International Trade and Finance, Part 2

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Feasibility of International Trade

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Contents

Preface

International Trade and Finance is a unique series of open educational resources that connects world events to economic and financial analysis. This OER explores not only the economics of international trade but also the feasibility analysis for making decisions regarding international trade and the role such analysis plays in selecting appropriate trading partners. The series also explores the risks faced by international organizations in trade finance and the various financial tools available to mitigate them. Thus, the *International Trade and Finance* series covers three key areas in three parts:

- *Part 1: Economics of International Trade* (Chapters 1 to 8)
- *Part 2: Feasibility of International Trade* (Chapters 9 to 15)
- *Part 3: International Trade Finance* (Chapters 16 to 22)

Part 1: Economics of International Trade introduces readers to the benefits of the free movement of goods and services and the factors of production, such as capital and labour, for participating countries and the world. We also explore the protectionist policies that limit the international trade in goods and services and productive resources. Readers are introduced to the effects of several protectionist policies, such as tariffs, quotas, and economic integration, on economic well-being and to the conditions under which such policies can make individual countries better off economically. Some policies and practices, such as dumping and export subsidies, adopted by governments and domestic producers to encourage exports are also evaluated.

Part 2: Feasibility of International Trade introduces readers to multiple tools and frameworks for assessing whether an organization is ready to enter international markets and to help them select the correct market for their products and services. We also present various rules and regulations applicable to international trade and provide readers with links to online resources where they can learn about various government organizations that help businesses with international expansion.

Part 3: International Trade Finance introduces readers to the role of trade finance in international trade decisions. Organizations around the world face many financial challenges when they decide to go global, including non-payment, non-performance, currency risk, etc. The text sheds light on the role financial tools and international financial organizations play in mitigating these risks.

After reading the three parts of International Trade and Finance, students of international business will have a sound knowledge of these key concepts and their application in the real world.

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Introduction

Welcome to ***Part 2: Feasibility of International Trade***. This OER focuses on the analysis, research, and planning required by an organization to ensure the successful expansion of an international venture. The text is divided into four sections. Section one examines an organization's readiness and motivation for expansion. Section two is dedicated to the risks associated with international markets and risk mitigation strategies. It also offers various frameworks related to corporate social responsibility and sustainable development when conducting business in less developed countries. Section three explains the different modes of entry available to organizations, as well as the scale and timing of entry. The last section is assigned to cost elements associated with international trade, available pricing strategies, and international pricing constraints, which help to assess the overall viability of international ventures. The appendix explains the risk management process, which students can apply to section two on risk identification and mitigation strategies.

International Trade and Finance – Part 2: Feasibility of International Trade was developed for use in **BUS1055 Feasibility of International Trade** in the Business – International Business diploma program at Conestoga College.

Features of this OER

Each chapter in *International Trade and Finance* is introduced with chapter-level **Learning Objectives** and a **Think About It!** box introducing the chapter's main themes, which may include a short **YouTube video**, a **Test Yourself** H5P quiz, or a set of **Reflection Questions**.

Think About It! boxes throughout the chapters give readers the opportunity to explore certain terms and ideas further, such as with videos or interactive H5Ps.

Let's Explore and **Review** boxes introduce external resources to help learners explore the foundations of a key concept or learn more about it.

Did You Know? boxes share interesting stories or supplemental information with readers.

Each chapter ends with a **Chapter Summary** based on the chapter's Learning Objectives and gives readers a chance to assess their learning with **Check Your Understanding** H5P quizzes.

Each part includes a complete **Glossary**, with **pop-up definitions** linked to terms used in context.

Acknowledgments

Land Acknowledgment

At Conestoga College, we would like to acknowledge that in Kitchener, Waterloo, Cambridge, and Brantford, we are located on the Haldimand Tract, the land promised to the Haudenosaunee people of Six Nations, which includes six miles on either side of the Grand River. This is the traditional territory of the Anishinaabe, Haudenosaunee, and Neutral peoples. Recognizing the land is an expression of gratitude and appreciation to those whose environment we reside in and a way of honouring the Indigenous people living and working on the ground for thousands of years.

Author Acknowledgments

I would like to thank the team at Conestoga College for their commitment to open educational resources (OER), especially Amy Gleiser and Kim Carter for their leadership and support on this project and for giving me the opportunity to be part of it. I also would like to thank Kiranjot for being the lead and facilitating the process, Sami and Kenrick for their contribution and support, and Rachel from Open Learning for making it happen. It was great working with all of you. Special thanks to my husband, Ahmad Noor, my kids, Mary & Allen, for their unconditional support and my furry friend Sherlock, who is always by my side.

— Dina Majid

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Many thanks to Sami Sappong-Kumankumah, professor in the School of Business at Conestoga College, who reviewed the manuscript for this project during development.

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Dina Majid, CPA, is a professor in the School of Business at Conestoga College. As a professional accountant, she is an active member of the Certified Professional Accountants Association of Ontario. Dina also has a master's degree in political economics from Moscow State University. For over 15 years, Dina worked in the Canadian manufacturing sector in senior accounting positions, where she oversaw foreign subsidiaries, dealt with suppliers and customers in different countries, and worked closely with the Canada Border Services Agency. Dina saw the need for students to learn more than just theory and has incorporated her real-world experience of international business into her teaching. This experience and her background as a business professional with extensive industry experience inspired and informed her writing of *Part 2: Feasibility of International Trade*.

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Kiranjot Kaur, MBA, PhD, is a professor in the Business – International Business program at Conestoga College. She completed her MBA degree with distinction and was offered a fellowship to pursue and complete her doctorate for her excellence in research. Her area of research for her PhD in business administration was international economics and trade. Kiranjot has participated in and presented papers at several international conferences, and she is the author of *Competitiveness and Complementarities in BRICS Trade* and the OER *Global Value Chain*. In industry, Kiranjot has worked in both the media and supply chain sectors. As an enthusiastic advocate of open pedagogy, this project was the result of Kiranjot's dedication to improving the quality of curriculum guidance. Kiranjot enjoyed working with her Conestoga colleagues, Kenrick and Dina, to create *Part 3: International Trade Finance* by sharing ideas and collaborating on the pedagogy of learning.

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Kenrick H. Jordan is a professor of international business management in the School of Business at Conestoga College. He holds MS and PhD degrees in food and resource economics from the University of Florida, as well as an MA in development economics from the University of East Anglia (UK) and a BA in economics from the University of the West Indies. Kenrick has taught undergraduate and graduate economics courses in microeconomics, macroeconomics, managerial economics, economics of developing countries, consumer economics, and international trade and finance at Conestoga College and other academic institutions, including the University of North Florida, Toronto Metropolitan University, York University, and Coastal Carolina University. Kenrick previously worked as an economist in the Canadian financial services industry and at the Caribbean Community Secretariat. Kenrick developed the content for *Part 1: Economics of International Trade* OER and appreciated collaborating with Kiranjot and Dina.

I. ORGANIZATIONS’ READINESS AND MOTIVATION FOR ENTERING INTERNATIONAL MARKET

CHAPTER 9: INTERNAL ANALYSIS: ASSESSING CURRENT STATE

Chapter 9 Introduction

Learning Objectives

After reading this chapter, you should be able to

1. Explain how an organization can determine if their product is ready to compete in an international market.
2. Explain how to determine if a company is ready to enter international markets.
3. Discuss the motivations behind a firm's decision to enter international markets.

Think About It!

Video: Export Experts: Are You Ready to Export?

In this video, trade experts from various countries give advice on how to assess your readiness for entering international markets, what questions to ask and what factors to consider when making that decision.

One or more interactive elements has been excluded from this version of the text. You can view them online here: https://ecampusontario.pressbooks.pub/internationaltradefinancepart2/?p=48#oembed-1

Source: International Trade Administration. (2014, November 19). *Export experts: Are you ready to export?* [Video]. YouTube. https://youtu.be/1CUkTzWdp1w?si=9jCkTfpv3k0-bmJR

Reflection Questions

Before we begin, we encourage you to reflect on the following questions:

1. What is the first question you should ask yourself when you are looking to export?
2. Why is it important to commit to long term when starting to trade internationally?

Introduction

Before embarking on a new venture in international markets, it is important that an organization assess their current state, available resources, and overall attitude toward expansion. This first step can help the organization determine whether the new venture is going to be feasible or not.

9.1 Characteristics of Export Ready Product

Product Readiness

A product is considered ready for export if it has the following criteria:

- **Successful domestically**
    - A product is deemed to be successful when it meets the financial metrics, producing consistent revenue and the desired profit margin per company standards, as well as the market metrics: high percentage of market share and a competitive position (ET Spotlight, 2023).
- **Competitively priced**
    - When a company sets the price of their product below the price of other similar products in the market or offers a higher value product for the same price as their competition, the product is considered competitively priced.
- **Unique in one or more ways**
    - A product is unique when it has a feature or quality that is better than what is already available in the market. The unique feature can have an innovative design that provides a new and better way to solve the problem.
- **Costly to imitate**
    - Products are considered costly to imitate if they require the competitors to invest significant amounts of time and/or capital to replicate them. A product may also be hard for competitors to copy if it is protected by a patent or a trademark. A costly to imitate product gives companies a competitive advantage.

In addition to the criteria listed above, an export-ready organization must understand the **resource-based view (RBV)** of the firm and follow the (valuable, rare, inimitable, organization) **VRIO framework**.

The resource-based theory or RBV is a concept proposing that if a company possess a strategic resource, that resource will help the company to develop a competitive advantage over its rivals. RBV concepts suggest that if a resource meets VRIO attributes, it gives the company a *sustainable competitive advantage*. As the name suggests, this model sees resources as key to superior firm performance.

Did You Know? What Is a Resource?

There are two main types of resources:

- ***Tangible Resources***
    - Are visible and have physical attributes such as: Labour, Capital, Land, Buildings, Plant Equipment, and Supplies.
- ***Intangible Resources***
    - Are invisible and have no physical attributes such as Culture, Knowledge, Brand, Reputation, or Intellectual Property (Patent, Design, Copyrights, Trademark, Trade Secrets).

Resources can also be categorized as **heterogeneous** and **immobile**.

Heterogeneous Resources

Bundles of resources, capabilities, and competencies that are unique and different from other rivals are considered heterogeneous resources. Let's consider an example of budget airlines in the United States. Southwest Airlines (SWA) and Alaska Airlines (AS) both compete in the same target market, and they are part of the strategic group (low-cost, point-to-point airlines). But they draw different resource bundles.

SWA relies on employee productivity which translates to turning around a plane fast. Southwest turns around planes at airport gates in only 15 minutes. All staff are trained to perform tasks needed to turnaround the plane, for example: pilots will help to clean the toilets and take out the rubbish. Another distinguishing capability that Southwest possesses is the maintenance of a culture of fun for the customers and staff.

Alaska Airlines differentiated itself by having unique marketing strategies such as various in-plane entertainment activities and by acquiring smaller airlines and taking over more routes, thus increasing its customer base. They were also diversified by offering passenger and cargo services, which they eventually dropped. The key to their success was their dynamic strategy decisions and flexibility in changing the business structure.

Immobile Resources

Resources are immobile when they do not move easily from company to company. For example, Southwest Airlines has maintained a sustainable competitive advantage and outperformed its competitors for decades. Continental was tempted to copy SWA, with Continental Lite offerings. Although it did lower its price and some of the costs, it was unable to successfully imitate the resource bundles and firm capabilities that make SWA unique.

Source: Alonso, 2022; Brown, 2021; Edwards, 2014; Gordian Business, n.d.

What Is the VRIO Framework?

VRIO framework is a valuable tool that evaluates a firm's internal resources and capabilities to find out if they can be a source of sustainable competitive advantage. It was developed in the 1990s by J.B. Barney and outlined in a *Journal of Management* article entitled "Firm Resources and Sustained Competitive Advantage." Barney identified four attributes that a firm resource must have in order to become a source of competitive advantage (Jurevicius, 2023). These attributes are being valuable, rare, and costly to imitate; the firm itself must also be organized to capture the value of the resource. The acronym of the framework comes from the terms valuable, rare, inimitable, and organized.

Valuable
Rare
Inimitable (or costly to imitate)
Organized to utilize the resources

A **valuable** resource is one that allows the firm to take advantage of external opportunities or negate external threats. If a resource does not allow a firm to minimize threats or take advantage of opportunities, it does not help strengthen the competitive advantage of the firm.

A **rare** resource is one that can only be acquired by one or a few companies. In other words, a resource is rare if other competitors do not widely possess it.

An **inimitable** resource is one that is difficult and costly for a competitor to either replicate or acquire.

Organization is required to exploit and capture the value of the resource. The resource on its own does not confer any advantage, even if it is rare, valuable, and inimitable.

Review: VRIO Framework

Review and expand your understanding of VRIO by reading "VRIO Analysis" in Strategic Management (published by Oregon State University).

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9.2 Export Ready Organizations

In order for an organization to determine if it is ready for international business, it has to analyze its current state and find out if the following criteria are being met:

Competitive Capabilities in Domestic Markets

The criteria of competitive capabilities in domestic markets are best explained by a powerful framework provided by Michael Porter (Porter, 1990). The framework is also known as "the diamond model." According to the model, the ability of the firms in an industry whose origin is in a particular country to be successful in the international arena is shaped by four factors: their country's demand conditions, their home country's endowment factor, related and supported industries within their home country, and strategy, structure, and rivalry among their domestic competitors.

Demand Conditions

Demand conditions refer to the nature and volume of domestic customers. When domestic customers have high expectations, firms try to live up to those expectations and produce high-quality products. As a result, they gain competitive advantage. For example, Japanese consumers are known for their expectations of quality and reliability. Japanese automakers such as Nissan, Toyota, and Honda have to work hard to satisfy their domestic customers, and in doing so, they are prepared to offer high-quality products internationally.

Factor Conditions

Factor conditions refer to the country's endowments in terms of natural resources raw materials, and other inputs, including qualified labour, that firms need to create goods and services. For example, companies in Canada and the United States have access to plenty of natural resources and skilled labour forces. They also benefit from a developed transportation system and highly sophisticated capital markets. All these factors help them to be successful and is giving them a competitive advantage. The manufacturing sector in China is another example, where having access to cheap labour and cheap capital helped the sector to grow excessively in recent years.

Related and Supporting Industries

Related and supporting industries refer to the upstream and downstream industries that facilitate the firm's activities. The availability of top complementors, firms that provide products or services, can lead to creating added value. The added value could be in terms of quality or efficiency. For Italian shoemakers such as Salvatore, Prada, Gucci, and Versace, for example, the availability of top-quality leather within their home country translates into efficiency. If they relied on imported leather, they would have lost some of their speed and flexibility.

Firm Strategy, Structure, and Rivalry

Companies that face stronger competition in their domestic market tend to perform well on the global level. The Olympics offer a great analogy to illustrate the positive impact of fierce competition on a firm's global performance. If an athlete competes against a strong competitor to make the national team, that athlete would push herself/himself to the best of their abilities and train hard. On the other hand, when domestic competition is weak, the athlete does not have to try very hard. When competing on the world level, the athlete who made the national team by training hard will have a better chance of competing against others and is likely to succeed.

Commitment of Owners and Top Managers

It may take at least two to three years before a company becomes profitable when entering the international market for the first time. It is important that the management of the company is prepared and understands that they are in for the long run and they are willing to invest the time, the personnel, and the required capital to fund the export program.

Experience and Training, Skills, Knowledge, and Resources

There are several factors an organization needs to assess before they decide to launch an international venture. Those who are new to international trade will need to do a much more in-depth analysis than those who already have some experience. Some of the key factors that should be considered when assessing their current state are:

Financing

When expanding to international markets, organizations need to treat their financing needs and cash flow planning differently than those that operate domestically. There are many additional costs associated with international transactions that should be determined at the early stages of the process for two reasons: First those costs will help with determining the product price correctly; secondly, and more importantly, organizations will be able to determine their financing needs accurately.

In assessing their financial needs and addressing gaps, organizations need to look at the following:

- Budget capacity to produce the product for overseas markets – without straining domestic market commitments.
- A steady cash flow from day-to-day sales as well as financing sources.
- Access to sufficient financial reserve and funding to support international operations for at least two years or until becoming profitable (Export Finance Australia, n.d.).
- The financial capability to compete with international competitors in terms of cost and quality.
- The knowledge and understanding of ways to reduce financial risk associated with international markets.
- Ask external third-party experts for professional advice on managing financial risk if such experts are not available internally (FIIT Team, 2017; Global Expansion, n.d.).

People

When expanding internationally, organizations require skills and experiences that will address the needs of their new venture. Human resources assessment enables businesses to better understand their current workforce and identify skills gap in critical roles. When assessing their human resources needs, organizations should consider the following:

- Is there a management team that has the skills and capabilities to develop a comprehensive export plan – have they done it before?
- Does the management team, especially those in critical roles, possess the skills and knowledge to satisfy the needs of the new venture or does the organization have the capacity to hire or contract staff for those roles?
- Personnel with culturally sensitive marketing skills and experience in buying and selling abroad or the firm has the ability to hire qualified people. The alternative is to use intermediaries (agents, distributors, or trading organizations) with the required expertise.
- Have a local contact or "go to" person and have ways to deal with language barriers (FIIT Team, 2017; Guide to Exporting, 2021; Global Expansion, n.d.).

Capacity

To make a proper assessment of production resources and capacity, organizations need to focus on their own internal production capacity as well as the capacity of their suppliers. Factors that should be examined and addressed are:

- Make sure that suppliers are able to deliver components and raw materials required to fulfill their obligations to both international and domestic customers.
- Be prepared to modify and manufacture versions of products and services to meet the cultural, regulatory and certification standards of the international market.
- Ensure the availability of spare production capacity or the ability to create extra capacity for unexpected growth in domestic and international markets demand (FIIT Team, 2017; TCC-Guide to Exporting, 2021).

