Master of Business Administration

(Open and Distance Learning Mode)

Semester – II

Global Business Management

Centre for Distance and Online Education (CDOE)

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SYLLABI-BOOK MAPPING TABLE

International Business

Syllabi	Mapping in Book
Unit 1. Introduction to International Business Unit 2. International Business Environment	**Unit 1:** Introduction to International Business **(Pages 5-26);** **Unit 2:** International Business Environment **(Pages 27-57)**
Unit 3. The Foregin Exchange Scenario Unit 4. Global Strategies of Business Unit 5. Mergers and Acquisitions	**Unit 3:** The Foregin Exchange Scenario **(Pages 59-81);** **Unit 4:** Global Strategies of Business **(Pages 83-113);** **Unit 5:** Mergers and Acquisitions **(Pages 117-130)**
Unit 6. Global Brands and Organization Behaviour Unit 7. Supply Chain Management and Global Distribution System Unit 8. Globalization	**Unit 6:** Global Brands and Organization Behaviour **(Pages 131-138);** **Unit 7:** Supply Chain Management and Global Distribution System **(Pages 139-162);** **Unit 8:** Globalization **(Pages 163-169)**

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INTRODUCTION

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For a very long time, there has been a real and significant need for a good textbook on International Business.

In India, we have long felt the need for a good reference textbook that provides the students of management with an understanding of:

- International business
- Global strategies
- The international business environment
- The different approaches to globalization

This textbook on international business is primarily intended for the students of management in undergraduate, graduate and diploma courses. However, we know that many such students are already manager anyway, who are undertaking part-time and distance education programmes of study. Hence, this book is written with the manager and the potential manager in mind.

When we look at the general scenario of continuing education in our country, we see that there is a tremendous potential and opportunity for providing flexible forms of learning that complement the professional practices of managers and executives. For instance, when learning has to be implanted by stand-alone resources (such as this textbook), one has to devise innovative means to impart knowledge and skills. We have attempted to do precisely this: each section of this textbook is broken up into convenient modules of units; and in each unit, we have attempted to present the learning material through a content exposition approach. In this approach, we begin with an introduction of the topic of the unit; then, we outline the learning objectives of the unit; and then we present the details of the contents in a simple and easy-to-learn manner. At the end of each unit, we have provided a summary for the purpose of quick recollection. Finally, we have carefully posed exercises and questions that you need to answer as you complete each unit.

In preparing this textbook on international business, we have attempted to keep in mind the needs of the manager in understanding problems related to management and organizational behaviour in many different organizations. In doing so, we have developed the themes around the concepts of international business environment, international business and global strategies. Obviously, how well a job we have done will be determined by you, the reader, as you go through the materials herein. We would be most grateful for critical comments and constructive suggestions so as to continually improve and refine the learning resources and educational value of this textbook.

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How This Book Is Organized

This book is divided into seven units:

Unit 1

This unit describes international business and gives an overview of the concept of international business. It also explains the importance of international business in the world economy. In addition, this unit explains the process of development of international business and the future of international business.

Unit 2

This unit explains the issues of the international business environment. It also describes the role of political, social and ethical environment in international business.

Unit 3

This unit explains the concepts of foreign exchange market and foreign exchange rate risk. It throws light on the lactoro affecting currency trading and exchange rate quotations.

Unit 4

This unit describes the basic concept of strategy related to business. It also describes many global strategies that are used to enter into the global market. In addition, this unit explains different experiences related to the globalization of Indian companies.

Unit 5

This unit introduces the concept of mergers and acquisitions in the modern industry. It also describes the process of merger and various issues related to it. It also explains acquisitions and how they benefit the shareholder. In addition, this unit explains the merger process on the global front and in the regional industry.

Unit 6

This unit explains how organizations can build up their brands in the international market. It also discusses the behaviour of the customers in the international market. In addition, this unit explains the behaviour of organizations in the international market.

Unit 7

This unit explains how the global distribution system can be used by organizations to distribute their products in the international market. It also discusses supply chain management and various methods through which the goods are supplied. In addition, it explains the role of transportation in the global distribution system.

Unit 8

This unit explains globalization. It also describes the various levels of globalization and the approaches used for defining globalization. In addition, this unit examines the drivers of globalization.

MODULE - 1

UNIT 1 INTRODUCTION TO INTERNATIONAL BUSINESS

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1.0 INTRODUCTION

The globalization of organizations has given rise to various issues regarding international business. International business is defined as the execution of business transactions beyond the local country. International business is growing day by day. No organization in the world is able to produce all the products independently. They have to bed dependent on other countries either to import raw materials or export finished goods. Domestic organizations have to pass through a number of stages to become international organizations. These stages can be trade, assembly and integration. However, the organizations have to face a number of problems in carrying out business activities.

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1.1 UNIT OBJECTIVES

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

- Explain the concept of international business and international marketing
- Describe the importance of international business
- Understand the difference between international business and domestic business
- Explain the development of international business
- Explain the future of international business

1.2 CONCEPT OF BUSINESS

Just like a human being functions with limbs, corporations or companies functions through their businesses. The term 'Business' can be broken as

'Busy-ness' meaning thereby an activity that keeps an individual busy. In the economic sense, the creation of utility is called business while in the commercial sense, activities concerned with purchase and sale of goods and services are called business. Business includes that part of production that is equally exchanged and results in mutual benefits to the parties who exchange goods in the transaction.

1.2.1 Business Definitions

According to Lewis H. Haney, 'Business may be defined as a human activity directed towards producing or acquiring wealth through buying and selling goods.'

According to Peterson and Ploughman, 'Business may be defined as an activity in which different persons exchange something of value, whether goods or services, for mutual gain or profit.'

According to James Stephenson, 'Business is the sum total of those processes which are engaged in the removal of hindrances of persons (trade), places (transport and insurance) and time (warehousing) in the exchange (banking) of commodities.'

According to F.C. Hooper, 'Business means the whole complex field of commerce and industry, the basic industries, processing and manufacturing industries and the network of ancillary services, distribution, banking, insurance, transport and so on, which serve and interpenetrate the world of business as a whole.'

According to section 2(13) of the Indian Income Tax Act, 1961, Business means 'any trade, commerce or manufacture or any adventure in the nature of trade, commerce or manufacture.'

1.2.2 Nature of Business

Business is a wide term. It includes all occupations in which people are engaged in earning income by production or purchase, sale and exchange of goods and services to satisfy the needs of people and earn profit.

The following points may be discussed to reveal the true nature of a business:

- **Economic activity**: Business is an essential economic activity. Profit motive is the key element that inspires a businessman to work efficiently.
- **Human activity**: Business is a human activity. In this sense, business is considered to be an economic activity of human beings only. A business is by the people and for the people.
- **Social process**: Business is a social process. All individuals involved in a business such as owners, customers and employees are an integral part of society. Business has to fulfil its social responsibilities.
- **System**: A system is a combination of things or parts forming a unitary whole. It is an established arrangement of components for the attainment of objectives. Similarly, business is a system consisting of various sub-systems that are operated in a balanced and coordinated way.

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1.2.3 Types of Business Activities

All human activities concerned with the earning of money are included under the term business. Cultivation by a farmer, teaching by a teacher and treatment taken by a patient from a doctor are also treated as business activities.

There are different types of business activities that may be classified as follows:

- **Industry**: An industry includes the activities connected with producing and processing of goods. Manufacturing enterprises are engaged in the production of goods. These kinds of industries can be classified as follows:
  - o **Analytical enterprises**: An oil refinery that separates crude oil into petroleum, kerosene and diesel oil is an analytical concern.
  - o **Synthetic enterprises**: An enterprise that combines several materials to produce one product is a synthetic enterprise. All soap and cement factories are synthetic enterprises.
  - o **Assembling enterprises**: All those plants engaged in the production of products such as radios, scooters and television sets are assembling enterprises.
  - o **Mining enterprises:** All those enterprises engaged in the production of mineral resources such as coal, iron ore, silver, gold, are mining enterprises.
- **Commerce**: It is the sum total of all those activities that are engaged in the removal of hindrances of persons or trade, places or transportation, risk of loss or insurance and time including warehousing in the exchange such as banking and financing of commodities. Commerce can be divided into two categories—trade and aid to trade. Trade can be further divided into two categories which are as follows:
  - o **Internal**: It includes the trade which is done within the country such as wholesale and retail trade.
  - o **External**: It includes the trade which is done across various countries such as export, import and trade.

  Aid to trade can be divided into transport, banking and insurance.

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Figure 1.1 shows the types of business activities.

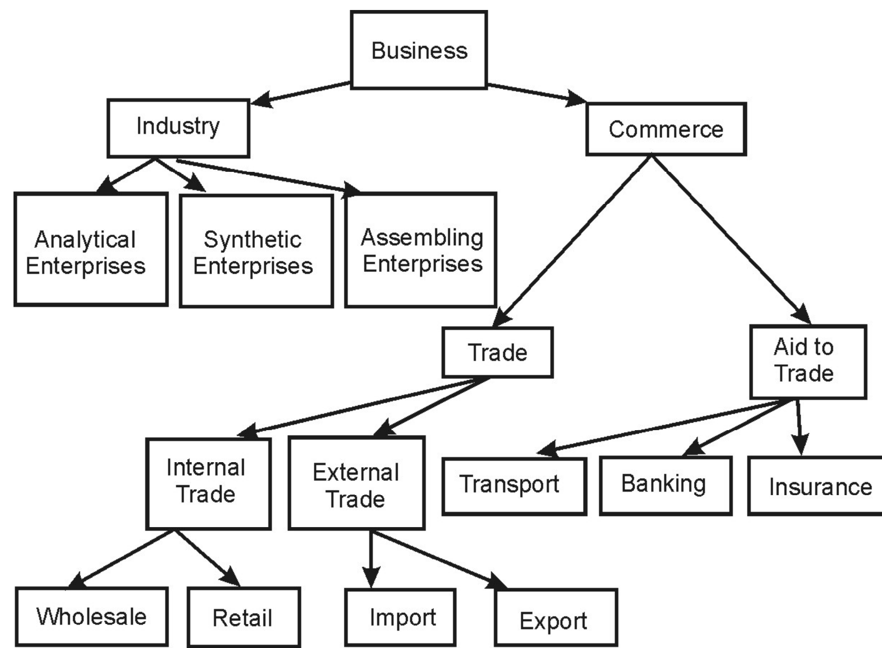

Figure 1.1 *Types of Business Activities*

1.2.4 Characteristics of Business

Business means creation of utilities. The essential characteristics of business may be summarized as follows:

- **Exchange or sale**: A business includes sale, purchase and exchange of goods and services.
- **Creation of utilities**: A business creates transfers and utilities of goods by making them available in proper form at the appropriate time and place.
- **Social institution**: A business deals with the people in a society. All the persons engaged in the business such as owners, customers, employees and other professionals belong to the society. A business has to fulfil its social responsibilities towards each part of the community and follow business ethics as well.
- **Profit motive**: Business activities are carried out to make profit. A business that does not earn profit cannot survive for long. Profits are essential for the growth of a business.
- **Risk and uncertainty**: There are two types of risks in a business. The first type of risk is floods and thefts. The second type of risk is loss due to fall in demand and labour trouble.

  Uncertainty arises because of unpredictability of profit in a business. Profit is such an element which cannot be predicted in advance.
- **Customer satisfaction**: A business always tries to satisfy its customers with better quality and reasonable prices.

1.2.5 Business Goals

The term 'goals' denotes what an organization expects to achieve in the future. A goal describes clearly the activities and tasks to be completed by an individual, a department or an organization. A business has a number of goals which describes a desired future state to which all the efforts are directed. The goals are like a measure to evaluate the success of a business. It helps the management to keep the organization and the individuals working for it away from distractive activities that are hindrances in the success of an organization.

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Characteristics of business goals are as follows:

- Business goals are derived from mission statements.
- Business goals are task-oriented and, therefore, they must state as to what is to be achieved by an organization.
- Business goals are short-term in nature.
- Business goals are challenging as they challenge the individuals who are responsible for its attainment.
- Business goals must specify the conditions that are necessary for the attainment of the organizational goals.

1.2.6 Objectives of Business

Objectives are needed in every field where performance and results affect the survival and prosperity of a business. Success in a business cannot be achieved without the proper selection of objectives. The structure, direction and management of a business closely depend upon its objectives. However, some of the important objectives are as follows:

- **Economic objectives**: Profit earning is the most important objective of a business. Profits must be earned by business to provide for its own survival, coverage of risks, growth and expansion. It is a necessary motivating force and it is in terms of profits that the efficiency of a business is measured. All the business activities are performed to achieve the following economic objectives:
    - **Incentive**: Profit is the biggest incentive for work. It is the driving force behind the business enterprise. It encourages a man to work to the best of his ability and capacity.
    - **Survival**: Profit is essential for survival of a business. In the absence of profits, an organization will not be able to survive. It also helps in replacing obsolete machinery and equipment and thus ensures the continuity of a business.
    - **Growth**: Stagnation is the biggest setback for any industry. The prosperity and continuity of an industry largely depends upon its growth and expansion.
    - **Measurement of efficiency**: Profits measure the performance of the business. It is the accepted yardstick for the evaluation of the efficiency of the business.
    - **Prestige**: A loosing business concern carries no goodwill. Higher profits not only provide economic power and status to the businessman but also improve the creditworthiness and bargaining strength of a business.

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- **Social objectives**: The purpose of a business is not only earning profits but also discharging responsibilities towards the society as well as employees. These objectives are as follows:
  - o **Service to society**: A business must serve society by considering the following factors:
    - – **Better products**: Customer satisfaction is the backbone of a business. Therefore, a business must ensure the supply of better quality of goods and services to its customers.
    - – **More employment**: A business provides employment opportunities to the members of the society. This is very important especially in the developing countries like India where the pressure of population is high and thus unemployment prevails.
    - – **Better environment**: No business can survive for long if it is harmful to the society. It must not cause any type of air, water or noise pollution. All efforts must be made to reduce the adverse effects of business on the quality of life. Men, animals and birds must also be protected from industrial pollution of the environment.
    - – **Better living standard**: Good employment opportunities, good quality of products, better services improve the living standard of the people.
  - o **Service to employees**: A business must serve its employees by considering the following features:
    - – **Fair wages**: Social justice requires that employees must get fair remuneration for their work. Besides, if the employers acknowledge their contribution, the employees would be satisfied and work more honestly.
    - – **Growth and promotion**: The work of the employees must be acknowledged and they should be given adequate training to improve their skill and performance so that they are ready to accept better and challenging responsibilities in an organization, if offered.
    - – **Partnership in the prosperity of business**: Employees should not be considered servants in an organization. Their contribution must be given due recognition. They must be allowed to share the prosperity of the business either by sharing of profits or capital.
- **Human objectives**: Production process consists not only of materials, machines and land, but also the workers working for the organization. Different human objectives can be listed as below:
  - o Fair wages, bonus, dearness allowance, provident fund, medical, educational and other facilities to the employees
  - o Workers' participation in the management
  - o Encouragement of creativity, initiative and provision of growth opportunities for the employees
  - o Job satisfaction and other provisions to raise the morale of workers
  - o Congenial working conditions
  - o To provide security of employment to workers
  - o Profit sharing schemes for the workforce

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- **National objectives**: Apart from the other objectives, there are also some national objectives which are as follows:
  - o Ensuring social justice
  - o Development of skilled personnel
  - o Development of small entrepreneurs
  - o Export development
  - o To abide by laws passed by local, state and central governments

1.2.7 Role of Objectives

Business objectives play a very significant role in strategic management. It helps the management in the following ways:

- Objectives are the base of strategic decision making. They do so by directing the attention of strategists to the areas where decision making is required and also by coordinating the individuals' behaviour towards strategic decision making.
- Objectives help in providing the standards with which the overall performance of both the individual as well as the organization can be judged.
- Objectives also define the relationship of an organization with its environment. This helps the organization to take into consideration what is needed to be achieved for its employees, customers and the organization itself.
- Objectives also help the organization define its vision and mission statements.

1.2.8 Responsibilities of a Business Towards Various Interest Groups

Different interest groups consist of persons connected with business such as consumers, shareholders and community. The responsibilities of a business towards various interest groups are as follows:

- **Responsibilities towards consumers**: A consumer is a person who determines what goods shall be produced and whether they should be sold in the market or not. Consumers not only determine the income of the business but also affect the success and survival of the business. Therefore, a business has some basic responsibilities towards the consumers that are as follows:
  - o To produce those goods that meets the needs of consumers of different tastes, classes and purchasing powers
  - o To establish lowest possible price with efficiency and reasonable profit to the business
  - o To ensure fair distribution of products among all sections of consumers
  - o To make the product more satisfactory to consumers through the study of consumers' needs
  - o To handle consumers' complaints more carefully and analyze them properly
  - o To answer consumers' enquiries related to the company, its products and services
- **Responsibilities towards shareholders**: The basic responsibility of a business is to ensure safety of investment and higher rate of return on the investment. Owners of a business may be proprietors, partners or shareholders. Interest of shareholders is to participate in the management and get regular dividends at the

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appropriate rate. It is, therefore, the responsibility of the management to improve the communication between the company and its shareholders. This can be done by providing maximum information to the shareholders through newsletters, annual reports or by holding the annual general meeting of the company at an appropriate time and place so that the maximum number of members can come and participate in the discussions.

- **Responsibilities towards the community**: Management has the responsibility of informing the community about organizational policies, activities and contribution towards the betterment of society. The various other responsibilities towards the community are as follows:
  - o Financial help to the municipal and district boards for the improvement of housing conditions
  - o To help the community by aiding hospitals, schools, colleges, religious and similar institutions.
  - o To organize community forums and group discussions to promote better understanding of national and local affairs
  - o To encourage sports and provide recreational facilities

1.3 OVERVIEW OF INTERNATIONAL BUSINESS

International business can be defined as the business activities or transactions that are carried out beyond the national border. However, not all business activities crossing the national border can be considered international business. For example, an organization importing some raw materials or items from a foreign country that are not available in the domestic country can not be considered an international business firm. The level of internationalization is very small in this example. On the other hand, an organization importing the inputs from a foreign country even though they are available domestically can be considered an international business firm. Therefore, the environment and the purpose of business activities differ and thus the level of internationalization of firms also differs. Organizations that import and export their inputs and outputs domestically and globally can also be considered international business firms. This is because the decisions of importing and exporting the inputs and outputs are the result of global sourcing.

International business can occur in different modes. These modes of international business can be exporting, licensing, contract manufacturing, foreign assembly, foreign production, joint venturing and others. A joint venture is a term in business which refers to combining two or more parties to participate in financial activities. These parties create a new entity by contributing equally economically. The level of internationalization in an organization also depends on these modes. Many domestic products manufactured by organizations can also be considered international products if the parts or components of these products are manufactured in foreign countries. The term international business not only refers to international business of goods and services but also Foreign Direct Investment (FDI). The term FDI consists of a parent firm and a foreign partner that combine to form a transnational corporation. A transnational corporation, also known as Multinational Corporation (MNC), carries out its business activities in at least two countries.

Check Your Progress

1. State how business was defined by Peterson and Ploughman.
2. What does the term 'goal' denote?

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1.3.1 International Marketing

International business also contains an indispensable term known as international marketing. The term international marketing should not be confused with international business. Different definitions of international marketing are given below:

According to Hess and Cateora, 'International marketing is the performance of business activities that direct the flow of goods and services to consumers or users in more than one nation.'

According to Walsh, 'International marketing is the marketing of goods and services across national frontiers.'

International marketing is the marketing function of multinational organizations.

The most relevant factors affecting international marketing are:

- **Social factors**
  - o Culture of the country
  - o Language of the country
  - o Environment and climate of the country
  - o Marketing infrastructure
  - o Financial system
- **Economic factors**
  - o Currency restrictions of the country
  - o Government policy
  - o Taxation
  - o Internal demand management policies
- **Opposition**
  - o Opposing organizations in the importing country
  - o Opposing organizations in competing countries
  - o Opposing organizations in own country
- **Logistics**
  - o Costs of planning and controlling the movement of goods
  - o Transport required
- **Risks**
  - o Political and commercial risks
  - o Risks from enemies, thieves and piracy

1.3.2 Comparison of International and Domestic Marketing

International and domestic marketing are two different concepts. However, there are some points of similarities between them. These points are:

- Both aim at satisfying the needs of their customers. Both try to find out the needs and requirements of their customers and plan a strategy to fulfil their needs.
- Both of them aim at building friendly relationships with their customers. A friendly environment makes it easy to implement the organizational strategies in domestic and international marketing. In order to increase sales, it is necessary to provide guarantees and after-sales services for products to customers.

- Both should have their own research and development centres for the continuous improvement of their products.

The various differences between international and domestic marketing are:

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- **Independent political entities:** Each country in the world is an independent political entity and the organizations in these countries carry out their international business activities. Such organizations have to face a number of problems. Some of them are:
  - o Custom duties: Custom duty is applied on imported goods from a foreign country. The custom duty makes the product very expensive. Organizations with weak economic systems sometimes find it difficult to import expensive goods.
  - o Quantitative restrictions: These restrictions are applied on the goods to protect domestic industries.
  - o Exchange controls: Exchange controls are the various controls that are applied by the government on the import/export business. Some of these controls can be the use of foreign currency in the country, amount of money that can be imported or exported and the fixed exchange rates.
  - o Local taxes: Local taxes applied on foreign goods are used to make them costlier than domestic goods in order to promote the domestic goods.
- **Different legal systems:** The legal systems of countries across the world differ from each other in many respects. Some countries follow the English Common Law and some countries follow the civil law. Some European countries have developed their own legal systems to make the life of businessmen comfortable. Incoterms and Uniform Customs and Practices on Documentary Credits developed by the International Chamber of Commerce tries to bring about a consistency between the different legal systems of different countries.
- **Different financial systems:** The financial system and exchange values of countries differ from each other. Some countries also use different exchange rates for different business transactions. However, the International Monetary Fund tries to build some rules to bring about a consistency between the different financial systems of different countries.
- **Different market characteristics:** The market characteristics of countries also differ from each other. Market characteristics can contain the demand pattern, distribution modes and promotion methods. However, market characteristics can also differ within the country. Countries like India and USA have different characteristics in their different states.
- **Different procedures and documentations:** Procedures and documentations are the rules and regulations to carry out the business activities. Each country has its own rules regarding the import or export of products from foreign countries by their organizations.
- **Cultural differences:** Organizations have to carry out international business in a cross-cultural environment. The marketer of a different country has to adjust himself to the foreign environment to promote his products. Culture can also be divided into two categories—low-context culture and high-context culture. Low-context culture prefers written communication rather than interpersonal and

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business relationships. However, high-context culture gives importance to interpersonal and business relationships. Therefore, even the oral word is enough to show commitment in a high-context culture. Countries like India have high-context culture because most of the business transactions in India are carried out verbally. The different characteristics of culture can be:

- o Culture can be instinctive.
- o Culture is persistent and interrelated.
- o Culture is shared by all the members of the group.

1.3.3 Problems in International Marketing

International marketing and the domestic marketing look very different from each other. However, the basic principles of both are the same. International marketing differs from domestic marketing only in the environment in which they are carried out. International marketing faces more problems and difficulties than domestic marketing. Some of the problems faced by international marketing are:

- The distinct legal and political system of countries is one of the problems for international marketing. The legal system can be different within a country too. Each country has different legal system in terms of civil law, common law and religious law.
- Cross-cultural environment of countries is another problem for international marketing. However, domestic marketing also faces such problems.
- Financial systems can differ from country to country.
- Currency units also vary from country to country. This poses problems in exchange rates.
- Language can also create problems for the marketer. Same words or terms may have different meanings in different languages. The language problem is a major issue in India.
- Market infrastructure of countries can differ from each other. The advertisement mediums used in one country may not be available in another market.
- Import restrictions imposed by countries on international marketing are another problem.
- The cost of transportation can be very high in carrying out international business transactions because of the large distance between the countries.
- Custom duties and taxes may also cause some problems in international marketing.

