—employ 6,000 scientists, engineers, and technicians. Unilever has entered many collaborative ventures to strengthen R&D, design, manufacturing, and other activities. International collaborations give the firm access to foreign partners' expertise, capital, distribution channels, marketing capabilities, and other assets.

Strategically locating R&D, production, and sales in appropriate countries provides enormous *location-specific advantages*, including access to superior labor and the ability to sell in top markets. For example, Unilever's plant in Durban, South Africa, benefits from top advantages in natural resources, physical infrastructure, and low-cost, high-quality labor. Unilever uses palm oil in the production of margarine, ice cream, soap, and shampoo. The firm's palm oil plantations in Malaysia benefit from good climate, abundant palm trees, and low-cost labor. Unilever's R&D centers in the UK leverage the country's abundant scientists and knowledge workers as well as capital needed to fund innovation.

Factor proportions refer to the relative concentration in countries of labor, capital, and other production factors. Unilever's plant in Hefei, China, makes personal care products under the Pond's, Dove, and Vaseline brands. China is a top manufacturing location because of plentiful low-cost, high-quality labor. The country's abundant land helps keep rents and other property-related costs low. China is also home to major stock markets and half of the world's largest 10 banks, which provide capital for Unilever's many activities there.

Recent Events

The FMCG industry is thriving due to rapid population and income growth in emerging markets. Unilever faces many challenges, including evolving demand, complex supply chains, and uncertainty in the natural environment. Consumers increasingly shop online. Many are "going green" and demand superior value. In advanced economies, more consumers are demanding products tailored to specific and fragmented needs. Such changes erode scale advantages and provide new opportunities to small players. On the supply side, natural resource shortages are affecting the costs of chemicals, food ingredients, and other key inputs. Trade protectionism is on the rise in several top markets. Unilever's numerous comparative and competitive advantages are providing big benefits that will help the firm navigate threats and opportunities.

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Case Questions

5-4. Unilever has used FDI extensively to internationalize its activities around the world. What advantages does FDI provide the firm? What steps can Unilever take to ensure its FDI ventures succeed?

5-5. What are the roles of comparative and competitive advantages in Unilever's success? Provide specific examples of natural and acquired advantages that Unilever uses to succeed in the global FMCG industry.

5-6. Discuss Unilever and its position in the FMCG industry in terms of the determinants of national competitiveness. What are the roles of demand conditions; firm strategy, structure, and rivalry; factor conditions; and related and supporting industries in Unilever's international success?

5-7. In terms of Dunning's eclectic paradigm, describe the ownership-specific advantages, location-specific advantages, and internalization advantages that Unilever holds. Which of these advantages do you believe has been most instrumental to the firm's success? Justify your answer.

Sources: Christopher Bartlett, "Unilever's New Global Strategy: Competing Through Sustainability," Harvard Business School case, August 24, 2016, www.hbsp.harvard.edu; Richard Benson-Armer, Steve Noble, and Alexander Thiel, "The Consumer Sector in 2030: Trends and Questions to Consider," December 2015, McKinsey & Co., www.mckinsey.com; Bhaskar Chakravorti, "Unilever's Big Strategic Bet on the Dollar Shave Club," *Harvard Business Review*, July 28, 2016, www.hbr.org; Saabira Chaudhuri, "Outfoxed by Small-Batch Upstarts, Unilever Decides to Imitate Them," *Wall Street Journal*, January 3, 2018, www.wsj.com; Saabira Chaudhuri, "Unilever and Nestlé Struggle with Cautious U.S. and European Consumers," *Wall Street Journal*, April 21, 2017, www.wsj.com; *Economist*, "Unilever Is the World's Biggest Experiment in Corporate Do-Gooding" September 2, 2017, p. 58; William George and Amram Migdal, "Battle for the Soul of Capitalism: Unilever and the Kraft Heinz Takeover Bid," Harvard Business School case, May 30, 2017, Harvard Business School Publishing, www.hbsp.harvard.edu; Vijay Mahajan, "How Unilever Reaches Rural Consumers in Emerging Markets," *Harvard Business Review*, December 14, 2016, www.cb.hbrp.harvard.edu; Marketline, "Company Profile: Unilever," February 28, 2017, www.marketline.com; Unilever, "About Unilever," 2017, www.unilever.com; U.S. Commercial Service, *Doing Business in the Netherlands: 2017 Country Commercial Guide for U.S. Companies*, www.export.gov/netherlands; U.S. Commercial Service, *Doing Business in the United Kingdom: 2017 Country Commercial Guide for U.S. Companies*, www.export.gov/unitedkingdom; Vivienne Walt, "Unilever CEO Paul Polman's Plan to Save the World," *Fortune*, February 17, 2017, www.fortune.com.

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END-OF-CHAPTER REVIEW

MyLab Management

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Key Terms

absolute advantage principle 157
comparative advantage 154
comparative advantage principle 158
competitive advantage 155
free trade 154
industrial cluster 164
internalization theory 170
mercantilism 156
national industrial policy 164

Summary

In this chapter, you learned about:

- **Why nations trade**

  Each nation specializes in producing certain goods and services and then trades with other nations to acquire those goods and services in which it is not specialized. Classic explanations of international trade began with mercantilism, which argued that nations should seek to maximize their wealth by exporting more than they import. The absolute advantage principle argues that a country benefits by producing only those products in which it has absolute advantage or can produce using fewer resources than another country. The principle of comparative advantage contends that countries should specialize and export those goods in which they have a relative advantage compared to other countries. Comparative advantage is based on *natural advantages* and *acquired advantages*. Competitive advantage derives from distinctive assets or competencies of a firm, such as cost, size, or innovation strengths, which are difficult for competitors to replicate or imitate. *Factor proportions theory* holds that nations specialize in the production of goods and services whose factors of production they hold in abundance. *International product life cycle theory* describes how a product can be invented in one country and eventually mass-produced in other countries, with the innovating country losing its initial competitive advantage.