Logistics

It is one thing to fulfill an order, and it is another to deliver it on time and in the expected condition. Export logistics are complicated and require professional management and expertise at every step of the process. Organizations must make sure that:

- They have the necessary skills and knowledge of the exporting process and know what it takes to ship products to international markets.
- They have staff with adequate knowledge of logistics procedures for international shipping.
- They have a staff that is capable of troubleshooting problems in a quick and efficient manner (FIIT Team, 2017).

For small or even medium-sized firms, it will be cost-effective to seek the help of outside experts, and freight forwarding agencies.

Let's Explore: Exporting

To learn more, visit Step-by-Step Guide to Exporting by Trade Commissioner Service of Canada and scroll down to "1.2 Are you ready?" Or visit the Trade Ready website by FITT.

Myth or Fact?

My company is too small to be successful at exporting!

This is a myth. To be successful in international markets, you do not have to be a big firm. Tens of thousands Canadian firms, small and medium sized (SMEs), with foreign sales of between $30K – $500K are currently exporting and are doing well.

For help and expert advice, visit Trade Commissioner in Canada or Abroad.

Think About It! Dream Big

In this video Andrew Angus, founder and CEO of Collingwood, Ontario-based Switch Video, explains how his small company successfully Expanded to international market with the help of the Canadian Trade Commissioner and Canadian Technology Accelerator.

One or more interactive elements has been excluded from this version of the text. You can view them online here: https://ecampusontario.pressbooks.pub/internationaltradefinancepart2/?p=98#oembed-1

Source: Global Affairs Canada. (2015, June 19). *The key to forging long-term relationships* [Video]. YouTube. https://youtu.be/iMMCWi_317s?si=C-IOHAEdqtnB6UDD

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9.3 Motivation for Going International

Expansion is a natural process for firms who wish to take their business to the next level. Expanding globally, however, was once only deemed to be achievable by large companies. However, declining trade barriers and increasing demand in developing countries have made the expansion process for companies of all sizes attainable. Many companies big and small, are taking advantage of this opportunity and expanding their business around the world.

The motivation for going international, however, can be different from company to company: some companies proactively work towards international expansion, while others expand internationally as a reaction to a domestic situation.

Proactive Reasons

Companies who proactively seek to expand internationally are known to have proactive reasons, and they are:

- **Profit-seeking** — entering a market where they can offer lower prices than those of the competition to gain a competitive advantage and increase their profit. Or manufacturing products in low-cost countries to reduce their cost and increase their profits.
- **Risk diversification** — another reason for a company to go global is to diversify its assets and reduce the risk. Many firms expand internationally to protect the company's bottom line against unforeseen events. For example, companies that have operations in different countries can offset negative growth in one market by operating successfully in another. They can also become more immune to external factors that have an impact on consumer behaviour and purchasing of their products, such as climate.
    - IDE Technologies provides "snowmaking" services to ski resorts around the world. They operate in countries in both hemispheres (e.g., Switzerland and South Africa) to ensure a consistent revenue stream.[1]
    - Coca-Cola is another example of a company that diversifies globally.[2]
- **Economies of scale** — economies of scale occur when the unit cost of a product or service is reduced due to an increase in the volume of production. By entering an international market, companies can increase their customer base and sell more units, which can lead to a high volume of production and, thus, economies of scale.
- **Increased capabilities** — finding increased capabilities is another top benefit of expanding internationally. International markets provide an opportunity to access new talent pools with a wide range of skills, diverse educational backgrounds, and language skills, increased productivity, innovation and more.

1. See IDE company website.
2. See *Coca-Cola Business Strategy: Goals & Case Study*

Did You Know? Apple Found Increased Capability in China

Apple's decision to produce its iPhone in China is mainly related to the Chinese subcontractors' quick response to changes. In a famous illustration of this capability, back in 2007, just a month before the first iPhone was to be released, Steve Jobs demanded that the glass screen on his prototype iPhone was scratched easily and that it needed to be replaced with un-scratchable glass screen. Making this last-minute change in the iPhone's design put Apple's market introduction date at risk. Apple had selected Corning to manufacture large panes of strengthened glass, but finding a manufacturer that could cut those panes into millions of iPhone screens was not easy. Then, a bid arrived from a Chinese company In Shenzhen. The plant's owners had started constructing a new wing to cut the glass and were installing equipment when the Apple team visited the factory. The plant also had a warehouse full of glass samples for Apple to experiment with. The company engineers were housed in dormitories, so they were available 24 hours a day to meet Apple's production demand. The Chinese company was hired. After a month of experimentation, the engineers figured out how to do it.

Three months later, Apple had sold 1 million iPhones. Four years later, Apple sold 200 million of them. Another critical advantage of China for Apple was that it was much easier to hire engineers there. Apple calculated that about 8,700 industrial engineers were needed to oversee and guide the 200,000 assembly-line workers involved in manufacturing the original iPhone. Finding that many engineers in the United States may have taken up to nine months, according to the company's estimates. In China, it took 15 days.

Source: Blodget, 2012.

Reactive Reasons

Some companies expand internationally because they face a challenging situation in their domestic market which leads to erosion of profits and even termination of their operations if they do not react on time. Or there is an opportunity in the international market which the company cannot forgo. Reactive reasons for going to international markets include the following:

- **Market opportunities and generation of new revenue stream** — this occurs when there is a demand for the company's products or there is the absence of competition abroad, which would give the firm the first mover advantage. (See Chapter 14.)
    - For example, Sony, a Japanese firm making consumer electronics, expanded globally because one of its owners, Akio Morita, decided that Sony should not be restricted to Japan and viewed the whole world as a potential marketplace. The company expanded to many countries and now has a presence in almost every continent ("About Sony," n.d.).
    - Another example is Abercrombie & Fitch. Their expansion to the international market was due to unsolicited orders received from other countries. They found that many customers were ordering by

catalogue and online from abroad. The company took that as a sign, and in 2007, they decided to expand overseas. The company first started to expand in the U.S. and then continued to expand to Europe and Asia. By 2013, they had stores in the Middle East and Australia ("About Us," n.d.).

- **Overproduction** — this can be the result of declining domestic sales, or the company may have excess capacity and can produce more units, but its domestic market is not large enough for all units.
- **Competitive strike** — when a competitor enters the company's domestic market and takes away the company's share of the market, then the company expands their business to either competitor's domestic market or attacks the competitor in a different international market.
- **Political and economic changes in the domestic market** — governments, from time to time, change their trade rules and regulations and assign **tariffs** to certain products entering the country. When that happens, the cost of the product entering the country increases and erodes the company's profit. This reduction in profit forces companies to expand their production to those countries where they will not be subject to such tariffs or increased costs. In other situations, the government might introduce environmental regulations that increase the cost of production for companies. This will also encourage businesses to move their business to countries where environmental rules and regulations are not too strict.

Let's Explore: Going International

Let's Explore: Going International

To learn more about the decision to export, read the Step-by-Step Guide to Exporting – Step 1 – Getting started: assessing your export potential from the Canadian Trade Commissioner Service (TCS) and Global Affairs Canada.

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Chapter 9 Summary

LO 9.1 How Organizations Can Determine If a Product Is Ready for an International Market

- A product that is ready for international trade should meet four criteria: It has to be successful domestically, competitively priced, unique in one or more ways and costly to imitate.
- Organizations can use the Resource Based View and VRIO framework to identify internal resources that can be a source of their sustainable competitive advantage.

LO 9.2 Determining if a Company Is Ready To Enter International Markets

- A company is most likely to succeed in the international market if it has competitive capabilities in its domestic market; the management of the company is committed to the international venture and is willing to allocate time, personnel, and capital to fund the new venture.
- The firm has the experience, training, skills, knowledge, and resources to go international. Organizations can use Porter's Diamond theory framework to determine their competitive capabilities in their domestic market.

LO 9.3 Motivations Behind Decisions to Enter International Markets

- Firms should be motivated to expand to international markets. The motivation can be based on proactive reasons or reactive reasons.
- Proactive reasons are profit-seeking, risk diversification, economies of scale, and increased capabilities.
- Reactive reasons include market opportunities and the generation of new revenue streams, overproduction, competitive strikes, and political and economic changes in domestic markets.

Check Your Understanding

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https://ecampusontario.pressbooks.pub/internationaltradefinancepart2/?p=105#h5p-1

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"Characteristics of Export Ready Product" and "Did You Know? What Is a Resource?" are adapted from " Chapter 4: Managing Firm Resources: Resource-Based Theory" from Mastering Strategic Management – 1st Canadian

II. IDENTIFYING RISKS ASSOCIATED WITH POTENTIAL INTERNATIONAL MARKETS AND SELECTING RISK MITIGATION STRATEGIES

CHAPTER 10: DIFFERENCES IN POLITICAL AND LEGAL SYSTEMS AROUND THE GLOBE AND THEIR IMPACTS ON INTERNATIONAL TRADE

Chapter 10 Introduction

Learning Objectives

After reading this chapter, you should be able to

1. Discuss the national differences in political systems of different countries.
2. Discuss the national differences in legal systems of different countries.
3. Identify risks associated with different political and legal systems.
4. Explain strategies to mitigate risks arising from political and legal systems.

Think About It!

Video: Political Risk Explained

In this video from the International Hub Shad Morris, Professor of International Business at Brigham Young University, explains how to identify and mitigate political risk.

One or more interactive elements has been excluded from this version of the text. You can view them online here: https://ecampusontario.pressbooks.pub/internationaltradefinancepart2/?p=51#oembed-1

Source: InternationalHub (2021, January 1). *Political risk explained: How to reduce political risk*. [Video]. YouTube. https://youtu.be/QXMZ3wWRiyo?si=adMV8c5ssyqe3Aaw

Reflection Questions

Before we begin, we encourage you to reflect on the following questions:

1. Explain at least two political risks associated with a given country or government.
2. Discuss some of the strategies businesses can adopt to mitigate political risk.

Introduction

Countries are different from each other in many ways. They have different political, legal, and economic systems. They also differ in their level of development and the societal culture, education, and skills levels of their population. The focus of this chapter and the next three is to explore those differences, describe the level of associated risks with each system, and discuss risk mitigation strategies that can be implemented by organizations operating in international markets.

10.1 What Is a Political System?

A political system is a set of different formal legal institutions that constitute a government. In other words, a political system is the system of government in a nation (Hill, 2022).

The political system of a country has a direct influence on the economic development of a country and shapes its legal and economic systems. Therefore, we need to understand the structure of different political systems before discussing legal and economic systems and the economic development of countries.

Types of Political Systems

Political systems around the world can be divided into 2 prominent categories: **democracy** and **totalitarianism**.

Democracy

Democracy is a type of political system where people govern themselves. The word democracy comes from Greek, and it means "rule of the people." In a democratic political system, people are involved in the decision-making process, either directly — **direct (pure) democracy** or through a representative — **representative (indirect) democracy**.

In a direct (*pure*) form of democracy, people make their own decisions about policies and issues that affect them directly. This form of democracy was practiced by several city-states in ancient Greece. These days, this form of democracy is only practiced in Switzerland. Citizens in Switzerland can have their say directly on decisions at all political levels.

All other modern societies practice the representative (*indirect*) form of democracy. This form of democracy is more efficient, where a single official represents a large number of the population based on a city, a region, or a state. People elect officials to represent them in **legislative bodies** and to vote on policies and issues on their behalf. If elected representatives fail to reflect the will of the people and perform their duties adequately, people will vote them out of office, and that is possible due to periodic elections. In a democratic system, political freedom is guaranteed by a constitution.

Representative democracy is becoming a more widely acceptable form of government globally and most countries are forming their government based on this form. Governments in North America, Western and Northern Europe, some Eastern European, South American, and South Asian countries have adopted representative democracies as a form of government (Desilver, 2019).

Totalitarianism

In this type of political system, the state controls all aspects of a society and takes away individual rights and freedom for the benefit of the state (Longley, 2022).

There are many forms of totalitarianism around the globe today. The most popular and widespread form of totalitarianism is **communist totalitarianism**. Communism is in decline, however, and many of the communist states in Eastern Europe and the Soviet Union collapsed around the 1990s. Some of the countries that are still run by communist parties around the world are China, Vietnam, Laos, North Korea, and Cuba (Hill, 2022).

Another major form of totalitarianism can be described as **right-wing totalitarianism (fascism)**. This form of totalitarianism gives individuals some freedom in economic aspects because it can be controlled but restricts their political freedom to prevent the rise of social movements such as socialism or communism. (Longley, 2022). The main common characteristics of totalitarian systems are single-party rule and an ideology that dictates all aspects of societal life.

Review: Political Systems

Review your understanding different political systems by reading "Types of Political Systems" in Introduction to Sociology: Understanding and Changing the Social World (published by University of Minnesota Libraries).

Main Institutions of Government

There are three main institutions in the modern state: the **executive**, the **legislature**, and the **judiciary**.

The legislature passes laws, the executive implements those laws, and the judiciary interprets them and ensures that they are in accordance with the constitution of the country.

In the United States, for example, the legislature, the United States Congress and the Senate, act as a check on the executive, the United States government, and the judiciary is the final court of appeal.

When the Health Care Reform law was ratified by Congress and then contested legally by the Senate, it was brought to the Supreme Court, where the court ruled that the law was constitutional.

In Canada, Parliament is the federal legislature. It includes the Monarch, who is represented by the Governor General, and the two houses of Parliament — the Senate and the House of Commons (Parliament of Canada, n.d.). The executive branch is composed of the monarch (or the Governor General), the prime minister and the cabinet. The judicial branch is made up of a system of courts (supreme court, federal court, provincial and territorial courts). In Canada, the judicial branch is independent of the legislative and executive branches.

The dynamics between the three institutions are what determines the conduct of the nation. In a perfect world, each one of these institutions will operate within their assigned work boundaries and avoid exerting influence on each other. Upholding and protecting the constitution must be the ultimate goal for all three institutions.

The degree to which the three main government institutions are adaptable, protect the constitution and stay within their boundaries of responsibilities can determine the stability of a political system.

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10.2 What Is a Legal System?

The legal system of a country is a set of rules or laws, procedures by which these rules or laws are enforced, and legal institutions where these rules or laws are interpreted.

A country's legal system is essential to the success of international business. Rules and laws of a country define the rights and obligations of parties involved in business transactions. These rules and laws of a country also determine the way business transactions are executed, and they regulate business practice.

The degree to which rules and laws of a country are enforced on parties involved in a **business contract** can determine the attractiveness of a country as a business or investment site.

Here, we are going to discuss national differences in legal systems and discuss the impact of different legal systems on business contracts.

Types of Legal Systems

There are three main types of legal systems around the globe: **common law**, **civil law**, and **theocratic law.**

Common Law

The common law system evolved in England and is now practiced in the United States and many of Great Britain's former colonies. The common law cannot be found in any code or body of legislation, but only in past decisions by judges – these are also known as **precedents**. In other words, the Common law system is created by the **judiciary** and is based on precedent rather than **statute**.

Precedent is a legal principle and constitutes cases and legal issues previously decided by a court (Liddell & Schubert, 2023). These cases are then used by other courts to resolve present pending cases and similar legal issues. Judges have the authority to interpret the law so that it can be applied to unique circumstances of individual cases. This new interpretation will then set a precedent for future cases (UpCounsel, 2020).

Common law countries rely on an **adversarial system**, where two opposing sides, the prosecution and the defence, present their facts in front of a neutral adjudicator, such as a judge or a jury (FasterCapital, 2023). This neutral adjudicator, a judge, or a jury then makes the decision based on the evidence and facts presented by the prosecution and the defence.

Civil Law

Civil law, also called Napoleonic law, can be found in Europe, South America and many other countries that were once European colonies. The civil law system is governed by statute and relies on comprehensive legal codes that contain all laws of the country. Statutes are written laws passed by the legislative bodies of the government, such as federal, provincial, and territorial legislatures (Wex Definitions Team, 2020).

The civil law legal system relies on the **inquisitorial system** rather than an adversarial one. The inquisitorial system is characterized by extensive pre-trial investigation and interrogations in order to avoid bringing an innocent person to trial (UNODC, 2018). The inquisitorial process can be described as an official inquiry to discover the truth, whereas the adversarial system uses the competitive process between prosecution and defence to determine the facts.

Theocratic Law

This is a law system that is based on religious teachings and texts as its primary basis. The court will interpret and present facts and statutes in accordance with those religious texts. Many Muslim countries use a theocratic law system for all or part of their laws. This law system is mainly concerned with moral behaviour and is only extended to certain commercial areas; therefore, in commercial areas, theocratic systems have elements of common or civil law.

Did You Know? Differences in Contract Law

A contract is an agreement between two or more parties that is enforceable by law. This agreement specifies all terms and conditions applied to the exchange of goods and or services and the rights and obligations of all parties involved in the contract. Business contracts are drawn differently under the common law and civil law systems.

In the common law system, where the law is ill-defined and open to the judge's interpretation when a contract is drawn, it is important to include all the terms governing between two parties and details of rights and obligations of all parties involved in the contract itself. This will result in a contract being long and costly to create.

In a civil law system, the laws are very explicit. Therefore, cases must be investigated by the court to see how facts of the case fit into already established codes applicable to the situation, therefore contracts do not need to be as specific. This means contracts under civil law are shorter and cost less to draft.

Sources: Hill, 2022; FasterCapital, 2023; Liddell & Schubert, 2023.

Review: Legal Systems

Review your understanding different legal systems by reading "11.3 Types of Legal Systems around the World" in Introduction to Political Science (published by OpenStax).

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10.3 What Is Political and Legal Risk?

Political risk is the possibility that an organization can be negatively impacted by political events attributable to a country's government, such as armed conflict, constitutional changes, or major policy developments (Stowe, 2022). It is an event or a set of circumstances that affect a firm's profit potential.

Legal factors are the official outcomes of political processes as presented in laws, regulations, and court decisions – all of which have a direct impact on a firm's performance.