1.3.4 Importance of International Business

International business is the private or governmental business activities involving two or more countries. The role of international business has become significant at the macroeconomic and microeconomic levels. All the countries in the world depend on other countries to import or export something. No country in the world is able to produce all goods or products by itself. These countries need to import items that cannot be produced domestically. These countries also try to export their items to foreign countries to make a balance of payments in the import and export goods.

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Many companies all over the world performing international business activities are involved in the export and import of products. Export involves the logical process to understand the environment and structure of the target country, developing a plan based on the country's structure, implementing the plan using the formulated strategy and using a control method to ensure that the plan is consistent with the strategy.

International business allows companies from various countries to interact and form an international network to get business-related advantages in the global market. Foreign Direct Investment (FDI) plays an important role in building an international business network. FDI organizations assist economically weaker partners financially. The FDI has certain aims that include acquiring natural resources, research and development expenditures recovery and earning large profits. International business also helps countries fulfil their needs. The organizations in a particular country can import the products from other countries that they cannot produce domestically. International business also helps in building good relationships between countries. The organizations performing international business activities are also able to improve their competitiveness. Therefore, the organizations have to be global in the areas of production and marketing to be a successful participant in the globally competitive environment. The organizations have to pass through different stages before becoming successful in the international business area.

1.4 INTRODUCING THE MULTINATIONAL FIRM

A firm is said to be a multinational firm or Multinational Corporation (MNC) if it is the owner and controller of enterprises in more than one country. In a broader sense, a firm is said to be a multinational firm if its foreign-related operations affect its total revenue and its foreign export affects its internal management decisions. A multinational firm always involves international financial markets and foreign manufacturing and distribution activities. The environment of a multinational firm encompasses different areas such as political, economic, social and legal and it has to operate in the international financial system. These different areas depend on the political, economic, social and legal policies of that country in which the firm is established. The physical and cultural environment of the country also affects the environment of multinational firms. This means the environment of a multinational firm is dependent on various conditions in more than one country.

1.4.1 Environment of a Multinational Firm

The environment of a multinational firm is significantly different from the environment of a domestic firm. Generally, a domestic firm operates in a single political, economic, physical, cultural and legal environment. However, apart from operating domestically, a multinational firm has to operate in the international financial system. Here the host countries in which the multinational firm is operating have their own environment depending upon their politics, economics and legal systems. In other words, unlike domestic firms, a multi-national firm has to operate in multiple political, economic, physical, cultural and legal environments. Moreover, while functioning, a multinational firm also needs to consider the international financial environment. Figure 1.2. shows the environment of a multinational firm.

Check Your Progress

3. What is international business?
4. List the factors that affect international marketing.

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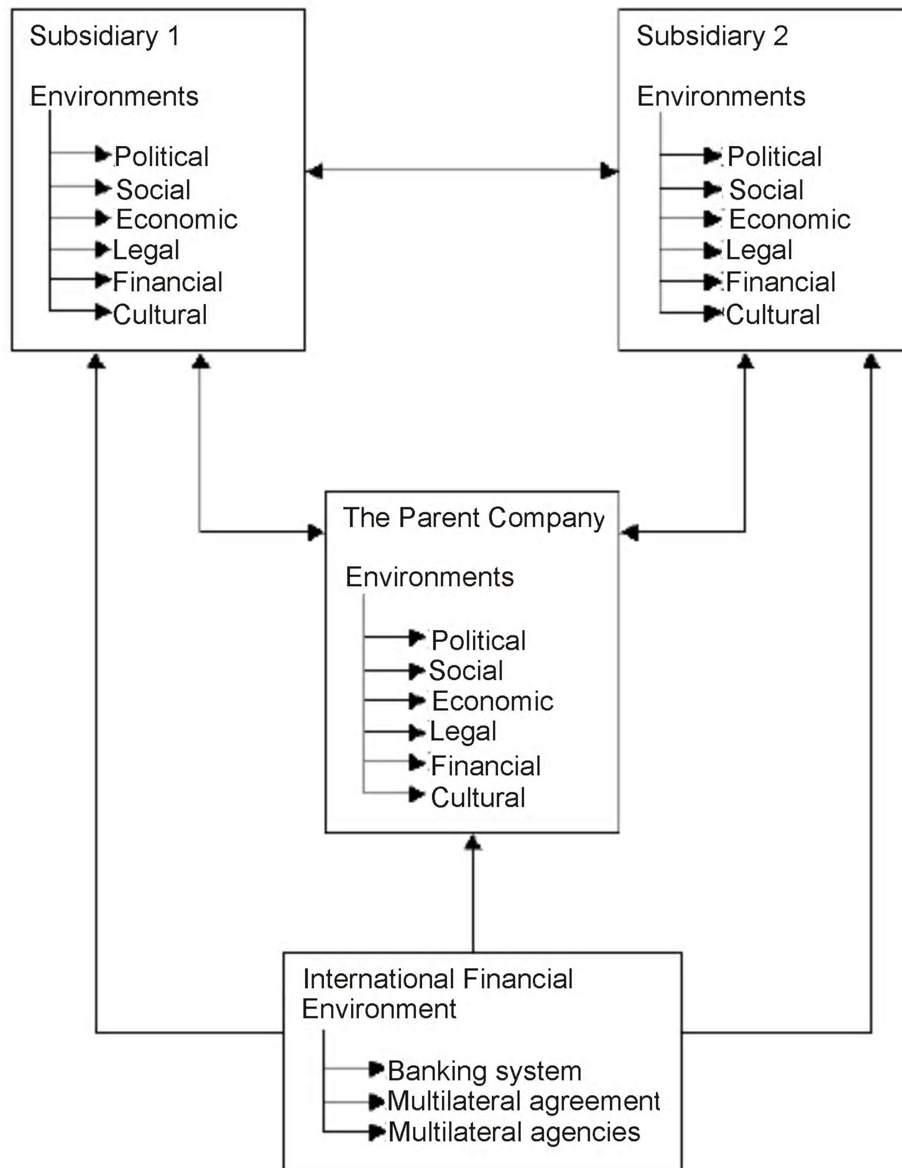

Figure 1.2 *The Environment of a Multinational Firm*

1.4.2 Challenges of a Multinational Firm

Since a multinational firm operates in diverse environments, the finance manager of the firm encounters a large number of challenges. They include:

- **Complex taxation systems**: Multinational firms, operating in different economic systems with their subsidiaries, have to come across multiple tax systems. The diversity of taxation affects the profitability of the multinational firm and it becomes a tedious job for the finance manager to perform decision-making tasks in such complex situations.
- **Diverse financing mediums**: A multinational firm has various sources of financing. However, some of them, coming from the economy in which the firm is new, may generate market-prone risks. This can be due to some specific risks pertaining to the economies that cause the decline in the profitability of the firm.

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- **Political risk**: Multinational firms, while investing in a country, are prone to the political risks of that country. The major political risk faced by them is expropriation. It is, therefore, necessary for the firms to carefully analyze the investment ratings of the countries before they invest.
- **Risk of foreign exchange**: Multinational firms may also face foreign exchange risks which mainly occur due to fluctuations in the exchange rates. The fluctuation in the exchange rate affects the values of the assets, liabilities and transactions that are dominated by foreign currency.
- **Diversity in physical environment**: Multinational firms also face challenges due to its diverse physical environments. This hampers standardization of products, procedures and management styles of a multinational firm. The weather and the landscape of the locations may also affect the performances of the individuals of the firm.
- **Conflicts with host country environment**: Most multinational firms face conflicts with the environments of the host countries due to differences in the goals and objectives of the firms with those of the host countries. The goals and objectives of the firms tend to bring profits to their parent companies, while those of the host countries aim at the preservation of the foreign exchange. Some of the prominent causes behind the conflict of a multinational firm with the host country are:
    - o Objectives and policies regarding economic development
    - o Monetary policies and credit restraints
    - o Fiscal and taxation policies
    - o Policies for labour and employment
- **Ethical conflicts**: A multinational firm faces ethical conflicts when it tries to violate the existing code of ethics or behaviour of its local environment.

1.4.3 Opportunities for a Multinational Firm

Although the finance manager of a multinational firm has to face a lot of challenges in terms of environmental and organizational conflicts, there are several opportunities that provide the firm with an edge over other domestic firms. Some of these are:

- **Multiplicity of tax systems**: Multinational firms carry out their operations in different countries and thereby come across the different economies. The different tax structures make the firm work in an environment of multiple tax systems. This multiplicity of tax systems is very helpful in reducing the tax burden for the firm as it can delegate its income in a higher tax region to another region having a lower tax structure.
- **Diversity of medium of financing**: There are various forms of financing mediums that are available to an MNC. An MNC can make use of these to avoid the regulation of the stock market to disclose its financial statements. An MNC can also organize funds through the various depositories such as American Depository Receipts (ADRs) and Global Depository Receipts (GDRs). It depends on the efficiency of an MNC to use these various financing forms effectively. Therefore, it provides an opportunity to the MNC to reduce cost of capital.
- **Diversity in currency and institutional environments**: An MNC operates in different countries and with various currencies. This allows it to increase its profits and reduce fluctuations in cash flows. The institutional diversity provides an

opportunity to possess the required capital with soft conditions because an MNC has larger options available with it.

- **Diversity of physical forces**: When an MNC carries out its operations in diverse countries, it comes across different physical forces such as landscapes, climates and human resources. An MNC can use these physical forces to its advantage.
- **Varied capital markets**: MNCs operate in different nations and diverse capital markets. These provide an opportunity to the MNC to minimize the cost of capital. If there was only one capital market, it would have been difficult for the MNC to collect capital for its projects.

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1.5 DEVELOPMENT OF INTERNATIONAL BUSINESS

Every organization wants to become an MNC. Domestic organizations have to pass through different stages to become an MNC. Figure 1.3 shows the three stages of development.

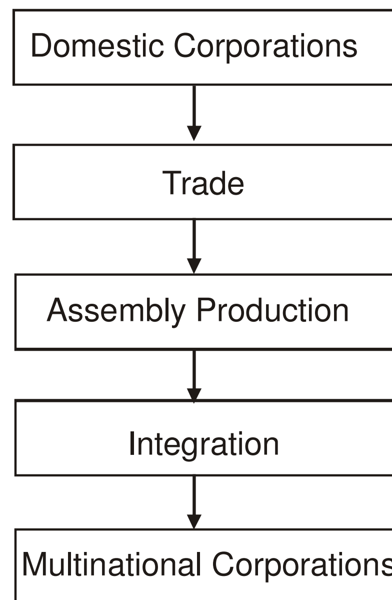

***Figure 1.3** Various Stages of Development of International Organizations*

- **Trade:** Some organizations are able to produce products and goods that have worldwide demand. Therefore, these organizations export their products to foreign markets. This is the first stage of development of international organizations. These organizations in the beginning use a marketer to deal with foreign markets. But after some time, when it becomes a regular phenomenon, the organizations can create their own export department to replace the third person interruption. The organizations can also set up their own subsidiary branches in different countries to carry out international business activities. These subsidiary branches in different countries act as an advertisement medium and help the organizations grow their business by informing them of the changing needs of the customers.
- **Assembly or production:** The products manufactured in the local country and exported to the foreign market are very costly. The high cost of the exported

Check Your Progress

5. When is a firm considered multinational?
6. Name three challenges faced by a multinational firm.

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products is due to the different taxes applied on the product as well as the transportation cost. Therefore, some organizations decide to manufacture these products in the importing country to avoid different taxes, tariff and transportation cost. This is the second stage of the development of the multinational firm.

- **Integration:** The organizations integrate the activities of their different units operating in different countries. These organizations distribute money and materials among their different units in different countries to maintain the level of productivity. This technique helps them increase total profit. The implementation of different management functions such as finance, marketing, production and personnel also requires the integration of different units of the organization in different countries.

1.5.1 Factors Leading to Growth of International Business

Domestic organizations desire to go international in order to increase their sales and profit. There are some other factors that force the domestic organizations to expand their activities in the international market. They are:

- Technological development
- Emergence of supportive institutions
- Competition from other organizations
- Development of financial policies for different countries

There has been a great advancement in the fields of process technology and information technology over the past few years. Organizations all over the world are using advanced technologies to manufacture products in less time and of better quality. The developed technology used by the organizations sometimes requires a larger market than the domestic market. Therefore, the organizations try to expand their business activities all over the world. The advanced technological development also brings the different countries closer and allows organizations to export their products to foreign markets with minimum effort.

There are many institutions that help domestic organizations become international organizations. The International Bank for Reconstruction and Development assists different domestic organizations financially to help them develop as international organizations. There are many financial institutions in other countries that help domestic organizations overcome the financial difficulties they face in carrying out their business activities. The American aid programme also helps US organizations expand their business in other countries by providing necessary infrastructure.

Structural adjustment and macroeconomic improvement are some other factors for the growth of international business. Macroeconomics is the area of economics that considers the performance, structure and behaviour of the financial system. Structural adjustment is a term that is used to represent the different policies applied by the International Monetary Fund (IMF) and the World Bank. These polices define the conditions, rules and regulations for getting loans from the IMF and World Bank.

The growing competition between different organizations operating in different countries is also another major reason for the growth of international business. Competition is a term used in business which means that organizations vie to defeat each other in terms of income, profit, pride and dominance. This competition forces organizations to import economical raw materials and semi-finished goods from foreign countries and export their finished goods to foreign markets to earn more profit than they can in

domestic markets. These organizations also set up their independent units in different countries to minimize the cost of operation and financial risk. Thus, the aim of cost minimization, risk reduction and more profit leads domestic organizations to go for the process of internationalization of business.

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1.6 COMPARISON OF DOMESTIC AND INTERNATIONAL BUSINESS

Businesses can be domestic or international. International businesses carry out their activities or transactions across the boundaries of the nation. Domestic businesses carry out activities within the boundaries of the nation. International businesses also face more problems and complexities than domestic business. Some of the problems faced by the international business are cross-cultural environment, differences in legal, political and financial systems and different market infrastructures.

Business transactions in international business are intra-firm. Intra-firm business means the flow of finished goods, intermediate goods and raw material between the different supplementary arms of the same firm. Therefore, the cost of the products manufactured by these international business firms is more than that of the domestic firms because of the transportation cost and extra taxes such as custom duty and different tariffs.

Also, international business activities or transactions are carried out in unusual conditions. These conditions can affect the way of conducting international business. Countries differ in their political and legal aspects and impose certain conditions, rules and regulations on conducting international business activities. Domestic business activities are free from these restrictions because they are carried out in the same infrastructure and environment and within the same rules and regulations.

The strategies formulated by organizations carrying out international business activities can be different from organizations carrying out domestic business activities. The strategy formulation for international business is not an easy task because of the different environments and cultures of the organizations. The strategy formulated for one country may not suit the culture and environment of other countries. Therefore, the management of the organization has to take care while formulating the strategy. However, domestic businesses can propagate with a unique strategy that could not be very difficult to formulate for the management. If the strategy formulated by the organization conducting international business does not suit the legal, social and financial environment of the host country, then many conflicts can arise between the organization and the host country. Sometimes, some organizations find them successful in imposing their own business principles on the host country environment. But in many cases, this strategy of the organization creates further problems. For example, the child labour in a country like the USA is prohibited, but in India, most business firms are carrying their business activities using child labour. Therefore, an organization of the USA has to adjust its strategy while conducting international business in India. Similarly, the Indian firms have to adjust their business strategies in carrying out business transactions abroad. Therefore, there are many cases in which conflicts can arise and the management has to do a lot of hard work to overcome these types of conflicts.

International business also faces certain types of risks. Political risks are one of these risks that international business can face. Political risk means value of the investment

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can be affected by the government of the host country. The foreign firms may have to provide some compensation to the government to execute their business. The other type of risk may be the exchange rate risk. This includes international transactions such as export and import, borrowing and lending and receipts and payments. These factors can increase the risk for the organizations and therefore, the firms should be alert to these risks. Domestic business is free from all these risks.

The management functions including finance and accounting, personnel, marketing and production of the international business can differ from the management functions of the domestic business. The international business has to implement International Human Resource Management (IHRM). P.V Morgan defines International Human Resource Management as the result of interplay between human resource activities, types of employees and countries of operation. IHRM faces the challenge of operating in various countries and employing different national categories of workers. The currency level of the countries can also differ and therefore, the international firm has to take some critical decisions about the domestic currency and host country currency and has to resolve the problem of foreign exchange rate and foreign exchange market. Foreign exchange market is a global market in which traders buy and sell currencies using different communication mediums which include telephone, Internet, telex and computers. The marketing strategy of the international firm also differs from the marketing strategy of the domestic business because the marketer has to adjust in the cross-cultural environment. These different decisions make international business really very complex.

1.6.1 Factors Changing Domestic Business to International Business

There are many factors that are responsible for the transition from domestic to international business. Some of the factors can be:

- Export behaviour of the organization
- Export business decisions
- Commitment
- Producing for export

Export Behaviour of the Organization

Every organization starts its business as a non-exporter. There are many reasons that force an organization to go for export business. Some of these can be:

- **Characteristics of the organization:** The characteristics of the organization can be measured in the following terms:
  - o Products and goods manufactured
  - o Size and growth
  - o Production capacity
  - o Capacity of the organization to export products
- **External export encouragement:** This contains the external market conditions of the organization. It may include:
  - o Market opportunity
  - o Encouragement from government
  - o Accidental orders

- **Internal export encouragement:** This includes the analysis of the effect of export on the business of the organization. It may include:
    - o Level of profits
    - o Growth objective
    - o Capacity utilization
- **Organizational commitment:** The decision-makers of the organization must agree upon the export commitment level. These managers must make decisions about the resources that can be used for the implementation of the international business. These resources may be used for implementing different managerial functions.

Export Business Decisions

There are many things that can affect export business decisions. Some of them are:

- **Level of profit:** The rate of profit from the export business must be higher than in domestic business.
- **More domestic demand:** Export businesses can also be used to fulfil the domestic demand of the products. This can minimize the cost and increase the profitability of the organization.
- **Reducing business risks:** Business decisions should be made to reduce the risks that can arise in conducting international business activities.
- **Legal restriction:** The government of the country can impose certain legal restrictions on the growth of the firm. The management has to make decisions to overcome these legal issues.
- **Increased productivity:** Every organization needs to increase its productivity. Therefore, some organizations want to go for international business to increase productivity.

Commitment

The organizations must show their commitment to carry out international business activities. It can contain four distinct categories. These are:

- **No involvement:** Sometimes, organizations do not advertise their products. Foreign buyers themselves come to the organizations and purchase the products to fulfil their requirements.
- **Temporary involvement:** The organization can be involved in international business to exploit temporary excess capacity.
- **Continued involvement:** The organizations need complete involvement when they are serious about implementing international business. The managers of the organizations have to visit foreign countries to look after the organization's interests.
- **Global involvement:** The organization with global involvement becomes a fully international organization that has to carry out the actual international operations by establishing a number of branches in different countries.

Producing for Export

An organization may set up operations to satisfy foreign demand. This is the case when companies have higher production to satisfy the needs of domestic users as well as the

temporary demands of foreign users. This type of business is more successful in India because Indian labour is highly skilled and labour costs are lower than other developed countries.

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1.7 THE FUTURE OF INTERNATIONAL BUSINESS

The globalization of organizations is not a new concept in business history. Many organizations in the sixteenth and seventeenth centuries started their business internationally. But the growth of international business started heavily in the late 1940s. In this period, American companies were well developed and needed new sources of raw material. These companies also wanted to retain and expand their share of the world market. Around 1960, many European companies also started international business and decided to make their organizations global. However, during this period the concept of international business was not very famous in the Indian economy. But with the passing of time the advantages of international business have become visible to the organizations and almost all organizations of the world have decided to expand their business internationally. Many organizations got success in this arena. But the question arises about the future of the international business. Many advantages such as profit, pride and dominance in world business forces organizations to go for international business and this shows that many domestic organizations can become international organizations in future. But there exist some critical points that mark a question on the future of international business. Factors such as social, economic, opposition, logistics and risks can force the organization to think about the international business. The governments of different countries are applying different taxes and custom duties to make foreign products costly and promote their domestic products. This can also be one of the reasons of demotivation for the organizations to carry out international business activities.

A special article on globalization appeared in an issue of the *Economist* in 2002. This article demonstrated the continuous fall in the big economies of the world and in some other emerging economies too. There is a continuous decrease in the cross-border flows of goods and capital that deaccelerate the economic integration too. The attack by terrorists on the World Trade Centre in USA also left an impact on the global interconnections. Some opponents at that time said that this was the end of the globalization. Economists also found some evidence of decline in the global economic integration. The article also depicts an important point that globalization is not global because very few countries of the world are contributing to the large proportion of trade and investment.

Many economists described that there will be a continuous fall in the world economy. The slowdown of economy also shows less consumption and production that affects the domestic and international trade investment. The 9/11 terrorist attack on the World Trade Center was considered the major cause for the decline in the world economy. This attack slowed down international trade and investment and caused the decline in international travel of people, higher costs of insurance and security and closer analysis of international financial transactions. The economic collapse of Argentina also raised some questions about the future of international business.

However, despite the economic slowdown and other events, the concept of globalization is growing at a high rate though there is no guarantee of its growth in future. Some factors like the advanced technological development, competition from other organizations, supportive institutions and development of financial change policies

Check Your Progress

7. What are the factors that lead to the growth of international business?
8. What factors are responsible for the transition from domestic to international business?

between different countries in the world suggest that globalization will persist and probably accelerate.

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1.8 SUMMARY

Business activities carried out across the national border are termed international business. Almost all organizations of the world are engaged in international business in one form or the other. Some organizations that require raw material import it from a foreign country and some organizations export materials to a foreign market to earn more profit. International marketing is considered an indispensable element in the area of international business. International marketing can be defined as marketing of the goods and services of the organization across national borders.

Every domestic organization has to pass through certain stages to become an international organization. It is not an easy task for the organizations to carry out international business activities. The organization have to face many problems due to cross-culture environment.

1.9 KEY TERMS

- **Business:** It may be defined as a human activity directed towards producing or acquiring wealth through buying and selling goods.
- **International marketing:** It is the performance of business activities that direct the flow of goods and services to consumers or users in more than one nation.

1.10 ANSWERS TO 'CHECK YOUR PROGRESS'

1. According to Peterson and Ploughman, 'Business may be defined as an activity in which different persons exchange something of value, whether goods or services, for mutual gain or profit.'
2. The term 'goals' denotes what an organization expects to achieve in the future. A goal describes clearly the activities and tasks to be completed by an individual, a department or an organization. The goals are like a measure to evaluate the success of a business.
3. International business can be defined as the business activities or transactions that are carried out beyond the national border. An organization importing the inputs from a foreign country even though they are available domestically can be considered an international business firm.
4. The factors that affect international marketing are listed as follows:
    - Social factors
    - Economic factors
    - Opposition
    - Logistics
    - Risks
5. A firm is said to be a multinational firm or Multinational Corporation (MNC) if it is the owner and controller of enterprises in more than one country. In a broader

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sense, a firm is said to be a multinational firm if its foreign-related operations affect its total revenue and its foreign export affects its internal management decisions.

6. Three challenges faced by a multinational firm are listed as follows:
   - Complex taxation system
   - Diverse financing mediums
   - Political risks
7. The factors that lead to the growth of international business are as follows:
   - Technological development
   - Emergence of supportive institutions
   - Competition from other organizations
   - Development of financial policies for different countries
8. Some of the factors responsible for the transition from domestic to international business are as follows:
   - Export behaviour of the organization
   - Export business decisions
   - Commitment
   - Producing for export

1.11 QUESTIONS AND EXERCISES

Short-Answer Questions

1. Define international business and international marketing.
2. What are the problems in international marketing?
3. What are the different types of business activities?
4. What are the differences between domestic business and international business?
5. What are the challenges faced by multinational firms?