- **How nations enhance their competitive advantage**

  A major recent contribution to trade theory is Porter's determinants of national competitive advantage, which specify the four conditions in each nation that give rise to national competitive advantages: *demand conditions; firm strategy, structure, and rivalry; factor conditions*; and *related and supporting industries.* An industrial cluster is a concentration of companies in the same industry in a given location that interact closely with one another, gaining mutual competitive advantage. Competitive advantage of nations describes how nations acquire international trade advantages by developing specific skills, technologies, and industries. National industrial policy refers to governments' efforts to direct national resources to developing expertise in specific industries.

- **Why and how firms internationalize**

  The *internationalization process model* describes how companies expand into international business gradually, usually progressing from simple exporting to the most committed stage, FDI. Born global firms internationalize at or near their founding and are part of the emergent field of international entrepreneurship.

- **How internationalizing firms can gain and sustain competitive advantage**

  MNEs have value chains that span geographic locations worldwide. Foreign direct investment means that firms invest at various locations to establish factories, marketing subsidiaries, or regional headquarters. *Monopolistic advantage theory* describes how companies succeed internationally by developing resources and capabilities that few other firms possess. Internalization is the process of acquiring and maintaining one or more value-chain activities inside the firm to minimize the disadvantages of subcontracting these activities to external firms. Internalization theory explains the tendency of MNEs to internalize value-chain stages when it is to their advantage. The *eclectic paradigm* specifies that the international firm should possess certain internal competitive advantages, called *ownership-specific advantages, location-specific advantages*, and *internalization advantages*. Many companies engage in international *collaborative ventures*, inter-firm partnerships that give them access to assets and other advantages foreign partners hold.

Test Your Comprehension

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5-8. Describe the classic theories of international trade. Which theories do you believe are relevant today?

5-9. What is the difference between the concepts of absolute advantage and comparative advantage?

5-10. Summarize factor proportions theory. What factors are most abundant in China, Japan, Germany, Saudi Arabia, and the United States? Visit globalEDGE™ for helpful information.

5-11. How does factor proportions theory compare to international product life cycle theory?

5-12. Do you believe your country should adopt a national industrial policy? Why or why not?

5-13. There is a tendency for organizations to move from simple exporting operations to FDI over a period of time. Why is this often the case? What might slow or stop the process?

5-14. Industrial clusters can be valuable tools for a country's economy. Identify three global examples and describe their development. Do not choose your own country.

5-15. Are collaborative ventures the best option when a business has little knowledge of the market?

Apply Your Understanding

AACSB: Written and Oral Communication, Ethical Understanding and Reasoning, Analytical Thinking, Reflective Thinking, Application of Knowledge

5-16. According to the Observatory of Economic Complexity (OEC), Australia exports 152 products that display the characteristics of comparative advantage. The OEC defines this in slightly different terms than the generally accepted definition. They suggest that a comparative advantage is revealed by a country having a larger share of global exports than would normally be expected considering the overall size of its export economy and the actual size of the products' global market. In 2016, Australia had exports of just under $200 billion. Among the products in the comparative advantage category were items as diverse as animal hides, arts and antiques, glass, and vegetables.

Examine the report on Australia's comparative advantage, which can be accessed at the website of the Australian Council of Learned Academies (https://acola.org.au/wp/reports-library). The report provides a comprehensive appraisal of the comparative advantage products and sectors; it also suggests how the country can move to secure its position in the future. What are the key steps that Australia should take? Apply this approach to your own country. Identify any comparative advantages and then suggest ways in which these can be protected and developed into the future.

5-17. Economist Lester Thurow once posed the question "If you were the president of your own country and could specialize in one of two industries, computer chips or potato chips, which would you choose?" When faced with this question, many people choose potato chips because "everybody can use potato chips, but not everybody can use computer chips." However, the answer is much more complex. Whether to choose computer chips or potato chips depends on such factors as the relationship between national wealth and the amount of value added in manufacturing products, the possibility that the country can benefit from monopoly power (few countries can make computer chips), and the likelihood of spin-off industries (computer chip technology gives rise to other technologies, such as computers). In light of these and other possible considerations, which would you choose, computer chips or potato chips? Justify your answer.

5-18. *Ethical Dilemma:* To reduce poverty in Africa, government officials want to increase African exports to Europe. Africa's top exports include agricultural products, such as meat, coffee, peanuts, and fruit, and many Africans depend on food exports for their livelihood. However, the European Union (EU) imposes high trade barriers on the import of agricultural products. Among various reasons, Europeans are concerned about food quality, and the EU has adopted rigorous agricultural safety standards. However, the tough regulations hurt African countries, which have experienced problems with food toxins and bovine diseases in the past. In addition, the agricultural lobby in Europe is powerful, and the EU subsidizes farmers heavily. Many European politicians do not want to risk angering Europe's farm lobby by supporting free international trade in agricultural products. Suppose you are part of an EU government task force investigating trade barriers on African agricultural imports. Using the ethical framework in Chapter 4, analyze the arguments for and against agricultural trade with Africa. What should the EU do? Justify your answer.