Political risk can be an issue at the best of times, even in the most developed markets; for example, the European Union (EU) applied political and legal pressure on five of the largest US tech companies: Apple, Amazon, Facebook, Google, and Microsoft (Silicon Valley firms). EU's policy makers want to retain control over the internet to ensure that profits earned in Europe by Silicon Valley firms are taxed locally. Google and Facebook also had to make changes to their policies to comply with privacy requirements as described in the EU's General Data Protection Regulation (GDPR).

However, organizations need to be extra vigilant when expanding to emerging markets, where the political risk may be more difficult to identify and deal with. Emerging markets are becoming major consumption centres and offer attractive opportunities, and many companies are diversifying their business into these markets, that is why the political risk is becoming more pronounced.

Common types of political and legal risks include:

- government interference and expropriation
- transfer and conversion of currency
- political instability, violence, and corruption
- intellectual property (IP) protection

Government Interference and Expropriation

This risk evaluates the likelihood of weak governance conditions and or government actions that have an impact on a country's commercial environment (Graham, Johnston, Kingsley, 2017). For example, in 2017, as a result of anti-government protests in Venezuela, authorities seized the General Motors plant, which employed 2,700 people (Miroff, 2017). GM called the expropriation of its plant illegal judicial seizure of assets and had to withdraw from the country.

Another example of expropriation is Turkey, where the government started cracking down on businesses that they believed were linked to the failed military rebellion of 2016 (Yackley, 2016). The impact it had on foreign companies was that they needed to add an extra level of due diligence to their business dealings with Turkish companies. This extra step was necessary for protecting their assets or their assets would have gotten seized for being associated with the wrong companies.

Transfer and Conversion of Currency

In most developing countries where the government has a high level of control over its currency exchange, the government may impose various forms of control on the purchase or sale of foreign currencies by residents, on the purchase or sale of local currency by non-residents, or the transfer of currency outside the country. These controls help countries better manage their local currency. These controls also create risk for foreign companies doing business in the country. During economic and financial crises, governments may impose restrictions on the amount of foreign currency leaving the country, which translates into non-payment by the customer and creates risk for foreign exporters. For example, in 2003, the Chavez government in Venezuela announced controls over foreign currencies leaving the country (Forero, 2003). Many foreign companies that had customers in Venezuela lost their payments due to these restrictions. Their customers were willing to pay but they were not allowed unless they were paying in Venezuelan pesos.

Political Instability, Violence, and Corruption

Any violent or hostile act that results in overthrowing the government of a country or changing its policies poses a political risk to that country's commercial environment. A report by the global think tank, where 64 countries around the world were studied, found that corruption is another leading indicator of political instability. A recent example of political instability and violence is the Russian invasion of Ukraine and a conflict that forced many Western companies to fold and leave Russia for good. It also created risk for foreign companies that operate in Ukraine.

Intellectual Property (IP) Risk

Intellectual property is a term used for intangible assets owned by a company and legally protected by the company from outside use without authorization. Types of intellectual property range from domain names to trade secrets, patents, trademarks, and designs (FasterCapital, 2024). All developed and developing countries involved in international trade have laws protecting intellectual property. However, not all of them have a strong legal system to enforce the law. Intellectual property protection is being promoted by the World Intellectual Property Organization (WIPO), which was established in 1970 as part of the United Nations' 15 specialized agencies.

Let's Explore: The WIPO

For more information on intellectual property, visit the World Intellectual Property Organization (WIPO) website.

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10.4 Strategies to Mitigate Risks

The impact of any of the political risk events on a firm is unlikely to be localized, short-lived or isolated; it may ripple across the entire company and even the whole supply chain. How can a company prepare for a political risk?

Due Diligence

The first step to address and mitigate political risk is to have an ongoing political risk analysis and research plan. This process is known as completing "**due diligence**." Speaking to local export agencies is an important element of analyzing political risk. For example, the EDC and the Canadian Trade Commissioner Service have experts on the ground in most emerging markets and can help Canadian companies identify political risks and develop contingency plans.

Let's Explore: Due Diligence

These government agencies provide support to Canadians doing business in international markets:

- Export Development Canada (EDC)
- Trade Commissioner Service

Developing Relationships with Governments In the Target Market

There is value in developing relationships with key decision-makers in the target market. These relationships can be developed directly – through travelling and face-to-face meetings through an intermediary or through hiring local individuals. These relationships are critical to the success of the venture in the international market. Government officials can be helpful in explaining trade policies, and they are excellent sources of information regarding upcoming changes in government policies and regulations.

Involving Key External Stakeholders

If possible, having suppliers, customers, agents, and any other key stakeholders involved in political risk mitigation can help organizations develop better contingency plans and coordinate risk response.

Adjusting Operational and Financial Policies

A review of internal policies and procedures is extremely important in managing political and legal risks for a number of reasons:

- To ensure internal policies are in line with and do not contradict legislation and employment practices in the target market.
- To address the conflict of interest and the potential of corruption – organizations must adjust routine procedures and develop their ethics and code of conduct policies to align with those of their international market.
- To create a linkage with the local community and make sure to respect, protect and even improve the local community. This may require developing training programs for the staff to assist them in adjusting to the new working environment.

Intellectual Property (IP) Protection

The first and most important step an organization can take in protecting its intellectual property is to establish contractual security. There are certain features inserted into legal contracts that can protect intellectual property, and they are:

- **Non-disclosure** – ensures that all sensitive information related to technology transfers, licenses, and other business-related agreements will not be shared or available to parties other than those listed in the contract (Twin, 2024).
- **Clear ownership clause** – ensures that the party entitled to the intellectual property is clearly defined without dispute, this prevents all other parties from making a legal claim to that property (Chen, 2023).

Let's Explore: Protecting IP

For more information on how companies can protect their intellectual property, visit the "Protecting your Intellectual Property abroad" page of the Government of Canada website.

Acquire Political Risk Insurance

An organization may decide to transfer risk to an outside party by acquiring political risk insurance. By doing so, they can safeguard the value of overseas assets, protect access to foreign-held funds and maximize the potential of foreign investment.

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Chapter 10 Summary

LO 10.1 National Differences in Political Systems

- Political systems can be categorized into two prominent groups: democratic and totalitarian.
- In representative democratic political systems, citizens periodically elect individuals to represent them in legislative bodies and make decisions on their behalf. Political freedom is guaranteed by a constitution.
- In the totalitarian political system, the state is run by a party, a group, or an individual. Political power is concentrated by those in power, and citizens are denied political freedom.
- Government institutions are divided into three categories: the executive, the legislature, and the judiciary. The legislature passes the law, the executive implements the law, and the judiciary interprets the law and ensures that the law is in accordance with the constitution of the country.

LO 10.2 National Differences in Legal Systems of Different Countries

- There are three main types of legal systems around the globe: Common law, Civil law, and Theocratic law.
- Differences in legal systems have an impact on contract law, an important part of business dealings between two or more parties.
- The cost of drawing a contract depends on the legal system of the country where the contract is drawn.

LO 10.3 Risks Associated with Different Political and Legal Systems

- Common types of risks associated with political and legal systems include government interference and expropriation, transfer and conversion of currency, political instability, violence and corruption and intellectual property.

LO 10.4 Strategies to Mitigate Risks of Political and Legal Systems

- Mitigation strategies that can be used to reduce the impact of political risk on an organization are due diligence, developing a relationship with the government in the target market, involving key external stakeholders, adjusting operational and financial policies, and acquiring political risk insurance.

Check Your Understanding

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://ecampusontario.pressbooks.pub/internationaltradefinancepart2/?p=129#h5p-2

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CHAPTER 11: DIFFERENCES IN ECONOMIC SYSTEMS AROUND THE GLOBE AND THEIR IMPACTS ON INTERNATIONAL TRADE

Chapter 11 Introduction

Learning Objectives

After reading this chapter, you should be able to

1. Identify national differences in economic systems of different countries.
2. Identify risks associated with different economic systems.
3. Explain strategies used to mitigate economic risks.

Think About It!

Video: Introduction to Economics

In this video from Crash Course, Jacob Clifford, and Adriene Hill talk about economic systems and macroeconomics.

One or more interactive elements has been excluded from this version of the text. You can view them online here: https://ecampusontario.pressbooks.pub/internationaltradefinancepart2/?p=53#oembed-1

Source: CrashCourse. (2015, July 30). *Economic systems and macroeconomics: Crash Course economics #3* [Video]. YouTube. https://www.youtube.com/watch?v=B43YEW2FvDs

Reflection Questions

Before we begin, we encourage you to reflect on the following questions:

1. What role does the government play in a free market economy?
2. What does economist Thomas Sowell mean by phrase “There are no solutions, only trade-offs”?

Introduction

When engaging in trade with a foreign country, organizations face high levels of uncertainty due to the country’s fluctuating economic and financial conditions. Uncertainties are also caused by changes to tax laws and regulations by the country’s government. A thorough analysis and understanding of economic factors and implementing risk mitigation measures will allow organizations to reduce the impact of those changes and protect their assets.

11.1 National Differences in Economic Systems

What Is an Economic System?

An economic system is the means by which countries or governments allocate available resources and trade goods and services throughout a specific geographic area.

Resources are allocated to three areas: production, distribution, and consumption.

In the study of economics, resources include any or all of the following:

- land
- natural resources
- labour, physical and mental
- capital (monetary resources, buildings, equipment)
- entrepreneurship and knowledge

The land and natural resources serve as raw materials, which are then transformed into goods and services with the help of labour. The *capital* (monetary resources, buildings, and equipment) is needed for the production process. Entrepreneurship contributes the skill needed to tie all other resources together to produce goods or services, which are then sold to the marketplace.

Today's major world economic systems fall into two broad categories: a **free market economy** (or capitalist) and a **command economy** (such as socialism). Planned economy is another term for command economy. The differentiator between these two systems is whether the government or an individual decide on the following:

- Control of the **factors of production** (resources) – by whom and how the factors of production are owned and controlled
- Allocation of resources – the factors of production – how to allocate limited resources to individuals and organizations to best satisfy their unlimited societal needs and wants
- Production of goods and services – what goods and services to produce and in what quantities
- Distribution of the goods and services – how to distribute goods and services to consumers and at what price

Market Economy

In a pure market economy, factors of production (resources) are privately owned. Production of goods and services is not planned by anyone, and it is determined by the interaction of the two forces of a market: **supply** and **demand.**

The purchasing pattern of consumers signals to producers what to produce and how much, and the prices of products are also determined through the interaction of supply and demand. If supply exceeds demand, prices will rise and vice versa.

The supply of goods and services must not be restricted for a market to work effectively. Restriction occurs when there is a **monopoly** in the market. The firm that has the monopoly will reduce the supply of goods in order for the prices to go up so that the firm can make more profit. When a firm has a monopoly, the motivation for efficiency and quality of the product can also go down because the firm can transfer the cost to the consumer. This is not good for the welfare of the society.

The role of the government in a market economy is to encourage fair and free competition. Governments introduce laws and regulations such as antitrust laws in the United States and European Union.

Did You Know? Monopolies

A monopoly is a market structure where there is a single firm in an industry with no close substitutions. This situation gives a firm the power to create barriers to entry for their competitors and set high prices for their products to maximize profits. Some monopolies are government-regulated, such as those in the utility sector (Wikipedia contributors, 2024).

Command Economy

In a pure command economy, the production of goods and services is planned by the state. The government decides what to produce, how much to produce and at what price. In addition, in a pure command economy, all businesses are owned by the state. Thus, the government has the ability to direct resources where they are most needed and where those resources can serve the interest of the nation better as a whole rather than individuals.

In today's world, we can find a mix of both market and command economies. All countries have certain sectors of the economy where there is state ownership, and the remaining sectors are left to the private ownership and free market mechanism. They are called **mixed economies**.

For example, in Canada, there are some state-owned corporations called Crown Corporations, and they control certain sectors of the economy, such as VIA Rail Canada Inc., Canada Post Corporation, Atomic Energy of Canada Ltd., Bank of Canada, etc.

Companies that do business internationally must understand and adapt to the economic systems of the countries in which they operate and adjust their production and selling methods to accommodate the economic system of those countries.

Review: Economic Systems

Review or refresh your understanding of economy systems by reading 1.2 Economic Systems Around the World in Introduction to Management, from the University of Guelph.

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11.2 Risks Associated with Different Economic Systems

What Is an Economic Risk?

An **economic risk** is the possibility that changes in **macroeconomic factors** will negatively impact a company or an investment.

Macroeconomic factors to consider include the following:

- gross domestic product (GDP)
- inflation
- unemployment rate
- policy interest rates

Gross Domestic Product

Gross domestic product (GDP) is the monetary value of finished goods and services within a country's borders during a specific time period, a quarter, or a year. GDP encompasses goods and services produced for sale in the market, as well as non-market production, services, and goods provided by the government, such as education services and defence products.

The "official" figure for GDP does not include all activities produced in a country. For example, cash (black-market) transactions, unpaid work (performed by households or by volunteers), and barter exchange agreements are not included because they are difficult to measure (Callen, n.d.). That means if one valuable product, such as a basket of fruits, is exchanged for a loaf of bread under the barter agreement, this exchange will not contribute to the GDP and will not be recorded.

> GDP is the most commonly used factor by economists and investors to measure the size of an economy and to determine whether a country is growing or experiencing a recession.

Since GDP is collected in current or **nominal prices**, one cannot compare two periods without making adjustments for inflation. When determining whether an economy is growing or shrinking from one period to another, economists want to know the **real GDP** value. Real GDP helps them understand whether the GDP is up because the production of goods and services has increased or simply because prices are up due to inflation.

Comparing the GDP of Two Countries

When calculating the GDP, the currency used is the currency of the country for which the GDP is being calculated. Therefore, when comparing the GDP of two or more countries using different currencies, the currency needs to be converted. The usual method is to convert the value of the GDP of each country into U.S. dollars and then compare them.

The conversion to dollar can be done in two ways:

- Using the prevailing exchange rate in the **foreign exchange market**
- Using the **purchasing power parity (PPP) exchange rate**

The PPP exchange rate is the rate at which one country's currency is exchanged for another country's currency to purchase the same basket of goods and services. For example, if a basket of goods costs $200 in the United States and €150 in Spain, the PPP theory predicts that the dollar/euro exchange rate should be $200/€150 or 1.33 per Euro (i.e., $1 = €0.75).

There is always a large gap between the market exchange rate and the PPP exchange rate because the PPP rate accounts for the difference in the cost of living in different countries.

Inflation

Inflation is the rate at which the value of a currency is falling and, consequently, the general level of prices for goods and services is rising. In other words, inflation is the increase in the cost of living in a country.

> Inflation is commonly measured by the **consumer price index (CPI)**.

The consumer price index is a measure of the total value of goods and services consumers have bought over a specific period (Oner, n.d.a). For example, if one year, the basket of consumer goods costs $100 and the next year, that same basket of goods costs $102, it means that the inflation has risen by 2%, and thus, the rate of inflation is 2%.

Is Inflation Good or Bad?

Inflation is caused by the increased prices of goods and services. However, the household **nominal income** which consumers receive in current money does not increase as much or at the same pace as prices of goods and services. This uneven rise in prices reduces the purchasing power of consumers. In other words, their **real income** (inflation-adjusted income) falls, and they can afford less. Low purchasing power and low affordability mean low demand for, or consumption of, goods, which translates into low economic activities, low production, and overall slower economic growth.

Inflation also affects those who pay and receive fixed income. If a pensioner receives 2% annual increase in their pension but the inflation rate increases by 5%, the purchasing power of the pensioner will decrease. On the other hand, a borrower who pays a fixed interest of 5% on his or her mortgage would benefit from 5% inflation. The **real interest rate** (**nominal rate** – inflation) would be zero. For the lender (the bank or other financial institution), however, the real income would be lower (Tretina, 2022).

High inflation has a negative impact on the economy in general, but deflation or falling prices are not a desirable scenario either. When consumers anticipate prices to fall, they delay their purchases if they can. This also translates into less economic activity and lower economic growth.

Japan is a good example of falling prices and deflation. For a long period of time, Japan had no economic growth due to deflation (Nishizaki et al., 2012).

In order to prevent deflation during the global financial crisis of 2007, the U.S. Federal Reserve and other central banks around the world kept interest rates low for a long period of time and implemented other monetary policies to keep financial institutions liquid. Low interest rates encourage consumers and businesses to borrow and spend, which then results in increased economic activities.

Economists believe that inflation at a lower and predictable rate is good for the economy and helps economic growth. Also, knowing that prices will be slightly higher in the future, consumers will have the incentive to make purchases sooner. This again helps with an increase in economic activities and consequently boosts economic growth (Oner, n.d.a).

Unemployment Rate

The **unemployment rate** is the percentage of the labour force that is unemployed. The uniform definition of unemployed includes those people who are of working age, available for work, and have taken specific steps to find work. Some countries use different definitions of "unemployment" when calculating national statistics. So, when this uniform definition is applied to estimate the unemployment rate, that estimate can be more internationally comparable than the estimates based on the national definition of unemployment. Unemployment rate rises or falls due to changes in economic conditions.

As two sides of the same coin, unemployment and economic growth go hand in hand. With high economic activity, there is an increase in the level of production. To satisfy the increased production level, the demand for the workforce rises, and the unemployment rate falls. When the level of economic activity is low, the demand for the workforce falls, which causes a rise in the unemployment rate.

> The sensitivity of unemployment to economic growth depends on several factors, particularly labour market conditions and regulations.

One of the fundamental macroeconomic laws that present the connection between growth and unemployment is the Okun Law, named after U.S. economist Arthur Okun. It defines the negative correlation between the rate of growth and the unemployment rate, which, in the case of the U.S. economy, postulates that a decline in unemployment by 1 percentage point corresponds to a 3 percent rise in production output (Oner, n.d.). This Okun correlation coefficient is not universal for all economies. The estimates in Japan, for example, indicate a relatively low level of the Okun coefficient compared to the US, which is caused by the difference in the tightness of the labour market and the tradition of "lifetime employment" in Japan (Ball, 2012). Varied values of these differences reflect the specific characteristics of the domestic market, which are influenced by a country's institutional factors such as labour standards and other labour laws and regulations.