Long-Answer Questions

1. What are the differences between domestic marketing and international marketing?
2. Define the goals, nature, objectives and different activities of the business.
3. What do you understand by a multinational firm?
4. Explain the different stages of development of international business.
5. What is the future of international business?

1.12 FURTHER READING

International Business by Justin Paul.

International Business by Vyuptakesh Sharan.

UNIT 2 INTERNATIONAL BUSINESS ENVIRONMENT

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Structure

2.0 Introduction
2.1 Unit Objectives
2.2 The Concept of Political Environment
2.3 Socio-Cultural and Ethical Environments
 2.3.1 Culture
2.4 The Economic System
 2.4.1 Primary Economic Indicators
2.5 The Multinational Financial Environment
 2.5.1 Reasons for Increase in the Importance of International Finance
 2.5.2 Need for Studying Multinational Financial Environment
 2.5.3 The Finance Function in Global Context
 2.5.4 Principles of Global Finance
 2.5.5 Global Financial Markets
 2.5.6 International Monetary System
 2.5.7 Financial Environment of Multinational Corporation
2.6 Summary
2.7 Key Terms
2.8 Answers to 'Check Your Progress'
2.9 Questions and Exercises
2.10 Further Reading

2.0 INTRODUCTION

The international business environment includes the political, legal, socio-cultural and ethical environments. The political and legal environments play an important role in international business. A firm cannot ignore the political situations and legal formalities existing either at the home or host country if it has to operate successfully in the international business environment. The socio-cultural and ethical environments vary in different countries. In order to operate successfully in international business, managers have to be familiar with the socio-cultural and ethical environments of the home country as well as of the host country.

'Multinational financial environment' is a very broad concept in the field of international business environment. It is a structure of various components without which it cannot function. They include global financial markets, the international monetary system and multinational corporations (MNCs). These components are interrelated and interdependent and the entire multinational financial environment will be defunct if one of the components does not function properly.

2.1 UNIT OBJECTIVES

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

- Introduce the concept of an economic system and its influence on the international business environment

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- Describe social, cultural and ethical environments
- Understand the importance of international finance in the international business environment
- Explain the concept of the finance function in the global context
- Identify the types of global financial markets

2.2 THE CONCEPT OF POLITICAL ENVIRONMENT

The political environment of a country has a great impact on the operations of international business units. It is determined by the extent to which various sections of society, such as individuals, media, businesses and industry have a say in the affairs of governance. Democracy is a political system in which either the citizens themselves, or their elected representatives, as in a parliamentary democracy, take part in policy-making. The type of democracy a country follows plays an important role in the establishment of a company in a foreign country. On the other hand, in a totalitarian system, political power is in the hands of only one individual or party, who implement policies.

2.3 SOCIO-CULTURAL AND ETHICAL ENVIRONMENTS

The performance of a firm largely depends on human behaviour which, in turn, depends on the socio-cultural and ethical environment. This varies from country to country, and the differences between its various aspects play a crucial role in decision-making.

2.3.1 Culture

The culture of a country or region is made up of the knowledge, beliefs, morals, attitudes and behaviours shared by the people living there. The following are some of the most important factors that determine culture:

- **Language**: The medium that enables people to communicate with one another. It could be spoken or written in the form of words, or even expressed through gestures.
- **Religion and customs**: The faith that a person follows determines his or her value system, ideals and customs. Entrepreneurs must keep in mind the religious customs followed in the country or region where they want to do business. Some societies place great value on income generation, while other societies place emphasis on spiritual pursuits or leisure. Businesses find it easier to operate in societies that stress generation of material wealth.
- **Level of education**: The level and type of education determine the availability and trainability of a skilled workforce in a particular country or region. Multinational firms generally prefer to operate in countries where the level of education is high and suited to their needs.

2.4 THE ECONOMIC SYSTEM

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An economic system can be defined as the set of principles and techniques by which a society decides and organizes the ownership and allocation of different types of economic resources. Economic system is basically a mechanism which deals with the production, distribution and consumption of goods and services in a particular society. Economic system can be classified into following categories:

- **Centrally planned economy (CPE)**: In a CPE, it is a central authority, in most cases the government, which decides how to produce and distribute goods and services, usually following a certain economic or political agenda.
- **Market-based economy**: In a market-based economy, it is market forces that allow businesses and firms to decide how to invest and produce. This system allows freedom and choice to both producers and consumers, who then decide on the basis of how far they can maximize their wealth.

2.4.1 Primary Economic Indicators

When a firm contemplates operating in another country, it has to take note of a set of primary economic indicators. The host country's primary economic indicators will enable the firm to determine the following:

- How much demand there is for the proposed product
- How much it will cost to produce the product
- How much can be earned from it
- How efficiently the earnings can be sent back to the home country

Demand, cost, earnings and ease of transfer of profit depend on a number of variables, such as income and distribution of wealth in a population, rate of price rise, availability of resources and a skilled workforce, the industrial and fiscal policies the government implements and the country's overall strength in terms of foreign exchange, trade and balance of payments.

Income and wealth

A country's income level is best determined by its per capita income. The World Bank has classified all countries into three groups—low-income, middle-income and high-income. Table 2.1 shows the per capita income for the three groups.

Table 2.1 *Per Capita Income Classification for Different Countries*

Country Classification	Per Capita Income
Low-income	Up to US $755
Middle-income	US $756- 9,265
High-income	US $9,265 or above

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A country's income level has significant implications for firms planning to do business there as it determines consumer behaviour. Low-income countries will not be a good market for high-priced goods, and similarly, consumers in high- or middle-income countries will be choosier about the quality of a product rather than its price. Multinationals also favour manufacturing products in low-income countries, due to the easy availability of cheap labour, and then selling them in high- or middle-income countries. Distribution of wealth can also determine if there is a market for a particular product. Even in a low-income country, if the distribution of wealth is so uneven that only ten per cent of the population holds sixty per cent of the wealth, there could be a market for high-priced products.

Price rise

The demand for a product and its cost of production also depends on the rate of inflation in the country. If the rate of inflation in a country is high, the real income of its citizens will be low, leading to lower purchasing power. In other words, you can say that the rate of inflation in a country is inversely proportional to the purchasing power of the consumers. The rate of inflation in a country also influences the cost of production. If the rate of inflation is high in a country, then the cost of production will also be higher.

Workforce and material resources

Cost and convenience of production depends on easy availability of a trained workforce and material resources. A country with a high level of education and abundance of raw materials will provide greater human and material resources than a country that has neither.

Economic and industrial policies

Multinationals prefer countries that have beneficial economic and industrial policies, such as low taxes and duties, and favourable rates of interest or credit.

Foreign exchange

As multinationals want to transfer their profits to their home countries, it makes sense for them to operate in countries that have liberal fiscal policies and a favourable ratio of export-import, current account balance and GDP, and current receipt and GDP.

2.5 THE MULTINATIONAL FINANCIAL ENVIRONMENT

The multinational financial environment or global financial environment is one of the products of globalization and liberalization. In simpler terms, a multinational financial environment is the cause and effect of international trade. The concept of multinational financial environment cannot be completely understood until we understand the international finance system which is the integral part of multinational financial environment. The international finance system is very important for international trade as the system provides a payment mechanism without which trade is not possible. This payment mechanism is known as the international payment system and it grows as the volume of trade of goods and services increases. As the international payment system expands, the importance of international finance also boosts up because of various reasons.

Check Your Progress

1. State the important factors that determine culture.
2. What are the two categories into which an economic system can be classified?

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2.5.1 Reasons for Increase in the Importance of International Finance

The importance of international finance depends upon the importance of international trade and various other aspects of the world economy. The six different aspects of the global economy having their influence on international finance are as follows:

- Specialization of countries and trade
- Opening of economies across the world
- Globalization of business enterprises
- Emergence of new forms of business organizationorganizations
- Increase in global trade
- Need of the development process of nation

Specialization of countries and trade

Different nations specialize in the production of different goods and services according to the resources available to them and their requirements. When a country specializes in a product or service, it has an advantage over other countries which either do not produce or produce very little of that product or service. In such a situation, the country specializing in the product or service exports them to other countries and thus leads to international trade which is not possible without international finance and payment system.

Opening of economies across the world

Earlier, most countries had closed economies which meant that they did not indulge in trade with other countries. A group of economic experts was of the opinion that countries should only export goods and services to other countries and should not import from them as imports impoverish a nation. Later on, the countries realized the importance of open economies and started international trade including both import and export. The nations opening up first were those who had developed state of the art technologies and specialized in certain goods and services. In the process of expanding their economies, these nations search for new markets, especially outside their home country and globalize themselves. The developing nations also open up their economies and globalize themselves as they face intense pressure from the developed nations. As the developing nations do not have sufficient finance for the required investment because of lack of resources and savings, they promote exports to acquire more finances. These nations also import state of the art technologies and goods and services they do not specialize in from other nations. This process of opening up of economies across the world has led to the integration of the world and turned it into a 'global village'.

Globalization of business enterprises

Different business enterprises operating in different countries make international trade possible. Business enterprises also establish themselves internationally either through exports or by direct foreign investment. The use of both these methods have increased to a great extent in the recent past and will continue to increase. There are various reasons for a business enterprise to globalize itself. They do so to seek raw materials, technology, knowledge and to have a competitive edge over its domestic counterparts.

Apart from these reasons, there are various theories which provide a reason to the business enterprises to globalize. These theories are as follows:

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- **The theory of competitive advantage**: A business enterprise can attain a competitive advantage over other enterprises because of several factors such as research and development, use of innovative technologies in production, specialization in management style, technological upgradation, location of the firm and favourable government policies. When a business enterprise attains competitive advantage, it needs to maintain it because it enables the enterprise to produce goods cheaper than the competing firms in the same industry.
- **The theory of imperfect markets**: Not all the countries have all the resources in sufficient quantities that are required to run their economies. The availability of resources needed for the production of goods and services differ from one country to another. Thus, countries specialize themselves in the production of those goods and services for which resources are available with them and to attain a competitive advantage over their counterparts. The country can ride upon this advantage only if the markets are imperfect. Imperfect markets restrict the mobility of factors of production. On the other hand, if the markets are perfect, the competitive advantage can not be harnessed because the resources can be freely transferred to the places where they are needed. Such unrestricted movement of resources can make the process of international trade and investment ineffective. However, in imperfect markets, because of the restrictions on the mobility of resources, firms take advantage of the resources available with them and lure the other firms to make foreign investment which is one of the ways the firms use to globalize themselves.
- **The product life cycle theory**: According to this theory, a business enterprise establishes itself firmly as it gains a distinctive advantage over its domestic competitors. The business enterprise can easily compete with its domestic competitors as the information about the competition is readily available in the domestic market. It can also fulfil the international demands for the product it produces by exporting it. As the demand increases even more, the business enterprise may decide to establish itself internationally so as to reduce the cost of production and transportation. This will lead to even more competition, this time from the international companies in the same business. To maintain its position in the tough competition, the business enterprise can develop and adopt specialized strategies.

In short, we can say that as the business enterprise grows, it starts looking for opportunities outside its home country. How well the business enterprise makes use of the available opportunities to expand itself depends how successful it is in maintaining an advantage over its competitors.

Emergence of new forms of business organizations

To globalize or establish themselves in foreign markets, business enterprises may need to adopt one of the many forms of organizations. These forms are: international trade, licensing, franchising, joint ventures, acquisition of existing operations and establishing of new foreign subsidiaries. These forms help a business enterprise to have access to foreign markets and take advantage of imperfect market situations. By adopting these forms of business organizations, a business enterprise can avoid barriers that restrict the access to foreign markets.

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Increase in global trade

International trade has increased from $315.1 billion in 1970 to $3,632.3 billion in 1992. There is an increase in the global trade either because of the increased and improved production capacities or due to the necessity of nations. The developed nations, which produce goods in large quantities, export it to other nations and import goods and services in order to provide better choices and higher standards of living to their population. International trade is beneficial for the developing countries also as it provides them foreign exchange necessary for importing goods, services and technologies.

A nation's need for development

Every nation wants to transit from being an underdeveloped nation to a developing and then to a developed nation. This process of development can either be internal or external. In the internal process of development, the nation and its economy completely depends on its internal resources and internal research and development for development. In case, the country borrows money from the external or international sources, it tries to pay it back as soon as possible. In the internal development process, greater emphasis is given on developing indigenous technologies and producing substitutes for the imported products. But, both these activities are difficult to achieve and require a lot of time as proper research and development is needed, which requires sustained effort and huge amount of money.

In the external process of development, finance is obtained from the external sources rather than from within the country. Apart from money, the country also seeks foreign technology to improve its production process. It becomes important for the countries that are dependent on the external sources to understand the international financial environment.

Thus, we see how and why the international finance has gained so much of importance in this highly globalized world where no nation can exist in isolation and is directly or indirectly dependent on other nations.

2.5.2 Need for Studying Multinational Financial Environment

The very first question that arises in our minds is 'why do we actually need to study multinational financial environment'? The following reasons will give an answer to this question:

- **To understand a global economy**: In the 1990s, the economic changes in the world were at its peak. There were a number of changes taking place simultaneously which were sure to have a positive impact on the global economy. Some of the changes are as follows:
  - o The establishment of the world's joint mechanisms such as the World Trade Organization (WTO)
  - o The disintegration of the Soviet Union
  - o Liberalization of trade through regional trading blocs such as the European Union (EU)
  - o The creation of a single European market
  - o The emergence of market-oriented economies in Asia
  - o Political and economic freedom in eastern Europe

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These political and economic changes indicate that with the increase in global integration despite stiff international competition, United States, Europe and Japan might emerge as the major powers that will create a system of free trade and open markets.

The end of the Cold War, the emergence of growing markets among the developing countries of east Asia and Latin America and the increasing globalization of the international economy have influenced the global financial environment to a great extent. A brief description of these changes is as follows:

- **The end of the Cold War**: After dominating the eastern European countries for 40 years, the Soviet Union relaxed its control in 1989. Taking advantage of this opportunity, the eastern European countries uprooted the authoritarian communist rule. Two years later, the Soviet Union itself faced a political and ideological upheaval and it was fragmented into 15 independent states. Most of these states, which were earlier centrally planned economies are transiting from central planning and state ownership to market forces and private ownership.
- **Industrialization in developing countries**: There has been a rapid industrialization and economic growth in various developing countries throughout the world. Hong Kong, Singapore, Taiwan, China, South Korea and India are some of the countries that emerged as fast growing economies and are still growing.
- **Increasing globalization**: Ever increasing globalization is one of the major contributors in the growth of multinational financial environment. As geographical and technological limitations are being resolved and tariff barriers are being reduced, communication, trade and transport have become easier than before. All these changes have led to numerous trade opportunities and increased foreign direct investment.

A deep study and analysis of these changes will help understand the future of global financial environment, possible challenges, potential opportunities and how to exploit these opportunities.

To understand the impact of global finance on business, it is necessary to study the operations of multinational companies or MNCs. A study of the impact of global finance on business is of utmost importance to the MNCs as they have to work in a multinational financial environment. For example, business ventures like Coca Cola and McDonald's earn more than 50 per cent of their operating profits through international operations. MNCs such as General Motors and Sony are operating and doing business in some 150 countries. Therefore, it is necessary to study the multinational financial environment if one wants to understand the dynamics of economy and policy issues of finance, trade and investment flow among different countries.

2.5.3 The Finance Function in Global Context

In a non-financial firm, the finance function includes two main tasks: treasury and accounting and control. The treasurer and the controller do not work in isolation or in watertight compartments but keep exchanging information. Apart from this, they also indulge in mutual consultations. In fact, in many of the firms, a single head looks after both the tasks of treasury and accounting and control and there is no formal separation of the two responsibilities. Figure 2.1 shows the finance function and the responsibilities of the treasurer and the controller.

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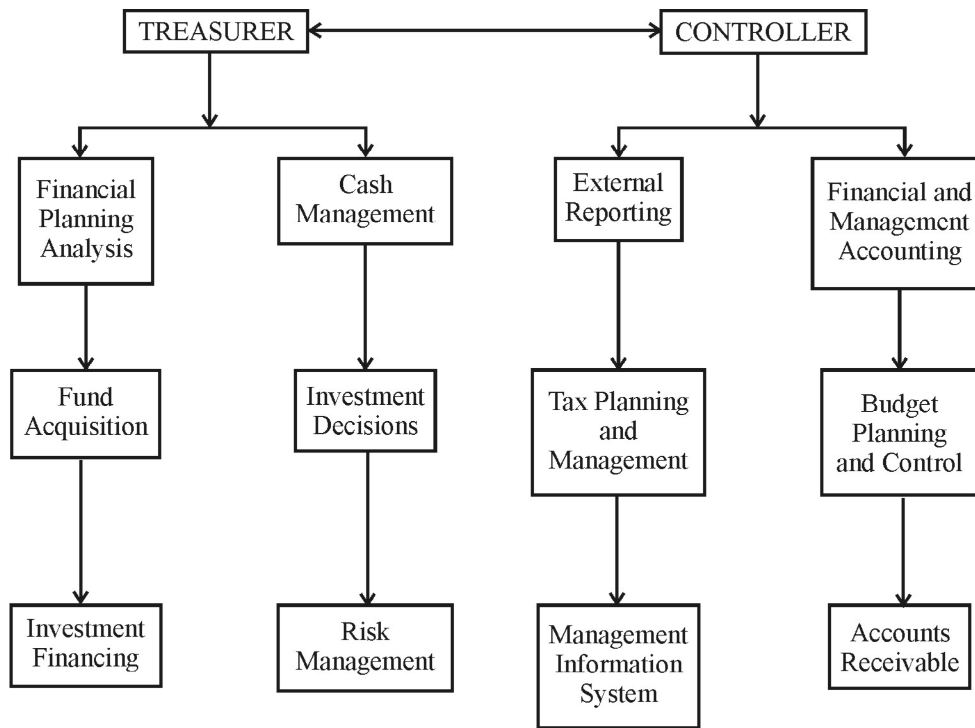

Figure 2.1 *The Finance Function*

In a national or domestic financial environment, the tasks of the controller and the treasurer are same. But, in a multinational financial environment, their tasks differ in terms of available choices and the attendant risks. Following are the main differences in the tasks of the controller and the treasurer:

In a multinational financial environment, the firm has to deal with multiple currencies. It means that the firm has to make or receive payments, raise finances and carry financial assets and liabilities in foreign currencies. Therefore, the firm and its concerned employees should have expertise to deal with the foreign exchange market. They should also be able to handle the uncertain situations created by fluctuations in the exchange rates.

- A treasurer has multiple sources of finance to choose from when operating in a multinational financial environment. The treasure has various options such as different capital markets, different instruments, different currencies and a large investor base. Such diversity is not present in a national financial environment.
- If the sources of finance are many, so are the outlets to utilize the available funds in a multinational financial environment.
- While working in a multinational financial environment, there are various risks such as exchange rate risk and political risk. A firm might have to suffer because of changes in the foreign tax laws, laws pertaining to interest, dividend and other payments to non-residents. Apart from this, the firm also faces challenges such as risks of nationalization and expropriation.

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- A firm operating in a multinational financial environment is also supposed to be familiar with the country's accounting practices, standards and tax laws applicable in foreign jurisdiction.

The finance function becomes complex in a global context. Wider opportunities, varied risks, multiplicity of regulatory environments increase the complexity of the finance function and it becomes difficult for the treasurer and the controller to take right decisions at the right time.

2.5.4 Principles of Global Finance

There are seven principles of global finance in a multinational financial environment. These principles are as follows:

- **Risk-return trade-off**: This principle suggests that the trade-off between risk and return or profitability determines the increase or decrease in the wealth of a stock holder. It means that the risk and return on an investment are directly proportional to each other. The higher the risk, the higher the return and vice-versa. This is not true in all the cases but in nearly all the cases. Thus, a financial manager of a company should strive to maintain a balance between the risk and return which will lead to an increase in wealth of the company's stakeholders. All financial decisions taken by a financial manager such as global financing decisions and global investment decisions involve the risk-return trade-off.
- **Market imperfections**: According to this principle, there are a number of market imperfections in an economy but still these imperfections can be exploited to achieve maximum benefit. This principle can be better understood if we try to understand the functioning of an economy.

  In an economy, when the sellers of goods and services have the freedom to enter in and exit out of a market, then it is known as perfect competition. In perfect competition, goods and services move freely and are transferable. This uniform availability of goods and services creates equality in their costs and returns across the countries. This cost and return equality throughout the world would remove the incentive for foreign trade and investment. But, in reality the markets are generally imperfect with restrictions on transfer of goods and services. The restrictions can be in the form of government rules and policies, excessive transportation, transaction cost, lack of information, etc. In other words, imperfections in the national economies create incentives to seek out international business and do international trade. For example, the Japanese automobile manufacturers such as Toyota established their plants in the United States (US) to circumvent US restrictions.
- **Portfolio effect (diversification)**: According to the portfolio effect, as more assets are added to the portfolio of a company, the risk of the total portfolio decreases. The addition of assets in a portfolio is also known as diversification of portfolio. This principle specifies the reason why multinational corporations (MNCs) diversify their operations not only across industries but also across countries. For example, Nestle, an MNC, has its business across the world in countries such as the United States, Japan, Hong Kong, France, Russia, Mexico, Brazil, Vietnam, Nigeria and South Korea.

  Investment projects in one's home country tend to correlate more with other domestic projects and less with foreign investment projects. Moreover, the

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economic cycle of different investment projects in different countries vary from each other, whereas the economic cycle of all the investment projects in the a country remains same. Thus, international diversification is much more profitable, effective and reduces risks on return than domestic diversification.

- **Comparative advantage**: This principle states that a country can seek international business by making use of its comparative advantage. Comparative advantage means that a country specializes in something which the other countries do not. For example, country A produces wheat better, both in terms of quantity and quality, than country B and country B produces rice better than country A. Here, the principle of comparative advantage states that trade between the two countries—country A exporting wheat to country B and country B exporting rice to country A—can improve the living standards of both the countries and provide them more choice. Both the countries can consume both rice and wheat and not just either wheat or rice. Thus, international trade allows the countries to do what they do best and enjoy greater choices simultaneously.
- **Internationalization advantage**: Internationalization advantage refers to the advantages a country has to offer in terms of location, ownership and international exposure for attracting foreign investment and international trade. Internationalization advantage is one of the principles based on which the business enterprises decide how to expand themselves internationally, either by exporting their goods and services or by establishing their manufacturing plant overseas. Another deciding factor can be the fact that to be a part of the global market, a company should have a worldwide presence which cannot be sustained by exports only. Therefore, the company has to invest in foreign markets to attain global exposure.
- **Economies of scale**: Economies of scale refers to reduction in per unit cost of production through an increase in the production volume. According to this principle, business enterprises tend to gain from greater economies of scale if their assets and capital are deployed on a global basis.
- **Valuation**: This principle states that the value of an asset is equal to the value of its present expected earnings. The valuation principle also suggests that the value of an MNC is generally higher than the domestic companies because MNCs earn more profit than the domestic companies. Moreover, the securities of MNCs have greater marketability and these companies are better known among the investors. Therefore, business enterprises try to establish themselves internationally and exploit global market rather than just confining themselves to the domestic market.