Policy Interest Rate

Policy interest rate, also known as the "overnight" rate, is set by central banks and is used by financial institutions for one-day lending transactions among themselves. Financial institutions also use this key interest rate to determine and set interest rates for mortgages, business and consumer loans and other lending instruments (Bank of Canada, n.d.).

As part of monetary policy, interest rate is a tool that central banks use to preserve the value of money by keeping inflation low, stable, and predictable and to maintain economic growth.

For example, the Bank of Canada is mandated to keep inflation at a target rate of 2 percent, the midpoint of a 1 to 3 percent target range. To achieve this inflation target, the bank adjusts (raises or lowers) its key policy rate. If inflation is below target, the bank may lower the policy rate to encourage banks and other financial institutions to, in turn, lower their interest rate on their mortgages and loans and stimulate economic activity. The bank may raise the key interest rate if inflation is above the target rate. In other words, the bank is equally concerned about inflation falling below or rising above the target. This approach guards against both deflation and high inflation (Mathai, n.d.).

Other Economic Risk Factors

Other risk factors arise from rules and regulations countries impose to improve their economies, and they are:

- government exchange controls
- local content laws
- **tariffs** on foreign goods

Government Exchange Controls

These are restrictions imposed by the government to control and limit the exchange of foreign currency by residents of a country. Exchange controls are used when a country has low foreign currency reserves and cannot meet its debt obligations. Another reason for exchange controls is to protect domestic currency value. For the government to successfully control foreign currency exchange, it is mandatory for all businesses and residents to sell their currencies at a designated facility, such as a central bank and at a predetermined rate (Encyclopedia Britannica, n.d.). Depending on the stage of the economy, political situation, and foreign currency reserve levels of the country, governments can implement control and limits on the following transactions:

- Purchase or sale of foreign currency by residents of the country.
- Purchase or sale of local currency by non-residents.
- Any currency crossing national borders.
- Import of non-essential goods

The risk to international trade is associated with the latter two restrictions, limits on currency crossing national borders and import of non-essential goods (CFI Team, n.d.). Doing business in a country where the government can impose restrictions may result in non-payment for the seller of the goods.

Countries that are allowed to impose exchange controls are those that have developing or transitional economies. Under the International Monetary Fund's governing documents, these countries are known as "Article 14 countries."

Local Content Law

These are restrictions undertaken by governments around the globe to protect their national interests. They range from the mandate of hiring locally to sourcing goods and services from domestic suppliers. These requirements must be followed by international companies in the local market. Local content laws have become more widespread since the 2008 financial crisis, with governments trying to improve the employment and industrial performance of their countries (Hestermeyer & Nielsen, 2014). A study done by the Organization for Economic Cooperation and Development (OECD) found that local content laws cause international businesses to incur additional costs and, therefore, lose their international competitiveness (OECD, n.d.).

Tariffs on Foreign Goods

These are fees implemented by the government of a country for certain products. (See Chapter 15). Companies doing business internationally have to consider the possibility of being hit by unexpected tariffs if their products pose a threat to local industries in the host country or if there is political tension between their domestic and host country governments.

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11.3 Strategies to Mitigate Economic Risk

Before selecting a strategy to mitigate economic risk, companies need to thoroughly analyze both current and historical data related to the target market. There are many credible sources of information available for data collection; one of them is the Country Risk Quarterly, published by Export Development Canada (EDC). *Country Risk Quarterly* provides companies with risk ratings of more than 100 countries around the globe. With over 1,000 trade commissioners in over 160 countries worldwide, the EDC's Trade Commissioner Services also supports companies by introducing them to valuable contacts in their market of interest. Trade commissioners can provide business managers with the target market's current business environment as well as credit and business information about potential partners and customers. When collecting information on economic risk, the following factors need to be considered:

- market's growth rate, gross domestic product (GDP)
- target market's inflation and unemployment rate
- target market's foreign currency reserve position
- target market's duties and tariff rate applicable to their product

If the target market has local content laws, such as hiring locally and sourcing domestically, companies need to analyze if the local labour force is adequate. They must also determine if local suppliers can support the required demand, product quality, and specifications to stay competitive.

Let's Explore: Export Development Canada

Learn more about the Canadian government agency Export Development Canada by visiting the EDC website and reviewing the Country Risk Quarterly.

Foreign Financial Involvement and Building Relationships

Building relationships with financial intermediaries and getting them involved with the project can reduce the risk for organizations in the event of a threat from the local government. When financial intermediaries have a stake in the project, they will act as champions on behalf of the organization.

Developing Plans for Variety of Scenarios

When analysis of economic data is completed and associated economic risks with the target market are identified, organizations must develop plans and multiple scenarios for high-risk areas should those risk events occur. By being prepared and having contingency plans in place, organizations can take control of the situation quickly and efficiently.

Share the Risk

By developing partnerships with local businesses or individuals, organizations can share the financial risk as well as get access to local knowledge. Partners in target markets can offer better advice on responding to events as they happen.

Acquire Insurance

Insurance for certain economic risks is available through local export credit agencies such as EDC in Canada. The type of insurance and coverage will depend on the needs of the organization, the country where the organization is operating, and the target market where the organization is starting its new venture.

Chapter 11 Summary

LO 11.1 National Differences in Economic Systems

- Economic systems fall into two categories: a free market economy (or capitalism) and a command economy (or socialism).
- In a free market, factors of production are privately owned, and the interaction of supply and demand determines the production of goods and services.
- In command economies, the state makes decisions about production and resource allocation based on government planning.
- Today, all countries are mixed economies, with some sectors that are state-owned and some left to private ownership.

LO 11.2 Risks Associated with Different Economic Systems

- Economic risk is the possibility that changes in macroeconomic factors will negatively impact a company or an investment.
- Macroeconomic factors are gross domestic product, inflation, unemployment, and policy interest rates.
- Other risk factors associated with different economic systems are government exchange controls, local content laws, and tariffs on foreign goods.

LO 11.3 Strategies to Mitigate Economic Risks

- Strategies to mitigate economic risks include
    - foreign financial involvement and building relationships.
    - developing plans for a variety of scenarios.
    - sharing the risk and acquiring insurance.

Check Your Understanding

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://ecampusontario.pressbooks.pub/internationaltradefinancepart2/?p=163#h5p-3

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“Comparing the GDP of Two Countries” is adapted from “The Macroeconomic Perspective: Comparing GDP among Countries” in “OpenStax Macroeconomics 2e” available from Lumen Learning, under a CC BY 4.0 International license. Download for free from Openstax.

CHAPTER 12: DIFFERENCES IN ECONOMIC DEVELOPMENT

Chapter 12 Introduction

Learning Objectives

After reading this chapter, you should be able to

1. Discuss economic growth and outline factors that influence economic growth of a nation.
2. Explain how the Human Development Index (HDI) is a measure of economic development.
3. Explain how differences in political, economic, and legal systems affect the economic development.
4. Discuss how differences in economic development impact the cost of international trade.

Think About It! Title

Video: Economic Development

In this video from Tutor2u, some of the key interpretation of what economic development means, are being explained.

One or more interactive elements has been excluded from this version of the text. You can view them online here: https://ecampusontario.pressbooks.pub/internationaltradefinancepart2/?p=55#oembed-1

Source: tutor2u. (2021, January 23). *Economic development – Meaning and measurement I A level and IB economics* [Video]. YouTube. https://www.youtube.com/watch?v=qtHLkrtdKz0

Reflection Questions

Before we begin, we encourage you to reflect on the following questions:

1. What or who is economic development about?
2. What are the three parts of Human Development Index
3. Do countries with high per capita income also stand high based on HDI?

Introduction

In Chapter 10 and Chapter 11, we discussed how countries differ from each other based on their political, legal, and economic systems. In this chapter, we explain how those differences impact the economic development of a country and how a country's level of economic development makes it viable and attractive as a place to do business.

12.1 What Is Economic Growth?

Economic growth of a nation refers to an increase in the value of goods and services produced by all sectors of an economy. The growth relates to an increase in one or all components of the GDP: *consumption*, *investment*, *government spending* and *net exports*. Economic growth is measured by quantitative factors such as an increase in the nation's per-capita income (Ostwald, n.d.). Countries differ dramatically in their economic growth, however when comparing one country to another, the GDP per capita can be misleading because it does not consider the cost of living. To account for the cost of living, the GDP must be adjusted for purchasing power, known as purchasing power parity (PPP) adjustment (see Chapter 11).

The main factors that influence the economic growth of a nation include geography and natural resources, education, and demographics.

Geography and Natural Resources

Geographic location influences the economic policies of a country. Countries with access to seas and waterways are more likely to engage in trade, which promotes economic growth. Landlocked countries, on the other hand, are unlikely to develop economically as fast. The study done by Gallup, Sachs, and Mellinger (1998) confirms that landlocked countries have slower growth rates than coastal countries. The study also shows that tropical regions—those closer to the equator—grow slowly compared to temperate regions—such as North America and Europe. The reason is that the tropic regions have poorer soil and higher rates of diseases (Gallup et al. 1998).

Natural resources such as land, the quality of soil, minerals, water sources, good climate, etc., are the base of our living and the entire economic activity. For an economy to grow, it has to produce goods and services for which the use of natural resources is unavoidable. If countries do not have access to the necessary natural resources within their geographic borders, they have to acquire them from other regions. Economic growth is not possible without access to natural resources; however, in today's world, many developed countries do not own resources and are dependent on other countries.

On the other hand, resource-rich countries have a slower growth rate than those with no resources. For example, Russia holds $75 trillion US dollars on natural resources, while the United States has natural resources of over $45 trillion US dollars (Jaganmohan, 2024). While the growth rate based on GDP for the United States was $25 trillion US dollars as of 2022, Russia's GDP for the same period was $2.27 trillion US dollars (O'Neill, 2024, May 3). At the same time, countries such as Singapore that is not rich in natural resources but invested 20% of its national budget in the education sector (Hirschmann, 2024), has strong regulatory institutions, political stability and favourable geographic location, with $66,176 GDP per capita, 2021, ranks the highest in the region (EDB, n.d.), while Sub-Saharan Africa which owns over 30% of world's natural resources (NRGI, n.d.) has a $4,455 GDP per capita for 2021 (O'Neill, 2024, May 16). These statistics show that resource-rich countries need strong regulatory institutions and political stability to develop, administer and control their natural resources. This can be achieved by investing in the labour force's education and training.

Education

Education is considered another main force in economic growth. Countries investing in education have experienced greater economic progress. According to Hanushek and Wößmann (2010), education helps with economic growth in three ways: labour productivity, innovation capacity, and fast learning abilities.

Labour Productivity

An educated labour force can be productive, and productivity translates into economic growth. An analysis published by the Economic Policy Institute in the US shows that states with the most educated workforce have experienced higher productivity and growth (Berger, 2013). The analysis also shows the link between productivity and higher wages. Median wages in those states that have a more educated workforce are much higher than those in states with a less educated workforce.

Innovation Capacity

Education can cultivate innovation and technological advancement, which in turn promotes productivity and growth. Innovative ideas are transferable and can be used by others as well. Therefore, the value derived from education extends beyond the benefit granted to the immediate recipient and can create value for an entire economy (Biasi, 2021).

Fast Learning Abilities

Education improves brain function and promotes cognitive performance, which helps with faster processing of new information (Guerra-Carrillo et al., 2017). A labour force with fast learning abilities is more efficient, and efficiency contributes to economic growth.

Demographics

The growth rate and dynamics of the population are important determinants of a country's long-term economic growth. The world population has grown from 3 billion in 1960 to 6 billion around 2000 and is expected to reach 9 billion by 2037. However, there is a big shift when it comes to population distribution by region. Less developed countries are home to 84% of the world's population today compared to 68% in 1950 (Bloom, 2020).

Growing Population

A growing population contributes to economic growth in two ways: an increase in the labour force supply and the creation of demand for goods and services. A large labour force produces a large amount of goods and services, which are then absorbed by this wide market. Employment and income keep on rising, and economic growth continues (Investopedia Team, 2023). It is worth mentioning that population growth is more desirable in low-populated countries with advanced economies, such as Canada, where the growth helps with worker shortages and boosts economic growth (Gravelle, 2023). The outcome is not the same in overpopulated countries such as India, where a further increase in population will only put more strain on the economy (Bloom, 2020).

Population Dynamics

Population dynamics refers to population variation based on birth and death rates, immigration, and the aging population. Population dynamics are influenced by age structure, which impacts the **participation rate** in the labour force of a country (Crossman 2019). The mortality and fertility rates directly affect the **working age population**. The Organization of the United Nations divides age structure into three phases. In phase one, the fertility rate is rising, but the mortality rate falls, and more children survive through their childhood, leading to an increase in the **younger age population**. In the second phase, both fertility and mortality rates go down, and the number of young children also goes down in proportion to the adult and working-age population. The decrease in dependent young children and the increase in the working-age population leads to productivity and growth in income, which results in a demographic dividend. The third phase in the age structure is called **aging population**. This is when the low fertility level stays unchanged over many decades, the number of young adults declines, while the number of people growing older rises (DESA, 2017). The aging population requires more healthcare services, pensions, and other government support, which stresses government finances (Hayes, 2023).

Did You Know? The Demographic Dividend

When economic growth results from changes in the age structure of a country's population, this is known as a **demographic dividend**. The age structure that enables demographic dividend is caused by low mortality and fertility rates. To receive a demographic dividend, a country must go through a transition that changes from a rural agrarian economy to an urban industrial economy. The rural agrarian economy is characterized by large family size (high fertility rate) and high mortality rate. The urban industrial economy is characterized by a low fertility rate and, with the help of advancement in medicine, experiences a low mortality rate. This transition from rural to urban leads to a growing labour force and labour productivity due to decreased dependant rates (Lee & Mason, 2006).

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12.2 The Human Development Index (HDI)

Economic development refers to the increase in the living standards of a nation. The development relates to the growth in *qualitative* factors of human life, which are best measured by the **Human Development Index (HDI)**.

Human development is about giving people more choices and freedom to develop to their full potential and lead a productive life (UNDP, 2015). The three essential choices for people at all levels of development are to live a long and healthy life, to have access to quality education, and to have access to enough resources required for the basic needs of life. Without having access to these essential choices, all other opportunities for improving quality of life are not attainable. Human development goes far beyond economic growth. Economic growth is about increasing income, while human development focuses on qualitative factors such as health, education, clean environment, and material well-being. In other words, economic growth creates the opportunity for human development by providing people with the income they need to fulfil their development needs. As the experts at the United Nations Development Programme tell us: “Human development is the end – economic growth a means” (Kollanyi et al., 1996).

Let’s Explore: The HDI

The United Nations use the HDI to measure quality of human life in different nations based on the following dimensions:

- Health is measured by life expectancy at birth.
- Education is measured by the age at which children enter school and the average number of schooling years for adults.
- Access to resources for basic life needs is measured by average income.

To learn more about how the HDI is calculated and to see country development rankings based on HDI, read the Out World in Data article “The Human Development Index and related indices: what they are and what we can learn from them.”

Did You Know? The UN Sustainable Development Goals

Human development as measured by HDI was formally recognized by the United Nations General Assembly in 1990, and since then, in most years, an independent report has been prepared by the United Nations Development Programme (UNDP) on the three criteria (Stanton, 2007).

In 2000 the United Nations set eight goals to tackle the three essential needs of HDI and more, they were called Millennium Development Goals (MDGs), which were focused only on developing countries (Millenium Development Goals, 2024).

To address the shortcomings and criticism of MDGs as a platform imposed on developing countries, in 2015, the United Nations developed 17 Sustainable Development Goals (SDGs) that apply to all countries at all stages of development.

To learn more about the SDGs and how these goals are different from MDGs, explore the SDGs in Action page of the UNDP website.

Video: The SDG Origin Story

One or more interactive elements has been excluded from this version of the text. You can view them online here: https://ecampusontario.pressbooks.pub/internationaltradefinancepart2/?p=186#oembed-1

Source: Swiss Learning Exchange. (2020, April 22). *Episode 4: Origin story of sustainable development goals | Origin of SDGs | SDG Plus* [Video]. YouTube. https://www.youtube.com/watch?v=1zm7In9FRtE

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12.3 How Differences in Political, Economic, and Legal Systems Shape Economic Development

Countries around the globe differ drastically in their levels of economic development, which is influenced by the political, economic, and legal systems of a country. To understand the relationship between economic development and the *political economy* of a country, we need to explore and understand the two main drivers of economic growth: *innovation* and *entrepreneurship*.

> The study of the interrelationship between the political, economic, and legal systems of a country is called **political economy** because all three systems are interdependent; they interact with and influence each other (Frieden, 2020).

As underlying factors of economic growth and development, innovation and entrepreneurship form a dynamic environment that enables progress and prosperity. Countries that have adopted innovation and entrepreneurship have experienced enormous economic growth, while those resisting or unable to change have stagnated (Cao, 2018).

Innovation

Innovation is a useful new or improved idea that offers a solution to a problem (Boyles, 2022). It has long been recognized as a catalyst for progress, and these days, with rapid technological advancements, globalization, a constantly changing business environment, and the need to solve emerging problems, innovation is becoming more pronounced than ever. Innovation, whether in the form of creating a new product, service, process, or business model and/or improving existing ones, serves as a driving force for entrepreneurship (AIContentify Team, 2024).

Innovation can be grouped into two categories: sustaining and disruptive.

- **Sustaining innovation** is a continuous improvement of the product over a long period of time. The purpose of sustaining innovation is to gain more profit, either by entering an existing market or creating a new market (Twin, 2023).
- **Disruptive innovation** refers to a concept, a process, a product or service, or a business model that creates a new value field (Cote, 2022).

Let's Explore: Sustaining vs. Disruptive Innovation

In this video from HBS Online, the presenter explains the two types of innovation, the factors that differentiate them, and the importance of incorporating disruptive innovation into business strategy.

One or more interactive elements has been excluded from this version of the text. You can view them online here: https://ecampusontario.pressbooks.pub/internationaltradefinancepart2/?p=189#oembed-1

Source: HBS Online. (2023, July 26). *Sustaining vs. disruptive innovation* [Video]. YouTube. https://www.youtube.com/watch?v=vF9jLDyp7cE

Entrepreneurship

Entrepreneurship is a way of thinking, the ability and capacity to initiate a transformation and a holistic approach to turning innovation into a successful business (Villacci, 2023). Entrepreneurs, therefore, translate ideas into products and services and foster creativity and innovation. The interplay between innovation and entrepreneurship enhances productivity levels across all sectors of the economy. Innovation in processes, business models, technology, and organizational structures increases efficiency. This efficient way of operating translates into increased productivity, greater profitability, and overall economic growth (Jobanputra, 2023).

Therefore, high economic growth and development are experienced in countries that encourage entrepreneurship and foster innovation. In today's world, countries considered economically developed, such as Switzerland, Singapore, the USA, Germany, Canada, and other developed countries, share similar political economies and legal institutions.

Democratic Political Systems

Entrepreneurship requires freedom, which is possible in a democratic society. Limiting human freedom suppresses human development and, therefore, limits progress. A study done by Farè, Audretsch, and Dejardin (2023) using data from 23 countries between 1972 and 2010 suggests that there is direct link between democracy and entrepreneurship (Fare, 2023). Almost all countries have a constitution which protects and limits individual freedom at the same time, however in a democratic society where people have the freedom of expression and the right to participate in political decision-making process, they can have an impact on those limitations of freedom (Johnson, 2005).

Market Economies

Economic freedom is key to entrepreneurial activity and is achieved through a market economy. In a command economic system, the state owns all enterprises. It controls all economic activities, and individuals are not compensated or recognized for their contributions, leading to a situation where people are less motivated to use their creativity and talent in their work. A market economy offers the *rights to private property* and *freedom of enterprise*:

- **Rights to private property** refers to the official right to ownership of tangible and intangible property that can be used, controlled, and transferred or passed on as an inheritance. The right to own and control one's property motivates individuals to change, improve, and create – resulting in progress and economic prosperity (Garrett, 2005).
- **Freedom of enterprise** refers to freedom of economic activities without government intervention or regulations. Free enterprise gives individuals the freedom to start any business or enter a contract in a manner that is most beneficial to them, and they have the freedom to form any type of company or firm wherever they like, providing they have the skills, the means and the entrepreneurial spirit of risk-taking (Banton, 2024).

Strong Legal Institutions

Innovation requires strong property protection laws and legal institutions that can implement those laws. With no protection of intellectual property, it would not be possible for the entrepreneur to fully realize the financial gain of the property that rightfully belongs to them (Goudreault, 2019).

> According to the World Intellectual Property Organization, **intellectual property** "refers to creations of mind, such as inventions; literary and artistic works; designs and symbols, names and images used in commerce." (WIPO, n.d.)

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12.4 Impact of Economic Development on the Cost of International Trade

As noted in Chapter 10 and Chapter 11, the political, economic, and legal system of a country has an impact on whether the country is an attractive site for international trade. In this chapter, we have discussed that countries with democratic political systems, market economies, and strong legal institutions are likely to have higher economic growth, which makes them more suitable for business.

However, when deciding on doing business in less developed countries, organizations must thoroughly analyze the long-term benefits and costs associated with a given market.

We will use McDonald's in Russia as an example to understand the costs associated with doing business in less developed countries.

McDonald's opened its first restaurant in Russia in 1990. By March of 2022, when McDonald's had suspended its operations due to the invasion of Ukraine, it had 853 locations all over Russia, including one in Eastern Siberia (Rainey, 2023). It was a costly venture to enter the Russian market in the beginning. Based on an analysis done by Kristy Ironside, factors that contributed to the costs were as follows:

- **Political factors** – due to government bureaucracy and red flags, entering the market and registering the business was complicated and time-consuming. It took at least a year to register a joint venture simply.
- **Infrastructure** – the lack of a commercial real estate market made it challenging to find a location. McDonald's headquarters had to operate out of a hotel, occupying an entire floor. To build their first restaurant, McDonald's had to tear down half of a building and reconstruct it.
- **Related and supporting industries** – restaurant supplies such as cups and plates had to be imported from other countries. McDonald's also had to build its own production facility of 100,000 sq. feet where they prepared all their products.
- **Human resources** – labour shortage was not an issue in Russia, in fact after running one ad in a newspaper, McDonald's received over 30,000 applications, however they did not have training in the management area. McDonald's had to send some applicants to Chicago for management training programs (Ironside, n.d.).

Before selling a single burger, McDonald's incurred over $50 million in costs for the opening of their first restaurant in Russia. However, from day one of its opening, McDonald's was a success in Russia when they served over 30,000 meals, 6 times more than initially expected.

When organizations recognize the potential of a developing country, they may reap greater benefits than those firms that forgo the opportunity.

A framework developed by Michael Porter, "the diamond model," can be used to identify factors contributing to the success of an organization in any given market (see Chapter 9.2 Export Ready Organizations).

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Chapter 12 Summary

LO 12.1 Economic Growth and Factors that Influence Growth

- Economic growth refers to an increase in the value of goods and services produced by all sectors of an economy.
- Economic growth factors include geography and natural resources, education, and demographics.

LO 12.2 Explain the Human Development Index (HDI)

- The United Nations uses the Human Development Index to measure economic development based on health, education, and access to resources.
- Health is measured by life expectancy at birth.
- Education is measured by the age at which children enter school and the average number of schooling years for adults.
- Access to basic resources for basic life needs is measured by average income.

LO 12.3 Differences in Political, Economic, and Legal Systems

- The political economy of that country influences its economic development.
- Countries with a democratic political system, a market economy, and strong legal institutions promote innovation and entrepreneurship – the underlying economic growth and development factors.

LO 12.4 Differences in Economic Development and Cost of International Trade

- Economically developed countries are more suitable for business, while less developed countries may result in higher costs for conducting business.
- When deciding to do business in developing countries, organizations must thoroughly analyze the long-term benefits and costs associated with a given market.

Check Your Understanding

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CHAPTER 13: DIFFERENCES IN CULTURE AND SOCIAL RISK IN INTERNATIONAL TRADE

Chapter 13 Introduction

Learning Objectives

After reading this chapter, you should be able to

1. Discuss what is meant by culture and social structure.
2. Explain the business and economic implications of social structure.
3. Discuss the importance of cross-cultural literacy.
4. Discuss social risk in international business and identify strategies to mitigate the risk.

Think About It!

Video: Cross-Cultural Management

This video from International Hub describes the 3R approach to working effectively in a cross-cultural environment.

One or more interactive elements has been excluded from this version of the text. You can view them online here: https://ecampusontario.pressbooks.pub/internationaltradefinancepart2/?p=57#oembed-1

Source: InternationalHub (2017, May 24). *Cross-cultural management* [Video]. YouTube. https://youtu.be/rJ4IbhXrqnc?si=oBbqKiDpzW6HFIJw

Reflection Questions

Before we begin, we encourage you to reflect on the following questions:

1. How does learning differences in culture improves communication and create positive atmosphere?
2. What is the impact of cultural dimensions on the negotiation process?

Introduction

This chapter explains cultural differences within and across countries, which can impact a firm's operations, business transactions and strategies while doing business in international markets. Understanding these differences – cross-cultural literacy – helps organizations adopt business practices that will create a common bond among people from different cultures.

A second theme in this chapter is the social risk associated with international markets. Understanding social risk and operating in a more socially, economically, and environmentally responsible manner make companies and their products more attractive to consumers and help companies be more competitive and sustainable.

13.1 What Is Culture?

There is no consensus among scholars of different disciplines on the definition of culture.

Social psychologist Greet Hofstede defined culture as the programming of the human mind by which one group of people distinguishes itself from another group (Culture Factor Group, 2023). But according to anthropologist Edward B. Tylor, "culture or civilization, taken in its wide ethnographic sense, is that complex whole which includes knowledge, belief, art, morals, law, custom, and other capabilities and habits acquired by man as a member of society" (as cited in Logan, 2012).

In general, sociologists define culture in two ways: *nonmaterial* and *material*. The nonmaterial aspect of culture is defined as values and beliefs shared by a group of people. In contrast, material culture consists of things made by humans, ranging from buildings and clothing to arts and literature. Emile Durkheim, a French sociologist, believes that both material and nonmaterial culture holds society together (Cole, 2019). Sociologists consider culture to be the production of social order and norms, which play an important role in how members of a society function, cooperate and interact with each other.

For the purpose of this text, we will define culture as a system of collective programming (values and norms) shared by a group of people, which, when taken together, determines a society's way of living.

Culture as a system of values and norms guides the social behaviour of people and serves as the foundation of social structure. Therefore, ignorance of cultural differences can result in a negative return on investment or weak market share, legal challenges, termination of contracts, or even lead to outright business failure.

Values

Values are shared ideas of what a group considers good or bad, right or wrong. Individuals get values from groups in which they are members (Differences Between Norms and Values, n.d.). For example, loving animals is a value that individuals get from the group to which they belong. Some social groups will not let dogs inside the house or to touch them, while others will prosecute someone for being unkind to dogs. Furthermore, helping others, being honest, and saving the environment are all examples of values that people derive from their groups. Values play a strong role in the development of one's personality and behaviour. They vary from one place to another and from one culture to another (Conerly et al., 2021).

Norms

Norms are social rules and guidelines that define appropriate behaviour in a specific situation (Cole, 2018). Norms can be divided into two categories:

- **Mores (formal norms)** are written rules which support social institutions such as public schools, the healthcare system, the military, etc. These norms exist in all societies.
- **Folkways (informal norms)** are unwritten routine conventions of everyday life learned through socialization; therefore, members of the same group of people show consistency in their behaviour. Examples of informal norms are dress codes, good social manners, rituals, etc. (Crossman, 2019).

Social Structure

Social structure is the design of social relations. How people and groups treat each other and interact shows how that society is organized. Social structure also indicates how society is organized in terms of values and norms (New World Encyclopedia, 2008).

There are many dimensions when explaining differences across social structures; however, to understand the business and economic implications of different social structures, the following two dimensions are particularly important:

- Is the basic unit of a social structure an individual or a group?
- What is the stratification of a society based on castes or classes?

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13.2 The Implications of Social Structure

Individual-Oriented Social Structure

Individual-oriented societies encourage individual achievement and recognize the individual as the basic unit of society. Individuals can choose their career paths and set goals without consulting or asking anyone else's opinion. This emphasis on individualism often translates into innovation and creativity from which the whole society can benefit. That is the main reason why places such as the United States, Europe, and other developed nations, where individualism is encouraged, see high level of innovative and entrepreneurial activities. Individualistic societies also encourage their members to rely only on their own abilities and improve their knowledge and skills so they can achieve their personal goals.

Business implications of an individualistic society are that in trying to advance their careers and succeed, individuals become more competitive in the workplace, which can be damaging to the overall morale. This desire to advance and make more money also encourages individuals to move from one company to another, which can also have a negative impact on the organization (Ehsanfar, 2019).

Group-Oriented Social Structure

Unlike individual-oriented societies, group-oriented social structure believes in relationships and emotional attachment. People in group-oriented cultures consider their actions to reflect the whole group, not just them; therefore, they value what others think about their choices.

Group-oriented culture is more about teamwork, and people in this culture are loyal to their employers and are most likely to stay with one employer for a long time, even for a lifetime. People from group-oriented societies, however, lack creativity (Ehsanfar, 2019).

Did You Know? Identity in Japan

In Canada, when you ask a person to describe their identity, they will usually reply, "I am a professor," or "I am a nurse," or "I am in marketing." However, in Japan, people are more likely to identify with their place of work rather than with their occupation in general. For example, instead of saying, "I am a lawyer," a lawyer in Japan is more likely to say, "I am from XYZ law firm."

Source: Hill, 2022.

Group primacy also lacks entrepreneurship. A recent study on the labour market and patent data by Katharina Hartinger (2023) of the Gutenberg School of Management confirms that individualism positively affects innovation. Earlier research also confirms the positive relationship between creativity and individualism (Goncalo & Staw, 2006).

Some argue that social structures based on individualism are great at innovative ideas, while social structures that identify with group primacy are better at implementing those ideas.

Social Stratification

All societies rank their people hierarchically into categories called social strata. The rankings are based on socioeconomic characteristics such as family background, wealth, power, education, and income (Cole, 2019, September 3).

Social strata represent the uneven distribution of resources in a society. Typically, those with access to a larger portion of resources are ranked as upper class and others with access to fewer and fewer portions of resources are ranked lower.

The business and economic implications of social stratification can be significant when members of a strata do not have the ability to overpower the barriers created by their social strata and move out of it. Low **social mobility** has a high cost for companies and for the overall economy.

Social Mobility

The term social mobility means the ability of individuals to change positions within a social stratification system. When people can move out of the strata into which they were born, they experience social mobility. For example, people who rise from poverty and become successful are deemed to have diminished their economic status in a way that affects their social class. They have experienced social mobility (Conerly et al., 2021).

Social mobility varies from one society to another, depending on the social stratification system in the society. The most rigid system of social stratification is the caste system, which is a closed system in which social mobility is not possible. In those societies with a class system, which is a less rigid form of social stratification, social mobility is possible. (Encyclopaedia Britannica, 2023.)

Caste System

A caste system is a closed system of social stratification, where the social standing is determined by the family to which the individual is born. It cannot be changed and is considered one's fate in life. The caste system is diminishing in many societies; however, one example remains. In India, especially in rural areas. Even though the caste system has been abolished officially since 1949, after India gained independence from Britain, it declared and ratified its new constitution. The caste system determines what occupation a person can have and who he marries. It makes it impossible for people to marry someone outside their caste. A person who belongs to a certain caste must continue the line of work of his ancestors, regardless of his own interests, education, and skills.

Class System

A class system is an open form of social stratification based on multiple social rankings such as economic status, education, achievements, etc. A person born into a class is not bound by any customs or traditions and can move up or down in society, meaning they have vertical mobility. While many industrialized countries in Europe and North America have class systems, the social mobility within a class system also varies from one society to another. For example, the class system in the U.S. has a higher social mobility than the class system in the UK. Most of Britain's decision-making institutions consist of graduates from Oxford and Cambridge universities. Those who attend those universities are usually individuals from the UK's upper class and upper middle class. This practice makes it difficult for lower-class individuals to move up (Simon, 2023). In the U.S., there are many successful individuals who came from humble origins, like Bill Gates and Oprah Winfrey.

From a business perspective, the cost of doing business in societies with low social mobility can be very high and will affect business operations. For this reason, assessing social mobility becomes crucial when trading internationally. To address this issue, companies must incorporate appropriate strategies to their business planning. For example, in the UK, the hostility between upper- or middle-class managers and employees from the lower class makes it difficult for them to work well together. These hostile working conditions and a lack of cooperation result in low productivity and disputes. This makes it difficult to establish a competitive advantage in a global economy. Companies doing business in the UK will have to set aside extra financial and human resources for the special training of their management teams (Simon, 2023).

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13.3 Cross-Cultural Literacy

Companies conducting business internationally fail to recognize the importance of cultural literacy. To them, all businesses across the globe are the same because they share the same goal – making a profit. They tend to ignore the fact that business practices that are acceptable in one country may not be acceptable in another country. They underestimate the impact of these different practices on their company's profitability. A little effort into learning the new market's cultural values and business etiquette can help organizations present themselves in the best way. To better understand differences in cultures, organizations can refer to cultural dimensions theory, which was developed by a Dutch social psychologist, Geert Hofstede.

Cultural Dimensions Theory

Geert Hofstede divides cultural differences across countries into six dimensions: power-distance index, collectivism vs. individualism, uncertainty avoidance index, femininity vs. masculinity, short-term vs. long-term orientation, and restraint vs. indulgence. Hofstede's cultural dimensions are used in multiple areas, including business dealings and communication.

- **Power Distance Index –** explains to what extent members of society tolerate power and inequality. A high-power index describes a culture where inequality and power differences are accepted and there is high respect for authority. A low power index, on the other hand, indicates that a culture believes in power distribution and participatory decision-making. (Nickerson, 2023)
- **Collectivism vs. Individualism –** describes whether a social basic unit is "individual" or "group." In a society where the basic social unit is an individual, the emphasis is made on individual rights and achievements. However, a society based on collectivism places importance on the well-being of a group and values loyalty and relationships. (Pitt Law Online Blog, 2023)
- **Uncertainty Avoidance Index –** shows how uncertainties and unusual situations are dealt with by the members of the society. A high certainty avoidance index indicates a low tolerance for risk and uncertainty. These societies implement strict rules and regulations to reduce uncertainty and risk. A low certainty avoidance index indicates that the tolerance for risk and uncertainty is high. Individuals in these societies embrace changes and uncertainties and feel comfortable with unstructured situations.
- **Femininity vs. Masculinity –** this index refers to gender roles and the extent to which a society values masculine and feminine roles. The high feminine index shows traditional feminine roles are more valued and will most likely have better maternity benefits and childcare services. Meanwhile, the low femininity index indicates female representation in leadership roles.
- **Short-term vs. Long-term Orientation –** describes the extent to which a society plans for the future. A long-term-oriented society values sustainable growth, savings, and long-term achievements over short-term success. Short-term-oriented society focuses more on the present than the future, emphasizing quick results and short-term success.
- **Restraint vs. Indulgence –** refers to the extent to which a society tends to fulfill its desires. Indulgence indicates that a society enjoys life and is more likely to spend money on luxury. Restraint indicates that members of society are more likely to limit themselves to absolute necessities and spend money on more practical needs.

Issues To Address in Cultural Literacy

Differences in Communication

Language and verbal communication in international business can be challenging to overcome; however, hiring a translator or interpreter can resolve the issue.