2.5.5 Global Financial Markets

The process of integration of the world's major financial markets began in the mid-1980s and resulted into a huge, global market. But nobody really knows how much of this fact is true and how much is false. The question of whether the financial markets across the world are integrated or fragmented can be looked from following perspectives:

- There are legal barriers in all the countries which prevent the borrowers residing in that country to access the markets in another country. Similarly, the investors of one country have limited opportunities to acquire or invest in foreign assets. Moreover, non-resident entities of a country are not allowed to access or have

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limited access to the financial markets of that country. Such limitations might affect the integration of financial markets.

- Apart from legal barriers, another factor that causes segmentation of financial markets is the differences in generally accepted accounting principles, disclosure norms, regulatory structure and market practices. These differences create informational asymmetries between the resident and non-resident investors. Thus, it becomes difficult for the non-resident investors in a country to obtain and understand information about potential investment opportunities even though there are no strict restrictions by the government on foreign investors.

Classification of financial markets

Global financial markets can be classified into two categories: domestic or onshore markets and offshore markets. Domestic markets are the national markets and subjected to the regulatory jurisdiction of the country's monetary and securities market authorities. The domestic markets make trade transaction in the country's currency. The Indian domestic market includes the markets for the government and corporate debt, bank loans, the stock market, etc. Similar markets exist in other countries also and referred as the domestic markets of that country. The main characteristic of the domestic markets is that they are closely monitored and regulated by the country's central bank, finance ministry and security authority.

Offshore or external markets are the markets in which trade transactions take place in international currency but are located outside the geographical boundaries of that currency.

The main characteristic of the offshore markets is that unlike domestic markets these markets are not subjected to close monitoring and regulation by the various authorities of both the countries—the country in which the market is located and the country whose currency the markets are using for trade.

Evolution of offshore markets

Offshore markets or the Eurocurrency markets, especially the Eurodollar markets, have originated because of the fact that the Russian authorities wanted to have dollar-denominated deposits outside the jurisdiction of the US government. The banks in France and Britain obliged to this demand of the Russian authorities and the Eurodollar market was born. After the Eurodollar market was established, there was considerable growth in it because of various factors which are as follows:

- During the 1960s and the 1970s, American banks and other depository institutions had to observe ceilings on the rate of interest they could pay on deposits. But, such restrictions were not applicable to the banks operating outside the US boundaries and thus, a number of American banks began accepting dollar deposits in their foreign branches which were established outside the USA. The dollars accepted were generally reinvested in the USA. However, most of these restrictions were lifted by the mid-1970s.

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- Reserve requirements and deposit insurance implied higher effective cost of funds for the US domestic deposits. As the branches of the US banks outside the US did not have to face such restrictions, they offered slightly higher rates to depositors and slightly lower rates to borrowers. Thus, it was lucrative to accept dollar deposits in foreign branches rather than at home.
- The dollar was the vehicle currency in international trade and finance and thus, it was of great importance. Therefore, many European corporations had cash flows and surpluses in dollars and wished to have deposits denominated in dollars. Convenience of the same time zone as well as their greater familiarity with the European banks inclined these companies to prefer European banks, a choice made more attractive by the higher rates offered by European banks.
- Another important factor was the demand for Eurodollar loans by non-US entities and by US multinational corporations. They needed these loans to fund their foreign operations. However, during the 1960s, the US balance of payment declined and the government imposed a number of restrictions. This made it difficult and expensive for foreign entities to borrow money in the USA. The voluntary foreign credit restraint of 1963, followed by compulsory controls on foreign lending and the interest equalization tax, induced channelling of funds through the Eurodollar markets where these regulations did not apply.

It is difficult to get the precise estimates of the size of the offshore market, especially the net figures, i.e., excluding interbank placement of funds. Table 2.2 shows some recent data on the outstanding volume of external loans and deposits of the reporting banks taken from Bank for International Settlements (BIS). This data include loans made to and deposits taken from all non-residents by banks in BIS reporting countries and thus include the so-called Euro loans and deposits.

Table 2.2 *External Loans and Deposits of Reporting Banks*

Year	Loans (in billion US Dollar)	Deposits (in billion US Dollar)
December 1999	7887.7	8844.1
December 2000	8317.7	9457.4
December 2001	8584.7	9833.0

Note: *This data is based on the Quarterly Review of International Banking and Financial Market Developments, BIS, March 2002.*

Interest rates in the global money markets

The spectrum of interest rates existing in an economy at any point of time is the result of the complex interaction between several forces. Figure 2.2 represents the schematic picture of interest rate determination.

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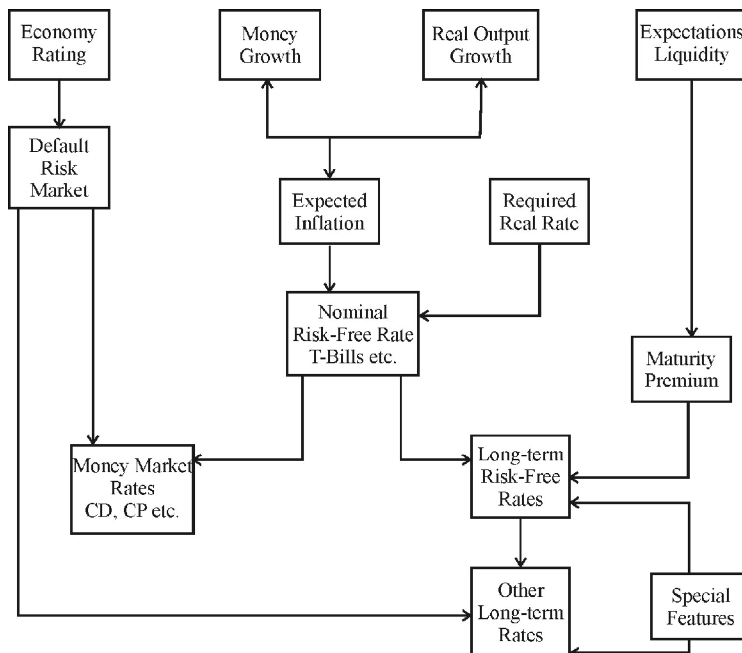

Figure 2.2 *Determinants of Interest Rates*

In the Figure 2.2, short-term money market rates in a domestic money market are linked to the so-called risk-free nominal interest rate, usually the yield offered by short-term government securities like treasury bills or T-bills. In the Eurocurrency market, which is primarily an interbank deposit market, the benchmark is provided by the interbank borrowing and lending rates. The most widely known benchmark is the London Interbank Offer Rate (LIBOR). This is an index of the rate which a 'first class' bank in London will charge another first class bank for a short-term loan. Here it should be noted that LIBOR is not necessarily the rate charged by any particular bank. It is only an indicator of demand-supply conditions in the interbank deposit market in London. Another rate often referred to is the London Inter-Bank Bid Rate (LIBID), the rate, which a bank is willing to pay for deposits accepted from another bank.

LIBOR vary according to the term of the underlying deposit. Thus, the financial press normally provides quotations for three and six month LIBORS. In the market, deposits range in maturity from overnight up to one year. LIBOR also varies according to the currency in which the loan or deposit is denominated. Table 2.3 gives three- and six-month LIBORs for various currencies.

Table 2.3 *Three-Month and Six-Month LIBORs (20 March 2002, in % per annum)*

Currency	3-month LIBOR	6-month LIBOR
US $	1.99	2.25
Euro	3.38	3.50
Japanese Yen	0.10	0.104
Pound Sterling	4.15	4.31
Swiss Franc	1.70	1.83

Figure 2.3 shows the short-term rates in the United Kingdom (UK).

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Treasury Bill Rate: 3.83 (Q4, 01)
Deposit Rate: 4.19 (January 02)
Leading Rate: 5.92 (January 02)
Interbank Rate: 4.05 (Q4, 01)

Figure 2.3 *Short-term Rates –UK (% per annum)*

Figure 2.4 shows the average short-term rates in the US as on February 2002.

Federal Funds: 1.74
3-months Treasury Bill: 1.73
3-months Commercial Paper: 1.79
Prime Rate: 4.75
90-day CD Rate: 1.82

Figure 2.4 *Short-term Rates –US February 2002 Average (% per annum)*

Let us now understand the relationship between the interest rates in the domestic and Euro segments of the money market. Consider Table 2.4 as given below.

Table 2.4 *US Dollar Three-Month Domestic and Offshore Interest Rates (%)*

Month/Year	CP	CD	Euro$
January-99	4.77	4.89	4.88
February-99	4.79	4.90	4.86
March-99	4.81	4.91	4.88
April-99	4.79	4.88	4.87
May-99	4.81	4.92	4.90
June-99	4.98	5.13	5.09
July-99	5.11	5.24	5.21
August-99	5.25	5.41	5.36
September-99	5.32	5.50	5.48
October-99	5.88	6.13	6.09
November-99	5.81	6.00	5.97
December-99	5.87	6.05	6.06
January-2000	5.74	5.95	5.94
February-2000	5.87	6.01	6.02
March-2000	6.00	6.14	6.13
April-2000	6.11	6.28	6.25
May-2000	6.54	6.71	6.70
June-2000	6.57	6.73	6.73

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The above Table shows the data on US dollar three-month commercial paper certificates of deposit interest rates in the domestic market and three-month LIBOR in the offshore market. Though they are not quite similar to each other, they serve to give an idea about the relationship between the two markets. The above Table shows that the rates of the two markets are closely similar and generally move together. Arbitrage, i.e., the simultaneous purchase and sale of the same securities, commodities, or foreign exchange in different markets to profit from unequal prices by the borrowers and investors with access to both the markets should serve to keep the rates close together.

Suppose in the US markets, 90-day CD (Certificates of Deposit) rates are ruling at 8.75 per cent. There is a reserve requirement of 5 per cent against funds raised with CDs and a deposit insurance premium of 0.055 per cent. This means that a US bank can raise funds in the US domestic market at an effective cost of:

$$[(8.75 + 0.055) / (1 – 0.05)] = 9.26 \text{ per cent}$$

Suppose the bid rate for 90-day US dollar deposits in London is 10.85 per cent. Banks having access to the US domestic market can raise funds there and place them in London for an arbitrage profit of 1.59 per cent. By doing so, the US banks would bid up the CD rates in the US domestic market and make a downward pressure on 90-day US dollar LIBID, bringing the two rates close together to remove the arbitrage gap between the two markets.

These two rates are not equal because of the following reasons:

- The first reason is the demand side, i.e., the differences in investors' (depositors') perception of risks associated with different banks. If the Eurobanks are perceived to be more risky in comparison to other banks, the depositors would sought for a risk premium which would act as a risk coverage for them and force the eurobanks to pay somewhat higher deposit rates. But, if the depositors who are not residents of the US perceive a degree of political risk in depositing their funds in the US, eurobanks can attract more deposits from them even if the eurobanks pay a lower rate of interest.
- Second reason emphasizes the supply side, i.e., the impact of regulation on bank's cost of funds. The US banks are subject to make provision for reserves and insurance premia for Federal Deposit Insurance. This results in higher costs of funds for a given rate paid on the deposits. Eurobanks are exempted from these regulations and therefore, are in a position to pay higher rates of interest. So, for example , both the US banks and the Eurobanks pay an annual rate of interest as 9.25 per cent .We assume that the reserve requirements for the US banks to be as 4.35 per cent and deposit insurance to be as 0.075 per cent per annum. The effective cost of funds for the US banks would be (9.25 + 0.075)/(1"0.0435) = 9.75 per cent (approx.) while for the eurobanks it is 9.25 per cent. The example charts show the Eurodollar rates are a bit higher than their US counterpart.
- There can be a third reason for such dissimilar interest rates. Though the effects of this reason are quite small, the reason can be taken into account. The reason is the depositors outside the US may prefer offshore banks on account of the convenience of time zone and greater familiarity with Eurobank practices.
- The fourth reason can be the cost of funds which would imply that the Eurobanks can charge slightly lower rates on loans than their domestic counterparts as their cost of fund is marginally lower in comparison to the US banks.

Sometimes due to speculation against domestic currencies and balance of payments, the national authorities impose temporary controls on cross-border funds flow which results in divided capital markets as arbitrage transactions are not permitted. Under these situations, the close link between the domestic and offshore rates disappears. This situation occurred in the early 80s when the authorities of France imposed sanctions on resident and non-resident borrowers, investors and banks. This led to the Euro-French Franc deposit rates being much higher than corresponding domestic deposit rates.

Now let us discuss the relationship between interest rates among various currencies. As shown in Table 2.2, at any point of time, LIBOR for various currencies varies substantially. The LIBOR is fixed on a daily basis by the British Bankers' Association. The LIBOR is derived from a filtered average of the world's most creditworthy banks' interbank deposit rates for larger loans with maturities between overnight and one full year. For example, a borrower wants to borrow money from the European market for a period of six months. Then person may change his mind of borrowing from the European market in Pound Sterling and would rather prefer to borrow money in Japanese Yen because of difference in interest rates of Pound Sterling at 4 per cent as compared to Japanese Yen of 0.5 per cent. Suppose the depositor is an Indian and his functional/working currency will be Indian Rupees to use the funds. To repay the loan in six months, he has to pay the money with interest in foreign exchange. Thus, to eliminate the risk of volatile foreign exchange rate change, he makes an agreement with a bank which sells the foreign exchange at a specified rate at that time. This is called Forward Exchange Rate. Now the depositor while choosing between Pound Sterling and Japanese Yen will compare cash outflows in rupees for payments after six months in both the currencies for a given rupee inflow as on today.

This comparison is based on two factors—the interest rates to be paid and the Forward Exchange Rate at which the currency of the loan can be bought against rupees at the time of payment of the loan. Suppose, as on 10 April, 2007, the following rates are available:

Pound Sterling six-month LIBOR: 4 per cent per annum.

Japanese Yen six-month LIBOR: 0.5 per cent per annum.

Spot exchange rate—Rupees vs. Pound: Rs 84.4647 per pound

Spot exchange rate—Rupees vs. Yen: Rs 0.3581 per yen

Six-month Forward Exchange Rate for Pound: Rs 86 per pound

Six-month Forward Exchange Rate for yen: Rs 0.382 per yen

Suppose the Fund to be borrowed is Rs 10 crores, then

1. For Pound - principal amount of (10,00,00,000/84.4647) or 1183927 pounds (approx). The repayment after six months would be:

   1183927 [1 + (0.04/2)] = 1207606 pound (approx)

   To buy this at Forward Exchange rate @Rs 86/pound costs - 1207606 * 86 = Rs 10, 38,54,116 after six months.

2. For yen - For Pound - principal amount of (10,00,00,000/0.3581) or 27,92,51,606 yen (approx). The repayment after six months would be:

   27,92,51,606 [1 + (0.005/2)] = 279949735 yen (approx).

To buy this at Forward Exchange rate @Rs 0.382/yen costs - 279949735 * 0.382 = Rs 10, 69,40,799 after six months.

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So after six months, if the depositor takes loan in Japanese Yen, he has to pay Rs 30,86,683 more than in comparison to Pound. So even though with much more attractive interest rates of Yen, he has to pay more in Yen as compared to Pound. This is because the effective cost of the loan consists of interest rates and the loss/gain factor on currency conversion which in turn depends on the exchange rate at the start at which conversion is done at the time of loan repayment. In this example, the loan maturity date is after six months; the borrower had to buy foreign exchange at a higher rate than the rate at start. The difference in spot rate and forward rate reduces the benefit of lower interest rate of Japanese Yen. So the borrower could have bought the foreign exchange in the spot market at the time of loan maturity instead, but he could have been at the risk of foreign exchange fluctuations.

The above examples indicate that the relationship between the domestic and offshore market interest rates for a currency are governed by risk premia, reserve requirements and other regulations that apply to domestic deposits and the presence of capital controls. The differences in interest rates between currencies in the euromarket are explained by the differences in the spot-forward margins via the covered interest parity mechanism. In equilibrium, covered, i.e., hedged for exchange risk returns on all currencies would be equal.

2.5.6 International Monetary System

To understand the international monetary system, we need to understand the following aspects of the system:

- Exchange rate regimes, past and current
- International liquidity which is the volume and composition of reserves, sufficiency of reserves, etc.
- The evolution, role and functioning of the IMF
- The adjustment process which refers to the process of coping with payment imbalances between the trading nations
- Economic and Monetary Union (EMU) in Europe

Exchange rate regimes

Exchange rate is the value of one currency in terms of another currency. The term exchange rate regime refers to a set of mechanisms, procedures and framework to determine the exchange rates at a given point of time and change in the exchange rates over a certain time period. The exchange rate regime also determines the reasons for the changes in the exchange rates. Exchange rates are of two types: fixed or rigid exchange rates and flexible or floating exchange rates.

Fixed exchange rate regime

The gold standard is the oldest fixed exchange rate regime. The gold standard functioned till the beginning of the World War I and even few years after that. According to the gold standard, the currency in circulation is convertible into gold at a fixed rate. Therefore, the exchange rate between any two currencies is determined by the value of the currencies in terms of gold. For example, if a given quantity of gold is convertible into two dollars or one pound, the mint parity exchange rate between dollars and pounds should be 2.00 dollars per pound.

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After the fall of the gold standard, the world monetary system was in chaos and the volume of international trade fell considerably. Thus, in place of the gold standard, the gold exchange standard, popularly known as the Bretton Woods System, was put up after the World War II by the victorious allies of the war. The characteristics of the gold exchange standard were:

- The US government took the responsibility to convert the US dollar into gold at a fixed parity of $35 per ounce.
- The International Monetary Fund (IMF) was created to act as a central bank to the central banks of the member countries.
- The member countries of the IMF agreed to fix the parities of their currencies vis-à-vis the dollar with one per cent variation on either side of the central parity being permissible. If the exchange rate hit either of the limits, the monetary authorities of the countries were obliged to 'defend' it by standing ready to buy or sell dollars against their domestic currency to any extent required to keep the exchange rate within the limits. This is called 'intervention'.

The member countries were given the advantage of borrowing money from the IMF to carry out their 'intervention' obligation in the currency markets. Another important feature of this system that made it more flexible unlike the gold standard was that the parity of the currency against the dollar could be changed in the face of fundamental disequilibrium. A fundamental disequilibrium is the situation when at the given exchange rate, the country repeatedly faces balance of payments disequilibria and has to constantly intervene and sell foreign exchange or buy foreign exchange against its own currency. It was also decided that the changes of up to one per cent could be made without consulting the IMF but changes more than one per cent had to be approved by the IMF.

The working of the Bretton Woods system can be better understood with the help of demand and supply curve. Figure 2.5 shows the supply curve S-S and a demand curve D1D1 for dollars.

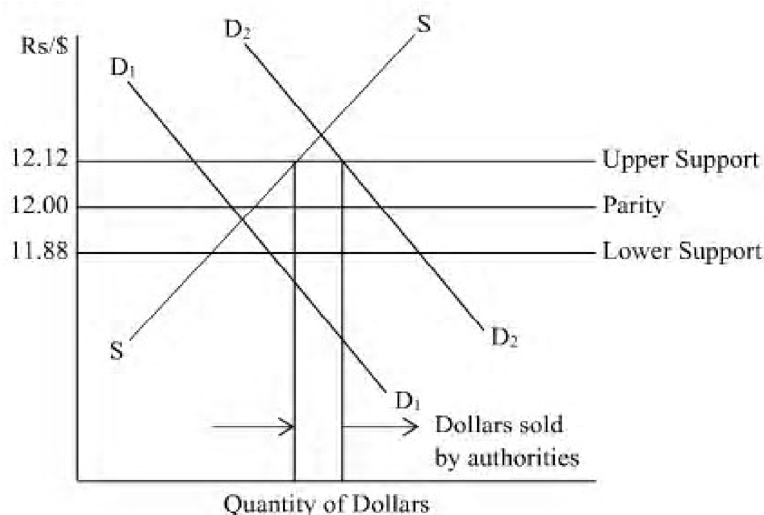

Figure 2.5 *The Supply and Demand Curve for Dollars*

In the above graph, the vertical axis shows the price of dollars in terms of rupees, i.e., the exchange rate between rupees and dollars. The horizontal axis shows the quantity of dollars demanded and supplied. We can assume that the demand for dollars arises from Indian residents wanting to import American goods and services while the supply

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of dollars arises from Americans wishing to import goods and services from India and therefore wishing to exchange their dollars for rupees. Consider that the parity exchange rate is Rs 12.00 per dollar. The +1 and "1 limits are, therefore, Rs 12.12 and Rs 11.88, respectively. These limits are called support points.

As long as the demand and supply curves intersect within the permissible band, the Indian authorities need not do anything; the exchange rate resulting from autonomous demand and supply factors falls within the permissible band. But, suppose the demand curve shifts upward to the right due to a change in preferences of Indians in favour of American goods. This upward shift is shown by the curve D2D2. Now the 'market determined' exchange rate would fall outside the band. The Indian authorities are obliged to prevent this situation by supplying dollars from their reserves and buying rupees so that the exchange rate does not rise above the upper support point of Rs 12.12 per dollar. The authorities support the value of the rupee by intervening in the market for foreign exchange.

In the reverse case, if the supply curve of dollars shifts downwards to the right so that the exchange rate would tend to cross the lower support point of Rs 11.88, the Indian authorities must be ready to buy dollars and supply rupees to prevent it. Here the question arises, how can the Indian authorities supply dollars beyond a limit to support the value of the rupee? In such case, after exhausting their own reserves, the Indian authorities can borrow dollars from the IMF or perhaps the US government.

The Bretton Woods system lasted from 1941 to 1971. During the 1960s, problems emerged as the US balance of payment deficits started rising. After that, a series of events forced the US to give up its role as the anchor of the world monetary system. Finally, in August 1971 the dollar-gold link was discarded. With the end of the Bretton Woods system and fixed exchange rate regime, the era of flexible or floating exchange rate regime had begun.

Floating exchange rate system

Floating exchange rates can be broadly classified into two types: pure float and dirty float. In a pure floating exchange rate system, the exchange is determined by the forces of demand and supply without any intervention from the central authorities. But when the central banks intervene to either raise or lower the exchange rate in a floating exchange rate system, it is referred as dirty float or managed float.

In a pure float, the authorities have no exchange rate target to achieve and thus, they do not intervene to influence the exchange rate in whatever way. Demand for a certain currency arises when the traders wish to import goods and services from the country of that currency and from the borrowers who have borrowed money in that currency and want to either pay back the money or pay the interest on money. Supply of the currency also arises from similar transactions such as residents of the country importing goods and services from other countries, acquisition of foreign assets, paying interest on the foreign loan, etc.

In the dirty float, there are two main reasons why the central banks and other authorities intervene in the exchange rate system. The reasons are as follows:

- **To stabilize fluctuations in exchange rate**: Decisions regarding international trade and foreign investment are difficult to make if there are rapid changes in the exchange rate value. Continuously fluctuating exchange rates makes it very tough for the traders and investors to determine the profitability of the trade or the

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investment which leads to decrease in international activities. Thus, international traders and investors prefer stable exchange rates and sometimes put pressure on the government and central bank to intervene in the foreign exchange market to stabilize fluctuations in exchange rates.

- **To reverse the growth of trade deficit**: Trade deficits generally arise when a country's exchange rate rises significantly. Rise in exchange rate means that the currency of the country will have a higher value. This will make foreign goods and services relatively cheaper and will stimulate imports. On the other hand, the domestic goods will seem relatively expensive to the foreigners and it will lead to reduction in exports of the country. This means that a rise in currency value can result in rising trade deficit. Thus, in the situation of trade deficit the central bank can intervene to reduce the value of the currency in the foreign exchange market which will reverse the growth of trade deficit.