What is more important in communication is the non-verbal language, which is harder to determine. For example, business professionals in the Netherlands prefer to communicate only the essentials, while Italians like to build relationships and have friendly communication. Some nations like direct eye contact during business meetings, while others find direct eye contact intimidating. Other examples of non-verbal communication include physical distance, such as bowing or speaking closely (Pitt Law Online Blog, 2023).

Business Etiquette

Before meeting with their business counterparts from another country, it is recommended that organizations do some research about basic business etiquette and be as prepared as possible. For example, when meeting with business professionals from the U.S. or Canada, a firm handshake, good eye contact and keeping a proper distance are in order. On the other hand, if the meeting is with business leaders from Russia or Brazil, for example, be prepared for at least three kisses on the cheeks. Being considerate of workdays and holidays is also important when scheduling business meetings. Different countries have different work weeks. For example, most traditionally Christian countries have Saturdays and Sundays as non-working days. Still, in Judaism, the sabbath falls on Fridays and Saturdays, so the “weekend” days in Israel are different.

Negotiation

As the most delicate part of business, negotiation is an art and requires strong social skills, even when dealing with people from the same culture. Adding cultural differences can make it even more difficult. However, studying other cultures, especially applying Hofstede’s Cultural Dimensions Theory, can be very handy when preparing for negotiation with other countries’ business parties.

Managing Culturally Diverse Teams

With the globalization of production and services and companies operating around the world, having to manage culturally diverse teams is inevitable.

Diversity is great for bringing different perspectives and creative ideas to the project and can help solve the problem faster and better; however, managing diverse teams can also be challenging. (Taras et al., 2021). Acknowledging differences, making an effort to listen to and understand team members, showing respect and empathy, providing clear expectations right from the beginning and being transparent in explaining those expectations are some of the strategies managers use to address challenges associated with diverse teams (Marzullo, 2022; Brett, Behfar & Kern, 2006).

Organizations with managers and workers who have high cross-cultural literacy are more agile. These organizations can quickly and easily adapt to different processes, capture new opportunities, and respond to changes across diverse markets.

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13.4 Identifying and Mitigating Social Risk in International Business

Did You Know? Disaster at Rana Plaza

Rana Plaza was an eight-storey commercial building in Dhaka, Bangladesh, where five garment factories made clothes for major brands across the world, including the U.S., UK, Spain, Italy, Germany, and Denmark.

In April 2013, the Rana Plaza building collapsed, killing 1,132 people and leaving over 2500 others injured, many of them for the rest of their lives. It was the deadliest disaster in the history of the clothing manufacturing industry. People all around the world were in shock watching the images of the collapse as media reports poured into revealing the true extent of the human toll.

On Tuesday, April 23, large structural cracks were discovered in the Rana Plaza building. The shops and the bank on the lower floors immediately closed. However, warnings to avoid using the building after the cracks appeared were ignored by the garment factory owners on the upper floors.

Garment workers were ordered to return to work the following day. Due to management pressure, on Wednesday, April 24, thousands of workers went to work again at their garment factories located in the cracked Rana Plaza building. Only hours later, the entire building collapsed.

Dhaka, Bangladesh, is one of the largest clothing producing cities in the world, host to around 5000 factories, where 85% of the workers are women who support their families with an average $50 per month. Five months earlier, the factory Tarzeen collapsed, killing 110 people. Still, the scale of the Rana Plaza collapse brought worker safety in the fashion industry to headlines around the world, from *The New York Times* to *The Washington Post* and BBC (Goodwin, 2021).

The retailers involved in the Bangladesh factory disaster were: the Canadian fast fashion brand Joe Fresh, owned by Loblaw Companies Ltd.; J.C. Penney, the Plano, Texas-based mall chain; British fashion chain Matalan; Italian fashion brand Benetton; Walmart; The Children's Place; UK fast-fashion chain Primark; and other large chains, such as Zara from Madrid.

Sources: Clean Clothes Campaign, 2021; Doorey, 2017; Goodwin, 2021; McCombs School of Business, n.d.; Perkel, 2019.

What Is Social Risk?

Traditionally, companies considered compliance with local laws in a target market to be sufficient **due diligence**. However, as many companies now produce their products or source their services in one country and then sell them to customers in another, they are increasingly under public scrutiny and face social risks to their reputation.

Social risk refers to the negative perceptions of an organization's impact on a broad range of issues related to human welfare:

- working conditions
- environmental pollution
- hazards to human health, safety, and security
- threats to the region's biodiversity and cultural heritage

The consequences may include the following:

- brand and reputation damage
- heightened regulatory pressure
- legal actions
- consumer boycotts and operational stoppage can jeopardize short and long-term shareholder value

Exposure to Social Risk

Social risk can arise in numerous ways. In some instances, organizations may intentionally or unintentionally contribute to social or environmental problems and provoke stakeholders to take action through whatever means they possess. In other instances, organizations may be considered guilty by association, simply operating directly in areas with social problems.

The emergence of social risk is characterized by four components (Bekefi et al., 2006):

- **Issue** – social or environmental issues specific to the organization, the target market, and the planned venture.
- **Stakeholders** – a broad group that includes any person or group who may have an interest in the issue or are affected by it. Stakeholders could be traditional, such as shareholders, employees, customers, and suppliers or nontraditional, such as environmental organizations, human rights groups, students, colleges, trade unions, socially responsible investor groups, and academia.
- **Perception** – stakeholder perceptions are based on various information sources, including official news media, word of mouth, the internet, and the company. Negative perceptions may arise from anti-corporate or anti-capitalist sentiment. Negative perception is more likely to arise in the absence of regular communication and information from the organization itself. It can be accurate or inaccurate; both can lead to challenges for the company.
- **Means** – a stakeholder may possess a variety of means to affect organizational conduct. Small grassroots non-profit organizations may be able to mobilize large networks of allies very quickly.

Did You Know? Loblaw Companies After the Rana Plaza Disaster

Let's consider an example of how these four components apply to a real-world example.

Between 2007 and 2013, Loblaw Companies Ltd. imported over 13 million garments from 73 factories in Bangladesh, where workers are paid some of the lowest wages in the world. One of their main suppliers in Bangladesh was Pearl Global, a company that subcontracted work to a company called New Wave, which was located in Rana Plaza.

New Wave employed many garment workers, young girls (under the age of 18), who were severely underpaid (as little as CDN 0.37/hour) and who created clothing for the company's Joe Fresh brand. The contract between Loblaw Companies and Pearl Global required goods to be produced in compliance with Loblaw's Corporate Social Responsibility (CSR) Standards. So, in 2011, Loblaw Companies hired Bureau Veritas (BV) to conduct social audits of New Wave's factory at Rana Plaza.

BV undertook two audits reporting 21 instances of non-compliance, including 11 health and safety violations in the first audit and 9 in the second audit. BV also reported that the facility did not have a factory license which would have been required to operate legally. Unfortunately, none of the deficiencies were followed up on by Loblaw and in 2013 the Rana Plaza factory (which was poorly and inadequately constructed), collapsed.

A lawsuit was launched against Loblaw Companies seeking compensation for victims and their families. The plaintiffs alleged that Loblaw Companies knew the workplace was dangerous and had responsibility for worker safety. However, both the Ontario Superior Court and Ontario Court of Appeal denied the class action certification, with Superior Court Justice Paul Perell stating that Bangladesh's laws applied, that Loblaw Companies owed no "duty of care" to the proposed class members, and that "the imposition of liability [on Loblaws] is unfair given that the defendants are not responsible for the vulnerability of the plaintiffs. Loblaws did not create the dangerous workplace, had no control over the employers or employees or other occupants of Rana Plaza" (Perkel, 2019).

Loblaw won the legal action; however, Joe Fresh customers, horrified by scenes of carnage and destruction after the deadly factory collapse, warned they would boycott the Toronto fashion label until there was proof of change.

Loblaw and more than 200 other clothing companies joined a new, binding agreement called the "Accord on Fire and Building Safety in Bangladesh," which closely tracks factory safety. Inspectors now regularly audit factories, and reports are shared with factory owners, unions/workers, and clothing companies. Although CSR is a step toward enforcing standards, suppliers are not held to reasonable standards. While it may still be possible to avoid legal liability for unsafe working conditions in the supply chain, companies that seek out low-wage suppliers must remain wary of unsafe working conditions and be proactive in the implementation of CSR standards if they genuinely intend to improve the working conditions of those who are most vulnerable.

This is a typical example of the social risk associated with international trade, where Loblaw

Companies unintentionally contributed to a social problem and provoked stakeholders to take action. The case also explains the four components of social risk:

- **Issue** – hazards to human health, safety, and security
- **Stakeholders** – employees of garment factories and the community
- **Perception** – accurate negative perception that led to challenges for Loblaw Companies Ltd.
- **Means** – when legal action did not work, Loblaw was held accountable by the customers to address the situation

Sources: Clean Clothes Campaign, 2021; Doorey, 2017; Goodwin, 2021; McCombs School of Business, n.d.

Strategies to Mitigate Social Risk

Social risk is formed by how people react to an event or an idea, and so it is always evolving. Unlike traditional risks that manifest themselves because of specific events or incidents, social risk is built on who we are as human beings and what our circumstances are, our economic status, our social mobility, our community, our environment, etc. Therefore, when developing strategies for mitigating social risk, companies ought to respect human emotions and responses and act with humanity.

To mitigate social risk, organizations must look at its causes from a systematic standpoint, not on an event-by-event basis. As the Rana Plaza case has proven, following the target market's laws is not enough due diligence. Organizations should also perform their due diligence by looking at their customer base and the business practices of their suppliers, not just immediate ones but all suppliers along the supply chain. Organizations can incorporate a range of strategies and activities to help reduce social risk into their business concepts. They are the triple bottom line (TBL) framework, responsible business conduct (RBC), corporate social responsibility (CSR), and environmental, social, and governance (ESG) standards.

Triple Bottom Line (TBL) framework

TBL is an accounting framework that incorporates three dimensions of performance: social, environmental, and financial. It can be broken into "three Ps": profit, people, and planet. By incorporating this framework into their business concept, firms can determine if they are contributing to activities that have a negative impact on these three categories (Miller, 2020).

Responsible Business Conduct (RBC)

RBC consists of expectations and guidelines set by all governments that are members of the Organization for Economic Cooperation and Development (OECD) (Government of Canada, 2022). All organizations conducting business internationally are required to support economic, social, and environmental sustainability and respect human rights.

Corporate Social Responsibility (CSR)

A business model that helps organizations to determine how their practices impact various aspects of society such as economic, social, and environmental. It is a self-regulated model implemented by companies to be socially accountable to both their stakeholders and the public (BDC, n.d.a.).

Environmental, Social, and Governance (ESG)

The term ESG refers collectively to the ways in which a company can be evaluated beyond its financial statements — specifically, how it handles environmental, social, and governance issues. ESG recognizes that a company's financial statements do not tell all the facts about the business. For example, what type of energy sources is the company using, how much water does the company consume, and how much does the company contribute to pollution and greenhouse gases (BDC, n.d.b).

Let's Explore: Mitigating Social Risk

To learn more about the different approaches used to mitigate social risk, visit the following websites.

- The Triple Bottom Line: What It Is & Why It's Important — Harvard Business Review
- About Responsible Business Conduct Abroad — Government of Canada
- Corporate Social Responsibility (CSR) — BDC
- What Is ESG and What Does It Mean for Your Business? — BDC

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Chapter 13 Summary

LO 13.1 Meaning of Culture and Social Structure

- Culture is a system of values and norms that guides the social behaviour of people and serves as a foundation of social structure.
- The social structure refers to a society's basic social organization. The two main dimensions of social structure are the individual vs. group dimension and the stratification dimension.

LO 13.2 Business and Economic Implications of Social Structure

- In some societies, the individual is the basic unit of a social structure, and in other societies, a group is considered the basic unit of a social structure.
- All societies are stratified into classes. Some societies have low social mobility and a high degree of stratification, while others have high social mobility and a low degree of stratification. There are some societies which still have caste systems, especially in the rural areas.
- Caste is a closed system, and the individual who is born into it cannot move out of it.
- The caste system determines who the individual marries and what occupation an individual can pursue.
- Class is a more open system of stratification and is based on social ranking.
- Social ranking can change based on economic status and education level attainment.
- Social mobility level in a class system differs from one society to another.

LO 13.3 Importance of Cross-Cultural Literacy

- Geert Hofstede's Cultural Dimensions Theory explains how culture relates to values in the workplace. Cultural dimensions studied by Geert Hofstede are the power distance index, individualism vs. collectivism, uncertainty avoidance index, masculinity vs. femininity, short-term vs. long-term orientation, and restraint vs. indulgence.
- Organizations that put effort into gaining cross-cultural literacy are more agile and can easily adapt to different processes, capture new opportunities, and respond to changes across diverse markets.

LO 13.4 Social Risk in International Business and Mitigation Strategies

- Social risk refers to the negative perception of an organization's impact on a broad range of issues related to human welfare.
- Organizations can be exposed to social risk either by contributing to social and environmental problems, or they might be considered guilty by association, simply operating directly in areas with social problems.
- There are a range of strategies and activities companies can incorporate into their business concept to help reduce social risk: the triple bottom line framework, responsible business conduct, corporate social responsibility, and environmental, social and governance standards.

Check Your Understanding

An interactive H5P element has been excluded from this version of the text. You can view it online here:
https://ecampusontario.pressbooks.pub/internationaltradefinancepart2/?p=225#h5p-5

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III. ENTERING AN INTERNATIONAL MARKET – ENTRY MODES

CHAPTER 14: SELECTING AND ENTERING AN INTERNATIONAL MARKET

Chapter 14 Introduction

Learning Objectives

After reading this chapter, you should be able to

1. Discuss the selection of a foreign market, the time of the entry, and the scale of the entry.
2. Compare and contrast different modes of entry to a foreign market.

Think About It!

Video: CAGE Framework for International Trade

In this video from Carlson School of Management, Professor Pankaj Ghemawat, director of the Centre for Globalization of Education and Management at the Stern School of Business, discusses the CAGE framework and how businesses can use it to evaluate international trade opportunities.

One or more interactive elements has been excluded from this version of the text. You can view them online here: https://ecampusontario.pressbooks.pub/internationaltradefinancepart2/?p=59#oembed-1

Source: Carlson School of Management. (2015, March 12). *Pankaj Ghemawat: CAGE framework for international trade – Global matters* [Video]. YouTube. https://www.youtube.com/watch?v=7FpUJaG7uMk

Reflection Questions

Before we begin, we encourage you to reflect on the following questions:

1. What are the four dimensions of CAGE framework?
2. How does the CAGE framework help businesses determine a trade partner?

Introduction

This chapter will consider which international markets to enter, when to enter an international market and how to enter an international market.

14.1 Which Market to Select?

There are almost 200 countries, all of which offer differing potential to earn profit for firms that seek to expand internationally. When deciding on which market to choose, organizations must be careful not to overvalue the attractiveness of a market and ensure that all issues and risks associated with the market are evaluated. One way to do that is to analyze political, legal, economic, social, and cultural risks of a market which were discussed in early chapters. Another very helpful tool that assists organizations with international market evaluation is a framework developed by Pankaj Ghemawat, called the **CAGE Distance Framework**. CAGE is an acronym for different kinds of distances:

- Cultural
- Administrative/Political
- Geographic
- Economic

The CAGE Distance Framework

Most of the risks and costs associated with expanding the business to international markets are created by *distance*. Distance not only indicates geographic distance (kilometres, miles) but also, as the CAGE framework points out, cultural distance, administrative/political distance, and economic distance. The CAGE framework helps organizations to measure the distance between the home country and the target country. ***The greater the distance, the higher the risk level and the lower the opportunity for success.***

Cultural Distance

This refers to cultural differences between home and host country, such as social norms and values, language, ethnicity, and religious beliefs. These cultural differences directly affect customer preferences and contribute to different perceptions of the same situation. An organization's decision to enter an international market is largely influenced by cultural distance. Studies have shown that countries which share the same language engage more in international trade than countries with a different language. As former colonies of Great Britain, the USA, Canada, Australia, New Zealand, and Ireland exhibit a lower cultural distance and trade more among themselves than they trade with Russia, for instance, since they all speak the same language. Cultural distances can make interactions complicated and adaptation of cultural values time-consuming, thus increasing transactional costs. The cultural distance can also hinder the development of trust, which can increase the cost of entry and reduce the possibility that international trade will occur. Therefore, the greater the cultural distance among countries, the higher the cost of conducting business in those countries.

Administrative/Political Distance

This refers to distances captured by factors such as political association, weak or strong legal and financial institutions, common currency, trade agreements, and shared history.

The distance is greater between countries that have different political systems, such as democracy versus a totalitarian system. The distance can also be created by differences in law between countries, for example, some countries have strict environmental and labour laws, which make compliance and doing business more costly. Also, some countries may have restrictions regarding foreign investment in industries that are critical to national security e.g. communications, aerospace or a domestic business that is a large employer. These industries are hard to enter for foreign firms which are looking to expand, thus increasing the distance.

Geographic Distance

The physical distance between the home country and the new market is the main dimension of geographic distance. However, geographic distance captures more factors than the literal physical distance, such as a country's physical size, the within–country distance to its borders, its time zones, topography, and whether the countries are next to each other or have access to waterways. All these factors contribute to the cost of international trade. Other determinants of geographic distance are the country's infrastructure and communications networks. Lack of adequate infrastructure and communications system will lead to increased trade costs even if the host country is physically close.

Economic Distance

This refers to the differences in wealth and the per capita income of consumers; the bigger the difference, the greater the distance. Countries with similar economies have greater chance of success, however if the per capita income of the target country is relatively too low, doing business there could be challenging. Other differences that increase economic distance are financial resources and access to modern banking systems, knowledge and education level of human resources, infrastructure, and the differences in cost and quality of natural resources.

The success in implementing an international strategy starts with selecting the correct country. The CAGE distance framework allows firms to understand the distances as it comes to cultural differences, administrative functions, geographic barriers, and economic disparities, compare target countries, and select the correct one. The lower the CAGE distance, the lower the costs and risks of doing business are expected to be. **Table 14.1** summarizes all factors in the framework and their impact on creating the distance.

Table 14.1: Summary of CAGE Framework

Framework	Factors that Increase Distance	Industries/Products Most Affected
C= Cultural	• Different languages, religions, social norms, and values	• High linguistic content (media) • Products identifiable with nationality or religion (food)
A = Administrative/ Political	• No trade agreements • Weak legal institutions • Different political systems • Different currencies	• Products vital to national security (aerospace, telecommunication)
G = Geographic	• No common borders or access to waterways, inadequate infrastructure, and poor transportation and communication networks • Different climate and time zones	• Products that are perishable • Services where communication network is crucial (financial services)
E = Economic	• Large gap in per capita income • Differences in labour costs, natural resources costs and knowledge levels of human resources	• Products that require high income (luxury items, cars)

The Time of Entry

Once an organization decides which market to enter, the next important step is to decide on the time of entry. The right entry time is critical to the firm's performance and success in an international market. When an international firm enters a market before other foreign firms, the entry is called **early entry**, and when a firm enters the market after other international firms have already established their operations, the entry is called **late entry**. The advantage gained by a firm that first introduces its product or service to a market is known as the **first-mover advantage**.

First Mover Advantage

This refers to the competitive benefits gained by a company that first introduces a product or a service to a specific market. The first-mover advantage framework was developed by Marvin B. Liebermann and David M. Montgomery in 1988.

The advantages associated with being the first entrant in the market are as follows:

- **Initial market share** – gaining significant market share speeds up brand recognition and customer loyalty which also helps to reduce marketing costs.
- **Build sales volume** – results in increased production, which potentially facilitates the achievement of economies of scale. Reducing the cost through economies of scale enables early entrant to cut prices below those of a later entrant, and drive competition out of the market.
- **Control of resources** – the initial access to scarce resources that could range from strategic location to raw materials used in the production process or top talent and skilled labour for their workforce. By controlling

these resources, the first entrant can solidify its position in the market and gain a significant competitive advantage over subsequent entrants.

- **Buyer switching costs** – refers to the costs that a customer incurs when switching to a new supplier such as time and resources spent in qualifying a new supplier or investment that a buyer must make in adapting to a seller's product: for example, installation of a new software and the financial burden of training employees (CFI Team, n.d.).

First Mover Disadvantage

There are some disadvantages to being the first mover, and those disadvantages are, in effect, advantages for those firms who are late entrants to the market, and they are:

- **Informed buyers** – the first mover has to invest heavily in customer education. This is a cost that the late entrants can avoid (CFI Team, n.d.).
- **Product improvement** – late entrants can take advantage of the **reverse engineering** process and make the product better. A reverse engineering process is when a product is deconstructed for the purpose of enhancing its performance or duplication (Lutkevich, 2021).
- **Avoid mistakes** – late entrants can save cost and time by avoiding mistakes that are made by the first mover.

Let's Explore: First-Mover Advantage

Watch this video to learn more about the first mover advantages and limitations with real world examples.

One or more interactive elements has been excluded from this version of the text. You can view them online here: https://ecampusontario.pressbooks.pub/internationaltradefinancepart2/?p=254#oembed-1

Source: Business School 101. (2022, June 26). *First-mover advantages (with real world examples) | From a business professor* [Video]. YouTube. https://www.youtube.com/watch?v=xOuQicMOTy0

The Scale of Entry

Another decision that an international business needs to make is the scale of entry. The entry could be large-scale or small-scale. In making the decision on the scale of entry, the firm must consider the cost and the risk associated with both large-scale and small-scale entry.

Entering a market on a large scale will require a commitment of significant resources and is considered a **strategic commitment**; that is, a commitment that has a long-term impact and is difficult to reverse. Large-scale entry also attracts customers by giving them assurance that the company is there to stay. It also may cause rivals from other countries to rethink their entry to the market. On the negative side, large-scale entry may limit a firm's investment in other markets and may lead to a competitive response from local firms with similar products and services (Jordan, 2022).

Entry into a market on a small scale gives companies time to learn about the market and reduces the company's risk exposure. However, with small-scale entry, it may be difficult to build market share and to capture meaningful first-mover advantages (Workspace, n.d.).

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14.2 Modes of Entry into a Foreign Market

The selection of the market entry mode is the final and most important step in the international business decision-making process. The selection of the entry mode depends on company readiness factors, which were discussed in Chapter 9. They are the firm's competitive capabilities, experience and training, skills and knowledge, resources, motivation for going international, and the commitment of owners and managers.

There are many modes of entry from which to select, such as exporting, licensing, franchising, joint ventures, and wholly owned subsidiaries.

Exporting

Most firms begin their international market expansion by exporting – selling their product or services either directly or indirectly in an international market. Exporting is considered a low-risk and cost-effective entry mode.

It involves selling goods or services to customers across international borders. This can be done either by setting up the company's own selling program or by using local distributors through contractual agreements, where the local distributors will help with the delivery process and can play a role in marketing the goods and after-sales services.

- **Advantages** – exporting allows companies to avoid substantial costs associated with establishing manufacturing operations in the host country. Exporting may also help a company achieve economies of scale (see Chapter 9) by increasing its sales volume in the global market.
- **Disadvantages** – there are a number of disadvantages to exporting. First, high supply chain costs and tariffs can make exporting expensive. Second, by delegating work to local distributors, the company has less control over product delivery and marketing of the product. Third, the firm also doesn't have access to direct feedback from the customer, and that makes it difficult to customize their products and services to local preferences and tastes.

Licensing

An international licensing agreement is an arrangement between two parties whereby a producer company (licensor) allows a foreign company (licensee) to sell its products in exchange for royalty fees. The licensing agreement, therefore, allows the licensee to use the licensor's property for the duration of the agreement. This property is usually intangible property such as trademarks, patents, and production techniques.

- **Advantages** – the licensor is not responsible for the costs and risks associated with the foreign venture.
- **Disadvantages** – licensing offers very moderate returns and involves the loss of control over property.

Franchising

Replicating a business model is called franchising. Like licensing, franchising requires a limited-time agreement between a franchisor and a franchisee. But unlike in a licensing agreement, the franchisee not only pays royalty fees but also agrees to abide by strict rules as to how it does business. The franchisor often helps the franchisee with business operations on an ongoing basis. Royalty fees are paid based on revenue earned by the franchisee. While licensing is pursued mainly in manufacturing firms, franchising is mainly pursued by service firms.

- **Advantages** – The franchisor is relieved of costs and risks associated with setting up the franchise in the foreign market. Instead, the franchisee assumes all setup and operating costs, which creates a good incentive for the franchisee to run the operations efficiently and become profitable.
- **Disadvantages –** The main disadvantage of franchising is quality control. The very essence of franchising is delivering the same service and experience to a consumer, no matter where and in which country it is located. This level of quality may not be easy to achieve when a company is operating in foreign countries, especially when the franchisee in another country is not committed to delivering the same level of quality service.

Joint Venture

This strategy is used to share risk and cost when expanding to an international market. A joint venture is when two companies agree to work together and create an independently managed third company in a market, either geographic or product. The agreement could be based on an equal stake, minority stake, or controlling stake. In some countries, foreign companies are required to create a joint venture with local companies.

- **Advantages** – there are a number of advantages to joint ventures.
    - First, the company can benefit from the local partner's knowledge of market conditions and competition, culture and language, political system, and social environment.
    - Second, a joint venture eliminates the need to start from scratch in a new market, which can be risky, especially if the project is capital-intensive.
    - Third, having a local partner gives some protection against political unrest and government policy changes. Many policy changes may not apply to local business owners.
- **Disadvantages** – the major disadvantage of a joint venture is loss of control over technology. Another disadvantage of the joint venture is that it does not give the firm tight control over its operations to increase the efficiency or sales volume and realize economies of scale, which can then result in gaining a competitive advantage over rivalry.

Wholly Owned Subsidiaries

In this mode of entry, the firm owns 100 percent of the subsidiary. Wholly-owned subsidiaries can be formed in two ways: acquisition, where the firm can acquire an already established firm in the host country and integrate its product into that firm. Or greenfield venture, where the firm sets up the operation from the ground up and builds a brand-new operation system. We will look at both forms in detail separately.

- **Advantages** – there are several advantages associated with wholly owned subsidiaries. For firms that use technology as their main competitive advantage, the wholly owned subsidiary mode provides protection for and reduces the risk of losing control over their proprietary product. This form of entry is popular among high-tech firms. Another advantage of wholly-owned subsidiaries is keeping control over their operations, which gives firms the opportunity to achieve economies of scale, reduce costs, and increase their profit.

- **Disadvantages** – this mode requires heavy capital investment in the foreign market and is not the most cost-effective way of entering a market. Businesses also have to learn cultural ways of doing business in the host country and that could be challenging and costly as well (see Chapter 13).

Acquisition

Acquisition is a strategy where a firm gains control of another firm by purchasing its stock or by outright purchasing the company. Which option they take depends on whether the firm is public or private. The acquisition strategy is appealing because it helps a firm establish its presence rapidly by integrating its operations with the firm in the target market. As much as the integration of operations provides firms with access to the already established customer base and business network, the process of cultural integration between two firms from different countries can pose a challenge. A cultural clash between the acquiring and the acquired firm may result in high management and employee turnover. This loss of expertise in an international business can be harmful to the performance of the acquired firm, as it is difficult to find replacements for those who have local knowledge.

Greenfield Venture

Greenfield venture is a strategy where a firm builds a subsidiary from the ground up and establishes a brand-new operation in the host country. This type of venture is often costly, but it gives the company maximum control and offers high returns. Greenfield venture also gives organizations the ability to build their culture and operation routines from scratch. It is easier to build from scratch in this new venture than to convert the culture and operating routine of an acquired firm. The challenge with greenfield ventures is that it takes time to establish itself and generate revenue.

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Chapter 14 Summary

LO 14.1 Selection of a Foreign Market, the Time of the Entry, and the Scale of the Entry

- Organizations must analyze the political, legal, economic, social, and cultural risks of a market.
- The CAGE Distance Framework can assist them with international market evaluation, considering cultural, administrative/political, geographic, and economic distances.
- CAGE allows firms to *understand* the distance, *compare* target countries, and *select* the correct one.
- Time of entry is a critical step, with early entry before other foreign firms and late entry after other international firms have already established their operations in a market.
- Early entry provides a first-mover advantage, which allows for initial market share, building sales volume, control of resources, and buyer switching costs.
- Late entry advantages include informed buyers, product improvements, and avoidance of mistakes.
- The scale of entry can be large or small.
- Large-scale entry requires a commitment of significant resources and is difficult to reverse.
- Small-scale entry gives companies time to learn about the market and reduces risk exposure, making it difficult to build market share.

LO 14.2 Different Modes of Entry to a Foreign Market

- The selection of the market entry mode is the last and most important step in the international business decision-making process.
- Entry modes include exporting, franchising, joint ventures, and wholly owned subsidiaries, which include the strategies of acquisition and greenfield venture.
- All modes have advantages and disadvantages; selection depends on the company’s readiness factors, competitive capabilities, experience and training, skills and knowledge, resources, and motivation.

Check Your Understanding

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IV. ASSESSING THE VIABILITY OF INTERNATIONAL VENTURES

CHAPTER 15: PRICING STRATEGIES AND COST ANALYSIS

Chapter 15 Introduction

Learning Objectives

After reading this chapter, you should be able to

1. Explain what factors determine the price and elaborate on various pricing strategies.
2. Explain international pricing constraints and legislation.
3. Discuss internationally accepted trade terms and codes.
4. Identify cost elements that apply to international trade.

Think About It!

Video: Basic Pricing Strategies

Before reading this chapter, watch this video outlining factors to consider when determining the price of a product.

One or more interactive elements has been excluded from this version of the text. You can view them online here: https://ecampusontario.pressbooks.pub/internationaltradefinancepart2/?p=61#oembed-1

Source: Jason Richea. [2013, May 28]. Determining the price – Factors to consider. [Video]. YouTube. https://www.youtube.com/watch?v=UqFPWeCeFCI

Reflection Questions

Before we begin, we encourage you to reflect on the following questions:

1. Which key components are involved in determining the price?
2. Why is it important to determine the correct cost of a product, before setting the price?

Introduction

Businesses enter international markets to earn profits; however, not all businesses succeed in doing so. In many cases, managers fail to properly identify their import and/or export costs or the price that properly reflects the product cost and the firm's required profit margin. Many organizations are simply unaware of the extra costs associated with international trade. Learning about all cost elements is a necessary component of determining the viability of an international venture.

15.1 Determining the Price

Price selection is one of the most important functions of a business. The right price enables a company to generate high profits and consequently increase liquidity by generating more cash. On the other hand, an incorrect price could result in a company suffering a loss. If the price is low, it will result in low profit margins and lower growth opportunities and may even jeopardize business sustainability. If the price is high, it will result in low sales volume, reduced revenues, and consequently low profits for the company.

In general, price is determined by the following factors:

- **The cost** – price must cover the cost, or businesses cannot survive. This is the lowest price level.
- **The competition** – prices must be set to match the competition's price or even lower than the one offered by the competitor. This price is also the highest price level. If a product price is higher than the competition, customers will switch to the competition (Coursera, 2023).
- **Market forces** – supply and demand – price that is set based on market forces is the one that the customer is willing to and able to pay. This price is also the optimum price, which lies between the highest and lowest levels of price. (BDC, n.d.)

Types of Pricing Strategies

The most common pricing strategies used by businesses are penetration pricing, skimming pricing, and flexible pricing.

- **Penetration pricing strategy** – A pricing strategy where companies enter a market using low prices in anticipation of capturing a large market share and, consequently, large sales volume. Increased sales translate to a decrease in costs due to economies of scale, and reduction in cost results in high profits (See Chapter 9). Also, when this strategy is successful, and the company acquires a larger share of the market by getting rid of the competition, the company can then raise the price and increase profits even further (FITT Team, 2015). This strategy works when the market is sensitive to prices. Dell Computers is one of the companies that benefited from this strategy (eWeek Editors, 2001).
- **Skimming pricing strategy** – This strategy involves charging premium prices when the product is first introduced to the market, and there is no competition. These are generally innovative technology items which require high research and development costs, and charging premium prices helps the company recover their costs quickly (Bora, 2022). Once newer versions of the product become available or the market gets saturated with similar products, the company lowers the price to reach more price-sensitive customers. Apple is one of those companies that persistently follows a price-skimming strategy (YFZHA, 2016).
- **Flexible pricing strategy** – This is a dynamic strategy where the same products are offered at different prices to different groups of customers. This strategy can be used as a response to changes in customer demand or changes in other conditions, such as season or customer needs (Bjelobrk, 2022). Airlines and hotel chains use this strategy to maintain their revenue stream in low seasons, or they offer discounts when they need to fulfil extra capacity.

International trade adds additional complications to the selection of pricing strategies. When selecting the pricing strategy in international trade, aside from internal factors (company's desired profit margin and production and distribution costs), companies must also perform an in-depth analysis of all factors applicable to the target market, including market factors and economic factors

- **Market factors** include foreign exchange rates and applicable laws and regulations, competition, and market share.
- **Economic factors** include the inflation rate and the purchasing power of potential customers in the target market.

A successful pricing strategy is one that is flexible and can be easily adjusted to the dynamics of the global market.

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15.2 International Pricing Constraints

When selecting a pricing strategy, organizations must be aware of a number of pricing constraints that exist in international trade. These pricing constraints prevent organizations from having complete flexibility in making pricing decisions.

Anti-Dumping Legislation

Dumping occurs when the price of a product in the international market is lower than the price of that same product in the exporter's domestic market. In international trade, dumping is viewed as unfair because of the impact it has on local competitors (The Investopedia Team, 2021). Countries around the world have developed legislation preventing foreign firms from engaging in dumping practices. The most common anti-dumping measure that countries use is to impose **tariffs** and **duties** on imported goods that are found to be unfairly priced. These tariffs and duties raise the price of imported goods to match or exceed prices offered by the local competition. Companies can afford to use dumping practices with the help of subsidies received from their local governments. One such example is China's electric vehicles (EV) industries, where manufacturers receive billions of yuan in subsidies so they can sell EVs in Europe and the USA for a low price and take away market share from auto industries in these countries (Kawase, 2023; Winton, 2023).

Resale Price Maintenance

Resale price maintenance applies to sales transactions between affiliated companies and ensures that the **transferred prices** for goods and services from a company to an affiliated company reflect the true value of those goods and services. Transferred prices are monitored very closely by both domestic and destination countries because this practice enables organizations to avoid taxes by controlling their income by charging too much or too little for transferred products (Umit Kucuk & Timmermans, 2022).

Price Level Reviews

Price level reviews are used by some countries to control excessive increases in prices for the purpose of protecting the economy since an increase in prices causes inflation. Price level review applies to both domestic and international businesses, therefore companies must account for this when deciding to select their pricing strategy (Mahr & Whiting, 2023).

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15.3 Terms and Codes Used in International Trade

There are two accepted systems of terms and codes used by everyone involved in international trade: Incoterms® and the Harmonized Commodity Description and Coding system.

Incoterms

Incoterms stands for “International Commercial Terms,” which were created to minimize trade disputes due to misinterpretation and miscommunication when doing business internationally. These terms are developed by the International Chamber of Commerce and are the only internationally recognized trade terms.

Companies involved in international trade use Incoterms to understand the exact terms of their business contract — the exact rights and responsibilities of both parties, the seller and the buyer.

There are two groups of Incoterms. The first group applies to any mode of transportation. The second group applies to transportation across water, sea, and inland waterways.