In the pure float, the system is close to a free float whereas in the dirty float system, it is close to an adjustable peg. There are various other substitutes between the two extremes of fixed and floating exchange rate regimes and these substitutes try to incorporate the good features of both the regimes. The alternate exchange rate systems are as follows:

- The crawling peg system allows for modifications within the narrow band of +1 or –1 per cent and thus replaces the abrupt parity changes of the adjustable peg system. In simple words, crawling peg is a system in which a currency exchange rate is changed frequently, may be many times a year, mainly to make adjustments for rapid inflation.
- The wider bands system is more flexible as it has wider bands of variation around the central parity. The parity can either be shifted as in the case of crawling peg and then the wider bands are referred to as gliding bands or there may be discrete jumps as in adjustable peg.
- The multiple exchange rate system allows for applying different exchange rates to different transactions. For example, in 1992, India had two exchange rates—'official' exchange rate applicable to certain imports and a 'market determined' exchange rate for other transactions.

Exchange rate regimes: the current scenario

The IMF has classified its member countries into eight categories based on the exchange rate regimes they have adopted. The categories are as follows:

- **Exchange arrangements with no separate legal tender**: This group includes the following countries:
  - o Member countries of a currency union that share a common currency such as the 12 members of the EMU who have adopted euro as their common currency or
  - o The countries which have adopted the currency of another country as their currency. This group includes countries of the East Caribbean Common Market like Grenada, Antigua, St. Kitts and Nevis etc., member countries of the West African Economic and Monetary Union like Mali and Benin and member countries of Central African Economic and Monetary Union like Cameroon and Chad. Till 1999, 37 member countries of the IMF had adopted this exchange rate regime.

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- **Currency board agreement**: It is a regime under which the countries have a 'legislative commitment' to exchange their domestic currency with a specific foreign currency at a fixed rate. This exchange is monitored by the monetary authority to ensure that the member countries abide by the rules and the restrictions imposed. Till 1999, eight IMF member countries including Argentina and Hong Kong had adopted this exchange rate regime. These countries have tied their currencies to the US dollar.
- **Conventional fixed peg arrangements**: This exchange rate regime is similar to the Bretton Woods system or the gold standard exchange regime.
- **Pegged exchange rates with horizontal bands**: In this exchange rate regime, there is a peg but variation is allowed within wider bands. Till 1999, eight countries had such wider band regimes.
- **Crawling peg**: Under the crawling peg system, six countries were included till 1999.
- **Crawling bands**: In the crawling bands exchange rate system, the currency is maintained within certain margins around a central parity which 'crawls' or shifts either in a predetermined manner or in response to certain indicators. Till 1999, there were nine countries under this regime.
- **Managed floating with no preannounced path for the exchange rate**: Under this regime, the central bank intervenes in the foreign exchange market and influences the exchange rate by buying or selling foreign currency against the domestic country. There are 25 countries under this category.
- **Independently floating**: In independently floating exchange rate regime, exchange rate is market-driven or determined by the forces of demand and supply and the central bank intervenes only to moderate the speed of change and avoid rapid fluctuations in the exchange rate. The central bank does not intervene to maintain or drive the exchange rate towards a target level. Till 1999, 48 countries had adopted this regime.

Implementing optimal exchange rate regime

During the last century, the global economy has experimented with three main exchange rate regimes including their different variants. These three exchange rate regimes were: gold standard regime of fixed rates, adjustable peg system and finally, the floating exchange rate system. From 1985 onwards, efforts have been made to bring some amount of fixity and rule-based management in the exchange rates.

It has been at least 40 years now since the fixed versus floating exchange rate controversy started. During this time period, it was believed that floating exchange rate system is better than the fixed exchange rate system. But, after working with the floating exchange rate system for about two decades, it was realized that the claims made in the favour of floating exchange rate system were in fact exaggerated. During the late 1970s and 1980s, a number of developing Latin American countries and few other countries faced an economic crisis, basically because of high inflation rates. This made many economists of that time to analyze the floating exchange rate system again and reconsider its merits. After the analysis, by the end of the 1980s, many economists suggested a hard peg via a currency board-like arrangement rather than the floating exchange rate system. In fact, it was believed that the Hong Kong economy emerged out of the East Asian crisis of 1997 relatively unscathed because of Hong Kong's currency board arrangement

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with the US dollar. Argentina's success of achieving stability in its economy and bringing inflation under control in the 1990s was also attributed to the hard peg of the peso to the US dollar.

However, Argentina also started facing economic problems and it was realized that like every other exchange rate system, currency board arrangement too has its own limitations. The systems with crawling pegs and crawling bands were not very successful in Indonesia, Brazil and Turkey. Thus, it can be said that there is no 'ideal' exchange rate system for all countries at all the times. However, many economists believe that there will only be two types of exchange rate systems in the years to come: truly fixed-rate arrangements like currency unions or currency boards or truly market-determined, independently floating exchange rates. They are also of the view that exchange rate systems such as adjustable pegs, crawling pegs, crawling bands and managed floating, collectively known as 'middle ground', will no longer exist. Some analysts are hopeful and even predict that three currency blocks—the US dollar block, the Euro block and the Yen block—will emerge with a currency union within each and free floating between them. The argument for the impossibility of the middle ground refers to the 'impossible trinity', i.e., it asserts that a country can achieve any two of the following three policy goals but not all three:

- A stable exchange rate
- A financial system integrated with the global financial system, i.e., an open capital account
- Freedom to conduct an independent monetary policy

A stable exchange rate and the integrated financial system can be achieved with a currency union or board. An integrated financial system and freedom to conduct an independent monetary policy can be achieved with an independent floating exchange rate. Finally, a stable exchange rate and freedom to conduct an independent monetary policy can be achieved with capital controls. Figure 2.6 represents the 'impossible trinity' argument.

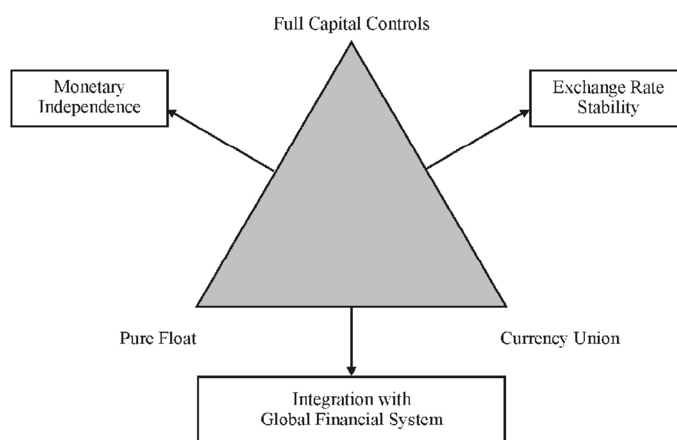

Figure 2.6 *Impossible Trinity Arguments*

International monetary fund

The IMF was created in 1944 and considered as a centrepiece of the world monetary order. It played an important supervisory role in exchange rate arrangements but its role weakened after the emergence of floating rates in 1973. In the monetary order, which was established after the World War II, the IMF had following responsibilities:

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- To collect and allocate money reserves
- To supervise the adjustable peg system
- To give advice to its member countries on their international monetary affairs
- To promote research in different areas of international economics and monetary economics
- To provide a platform for discussing and consulting issues among the member countries

The initial money reserve in the IMF was contributed by the member countries according to the quotas fixed for them. The quota was determined based upon the Gross National Product (GNP) of the country, the importance of the country and its GNP in international trade and similar other factors. Each member country was supposed to contribute 25 per cent of its quota in gold and the rest of the quota in their national currency. Since then the quotas have been revised a number of times, the last revision being done in 1990. Apart from the quota, the IMF also borrows funds from member and non-member countries to fund its various lending activities. The member countries are also allowed to borrow a part of their quotas or complete quotas whenever they want by fulfilling certain terms and conditions.

International liquidity and Special Drawing Rights (SDRs)

International liquidity refers to the stock of means of international payment. International reserve, which is a part of international liquidity, refers to the assets used for settling payment imbalances that arise while transacting with other countries. International reserves are taken control of by the monetary authority of a country and used by them for intervening in the foreign exchange markets. The reserve includes assets such as gold, foreign exchange, SDRs, etc.

The SDRs were created by the IMF in 1969 to support the Bretton Woods fixed exchange rate system. The member countries of this system were required to have official reserves of gold and popular foreign currencies that could be used to purchase the domestic currency in the foreign exchange markets to maintain the exchange rates. But the two key reserve assets, gold and the US dollar, were not in adequate supply to support the expansion of the world trade and the financial developments that were taking place. Thus, the international community decided to create SDRs under the aegis of IMF.

Figure 2.7 provides some data on official holdings of reserve assets including SDRs.

Item	Holding as of end March 2000 (in billions of SDRs)
Reserve positions in the IMF	54.30
SDRs	18.20
Foreigen exchange	1330.50
Total excluding gold	1402.80
Gold	
Quantity (millions of ounces)	960.70
Value	197.40
Total including gold	1600.20

Figure 2.7 *Official Holdings of Reserve Assets*

Figure 2.8 shows the shares of the major convertible currencies in official holdings of foreign exchange assets.

Currency	Holding as on end of year 1999 Billion	SDRs Share(%)
US dollar	800.130	66.2
Pound sterling	48.028	4.0
Swiss franc	8.406	0.7
Japanese yen	61.089	5.1
Euro	150.956	12.5
Total	1286.799	

Figure 2.8 *Currency Composition of Foreign Exchange Reserves*

The fall of Bretton Woods system and advent of floating exchange rate regime has lessened the need and importance of SDRs. Today, SDR is only used as a unit of account of the IMF and some other international organizations and has very limited use as a reserve asset.

Economic and monetary union (EMU)

The origin of the EMU can be traced back to the formation of the European Coal and Steel community (ECSC) in the early 1950s. It was the first attempt to harness European economic unity in order to achieve greater international competitiveness. The success of ECSC encouraged the foreign ministers of six ECSC nations to examine the possibility of further economic integration. Consequently, in 1957 one the most significant agreements in European economics history, the Treaty of Rome, was signed. The main goal of the Treaty of Rome was to provide for the creation of a common market. Under this treaty, various countries such as Belgium, France, West Germany, the Netherlands, Italy and Luxembourg committed to facilitate the free movement of goods, services and factors of production. They sought to eliminate internal trade barriers, create common external tariffs and harmonise member states laws and regulations.

This movement towards creating a common European market continued quite successfully till late 1960s. During the 1960s, the Bretton Woods system started facing problems and at the same time global inflation was also very high. In addition to this, the revaluation of the German Deustchemark and the devaluation of the French Franc resulted in substantial exchange rate instability in Europe. It became a common belief at that time that Europe can only be able to compete in the global economy only if a single currency can be introduced. Thus, the Werner Committee was established in 1970 to find out the most efficient way to converge economic performance and currencies. The committee recommended a three-stage process for achieving a complete monetary union within ten years. The final goals, as suggested by this committee, were free movement of capital, the permanent locking of exchange rates and replacement of the EC6 nations notes and coins with a single currency. The committee were to achieve the task of complete monetary union by 1980 but could not do so because of various reasons. The

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reasons included the introduction of a floating exchange rate regime and the infamous Oil Price Shocks of the 1970s. But, the members of the European community still pursued the concept of European Unity in the period of economic uncertainty.

In 1979, the European Monetary System (EMS) was established to foster a greater stability between member state's currencies and stronger coordination and convergence of economic policies. There were four main components of EMS: the European Currency Unit (ECU), the Exchange Rate Mechanism (ERM), the Financial Support Mechanism (FSM) and the European Monetary Cooperation Fund (EMCF). The EMS gained success during the 1980s and managed to reduce inflation rates in the European community. It also minimized the adverse financial effects of the global exchange rate fluctuations.

In 1987, the Single European Act was passed. It highlighted a comprehensive programme of 282 measures to be implemented to achieve a single market. The Single European Act intended to have a single market in place by 1993. But, it could not achieve its goal. In 1993, the Treaty of Maastricht expanded upon the Single European Act. It formulated a timetable to implement the single currency and put down the convergence criteria to be reached by those nations ascending into the EMU. The criteria are as follows:

- A country's inflation must not be higher than 1.5 per cent above the average for the three EU members with lowest rates during the previous year, indicating price stability must exists within an economy.
- A prospective EMU member state should also experience long-run interest rates no higher than 2 per cent above the three EU members with the lowest rates during the previous year.
- The exchange rates of each economy must have also been in the normal band of the ERM for two years without devaluation.
- Those considering imminent membership of EMU should also display fiscal prudence or rather the economy should not experience a budget deficit which exceeds 3 per cent of its GDP.
- Finally, it is essential that national debt does not exceed 60 per cent of GDP.

An adherence to these economic standards ensured that all the countries operating under the single currency could be brought to same position of the business cycle.

The final agreement, which led to the development of the EMU, was the Stability and Growth Pact. According to this pact, all the EMU members should maintain the Maastricht criteria and also define possible mechanisms to enforce these criteria. The Treaty of Maastricht also outlined the timetable of events, which made the single currency fully operational by February 2002. The timetable is as follows:

- From January 1999, the Euro became the official currency of the EMU, which ensured that from that point onward all foreign exchange operations and new public debt was issued in Euros.
- On 1 January, 2002, Euro coins and banknotes went into circulation, and in March 2002, the EMU authorities cancelled national currencies as a means of exchange.

Figure 2.9 shows the stage-wise formulation of EMU.

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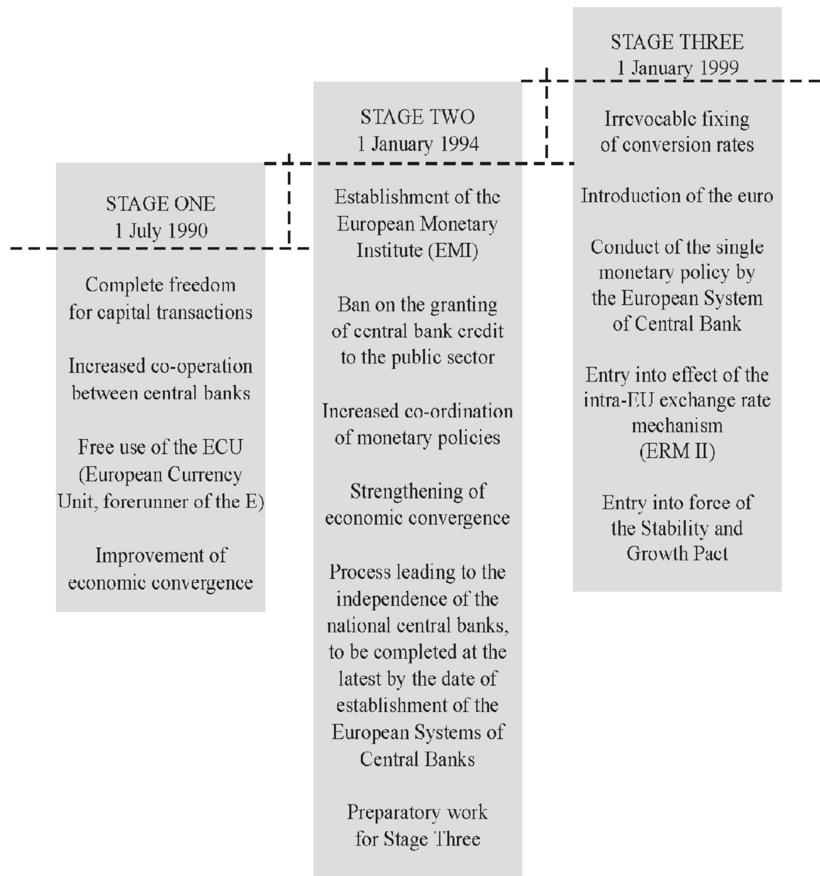

Figure 2.9 *The Three Stages of EMU*

Advantages of EMU

The development of the EMU has been a long and gradual process which spans more than 50 years. But the benefits it provides to business in the European nations, also known as Euroland, are many. Some of the benefits of the EMU are as follows:

- The EMU facilitates the movement of goods, services, people and capital through single European currency, i.e., Euro and the removal of trade barriers.
- The EMU makes it easier for the European firms to access the 12 Eurozone markets by creating an opportunity to introduce new or modified products for each member states or alternatively to provide a standardized set of goods and services for Euroland.
- The EMU also facilitates those companies who seek to derive the competitive advantage of factors of production available in some member states. The unrestricted movement of capital and labour allows firms to establish different aspect of their business operations throughout the Eurozone or Euroland such as research and development in Germany with production in Spain.
- The lowering of transport cost, specifically the abolition of restrictions on import taxes by the EMU, allows Euroland firms to develop more efficient channel of distribution of goods and services throughout Europe.
- The efforts by the EMU to reduce financial barriers ensure that Eurozone firms have inexpensive access to finance in all EMU member states.

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- Greater product choice, free movements of factors of production, efficient channels of distribution and a more liberalized financial market facilitates the Eurozone firms to operate in a highly dynamic, challenging and ever-expanding marketplace.
- The EMU encourages firms to seek strategic alliances and join ventures through removal of exchange rate and trade and administrative barriers. This can facilitate the sharing of intellectual property, research and development, capital and labour techniques, creating greater operational efficiency and improving both the firms' competitiveness within the Eurozone and international markets.

2.5.7 Financial Environment of Multinational Corporation

It is important to understand MNCs and the financial environment in which they work because a global financial environment is the outcome of the operations of MNCs. Had there been no MNCs, there would not be a global financial environment because of lack of international trade. But, what are MNCs actually?

There are many criteria to identify a firm as an MNC. The first criterion is the proportion of total revenue generated from foreign operations. There is a consensus that if a firm generates 20–30 per cent of its total revenue from foreign operations, the firm can be considered as an MNC. Significant involvement in the international financial markets, by way of borrowing and investing, despite limited foreign manufacturing and distribution activities also gives a firm the status of an MNC. It can also be defined as a corporation which is established in more than one nation, having offices, factories or branch plants in multiple countries. Also known as Multinational Enterprise (MNE) or Transnational Corporation (TNC), these corporations have a centralized head office from where they coordinate global management.

Environment of multinational corporation

Business enterprises that function within the domestic or national boundaries have to face single political, social, economic, legal, physical, financial and cultural environment. But an MNC has to work in an international environment which also includes an international political, social, cultural, economic, legal, physical and financial environment. In other words, an MNC has to operate in multiple international environments and this provides various challenges as well as opportunities to the MNC.

An MNC functions in different economic systems and thus, has to face different taxation systems. This creates complexities in the decision-making process as to how to achieve the targeted rate of return. Risk of expropriation is the biggest challenge. Therefore, these days the MNCs look for a country's investment ratings before making investments. Agencies like Moody and Standard and Poors have emerged that rate countries as per political risk and help an MNC to take decisions accordingly. MNCs also have to face foreign exchange risk which arises because of rapid fluctuations in the exchange rate. As all the MNCs have assets and liabilities in foreign currencies, fluctuation in the exchange rate also affects the value of the assets, liabilities and transactions. Currency and institutional diversity is another major challenge. It is very difficult to decide that a particular project should be financed in which currency and which institutions to deal with because different institutions have different procedures, rules, policies, delay times, etc. Diversity of physical environment also makes it difficult for the MNCs to standardize their products, management style. Dealing with the host country environment is also a challenge before the MNCs. The host country may pose various challenges before the management of the MNC. One such challenge is the repatriation of profits. The MNC would like to siphon off the profits to the parent but the host country would like to preserve the foreign exchange. Such

Check Your Progress

3. What are the six different aspects of the global economy that have an influence on international finance?
4. List the principles of global finance.
5. What are the ways by which the floating exchange rate system can be classified?

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problems arise because of factors like economic development policies and objectives, monetary policies and credit restraints, fiscal and taxation policies, balance of payment policies and exchange controls, labour and employment policies, etc.

Although, these challenges are tough to deal with but sometimes the challenges can also turn out to be the opportunities for the MNCs. For instance, due to the presence of multiple tax systems, it becomes possible for an MNC to reduce its total tax burden by transferring its income from high-tax locations to low-tax locations. This practice of transferring income is called transfer pricing and helps increase profits of an MNC. An MNC can get finance from various sources because of its entry into the capital markets of different countries. MNCs have a higher rate of profitability than the domestically oriented companies and thus they attract a large number of financers. An MNC has access to diverse landscapes or locations, climates, human resources, etc. and it can plan to exploit these diverse resources to maximize its profits and wealth of the shareholders. MNCs function in different nations across the globe and thus, can exploit the varied capital markets of these nations to minimize the cost of capital and consequently maximizing their profitability.

2.6 SUMMARY

The political, legal and economic environments are important factors that can influence international business, especially when there are differences between the home country and the host country. On the other hand, socio-cultural and ethical environment influences international business decisions and it also helps to determine human behaviour.

During liberalization, business enterprises began to globalize themselves to seek new sources of raw material, technology and knowledge. With this globalization, new trade opportunities emerged and the importance of global finance and international payment mechanism was realized. All these developments gradually led to the creation of a multinational financial environment of which the MNCs are the most important component. Such an environment consists of two main markets: offshore and onshore markets. For the growth and efficient functioning of these markets, it is necessary to have in place certain monitoring and regulatory monetary bodies. IMF and EMU are two such bodies which manage and control the working of the international monetary system. EMU has set an example for the other countries to follow by combining a number of European markets and introducing one common currency for them.

2.7 KEY TERMS

- **Economic system:** It the set of principles and techniques by which a society decides and organizes the ownership and allocation of different types of economic resources.
- **Multinational financial environment:** It is a structure of various components that include global financial markets, the international monetary system and multinational corporations.
- **Risk-return trade-off:** It is a principle that suggests a trade-off between risk and return or profitability and determines the increase or decrease in the wealth of a stock holder.

2.8 ANSWERS TO 'CHECK YOUR PROGRESS'

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1. The important factors that determine culture are listed as follows:
    - Language
    - Religion and customs
    - Level of education
2. The two categories into which an economic system can be classified are as follows:
    - Centrally planned economy
    - Market-based economy
3. The six different aspects of the global economy having their influence on international finance are as follows:
    - Specialization of countries and trade
    - Opening of economies across the world
    - Globalization of business enterprises
    - Emergence of new forms of business organization
    - Increase in global trade
    - Need of the development process of nation
4. The principles of global finance are listed as follows:
    - Risk-return trade-off
    - Market imperfections
    - Portfolio effect (diversification)
    - Comparative advantage
    - Internationalization advantage
    - Economies of scale
    - Valuation
5. The ways in which the floating exchange rate system can be classified are as follows:
    - Pure float
    - Dirty float

2.9 QUESTIONS AND EXERCISES

Short-Answer Questions

1. Define culture.
2. Mention the various reasons for which a business enterprise has to globalize itself.
3. What do you understand by the 'portfolio effect' principle of global finance?
4. Briefly describe the concept of economies of scale.
5. Write a short note on the Bretton Woods system.
6. What do you understand by SDRs and why were they created?
7. Write a short note on the financial environment of MNCs.

Long-Answer Questions

1. Explain the concept of the economic system.
2. Explain all elements of culture.
3. Discuss the reasons for the increase in importance of international finance.
4. Describe the three main theories which create a need for the business enterprises to globalize.
5. Explain the finance function in the global context.
6. Explain the offshore markets and their evolution.

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2.10 FURTHER READING

International Business- Concept, Environment and Strategy by V Sharan.

International Business by Justin Paul.

UNIT 3 THE FOREIGN EXCHANGE SCENARIO

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Structure

3.0 Introduction
3.1 Unit Objectives
3.2 Foreign Exchange Market
3.2.1 Foreign Exchange Market Participants
3.2.2 Factors Affecting Currency Trading
3.2.3 Trading in Foreign Exchange Market
3.2.4 Structure of Foreign Exchange Market
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3.3 Foreign Exchange Rate Risk
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3.7 Questions and Exercises
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3.0 INTRODUCTION

The foreign exchange market is a global market in which traders buy and sell currencies using different communication media, which include telephone, Internet, telex and computers. The purpose of the foreign exchange market is to facilitate the transfer of a specific amount of money denominated in the currency of one country to another country. The foreign market acts as a mediator between the buyers and sellers of the currencies and is involved in all financial activities related to the various deals of traders and brokers.