Incoterms define seller and buyer responsibilities related to shipments of goods. These responsibilities include the following:

- Liability transfer point from the exporter to the importer
- Insurance obligations of each exporter and the importer
- Custom duties payment obligations

Figure 15.1: Incoterms 2020

Any Mode of Transportation

Abbreviation	Name	Description
EXW	Ex Works	The seller is responsible only for having the goods ready for pick up at his location.
FCA	Free Carrier	The seller is responsible for delivering the goods to an agreed-upon location.
CPT	Carriage Paid to	The seller is responsible for delivering the goods to an agreed-upon location and paying for transportation.
CIP	Carriage and Insurance Paid to	The seller is responsible for delivering the goods to an agreed-upon location and paying for transportation and insurance.
DAP	Delivered at Place	The seller is responsible for delivering the goods to the buyer's destination without unloading.
DPU	Delivered at Place Unloaded	The seller is responsible for delivering the goods to the buyer's destination and unloading the goods.
DDP	Delivered Duty Paid	The seller is responsible for delivering the goods to the buyer's destination, unloading and import duties.

Sea and Inland Waterway Transport

Abbreviation	Name	Description
FAS	Free Alongside Ship	The seller is responsible for placing the goods alongside the vessel.
FOB	Free on Board	The seller delivers the goods and boards them on the vessel.
CFR	Cost and Freight	The seller is responsible for delivering the goods to the port of destination and paying for transportation.
CIF	Cost, Insurance, and Freight	The seller is responsible for delivering the goods to the port of destination and paying for transportation and insurance.

Source: Based on Thompson, B. (2024, May 28). *Incoterms® 2020 explained – the complete guide.* IncoDocs. https://incodocs.com/blog/incoterms-2020-explained-the-complete-guide/

Think About It: Incoterms 2020

Watch this video to learn more about the Incoterms, which were updated in 2020 by the International Chamber of Commerce.

One or more interactive elements has been excluded from this version of the text. You can view them online here: https://ecampusontario.pressbooks.pub/internationaltradefinancepart2/?p=277#oembed-1

Source: Inco Docs. [2020, February 2]. *Incoterms® 2020 explained for import export global trade*. [Video]. YouTube. https://www.youtube.com/watch?v=7g7IC4IzjDM

Questions

1. What are Incoterms?
2. Which international body is responsible for publishing them?
3. How many groups of Incoterms are there and what is the criteria for dividing them?
4. Are Incoterms rules binding for companies around the globe, if so why and how?

The Harmonized Commodity Description and Coding System

The Harmonized Commodity Description and Coding System is an international product code that contains over 5000 thousand commodity groups. The Harmonized System, or simply the HS code system, was developed by the World Customs Organization (WCO) to standardize the coding structure and product descriptions that are used in international trade. These codes are used by over 200 countries around the world for determining **duties**, **tariffs**, and **taxes** on imported and exported goods. Compliance with HS codes is mandatory and enforced by governments of all countries (Canada Border Service Agency, n.d.).

Let’s Explore: HS Codes

To learn more about the Harmonized Commodity Description and Coding System, visit the World Customs Organization website.

Did You Know? The Difference Between Duties, Tariffs, and Taxes?

Duties

Custom duties are fixed fees that the government of a country puts on all products imported from other countries. The rate of duties applied to products is determined based on the need for those products and the impact they have on the economy. The lower the economic impact, the lower the rate of customs duties. Duty rates range from 0 to 40%. Duty rates are negotiated and determined based on trade negotiations between countries (Descartes, n.d.).

Tariffs

Fees are imposed by governments on ***certain*** imported products or categories of products at a ***given time*** to protect domestic industries. For example, in 2018, the Trump administration imposed 25% tariffs on steel imported from China to protect the interests of US steel industries (Sherman & Josephs, 2022).

Taxes

While duties and tariff fees apply to imported goods, taxes are applied to all products sold in a country. Taxes may be called Value-Added Tax (VAT) or Goods and Services Tax (GST), based on a country. Different countries have different tax rates; for example, Canada has a GST rate of 5%, while the UK has a 20% VAT rate.

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15.4 Costs Elements Applicable to International Trade

To better understand and account for them, cost elements for international trade can be divided into three categories: product cost, export sales costs, and distribution costs.

Product cost consists of raw materials, labour, manufacturing overhead costs (rent, utilities, maintenance, administration, etc.) and product modification costs, which may incur if the international market has different standards. For example, the voltage or size of a product may differ from one country to another.

Export sales costs consist of extra costs associated with packaging, labelling, marking boxes or cases, and strapping. All these costs also apply to domestic sales; however, some countries have special requirements, which result in extra costs.

Distribution costs These costs are associated with delivering the product from the manufacturer's location to the buyer's location. In international trade, shipping costs vary based on the agreed-upon Incoterm. It is important to understand all costs and obligations associated with each Incoterm (see **Figure 15.1: Incoterms 2020** in section 15.3). Aside from incoterms, companies should also account for freight forwarding costs.

Freight forwarders are intermediaries between manufacturers and shipping companies and can advise on the most cost-efficient shipping options (DSV, n.d.). The services these agencies provide are invaluable when it comes to international trade, especially for small and medium-sized businesses that can't afford to hire logistics specialists. The services they provide include the following (Indeed Editorial Team, 2023):

- Preparing all documents for exporting or importing goods
- Help with custom clearance
- Advise on proper packaging and labeling
- Product arrival handling, storage, and warehousing arrangement

When calculating costs, companies should also account for the **duty drawback** on their imported products.

A duty drawback is a refund of duties, taxes and fees paid on certain product categories of goods imported to a country. This is a trade incentive program that encourages companies to participate in international trade. The selection of products and the amount of the refund vary from one country to another.

Let's Explore: Distribution Costs

To learn more about freight forwarding, read "What Is Freight Forward? Definition, Benefits and Key Stages" on the Indeed website.

To learn more about the duty drawback program in Canada visit the Trade Incentives Programs: Drawback Program page of the Canada Border Services Agency website.

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Chapter 15 Summary

LO 15.1 Factors Determining Price and Pricing Strategies

- Price is determined by the cost of the product, the competitor's price for a similar product, and market forces – supply and demand.
- There are various pricing strategies that organizations can select from: penetration pricing strategy, skimming pricing strategy, and flexible pricing strategy.

LO 15.2 International Pricing Constraints and Legislations

- Anti-dumping legislation limits exports from dumping lower-priced goods into a domestic market; the most common are tariffs and duties on imported goods.
- Resale price maintenance ensures that transferred prices of goods and services reflect the true value so that companies cannot use price manipulation to avoid taxes.
- Price level reviews are conducted by some countries to avoid inflation and excessive price increases.

LO 15.3 Internationally Accepted Trade Terms and Codes

- Incoterms developed by the International Chamber of Commerce minimize trade disputes due to misinterpretation and miscommunication when doing business internationally.
- The harmonized Commodity Description and Coding system developed by the World Customs Organization standardizes coding structure and product descriptions.

LO 15.4 Cost Elements of International Trade

- Cost elements that apply to international trade are product costs, export sales costs, and distribution costs, which also include freight forwarding costs and duty drawbacks.

Check Your Understanding

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Appendix: Risk Management Process

Introduction

Whether committing to a new venture, such as entering an international market, or simply managing day-to-day operations, companies must be prepared for unexpected events and things not going as planned. The risk management process can help identify problems and implement solutions in the most cost-efficient way. Before committing to a new venture, organizations must conduct a comprehensive analysis, carefully assess potential risks, and develop mitigation plans to address those risks. Risk assessment and planning must be done continuously to protect ongoing business operations and ensure profitability.

What Is Risk?

Risk is the likelihood of unexpected events with an adverse impact on the operations and profitability of an organization (Hill, n.d.). Risk is measured by the probability of occurrence; it is managed by assessing and responding to the possibility of the event through planning and implementing risk mitigation strategies.

Risk Management Process

The risk management process consists of the following eight steps:

Identify issues and set context – understand the intention of the risk management strategy, the size of the organization, and the risk tolerance level within the organization; identify stakeholders, those who are affected by the risk and those who are involved in the strategy selection process (Tysiac, 2012).

Identify key risks – the first step in managing the risk is to identify the risk. Thorough research of the target market is required for this step in the process. Research must be done on existing and emerging risks. Creating a list of all areas that may cause risk and categorizing risk by those areas is a good starting point. For example, risk could be categorized as political, economic, foreign exchange, social, cultural, legal, etc.

Measure risks – risk could be measured by the probability of occurrence and the severity of its impact on the organization. Measuring risk helps decision-makers with the data they need to make informed decisions and manage risk in an effective manner. Risk Assessment Matrix is used to create risk or threat profiles and measure the probability of occurrence and the severity of impact (Vice, 2024).

Table A – Likelihood of Occurrence

Description	Probability	Rank	Value
Highly probable	More than 75%	High	5
Probable	Between 50-75%	Medium-high	4
Occasional	Between 25-50%	Medium	3
Remote	Between 10-25%	Medium-low	2
Improbable	Less than 10%	Low	1

Table B – Severity of Impact

Description	Rank	Value
Catastrophic	High	5
Critical	Medium-High	4
Serious	Medium	3
Marginal	Medium-Low	2
Negligible	Low	1

Note: The Risk Score, or Threat Profile [TP], is a product of the 'Likelihood of Occurrence' [A] and the 'Severity of Impact' [B], i.e. TP = A * B

Table C – Risk or Threat Profile

Likelihood	Negligible	Marginal	Serious	Critical	Catastrophic
Highly probable	5	10	15	20	25
Probable	4	8	12	16	20
Occasional	3	6	9	12	15
Remote	2	4	6	8	10
Improbable	1	2	3	4	5

Rank risks – ranking occurs based on the results from the risk or threat profile. Risks with higher value take top priority compared to those in the lower ranks. Ranking risk is an important step in the decision-making process as it helps management to allocate ***time*** and ***resources*** and assess areas that have high threat values (FasterCapital, n.d.).

Assess the desired outcome – this stage of the risk management process determines whether the organization should stop or continue with the venture. The decision is made based on the organization's risk tolerance level and available resources. If the risk is too high and the company does not have the required resources to reduce or mitigate the risk, it is wise not to pursue the venture.

Develop response strategies – There are four options available to organizations in handling the risk: avoid, transfer, reduce, and accept (VPAF, n.d.).

- **Avoidance** – eliminate or refrain from activities that carry risks that are costly to mitigate. For example, when a company decides not to pursue a venture that may cause social or environmental damage and could possibly result in lawsuits in an international market.
- **Transfer** – in this situation, the organization is getting a third party to carry the risk on their behalf. Acquiring insurance is a form of transferring risk to another party.
- **Reduce** – also known as mitigate, which means the organization adopts some processes or uses methods to lower the impact and the cost of risk. An example of this is signing a forward contract with a bank to lower the impact of foreign exchange volatility.
- **Accept** – when the threat value is low, and the company can choose to retain the risk because the cost of insurance and or risk mitigation is higher than the cost of retention.

Select and implement strategies – when the organization decides to mitigate risk, it should develop some criteria and develop the strategy (strategies) based on those criteria. The selection must be based on a cost-benefit analysis and must be within the organization's financial means. When developing a strategy, the organization should also clearly determine who is involved during the strategy selection process and who will be responsible for implementation and execution of the strategy. The details of the strategy must also be clearly communicated to those individuals who are responsible for the execution and implementation of the strategy.

Monitor and adjust strategies – monitoring a strategy (strategies) on a regular basis is critical as the environment and conditions under which businesses operate change on a regular basis, and with trading in international markets, these changes are even more prevalent. Regular evaluation and adjustment of the risk mitigation strategy is crucial to ensure that changes in the target market are being addressed and precautionary measures are placed where needed.

Glossary

adversarial system

a legal system based on a procedure where parties in dispute are responsible for findind and presenting evidence

aging population

the decline in the number of young adults and the rising rate of people growing older

business contract

an agreement between two or more parties enforceable by law

business plan

a documented strategy that highlights business's goals and lists processes and resources required to achieve those goals

CAGE Distance Framework

includes different types of distance: cultural, administrative/political, geographic, and economic

civil law

a legal system that is governed by statute and relies on comprehensive legal codes

command economy

an economy where economic decisions are passed down from government authority and where the government owns the resources

common law

a law system that is based precendents — the past decisions made by judges

communist totalitarianism

form of totalitarianism in communist states such as Soviet Union and Eastern Europe, where the state takes away all individual rights

consumer price index (CPI)

a measure of inflation that government statisticians calculate based on the price level from a fixed basket of goods and services that represents the average consumer's purchases

demand

the relationship between price and the quantity demanded of a certain good or service, assuming other influences on demand remain constant

democracy

a political system in which the people choose the government leaders

demographic dividend

economic growth that is the result of changes in age structure of a country's population

direct democracy

when people make their own decisions about policies and issues

disruptive innovation

a concept, process, product, service, or business model that creates a new value field

distribution costs

costs associated with delivering the product from the manufacturer's location to the buyer's location

due diligence

reasonable steps taken by a person or an organization in order to satisfy a legal requirement

duties

fixed fees that government of a country put on all products imported from other countries

duty drawback

refund of duties, taxes, and fees paid on certain product categories of goods imported to a country

early entry

entering a market before other foreign firms

economic risk

the possibility that changes in macroeconomic factors will negatively impact a company or an investment

economy of scale

reduction in the long-run average cost of production that occurs as total output increases

entrepreneurship

a way of thinking, the ability to transform and a holistic approach to turning innovation into a successful business

executive

is a state institution that implements laws passed by legislature

export sales costs

consist of extra costs associated with packaging, labelling, marking boxes or cases, and strapping

factors of production

the resources such as labour, materials, and machinery that are used to produce goods and services; also called inputs

first-mover advantage

refers to the competitive benefits gained by a company that first introduces a product or a service to a specific market

folkways

are unwritten routine conventions of everyday life which are learned through socialization

foreign exchange market

the market in which people or firms use one currency to purchase another currency

free market economy

is an economic system, where factors of production are privately owned and production of goods and services is determined by the interaction of the two market forces: supply and demand

freedom of enterprise

refers to freedom of economic activities with no governement intervention or regulations

freight forwarders

are intermediaries between manufacturers and shipping companies

gross domestic product (GDP)

measure of the size of total production of goods and services in an economy in a single year

heterogeneous resources

bundles of resources, capabilities, and competencies that are unique and different from other rivals

Human Development Index (HDI)

a measure of growth in qualitative factors of human life

immobile

when resources cannot move easily from company to company

increased capabilities

a greater access to talent and diverse skills

inflation

a general and ongoing rise in price levels in an economy

inquisitorial system

legal system in which the court, or part of the court, is actively involved in investigating the facts of the case

intangible resources

resources that are invisible and have no physical attributes such as culture, knowledge, brand, or reputation; also includes intellectual property as identified in patent, designs, copyrights, trademarks, and trade secrets

intellectual property

a term used for intangible assets owned by a company and legally protected by the company from outside use, without authorization

judiciary

a country's court system and the judges responsible for interpreting and applying a country's laws; usually independent of the legislature or executive

late entry

entering a market after other international firms have already established their operations

legislative body

a group of elected representatives that propose and pass legislation

legislature

state institution that passes laws of the country, also a legislative body

macroeconomic factors

factors that impact wide range of population rather than small range of individuals

mixed economy

economy in which some sectors are owned by the state and some are left to private ownership

monopoly

a situation in which one firm produces all of the output in a market and other entities cannot compete

mores

are written rules which support social institutions such as public schools, healthcare system, military, etc.

nominal income

total income a person earns with no adjustments for inflation

nominal prices

prices of products and or services that are not adjusted for inflation

nominal rate

the interest rate before the adjustment for inflation rate

norms

social rules and guidlines that define appropriate behaviour in a specific situation

participation rate

labour force of a country, employed or in search of a job

policy interest rate

set by central banks and used by financial institutions among themselves for one day lending transactions; also known as overnight rate

political economy

the study of interrelationship between political, economic, and legal systems of a country

PPP exchange rate

the rate at which one country's currency is exchanged for the currency of another to purchase the same basket of goods and services

precedents

past decisions made by judges

product cost

consists of raw materials, labour, manufacturing overhead costs, administration costs, etc.

real GDP

a measure of the value of goods and services produced in an economy when it is adjusted for price changes, i.e. inflation or deflation, in a specific time period

real income

income that is adjusted for inflation

real interest rate

the nominal rate minus inflation rate

representative democracy

when people elect officials to represent them in the government

resource-based view (RBV)

an approach that uses internal resources in new ways to exploit external opportunities rather than acquiring new skills or resources

reverse engineering

a process where a product is deconstructed for the purpose of enhancing its performance or duplication

right-wing totalitarianism

also known as fascism, where individuals have some economic freedom, but the government restricts most civil rights and controls culture

rights to private property

the official right to ownership of tangible and intangible property that can be used, controlled, and transferred or passed as an inheritance

social mobility

means the ability of individuals to change positions within a social stratification system

social structure

the design of social relations, the way people and groups treat each other and interact with each other

statute

a written law passed by a legislative body

strategic commitment

a commitment that has a long-term impact and is difficult to reverse

supply

the relationship between price and the quantity supplied of a certain good or service

sustaining innovation

continuous improvement to the product over a long period of time

tangible resources

resources that have physical attributes

tariff

fees imposed by governments at a give time on certain imported products or categories of products to protect domestic industries

taxes

fees applied to all products sold in a country

theocratic law

the law system that is based on religious teaching

totalitarianism

a type of political system where the state controls all aspects of a society and takes away individual rights and freedom for the benefit of the state

transfer price

price charged for goods and services between affiliated companies; legislation requires that the price is determined under arm's length terms

unemployment rate

the percentage of the labour force that is unemployed

values

shared ideas of what a group considers good or bad, right or wrong

VRIO framework

a model identifying the firm’s internal resources and capabilities for sustainable competitive advantage by value, rarity, initimability, and organization

working age population

official working age population of a country, include both economically active and inactive

younger age population

is lead by the rise of fertility rate and the decline in mortality rate