In this unit, you will know about the foreign exchange scenario in detail.

3.1 UNIT OBJECTIVES

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

- Identify the types of global financial markets
- Identify the different participants of the foreign exchange market
- Understand how currency is traded in the foreign exchange market
- Explain the different transactions and quotations used for trading currency in the international business environment

3.2 FOREIGN EXCHANGE MARKET

Foreign exchange market has a huge impact on the international financial environment. Foreign exchange market is a market for the purchase and sale of currencies from countries around the world. Foreign exchange market plays an important part in making

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the payments across the borders and transferring funds. Foreign exchange market is the largest liquid market in the world. Among the various financial centres, the largest amount of foreign exchange trading takes place in the United Kingdom. The trading in foreign exchange market is done 24 hours a day by telephones, telex and fax machines.

3.2.1 Foreign Exchange Market Participants

There are various participants in the foreign exchange market which are:

- **Commercial banks**: Commercial banks are the main source of currency transactions for users of currency, central banks, traders and speculators. Most of their dealings are with other banks as they execute trade for their customers or for their own accounts.
- **Central banks**: Central banks play a major part in the foreign exchange market. Each major government has a central bank to manage its domestic money supply. The central bank can play a key role in the foreign currency market when it tries to influence the value of its currency by buying or selling the currency. Most transactions are handled through commercial banks, but central banks sometimes work directly through brokers.
- **Brokers**: Brokers are the most specialized group. They deal in large currencies such as $1 million or more among banks. Brokers operate mainly in the largest markets such as London, New York and Tokyo.
- **Traders and speculators**: This distinct group includes individuals, investment managers and corporate treasurers, all of who seek short-term profits by betting on the direction they think currency rates will move.
- **Hedge funds**: A hedge fund is a fund that is used by limited number of investors. An example of hedge funds is the George Soros' Quantum fund. George Soros' Quantum fund controls and borrows billions of dollars of equity. It supports all the currencies in the world. Figure 3.1 shows the participants in the foreign exchange market.

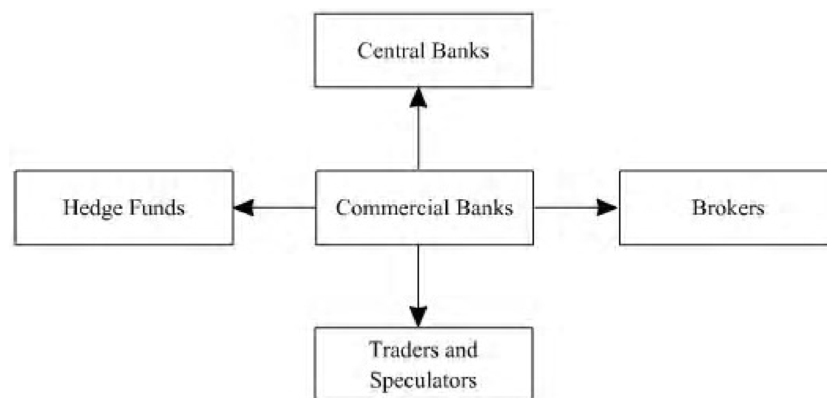

Figure 3.1 *Participants in the Foreign Exchange Market*

3.2.2 Factors Affecting Currency Trading

There are many factors that affect currency trading. These factors are as follows:

- Economic conditions
- Political conditions

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Economic Conditions

Economic conditions affect the performance of a currency. Some of the economic conditions are:

- **Inflation levels and trends**: If there is a high level of inflation in the country, then the currency will automatically lose its value. Inflation decreases the value of the currency because if there is a high level of inflation in the country, then the prices of the goods will also rise and hence there will be a decline in the demand of goods. This will lead to the decrease in the demand of a currency.
- **Economic growth and health**: A currency is also affected by the country's economic growth. The capacity utilization, retail sales and employment levels determine a country's economic growth. If the economic growth of a country is very healthy, then the currency will also perform better in an economy.
- **Government budget deficits or surpluses**: The performance of a currency also depends on the government budgets. If the budget of a country is not very good or positive, then automatically the performance of the currency will also decline.
- **Balance of trade levels and trends**: The flow of trade between the two countries also affects the performance of a currency. If there is a flow of trade between the two countries, then there will be a great demand for goods and services and hence, there will be a great demand for the currencies also. If there is any trade deficit, then it can also have a negative impact on the nation's currency.

Political conditions

The performance of a currency is also affected by the internal and international political conditions. In this context political instability which includes the amount of corruption and bribery and the degree of law and order plays a major role in the performance of the currency. If there is a political instability in the country, then it will have a political impact on the country's currency.

3.2.3 Trading in Foreign Exchange Market

In the foreign exchange market, trading of different currencies takes place. Central banks lay down certain rules and regulations which the foreign exchange market has to follow with regard to the trading of currencies.

Purpose and organization

Foreign exchange market allows currencies to be exchanged to facilitate international trade and financial transactions. In foreign exchange, an attempt is made to make money from the movements of different world currencies. There are various participants in the foreign exchange market such as central banks, hedge funds, brokers, traders and speculators.

Speculation

Speculation involves buying and selling of bonds, stocks and currencies. Speculators also involve in taking large risks. Speculators try to predict the future gambling in the hope of making quick, large gains. Speculation is an important feature of foreign market operations. There are two types of speculators which are:

Check Your Progress

1. Who are the various foreign exchange market participants?
2. Which is the major political condition that affects the performance of a currency?

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- **Bulls**: In a financial market, a bull is a certain group of securities in which prices are rising or are expected to rise.
- **Bears**: In a foreign exchange market, a bear anticipates a currency to become cheaper in the future, so that he is able to sell the currency at a relatively higher price.

3.2.4 Structure of Foreign Exchange Market

Foreign exchange market spans all over the world; so different countries use it to trade their currencies using electronic transactions system of banks. Commercial banks, investment banks, corporation banks and central banks are involved in the foreign exchange market. Tourists, migrants, importers, exporters and international agencies are other participants of the foreign exchange market. Currency trading among participants depends on the position of participants. A participant can improve its position in the local market through currency trading in the foreign exchange market. The foreign exchange market contains international liquidity of currency and thus helps improve the position of participants. Liquidity of a currency is its ability to be sold quickly, with minimum loss and anytime within market hours. A liquid market refers to a market in which participants can get ready and willing traders to buy and sell currency anytime. Different participants of foreign exchange market are categorised into the following groups:

- Price makers
- Foreign currency broker
- Price takers

Price makers

Price makers represent those participants of the foreign exchange market who are responsible for constituting different markets such as wholesale market and retail market. The constitutors of the wholesale market are known as primary price makers and constitutors of the retail market are known as secondary price makers. Primary price makers include commercial banks and large investment dealers who make a two-way market in which the price makers quote and accept separate bidding and selling prices for them and their clients. Primary price makers deal with different customers from time to time for increasing their currency values. For example, a primary dealer who has US dollar can improve his currency value in the market by exchanging US dollar with a customer having Euro. He has to exchange Euro with a customer having US dollar for regaining the original value of the US dollar.

Primary price maker uses two-tier market. In the first tier, multinational banks deal with each other for large amount of currencies. A broker is not involved in these dealings. In the second tier, large banks deal with small banks and local institutions for small amount of currencies with the help of brokers. Secondary price maker includes hotels, restaurants and shops and gets foreign currency from their customers directly in payment of bills and cheques. Due to direct communication with their customers, secondary price makers get more bidding price than the primary price makers. As a result, the secondary price makers do not need to interact with any broker and other customers to increase the market value of the currency. Some of the secondary price makers are specialized in buying and selling foreign currency for tourists and travellers.

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Foreign currency brokers

The foreign currency brokers act as a middleman between two primary price makers and buy or sell currencies according to the instructions provided by the primary price makers. For example, one primary price maker decides its currency value against any other currency and tells the fixed currency value to the foreign currency broker. The foreign currency broker then buys or sells currency for the primary price maker according to that fixed currency value. Foreign currency broker deals with another primary price maker according to the instructions given by the first primary price maker.

Primary price makers use foreign exchange brokers not only for currency trading but also for presenting their currency value in the market without using their own name. Foreign exchange brokers have more knowledge about currency price of the market because they maintain contact with different primary price makers. Thus, the foreign currency broker provides information about market situation and market price to the primary price makers who are responsible for making a market for foreign exchange.

Price takers

Price takers represent those participants of the foreign exchange market who buy and sell the currency for their own purpose such as making payment for import and paying interest on foreign currency loans or funds without concerning about the market price of the currency. Price takers include traders belonging to large multinational companies and central banks. Traders belonging to large multinational companies participate in the foreign exchange market to get more profit according to the currency rate of the market. Central banks participate to get knowledge about change in currency rate. Almost 85-90 per cent of total transactions of foreign exchange market are held between different banks and rest of the transactions are held between banks and non-bank customers.

3.2.5 Procedure of Currency Trading

Primary price makers are responsible for making foreign exchange market because they decide the currency price for buying and selling among the participants of the foreign exchange market. Currencies are represented in different ways in the foreign exchange market. The International Standard Organization (ISO) has specified a three-letter code for every currency.

The three letter codes representing different currencies used in foreign exchange market are:

- **USD**: US Dollar
- **GBP**: British Pound
- **JPY**: Japanese Yen
- **CAD**: Canadian Dollar
- **EUR**: Euro
- **CHF**: Swiss Franc
- **AUD**: Australian Dollar
- **SEK**: Swedish Kroner
- **NLG**: Dutch Guilder
- **BEF**: Belgian Franc
- **FRF**: French Franc

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- **ESP**: Spanish Peseta
- **ITL**: Italian Lira
- **INR**: Indian rupee
- **DEM**: Deutsche Mark.
- **SAR**: Saudi Riyal

The dealing process of different banks in the foreign exchange market is known as interbank dealing. Different banks are involved in the foreign exchange market as primary price makers. Primary price makers are also known as professional dealers of the foreign exchange market. There are two types of procedures, warehousing the dealing and back-to-back dealing for trading currencies between two or more professional dealers.

Warehousing the dealings

In this type of dealing, a professional dealer asks another professional dealer about the currency price for trading. If the other professional dealer is ready for trading the currency, then both professional dealers communicate with each other using short forms of the communication. The short form of communication contains two-way quote for representing the currency price. An example of such communication is given below:

```
Thursday, 14 August 9.35 a.m.

BANK X: Bank X calling. EUR-USD 30 please.

BANK Y: ‘25-40’

BANK X:  “Mine”

BANK Y: OK. I sell EUR 30 million against USD at 0.7340
value 14 August. CITY ABC for my USD to you.

BANK X: MNO_BANK F’ Furt for my EUR. THANKS & BYE
```

In the above example of short forms of communications, two banks, Bank X and Bank Y are communicating with each other. The first line in the example represents the day, date and time of the communication. In the second line, Bank X asks about Euro versus US dollar quote from Bank Y. The third line is the answer from Bank Y that specifies a two-way price in which price for buying a US dollar against Euro and price for selling a US dollar are quoted. All the dealers of the foreign exchange market know actual price of currency. Therefore, only last two decimals of the actual price are specified in the third line of the example for answering Bank X. The full quotation of rate of US dollar can be as 0.7325–0.7340, which is the bid rate and ask rate of Bank Y for buying and selling a Euro. Number 25 and 40 are the hundredth of the hundredth of the actual rate and known as points or pipes in foreign exchange market. For small denomination currencies such as Japanese Yen, points represent the hundredth of the actual rate of the currency. The difference between actual selling and buying price is known as bid-ask spread or bid-offer rate, which is 0.0015 or 15 pipes in the above example.

Note: *If a non-bank customer calls a professional dealer for asking the currency prices, then the dealer uses actual currency rate such as 0.7325–0.7340 for answering the caller.*

In the fourth line of above example, Mine indicates that the prices of Bank Y are acceptable to Bank X and Bank X is ready to buy 30 million Euros. If Bank X wants to sell the currencies, then it would have to use Euro instead of Mine. In the fifth line, Bank Y confirms the amount, rate, date of the dealing and place of bank. Last line of the example represents the termination of the communication after the deal with Bank X is finalized.

Back-To-Back dealing

Back-to-back type of dealing takes place when a professional dealer asks for such currencies that are at present not traded by other professional dealer. In this type of dealing first a professional dealer, say A, asks for currency price from another professional dealer, say B, for warehousing the deal. But if the second professional dealer B is not interested to warehouse the deal with the first professional dealer A, then it calls a third professional dealer, say C, to confirm whether or not the dealer is interested in trading currency with the first professional dealer A and here second professional dealer B plays a role of mediator between first professional dealer A and third professional dealer C. If the third professional dealer C is interested, then its currency price is quoted to the first professional dealer A. If the first professional dealer A accepts the currency price, then second professional dealer B asks the first professional dealer A to communicate with the third professional dealer C. First professional dealer A uses same communication statements as the statements used in the warehousing to third professional dealer C for dealing procedure.

Position of the bank

Participation of banks in the interbank dealing depends on the position of banks in the foreign exchange market. Position of the bank depends on the selling and buying of currencies rather than the bid-ask spread rate of the bank. The bid-ask spread rate represents the margin of the bank. This means, difference between buying and selling of the currencies determine the position of the traders in the foreign exchange market. For example, if a bank sells more US dollars than it has bought, this indicates a short position in the foreign exchange market. However, if a bank buys more US dollars than it has sold, then this indicates long position in the foreign exchange market. Position of the bank in the foreign exchange market represents the profit and loss condition of the bank that depends on the variability of the exchange rate for a currency.

When a bank realizes that it is in an undesirable position in the foreign exchange market, then it will adjust its bid-ask spread rate by setting an appropriate price for its currency to make a balance between deals. For example, if a bank has overbought Italian lira than Euro and wants to adjust its bid-ask spread rate for these two currencies, it has to change the currency price from 1.2300-1.2320 to 1.2310-1.2320. This means that the bank will offer more Italian lira per Euro at the selling time and buy more Italian lira per Euro. As a result, in the foreign exchange market, trust of one party depends on the position of the counterparty.

Society for Worldwide Interbank Financial Telecommunication (SWIFT)

All the dealings of currencies, currency rates and position of banks are decided by a large network called the Society for Worldwide Interbank Financial Telecommunication (SWIFT). SWIFT is a Belgian corporation that has a main office and a number of regional offices around the world connected through different media such as telephones and the Internet. SWIFT is responsible for handling all transactions done in foreign

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exchange market. When a trader makes a transaction in foreign exchange market, it gives all the information about the transaction to the nearest regional office or the main office of the SWIFT. But information related to dealings, which are done through brokers, are not provided to the SWIFT because brokers reveal the identities of both parties in the foreign exchange market and get commission for the dealing from both the participants of the deal.

Factors affecting the currency trading

There are different factors that affect currency trading done in foreign exchange market. These factors are:

- **Economic factors**: The economic factors that affect the currency trading include the economic polices of the government or central banks and economic conditions defined in economic reports. These economic conditions include:
    - o The budget, introduced by the government of a country, affects the currency value in the foreign exchange market. When there is a deficit in the budget, then the value of the currency may decrease while surplus increases the value of currency.
    - o The demand for the currency of a country is determined by the demand and trade of goods and services of that country in the international market. Therefore, if the country suffers from trade deficits, it will have a negative impact on the demand for the country's currency. Similarly, if the country's trade is in surplus, it will have positive effect on the demand for its currency. Trade deficit is the negative balance of trade and the difference between the monetary value of import and export done in a country during a specific period of time. A positive balance of trade indicates trade surplus.
    - o Value of a currency is also affected by the purchasing power of the currency. Purchasing power is that amount of currency which is available at a specific time in the market.
    - o Economic level of the country also affects the currency value.
- **Political condition**: Exchange rate of a currency also depends on the political condition of a country. More changes in the political state of the country have a negative effect on the currency value of that country.
- **Market psychology**: It refers to the behaviour of the market price depending on the scientific research on human and social emotions. It is not dependent on any balance sheet or income statements. In the following ways the market psychology affects the value of currency:
    - o Safe haven results in an increase in the price of currency in the foreign exchange market. Safe haven is defined as an activity in which currency is stored as stock for getting higher value without any loss.
    - o Economic statistics and indicators are used to analyze economic performance and predictions of future performance of the market.

3.2.6 Transactions in Foreign Exchange Market

Settlement of a transaction in foreign exchange market takes place when two parties of different countries transfer currency deposits on the same day. The countries to which the parties belong are known as settlement locations and the date or day on which transaction is settled is known as settlement date or value date. The date of dealing is

known as transaction date. The location where the transaction parties are located and deals in transaction in foreign exchange market is known as dealing location. For example, bank X of America located in New York can sell US dollar against Japanese Yen to another bank Y of Japan that is located in Tokyo. The settlement locations will be America and Japan and dealing locations will be Tokyo and New York. The settlement date must be the day on which both banks are open and transaction is settled. Transactions are categorized into different types according to the settlement date and the transaction date. Following are the four types of transactions:

- Spot transaction
- Forward transaction
- Swap transaction
- Short transaction

Spot transaction

In spot transaction, settlement date refers to one or two different business days. For example, bank A sells Euro against US dollar to another bank B on Tuesday. Bank B in America receives Euro on Thursday and transfers US dollar to bank A on the same day. Thus, the settlement date of this transaction is Thursday. There is one-day gap between Tuesday and Thursday due to a holiday in one of the banks. This means if bank B has a holiday on Thursday, then the day gap will be two days and the settlement date for bank A and bank B will be Friday. Day gap between the settlement dates can be confirmed from the SWIFT. The day gap can be reduced for the currency pairs related to same time zone such as US dollar and Canadian dollar and US dollar and Mexican peso.

Forward transaction

In forward transaction, there is a month's difference between the transaction date and the settlement date. Month difference may be of 1, 2, 3, 6, 9 and 12 months. Thus, you have to add month difference in the spot transaction date for getting final settlement date of the forward transaction. The month that is added to the spot transaction date is known as calendar month. For example, the transaction date for a deal of Saudi riyal against rupee is March 23 and traders have decided to finalize the deal after one month of its spot transaction date, that is, on April 25. In this example, March 23 is the transaction date, March 25 is the spot transaction date, March 25-April 24 is the calendar month and April 25 is the settlement date. If there is holiday on the final decided date of the forward transaction, then traders have to shift the forward transaction date to the next business day as in spot transaction. Thus, in the above example, if there is a holiday on April 25 in India, then the settlement date will be shifted to the next day which is April 26.

However, if the settlement date is not possible in the current year, then the date is shifted forward according to day difference which is approximately equal to month difference rather than accurate month difference. For example, the transaction date of Italian lira against rupee is settled for December 27 and traders have decided to finalize the deal after two months of its transaction date which is February 29. Consider that the year of settlement date is not a leap year and thus, February 29 does not exist. Therefore, accurate two months difference will not be possible for deciding the settlement date. In this example, February 28 will be decided as final date after adding approximate two months difference which is not accurate month difference. The main purpose of the forward transaction is to motivate the contracts and make surety for receiving the money for the transactions. Banks always do the transactions on forwarded fixed date. Some

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authorized dealers until January 1997 fixed deals with their customer for the maturity time of more than six months by getting approval of Reserve Bank of India (RBI) on the basis of the contract. But after that, the criteria of RBI approving the contract were removed. Margin of these transactions is determined on the basis of currency rate which existed between dealing date and settlement date. Some traders such as banks mostly use day differences such as 93 days or 139 days to forward their contract. Such contracts are known as broken date or odd date contract. A contract in which currencies are purchased or sold using only forward transactions is known as outright forward contract

Swap transaction

The combination of spot transaction and forward transaction is known as swap transaction. In the swap transaction, currencies are temporarily exchanged between traders. This means, a trader can buy a currency using spot transaction and sell the same currency through forward transaction. A contract in which double reversing forward transaction is done is known as forward-forward swap transaction.

Short transaction

A transaction is said to be a short transaction if the settlement date of the deal is before the short date. Short date indicates the time of maturity of a deal that is less than one month. Short date transactions involve a day swap and the price of these transactions depends on the interest rate differential.

Note: *In the foreign exchange market, 65-70 per cent of total transactions are spot transactions, 20-25 per cent are swap transactions and remaining are forward transactions.*

3.2.7 Exchange Rate Quotations

In the foreign exchange market, quotation adopted by Association Cambiste Internationale (ACI) is used for determining the exchange rate for a currency. ACI is an International financial market association in which foreign exchange professionals work for market development. Quotation is represented by a pair of three-letter SWIFT code for currencies separated by an oblique or a hyphen. The currency that is represented before the hyphen is the base currency and the currency which is represented after the hyphen is quoted currency. Some examples of quotation are:

- **USD/JPY**: In this quotation, US dollar is the base currency and Japanese Yen is the quoted currency.
- **EUR/GBP**: In this quotation, Euro is the base currency and Great Britain Pound is the quoted currency.
- **INR/AUD**: In this quotation, Indian rupee is the base currency and Australian dollar is the quoted currency.

Thus, exchange rate quotation is the representation of number of units of quoted currency for per unit of the base currency. A quotation can also consist of prices for two currencies separated by a hyphen. Price given at the left side of the hyphen is known as bid price and the price at the right side of the hyphen is called ask or offer price. Bid price is the price on which a trader wants to buy base currency against the quoted currency. Ask price is the price on which a trader wants to sell the base currency

against the quoted currency. Ask price of the quotation is always higher than the bid price. For example, USD/INR Spot: 48.5010/48.5020 represents a quotation from a trader that contains the bid rate of the trader which is USD 48.5010 for buying one unit of INR and ask rate of the trader is INR 48.5020 for buying USD.

Quotations are used to indicate the exchange rate of the currencies. These contain name of the currencies and their exchange rate. In common each country has two types of quotations, direct and indirect. Direct quotation represents the number of units of home currency of the country for per unit of foreign country. Examples of direct quotations are INR 48.5925/USD in India, USD 0.8740/EUR in America. Direct quotation is also called American quotation because it represents the exchange rate of currency in American term. American term represents the number of US dollar for per unit of currency. Some currencies such as EUR, GBP, AUD and New Zealand dollar are always quoted in American term. Most of the currencies are quoted in American term.

Indirect quotation or reciprocal quotation represents the number of units of foreign currency for per unit of home currency of the country. This type of quotation is the inverse representation of the direct quotation, so it is also called inverse quotation. Example of indirect quotation is USD 2.1010 per INR 100 in India indicating that the number of unit of rupee is 100. Indirect quotation represents the exchange rate of currency in European term. European term represents the numbers of unit of a currency for per US dollar. A quotation that is used to represent exchange rate for two non-dollar currencies is known as cross rate. For example, GBP/EUR represents non-dollar currencies, Pound and Euro. Some time, traders use short forms for the quotation. For example, INR/ JPY: 1.2940/1.2960 can be represented in the following forms:

- 1.2940/60, when the price of currencies is changed to decimal points.
- 40/60, when two traders regularly interact for trading a particular currency pair because they know the big figure of the currency rate. Big figure means starting digits of the rate that is 1.29 in 1.2940/60 quotation.

All the quotations used in foreign exchange market are divided into three main categories. These categories are:

- Spot quotation
- Outright forward quotation
- Swap quotation

Spot quotation

Spot quotations are used to represent the exchange rate of the currency according to the present rate in the market. Spot quotation must be in such a form that no arbitrage situation is created in the market.

Arbitrage situation

Sometimes, there are such market situations which help participants of the market to gain profit without any risk. These market situations are known as arbitrage situations. Participants of the market can gain profit by making some currency transactions with such banks which have quoted different prices for same currency pair. Consider an example of two banks, X and Y, quoting the exchange rates for EUR/USD. Figure 3.2 shows the EUR/USD quotations of Bank X and Bank Y.

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Bank X EUR/USD: 1.4530/1.4536

Bank Y EUR/USD: 1.4540/1.4550

Figure 3.2 *Exchange Rate Quotations of Bank X and Bank Y*

In the above Figure, Bank X quoted a bid rate of 1.4530 for Euro and offered an ask rate of 1.4536 for USD. This means that the Bank X will give 1.4530 USD for one unit of Euro and take 1.4536 USD for one unit of Euro. Bank Y quoted a bid rate of 1.4540 for Euro and offered an ask rate of 1.4550 for USD. This means that the Bank Y will give 1.4540 USD for one unit of Euro and take 1.4550 USD for one unit of Euro.

Participants of the market will buy Euro from Bank X at 1.4536 and sell Euro to Bank Y at 1.4540 and thus, will earn a profit of 0.0004 USD per Euro. As a result, the participants of the market get a net profit without any risk and commitment. Figure 3.3 shows the process used by the participants of the market to gain profit.

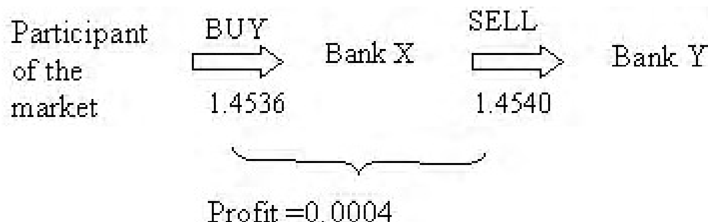

Figure 3.3 *Profit of the Participant*

One of the basic principles of modern finance is to avoid arbitrage situation. Figure 3.4 shows the arbitrage situation of the market.

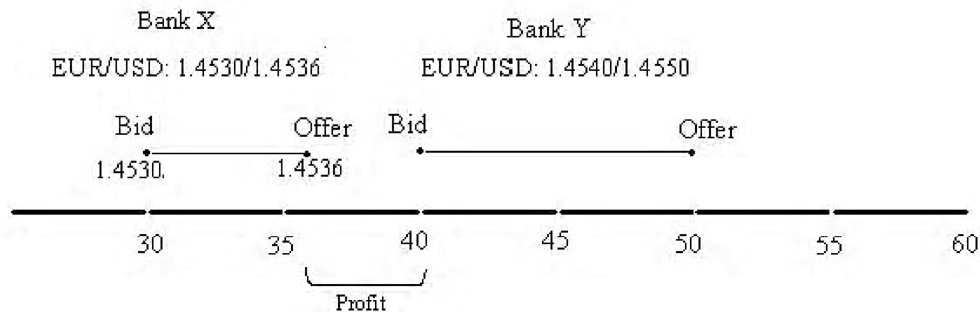

Figure 3.4 *Arbitrage Situation*

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Traders must carefully quote their quotation for removing arbitrage situation of the market. They should not use such type of quotations which generate arbitrage situation in the market. Arbitrage situations are generated due to margin in the rate of the currencies of two different quotations quoted by traders. There are two ways to remove the arbitrage situation depicted through Figure 3.5. The first way is that Bank X has to raise its ask price of the Euro and second way is that Bank Y has to decrease its bid price for Euro. Figure 2.14. shows both exchange rate quotations of Bank X and Bank Y used for avoiding arbitrage situation of the market.

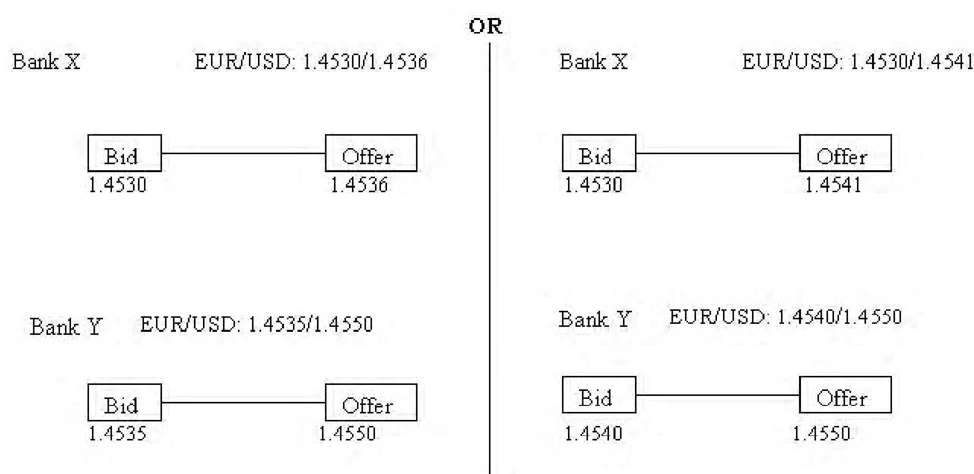

Figure 3.5 *Different Exchange Rate Quotations for Avoiding Arbitrage Situation*

As a result of increment in the ask price of the quotation quoted by Bank X, arbitrage situation of the market is removed because the price of Bank X and Bank Y are now overlapped. This means ask price of the Bank X quotation is increased from 1.4536 to 1.4541 and the bid price of the Bank Y is 1.4540. There is now no margin left between 1.4541 of Bank X and 1.4540 of Bank Y to get profit without any risk due to overlapping of the prices. Figure 3.6 shows the arbitrage situation to be avoided by changing rates of the quotations of Bank X.

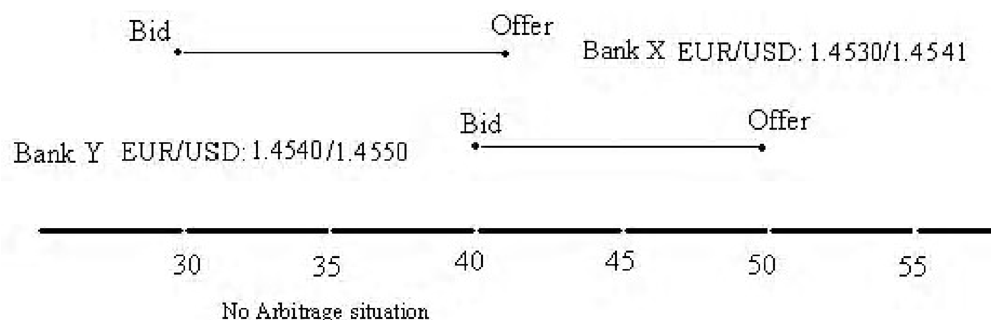

Figure 3.6 *Removing Arbitrage Situation by Changing Rate of Bank X*

As a result of decrement in bid price of the quotation quoted by Bank Y, arbitrage situation of the market is removed because the price of Bank X and Bank Y are overlapped. There is now no margin left to get profit without any risk due to overlapping of the prices. Figure 3.7 shows the arbitrage situation to be avoided by changing rates of the quotations of Bank Y.

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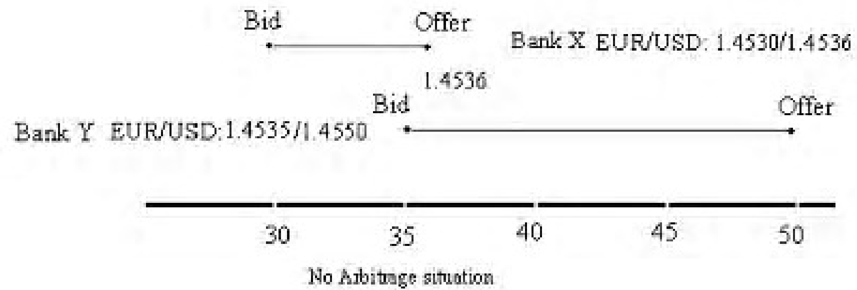

Figure 3.7 *Removing Arbitrage Situation by Changing Rate of Bank Y*

Inverse quote and two-point arbitrage

Two-point arbitrage is the condition when there is a chance to buy a currency from one market and sell that currency in another market where price of the currency is higher. For example, bank A in France has quoted a quotation as USD/EUR: 1.9345/1.9350 and another bank B in America has also quoted a quotation of same pair of currency as EUR/USD: 0.5345/0.5360 which is inverse or reciprocal quote of bank A. This means ask rate of bank A, which is EUR/USD, is the reciprocal of bid rate of bank B, that is, USD/EUR. This means reciprocal of ask rate of bank A is 1/(EUR/USD) which is equal to the bid rate of bank B. You can also say that EUR/USD bid rate of bank B implies 1/(USD/EUR) ask rate of bank A and EUR/USD ask rate of bank A implies 1/(USD/EUR) bid rate of bank B. In this way inverse quotation is used in two-point arbitrage situation.

For example, a trader can get profit by buying 1 million Euro from bank A and selling it to bank B. Total price for buying 1 million Euro from bank A is USD 1,000,000/1.9345 which is 516929 US dollar. Trader can get USD 1000,000×0.5345 which is equal to 534500 US dollar by selling 1 million Euros to the bank B according to its bid rate. The trader can get a profit of 534500"516929, which is equal to 17571 US dollar. This market situation can also generate an arbitrage situation because trader gets a profit without any capital investment or risk and by making phone calls only.

The bid rate in the quotation of bank B should be overlapped with the ask rate in the quotation of bank A to avoid two-point arbitrage situation.

Triangular arbitrage

Triangular arbitrage is that market situation in which a bank provides some exchange rates that are not directly inverse of exchange rate of another bank but provides an indirect way to get profit without any risk to the trader. For example, a bank M has quoted a quotation of USD/JPY: 110.25/111.10 and USD/AUD: 1.6520/1.6530 for two currency pairs USD/JPY and USD/AUD. Another bank N has quoted for one currency pair AUD/JPY with the rate AUD/JPY: 68.30/69.00 at the same time. Bank M and Bank N provide a way to generate an arbitrage situation in the market because a trader has to engage in two-step transactions for getting AUD against JPY from Bank M and get more value for its currency from Bank N. Such situation of the market is known as triangular arbitrage situation. Transactions made by the trader to get profit in triangular arbitrage situation for one Japanese Yen, which is represented by a symbol ¥, are:

- A trader will sell one Yen to bank M and gets USD[1/(USD/JPY) ask rate of bank M] that is equal to USD(1/111.10) according to the exchange rate of USD/JPY of bank M.
- The trader will sell that USD to bank M again to buy AUD{[1/(USD/JPY) ask rate of bank M] that is equal to AUD(1/111.10)(1.6520) according to the exchange rate of USD/AUD of bank M.
- Finally, the trader will sell the AUD to bank N and get ¥ {[1/(USD/JPY) ask rate of bank M][(USD/AUD) bid rate of bank M][(AUD/JPY) bid rate of bank N]} which is equal to 1.0156 Japanese Yen. The formula for calculating profit from investing one ¥ is:

```
¥(1/111.10)(1.6520)(68.30)= ¥1.0156
```

After the final transaction, the trader gets its own currency which is Japanese Yen with more value. This means that the trader makes transactions using only 1 Yen and finally gets 1.0156 yen in return, which is more than 1 yen, thus earning a profit of .0156 yen

Note: *In case of the transaction of 1 Yen the profit is less. However, traders can invest a large amount of currency in which they can get more profit without any risk and extra investment.*

Thus, firstly the trader had JPY. The trader then bought USD by selling JPY to bank M according to USD/JPY quotation and again bought AUD by selling USD to the bank M according to USD/AUD quotation. Secondly, he sold AUD for getting JPY to bank N. The trader now gets his own currency, which is JPY with more profit without any investment and risk, by doing some transactions. In other words, the quotation of bank N for AUD/JPY is implied by USD/JPY and USD/AUD quotation of bank M. Figure 3.8 shows the process of transaction carried out by trader to obtain profit in triangular arbitrage situation.

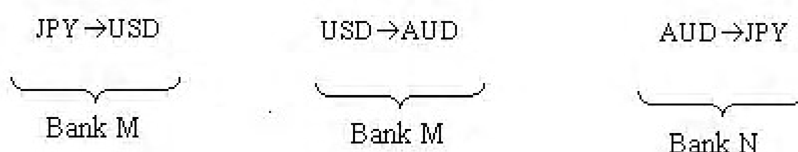

Figure 3.8 *Transactions in Triangular Arbitrage*

To avoid triangular arbitrage situation, ask rate of one pair of currency must be as high as bid rate of second pair of currency.

Outright forward quotation

Outright forward quotation is used to signify that final transaction of the deal will take place after a particular time which is given in the quotation. For example, an outright forward quotation is represented as:

USD/CHF 5-month Forward: 1.4570/80

In the above quotation, the trader will give CHF1.4570 for buying USD and take 1.4580 for selling USD. The delivery date for the deal is 5-month after the spot date of the transaction. You can calculate inverse or cross rate of the above outright forward quotation as:

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```
USD/CHF 5-month Forward = [1/(USD/CHF) ask rate of the
                          quotation] /[1/(USD/CHF)bid rate
                          of the quotation]
                        = (1/1.4580)/(1/1.4570)
                        = 0.6859 / 0.6863
```

You can also calculate inverse rate of two currencies using outright forward quotation of triangular arbitrage situation. This means, if you have to calculate inverse rate of currencies X and Y, using two outright forward quotations, Z/X and Z/Y. Cross rate of X and Y currencies is calculated using the following equations:

(X/Y)bid rate = (X/Z)bid rate*(Z/Y)bid rate

= [1/(Z/X) ask rate] * (Z/X)bid rate Equation 3.1

(X/Y) ask rate = (X/Z)ask rate * (Z/Y)ask rate

= [1/(Z/X)bid rate] * (Z/X)ask rate Equation 3.2

For example, there are two outright forward quotations, which are:

USD/INR-1-month forward: 49.2550/49.2565

USD/JPY-1-month forward: 121.45/121.60

Inverse rate of JPY/INR 1-month forwarded quotation is calculated as:

1-month forward (JPY/INR) bid rate of quotation

= (JPY/USD)bid rate * (USD/INR) bid rate

= (1/121.60)(49.2550)

= 0.4051

1-month forward (JPY/INR) ask rate of quotation

= (JPY/USD)ask rate * (USD/INR) ask rate

= (1/121.45)(49.2565)

= 0.4056

Premium and discount in forward market

When a trader has two quotations, spot quotation and forward quotation of the same currency pair, two terms related to currencies are introduced, forward discount and forward premium. A currency is considered to be a forward discount with respect to another currency of the forward quotation if the bid rate of that currency in forward quotation is less than the bid rate of currency in spot quotation. Another currency of the quotation is known as forward premium with relation to forward discount currency. For example, a pair of spot and outright forward quotation of USD/CHF is given as:

USD/CHF spot: 1.5679/1.5695

USD/CHF 1-month forward: 1.5575/1.5595

Then USD is the forward discount in relation to Swiss franc because it has less price in forward quotation than spot quotation and CHF is forward premium with relation to US dollar.

You can calculate annual discount or premium of a pair of spot and forward quotations. You have to use average of the bid and offer rate of spot and forward

quotations for calculating annual discount or premium of the quotation. Average rate of the quotation is known as mid-rate of the quotation. To calculate annual discount or premium, you have to use the following equation:

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$$\frac{\text{[Forward (quotation) mid – spot (quotation) mid]}}{\text{Spot (quotation) mid}} \times 12 \times 100 \quad \text{Equation 3.3}$$

In the above equation, multiplication by 12 is used to calculate annual discount. To convert the discount in per cent form, 100 are used. Sign of the result indicates that currency is either a forward discount or a premium. This means if sign of the result is negative, then currency is forward premium with another currency and if sign is positive, then the currency is a forward discount.

Thus, you can calculate annual discount or premium of USD in USD/CHF spot: 1.5679/1.5695 and USD/CHF 1-month forward: 1.5575/1.5595 quotations in the following manner:

$$\frac{\text{[Forward (USD/CHF) mid – spot (USD/CHF) mid]}}{\text{Spot (USD/CHF) mid}} \times 12 \times 100$$

Where, [Forward (USD/CHF) mid] = (1.5575 + 1.5595)/2 = 1.5585

[Spot (USD/CHF) mid] = (1.5679 + 1.5695)/2 = 1.5687

Thus, annual discount or premium is calculated as:

$$\frac{1.5585 - 1.5687}{1.5687} \times 12 \times 100$$

$$= -7.8 \text{ per cent}$$

Sign of the result is negative in the above example that indicates that USD is forward premium to CHF.

If you want to calculate forward discount or premium according to the time given in forward quotation then, you have to use (360/T) instead of 12 in the Equation 3.3, where T represents the time period given in the forward quotation. You have to use time period in days term, i.e., 31 or 30 days for one month. For example, a bank has quoted a pair of spot and forward quotation as:

(EUR/USD) Spot: 0.8740/0.8750

(EUR/USD) 51-day forward: 0.8685/0.8710

Thus, [Spot (EUR/USD) mid] = (0.8740 + 0.8750)/2 = 0.8745

[Forward (EUR/USD) mid] = (0.8685 + 0.8710)/2 = 0.8697

Annual discount or premium is calculated as:

[(0.8697 – 0.8745)/0.8745](360/51)(100) = – 0.044.

Negative sign indicates that EUR is forward premium to USD.

Reverse exchange rate risk

When a bank quotes forward quotation for dealing with a non-bank trader, there are more chances of loss in the dealing because a non-bank trader may not be able to fulfil bank commitment. In such a case, bank must fulfil its commitment to the counterparty by buying required currency in the spot market even though the rate of the required

currency is moved against the bank position in the market at that moment. This situation is known as reverse exchange rate risk. To avoid reverse exchange rate risk situation, bank asks the counterparty either to pay some amount of the dealing in advance or provide guarantee of the trader from another bank. If the non-bank trader has a credit line with the bank, bank reduces the amount of the forward deal from the credit line of the trader.

Swap quotation

Swap quotation is the combination of spot and forward quotation. Rates of the currencies for transactions involving swap quotation are different for spot and forward transactions. Difference between the rate of forward transaction and spot transaction is known as swap margin. Swap margin varies according to the currency forward discount and forward premium. Forward discount and forward premium is known as the pair of swap points in swap margin.

In the interbank market, when banks deal with non-bank customer using outright forward quotation, these quotations are represented in form of swap quotations. For example, suppose a bank X deals with a customer for buying US dollars against Euros after one month of the current date. Bank X has a long position in the Euro and short position in the US dollar. It is difficult to find such a counterparty, which is in opposite position in the interbank market with same currency. Therefore, there is a need of balancing the position of the bank in the interbank market. Bank X can use two swap transactions for balancing its position in the interbank market during one month of the forward transaction. These two swap transactions are:

- Creating a short position in Euro by buying Euro using spot transaction and selling it through one-month forward transaction.
- Again creating a long position in Euro after one-month by selling that Euro using spot transaction.

In other words, forward transactions are derived from swap transactions. For example, a swap quotation is given as: USD/CHF spot: 1.6570/80 1-month swap: 14/9

To get forward rate from the above swap quotation, you have to translate points form of the rate into original rates, that is, CHF 0.0014 and 0.0009, and then get forward rate by adding or subtracting swap bid rate from the spot bid rate and swap ask rate from the spot ask rate. Addition or subtraction of rate depends on two principles, first and second. According to the first principle, bank must get profit according to its rate of buying and selling. This means, selling price of the bank should be more than the buying price. According to the second principle, bid-ask spread should be expanded as the trader increases time for the completion of contract. Thus, bid-ask spread has least value for spot transaction among all transactions.

Therefore, you must ensure that the following rates should not be used in the dealing:

- If the spot rate is 1.6570/1.6574, then after adding swap points, you will get 1.6584/ 1.6583 rate which will be the forward rate after one month of the dealing. But these forward rates are not according to the first principle because first principle states that selling rate should be more than buying rate of the transaction.
- USD/CHF 1-month forward. (1.6570 + 0.0014)/(1.6580 + 0.0009), which is 1.6584/1.6589 rate and this rate will be forward rate after one month of the dealing. But these forward rates are not according to the second principle because second principle states that bid-ask rate should be minimum in spot transaction.

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However, in this forward transaction, bid-ask spread rate is 5, which is less than spot bid-ask spread rate,10.

To get accurate transaction rates and avoid above-forward rates, you have to follow some rules such as if swap points are given in low/high form, then you have to add swap points into spot rates to get forward rates. On the other hand, if swap points are given in high/low form, you have to subtract swap points from the spot rates to get forward rates.

For example, consider the following swap quotation: USD/CHF spot: 1.6570/80 1-month swap: 14/9

In the above quotation, swap points are given in high/low form. Therefore, you have to subtract swap points from the spot transactions to get forward rates, 1.6556/1.6571. These forward rates are according to both the principles specified for swap quotation. This means that the selling price of the quotation is more than buying price and bid-ask rate of the quotation is also greater than spot rate.

Forward-forward swap

When there are two forward transactions, it is possible to do a swap transaction between the two forward transactions. For example, if a trader sells a currency C1 using spot transaction to bank A and decides to buy it after 3-month forward against currency C2. At the same time, bank A buys currency C1 from bank B using spot transaction and decides to sell it after 5-month forward against currency C2. This type of transaction is known as forward-forward transaction. Position of trader in these types of transactions is known as swap position in the market. Profit and loss of the trader depends on swap margin of month difference of forward transaction such as 3-month and 5-month.

Change in exchange rate

International Monetary Fund (IMF) is an international organization which manages financial system by controlling exchange rate and balance of the transactions. The members of IMF need to ensure that correct exchange arrangement and exchange rate of the quotation is used in financial market. All the members are free to make arrangement of their exchange rate for their currencies but they cannot change their currency value by combining the value of gold with the currency value. They have to inform IMF about their exchange rate arrangement and any change which have been made in their currency arrangement. They can rearrange their exchange rates to meet the following objectives:

- To fluctuate or fix their exchange rate in term of other currency rate
- To maintain value of their currency according to other members of the IMF
- To determine daily exchange rate of rupee with the major trading partners of India

Indexes for exchange rate

Indexes for exchange rate are converted to foreign currency per unit of domestic currency. This conversion is affected by rise in the exchange rate. According to the rise in currency rate, currency is considered as approved or not approved in the foreign exchange market. There are three indexes, nominal, effective and real, which are used to analyze the effect of the exchange rate in the market.

Nominal index of a currency is the present rate of that currency in the foreign exchange market. This means, nominal index represents the total amount of currency

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which is paid against per unit of another currency. For example, if any trader gets 2 USD after paying 100 Indian rupees, then 2 is nominal rate of USD against Indian rupee. Nominal index is represented as USD/AUD: 1.45/1.

Real index is the nominal rate which is adjusted by two countries for pricing their currencies in foreign exchange market. Thus, real index represents purchasing power of the currency. It also implies the competitive power of a country in the foreign exchange market. The real index of exchange rate can be determined using the following equation:

$$I_R = (NI_D)/I_F \quad \text{Equation 4.4}$$

In the above equation, the following variables have been used:

- I_R: real index of exchange rate
- **N**: nominal index
- I_F: index of foreign price level
- I_D: index of domestic price level

Effective exchange rate represents the measurement of appreciation and depreciation of a currency used in a country against the currency of those foreign countries which are trading with that particular country. Effective exchange rates change according to reduction in the taxes and tariff which reflect the prices of import.

3.3 FOREIGN EXCHANGE RATE RISK

Foreign exchange rate risk is of utmost importance in the international business environment as it reflects the business in the international market. Foreign exchange risk refers to the variation in resources, liability, income and expenditures due to changes occurring in exchange rate. Foreign exchange rate risk for a trader is directly dependent on the position of the trader in the foreign exchange market. The process that is performed to avoid the foreign exchange rate risk is called hedging. Hedging means combining of assets and liabilities of exchange market in such a way that it reduces the chances of occurrence of foreign exchange rate risk. Traders or hedgers match their assets and liability with foreign currencies to avoid foreign exchange rate risk.

There are many techniques which are used to reduce and avoid foreign exchange rate risk. Forward contact is the simplest technique for reducing the foreign exchange rate risk. Forward contract helps fix the rate of currency on which future exchange rate of the currency is depended. Forward contract is best technique for those commitments which are fixed in advance. Thus, forward contract is an important part of risk management for banks. However, forward contracts are restricted to those commitments which are related to more than one million US dollar.

Future contract is also used for reducing the foreign exchange rate risk. Future contract refers to a contract for trading of the currencies on a future date according to a specified rate. It provides a way for anticipating the variances and liquidity of the transactions. There are two exchanges, the Chicago Board Of Trade (CBOT) and the Chicago Mercantile Exchange (CME), that uses future contract for trading commodities and currencies. A part of CME International Monetary Market (IMM) is responsible for all forward contract related to foreign currencies such as AUD, CAD, GBP, JPY and CHF, gold and treasury bills. It is very difficult to maintain security of future contract but it provides more security for the exchange rate of the currency than forward contact. Future contract has some similarities with forward contract when traders commit their

Check Your Progress

3. Define what triangular arbitrage.
4. Name the simplest technique of reducing foreign exchange rate risk

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deal of future by setting exchange rate for currency in advance. However, future contract is larger and less profitable than forward contract.

Future contract uses standard exchange rate for trading but forward contract uses a simple way of trading currencies. Thus, forward contracts are flexible in term of maturity, contract amount and managing crisis in liquidity. You have to commit a reverse deal with the counterparty to reject the forward contract. Future contract uses standard amount for trading and thus providing security and liquidity.

Money market alternative is another option for reducing foreign exchange rate risk. It represents the combination of spot transaction with the money market transactions. Money market transaction involves raising amount for a loan in a foreign country for traders who have an existing position in the market. This means, a trader arranges for loan according to foreign currency which is equal to the future instalments for repayment of loan for a particular time period. If any trader does not have an existing position in the market, then money needs to be borrowed in foreign currency. After this, the borrowed money needs to be exchanged with domestic currency and loan has to be paid back in the same manner as the existing traders pay the loan.

Another security technique is forward hedge and money market hedge. Forward hedge is used for simple transactions. It requires only one transaction which is absolute purchasing of currency. Money market hedge requires more transactions such as raising loan, purchasing foreign currency and paying foreign loan in foreign currency. Money market hedge technique is also used for determining the future price of the currency. Forward hedge and money market hedge are related to the interest and exchange rate of the currency. Money market hedge is preferred to forward hedge when market allows selected borrowers to credit at less market interest rate or when a trader pays more exchange rate than current market rate for a currency. Thus money market hedge is always preferred when more than one transaction needs to be performed and no forward hedge is available.

3.4 SUMMARY

The foreign exchange market is the market where one currency is traded against another currency. It is a global market and is used to perform transactions related to money and currencies. Various participants of the transactions are banks, industries and brokers. Different participants form the structure of the foreign market which consists of price makers, brokers and price takers. Price makers and price takers use different quotations for trading the currencies. These quotations include the bid and ask rates of the currencies according to the trader. These quotations are used to perform transactions such as direct and indirect. In direct and indirect transactions, different types of quotations such as spot, forward and swap quotations are used for trading currencies. Swap quotation is the combination of spot and forward quotations. The quotation of the currency in the market should be used to avoid arbitrage situations which cause profit to the participants of the market without any investment and risk.

3.5 KEY TERMS

- **Foreign exchange market:** It is a market for the sale and purchase of currencies from countries around the world.

- **Bulls:** It is a person who anticipates that in a group of securities prices are rising or are expected to rise.
- **Bears:** It is a person who anticipates a currency to become cheaper in the future so that it can be sold at a relatively higher price.

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3.6 ANSWERS TO 'CHECK YOUR PROGRESS'

1. The various foreign exchange market participants are listed as follows:
   - Commercial banks
   - Central banks
   - Brokers
   - Traders and speculators
   - Hedge funds
2. The major political condition that affects the performance of a currency is political instability, which includes the amount of corruption and bribery and the degree of law and order.
3. Triangular arbitrage is that market situation in which a bank provides some exchange rates that are not directly inverse of exchange rate of another bank but provides an indirect way to get profit without any risk to the trader.
4. The simplest technique of reducing foreign exchange rate risk is forward contact that helps fix the rate of currency on which future exchange rate of the currency is dependent.

3.7 QUESTIONS AND EXERCISES

Short-Answer Questions

1. Give the currency code for the following:
   A. Swiss franc
   B. Dutch guilder
   C. Belgian franc
   D. British pound
   E. Swedish kroner
   F. Italian lira
2. What do you understand by foreign currency broker?
3. What is meant by foreign exchange risk?
4. What is meant by forward contract?
5. Explain the different parts of the foreign exchange market in India.
6. Calculate bid-ask spread rate of USD/CHF: 1.5768/72.
7. Give a brief explanation of SWIFT.

Long-Answer Questions

1. Explain the floating exchange rate system with emphasis on pure float and dirty float.
2. Describe the origin and formation of EMU.
3. Explain the structure of foreign exchange market.
4. What do you mean by currency convertibility?
5. Describe the different types of transactions used in the foreign exchange market.
6. What do you mean by warehousing the dealing?

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3.8 FURTHER READING

International Business- Concept, Environment and Strategy by V Sharan.
International Business by Justin Paul.

UNIT 4 GLOBAL STRATEGIES OF BUSINESS

NOTES

Structure

4.0 Introduction
4.1 Unit Objectives
4.2 Basic Concept Of Strategy
 4.2.1 Definitions of Strategy
 4.2.2 Importance of Strategy
 4.2.3 Strategic Business Units
4.3 Introduction To Business-Level Strategies
 4.3.1 Generic Business Strategies
 4.3.2 Cost Leadership Business Strategy
 4.3.3 Differentiation Business Strategy
 4.3.4 Focus Business Strategy
4.4 Combination of Generic Business Strategies
4.5 Tactics for Business Strategies
 4.5.1 Timing Tactics
 4.5.2 Location Tactics
 4.5.3 Defensive Tactics
4.6 Strategies for International Business
 4.6.1 International Strategy
 4.6.2 Multidomestic Strategy
 4.6.3 Global Strategy
 4.6.4 Transnational Strategy
 4.6.5 Advantages and Disadvantages of Different Strategies
4.7 Strategy for Global Market Entry
 4.7.1 Market Entry Strategy Options
4.8 Global Strategies of Business in India
 4.8.1 Obstacles to Globalization of Indian Companies
 4.8.2 Factors for Encouraging Globalization in India
 4.8.3 Globalization Strategies used by Indian Companies
4.9 Summary
4.10 Key Terms
4.11 Answers to 'Check Your Progress'
4.12 Questions And Exercises
4.13 Further Reading

4.0 INTRODUCTION

A company, in order to implement an appropriate strategy for attaining globalization, will have to become familiar with the political systems in Europe and Asia. East Asian countries have already become world leaders in labour-intensive industries. A world market has emerged from what previously was a multitude of distinct national markets and the climate for international business today is much more favourable than yesterday. The two factors—mass communication and high technology—are creating similar patterns of consumption in diverse cultures worldwide. This means that many companies may find it difficult to survive by relying solely on domestic markets.

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It is no exaggeration to say that in a rapidly changing global scenario, the riskiest posture for an industry is to remain a domestic competitor. The domestic competitor will stand aside and watch as more aggressive companies use their growth to capture economies of scale and learning. It will then face an attack on its domestic markets by the globalizing companies using different (and possibly superior) technology, product design, manufacturing, marketing approaches and economies of scale. A few examples suggest how extensive the phenomenon of world markets has already become.

4.1 UNIT OBJECTIVES

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

- Explain the importance of strategy and the concept of strategic business unit
- Describe business level strategies which include generic business strategies, cost leadership business strategy and focus business strategy
- Describe different types of tactics which include timing tactics and defensive tactics for business strategies.
- Explain the global business strategies used in India

4.2 BASIC CONCEPT OF STRATEGY

The word 'strategy' is derived from the Greek word 'strategia' which means generalship, i.e., the actual direction of military force. The word 'strategy' means the art of the General. It is widely accepted that the emergence of strategy as a major component of management can be attributed to the increased scale and pace of technological changes, both within and outside the organizations. Strategy is a technique that helps a company to attain its desired goals and provides means for achieving the ends or the objectives. A strategy is comprehensive as it covers all the major aspects of the enterprise. It is integrated and all the parts of the strategy are compatible with each other. The word is commonly used in many fields such as:

- Business
- Chess
- Economic
- Military
- Marketing
- Technology
- Trading
- Strategic management

4.2.1 Definitions of Strategy

According to Bower and Shirley, 'Strategy is a plan or course of action, which is of vital, pervasive, or continuing importance to an organization as a whole.'

According to Gluek and Jauch, 'A strategy is a unified, comprehensive and integrated plan that relates the strategic advantages of the firm to the challenges of the environment. It is designed to ensure the achievement of the basic objectives of the enterprise.'

The main activity of a strategy in an organization is to match the enterprise resources with the varying business conditions. It determines how the organization should be positioned in future to take advantage of the market opportunities.

According to Thompson and Strickland, 'A company's strategy consists of the combination of competitive moves and business approaches that managers employ to please customers, compete successfully and achieve organizational objectives.'

Strategy consists of making choices among alternative action programmes, commitment to specific product markets, competitive moves and business approaches on the part of the managers to achieve organizational goals.

Johnson and Scholes define strategy as follows: 'Strategy is the direction and scope of an organization over the long-term which achieves advantage for the organization through its configuration of resources within a challenging environment to meet the needs of markets and to fulfil stakeholder expectations.'

Thus, strategy has the following features:

It helps in taking a course of action leading to a particular direction related to the company's functions.

- It helps in achieving objectives or mission of the company.
- It helps in dealing with uncertainties.
- It helps in ensuring the availability of resources for the future to implement a plan.
- It helps in coordinating with different activities to achieve the desired goal.

Strategy in business has taken various connotations based on the studies and views of various management experts. While deciding the course of action, a manager may have to get involved with the following situations:

- How to face the competition
- Whether to undertake expansion or diversification
- How to ensure stability or to decide upon disinvestment

For a successful performance of a company, unified, comprehensive and an integrated plan must include operational concerns.

The probability of success is enhanced with the combination of good strategic planning and implementation. A good strategy with poor implementation or a poor strategy with good implementation is unlikely to get successful.

4.2.2 Importance of Strategy

The importance of strategy has been widely accepted and applied to all the fields, especially in business and military expeditions. Formulation of a good strategy helps a company to attain its desired goals. A strategic plan provides an employee a clear vision of the purposes and objectives of the organization. The formulation of strategy forces the organization to analyze the prospects of change in the near future and prepare itself for change. Strategic formulation helps the organization to plan its capital budgeting. So,

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even if organizations have limited funds to invest, they can allocate capital funds more effectively to attain a higher rate of return on the investments.

On the contrary, an organization without a clear strategic plan destroys its goodwill in the market. The organization becomes purely reactive to external pressures and less effective at dealing with the change. In highly competitive markets, an organization without a rational strategy is likely to be defeated by its rivals and may face a declining market share or sales.

The formulation of a reliable strategy can be executed through the following steps:

1. A company must opt for the industry it desires to engage in, i.e., it needs to formulate its corporate strategy first.
2. The organization should then formulate its 'mission statement' consistent with its business definition.
3. The organization must develop its strategic objectives or goals and set performance objectives.
4. Based on its objectives and analysis of both internal and external factors of the environment, the organization must form a specific business strategy which will fulfil its corporate goals.
5. The organization should then implement the business strategies by taking specific actions such as reducing prices, forging partnerships and venturing through new distribution channels.
6. Finally, the organization needs to review the effectiveness of its strategy along with the performance evaluation and change its policy as per the requirement by repeating the above steps.

These steps form the core of strategic management in the organization.

4.2.3 Strategic Business Units

When a company possesses different businesses or portfolios of merchandise, the most common technique that a company adopts is to form Strategic Business Units (SBUs). In order to segregate the units or segments, each performing a similar set of activities, many companies are organized on the basis of operating divisions. These divisions are also known as profit centres or SBUs.

SBUs are generally formed when there exists a number of businesses, each being unique in some way or the other, either in terms of merchandise or in terms of markets in which they operate.

There are various levels of strategy involved in the process of SBUs. At first, there is a corporate-level strategy and then there are SBU-level strategies. We also need to realize that there are differences in their functional areas in terms of marketing, finance, production and operations. Therefore, functional-level strategies are required at both the corporate and SBU levels.

Figure 4.1 shows the functional-level strategies at the corporate level.

Check Your Progress

1. State how Gluek and Jauch have defined strategy.
2. What is the main purpose of strategy in an organization?

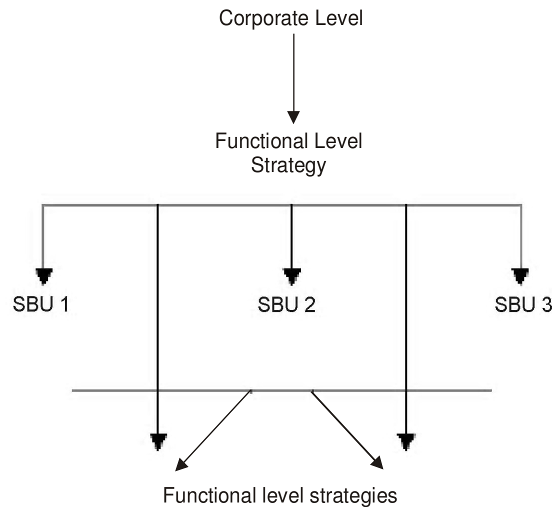

Figure 4.1 *Functional-level Strategies*

4.3 INTRODUCTION TO BUSINESS-LEVEL STRATEGIES

For any organization, it is very important to identify its functional strategies which help in building competitive advantage through efficiency, quality, innovation and customer responsiveness and achieving its business-level strategies. Strength, Weakness, Opportunity and Threats (SWOT) analysis helps in providing the information on the functional capabilities of the company. Later, the analysis based on production, marketing and research and development strategies help in gaining the picture of the company's course of action, i.e., where the company is going. At this point, the SWOT analysis helps an organization to evaluate the potential of its strategy. It recommends the pattern of its future actions that helps in defining the corporate and business strategies of the organization.

The corporate strategies provide a broad direction to the organization by guiding the individual businesses towards growth. The purpose of corporate strategies is to transfer the resources and skills, share activities and create strategies for different businesses. Corporate strategies lay down the framework in which business strategies operate. Thus, business-level strategies are derived from the corporate strategies.

A business-level strategy is a strategic management tool that helps an organization to maintain its position in the market. Business strategies are the course of actions adopted by the firms for each of its businesses separately to serve the identified groups of customer and provide value to the customer by satisfying their needs. In this process, the firm uses its competencies to gain, sustain and enhance its strategic or competitive advantage. If the company has individual business, then its business-level strategy is similar or identical to its corporate-level strategy in the industry. If the company has many businesses, then each business unit has its own business-level strategy.

The source of competitive advantage for any business operating in an industry arises from the skilful use of its core competencies. These core competencies are used to gain competitive advantage against the rivals in the industry. Competitive advantage results in the above-average returns to the company. Businesses need a set of strategies to secure competitive advantage.

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Michael E. Porter worked extensively in the area of business strategies which are also known as competitive strategies. His writings in the form of books, research papers and articles have deeply influenced the contemporary thinking in the area of industry analysis, competitive dynamics and competitive strategies. According to Porter, 'The basic unit for understanding the concept of competitive strategy is the industry which is a group of competitors producing products and services that compete directly with each other. Through competitive industry, the firm defines and establishes an approach to compete in their industry.'

According to Porter, the dynamic factors that determine the choice of competitive strategy are the following:

- **Industry structure**: It is determined by the following competitive forces:
  - o The threat of new entrants
  - o The threat of substitute products and services
  - o The bargaining power of suppliers
  - o The bargaining power of buyers
  - o The rivalry among the existing competitors in an industry

  These forces vary from industry to industry as every industry has a unique structure. These forces or factors determine the long-term profitability of firms in an industry.

- **Positioning of firm in the industry**: It is designed to gain sustainable competitive advantage. One type of positioning approach may be to offer mass-produced products distributed through mass-marketing which results in lower cost per unit. The other type of positioning approach is to market relatively high-priced products of a limited variety while focusing on the identified customer groups who are willing to pay the high price. These products are produced through batch production and marketed through specialized distribution channels. For this, the firms differentiate their products and services on tangible basis from that of its rivals so that the customer purchases the products even at the premium price. This approach is termed as differentiation approach in competitive advantage. Positioning of a firm in the industry is based on two variables which are as follows:
  - o **The competitive advantage**: To gain competitive edge over its rivals, firms adopt two techniques or approaches which are low-cost approach and differentiation approach. Low-cost approach is based on the competence of the firm to design, produce and market a product more efficiently than its competitors. Differentiation is the competence of the firm to provide unique and superior value to the buyer in terms of product quality, special features or after-sales services.
  - o **The competitive scope**: It defines the breadth of firm's target within its industry. Breadth of the firm's target means the range of products, distribution channels, types of buyers, geographic areas served and the array of related industries in which the firm may compete. The basic reason why competitive scope is important is that the industries are segmented, have varied needs and require different sets of competencies and strategies to satisfy the needs of customers.

When the two factors of positioning are combined, the result is a set of generic competitive strategies. These are also known as the business-level strategies.

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4.3.1 Generic Business Strategies

An organization follows various business strategies to improve its competitive position in the market. These strategies can be competitive or corporative. Competitive strategies are those strategies that an organization implements to compete with its competitors for achieving higher position. Corporative strategies are those strategies under which an organization works with one or more competitors to gain advantage over other competitors.

Business strategy depends on the industry structure and positioning of the firm in the industry. Porter developed three generic strategies that can be used individually or in combination to achieve a higher position in the market. Figure 4.2 shows the Porter's matrix of generic business strategies.

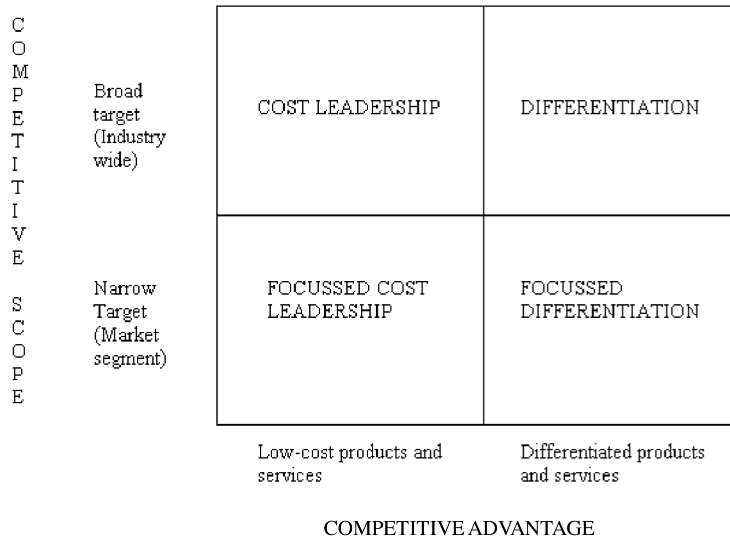

Figure 4.2 *Porter's Matrix of Generic Business Strategies*

Porter states that the strategies are generic because they are applicable to any type or size of business. Generic business strategies help organizations to establish a competitive advantage over industry rivals. Firms may also choose to compete across a broad market or a focused market. According to Porter, business strategies can be classified into three types:

- Cost leadership
- Differentiation
- Focus

4.3.2 Cost Leadership Business Strategy

Organizations compete for the wide range of customers on the basis of price. Price is based on the internal efficiency of the organization and the cost of manufacturing and distributing the products and services.

When the competitive advantage of a firm lies in a lower cost of products and services relative to what the competitors have to offer, it is termed as cost leadership. When an organization follows the cost leadership strategy to design, develop and market the product at a lower cost than its competitors, it is known as the low-cost strategy. This strategy requires the policies that aim at producing and distributing low-cost products and services in the market. The customer prefers to spend on low-cost products and services; therefore, an organization must gain a margin that sustain above-average returns

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and cost to the customer. An organization can minimize the overall cost by minimizing the costs incurred in the construction of efficient-scale facilities, overheads, operating expenses, input costs, labour costs, marginal customer accounts costs and lower distribution costs. Cost leadership strategy is mostly useful for the organizations selling the unbranded commodities such as beef or steel. Following are the few examples of the firms using corporate leadership business strategies:

- Tata Steel emerged globally as the lowest-cost producer of steel in 2000. Its vision statement included the intention of becoming the world's cheapest steel producer. Tata Steel attempted cost reduction through benchmarking with the global steel firms. World Steel Dynamics, a leading industrial analyst reviews the lowest-cost producer every year. In 1999, Posco of South Korea was rated as the lowest-cost producer of hot-rolled coils and Tata Steels was expected to replace Posco as the lowest-cost producer of steel globally.
- Moser Baer India, a Noida-based world class manufacturing company, dealing in compact discs that are known as CD-Rs for one time recording of data. The global market is dominated heavily by Taiwanese companies who are acknowledged as the low-cost manufacturers of CD-Rs. Moser Baer India aimed to become one of the top global companies in the data storage business. Its business strategy is based on low-cost and it focuses on achieving the economies of scale and leveraging the competitive advantages that it has in raw material and labour costs.
- Gujarat Cooperative Milk Marketing Federation (GCMMF), the country's largest cooperative known by its brand name Amul, operates in the branded ice-cream market on the lower-cost platform. It has the backing of about 180 cooperative dairy networks located across the country and an efficient supply chain in place for the procurement of high-quality milk. Besides these, it has developed a chain for supplying its refrigerated products through an efficient distribution network.

When the firms offer products at a comparable price, then the cost leader firm earns a higher profit owing to the low cost of its products. Thus, a low-cost leader in any market gains competitive advantage. Cost leadership offers a margin of flexibility to the firm to lower the prices if the competition becomes stiff and yet allows the firm to earn the same level of profit. The cost leadership strategy is appropriate under the following situations:

- When products and services are standardized
- When the generic goods are acceptable by the customers
- When the offered products and services are at lowest price
- When the price of the product is a vital factor for an organization while taking the purchasing decision
- When the branded products available in the market are very costly
- When the cost of the products available in the market is constant and not changing rapidly

The basic objective of achieving cost leadership is the understanding of the value chain for the product and services of a firm. Value chain is a framework which is used by the organizations to identify and evaluate the methods in which their resources and capabilities can add value to the product and services. Analysis of the value chain help in assessing the organizational capabilities, methods of reducing costs and finding the ways for adding value to the customer transactions to provide competitive advantage. Costs

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are spread over the entire value chain in activities and thus, contribute to the manufacturing of a product. The basic objective in achieving cost leadership is to ensure that the cumulative cost in the value chain is lower than that of its competitors. For doing the same, it is necessary to analyze the cost drivers and then identify the areas for optimization of costs.

To be a cost leader, continuous efforts are needed to lower the costs related to competitors. Following are the actions that you can take for achieving the cost leadership:

- Accurate demand forecasting and high capacity utilization are necessary to realize the cost advantage.
- Attaining economies of scale to reduce the per unit cost of the products and services by maintaining tight control over production and overhead costs and minimizing the cost of sales, research and development and service.
- Creating high level of standardization of products and offering uniform service packages using mass production techniques to yield low per unit costs.
- Aiming at the average customer makes it possible to offer a generalized set of utilities in the product and services to cover a greater number of customers.
- Investments in cost-saving technologies to make the product and services competitive in the market.
- Withholding differentiation till it becomes necessary to find another way for realizing cost-based competitiveness.
- Building such efficient facilities that it becomes costly for the rivals to imitate.
- High level of expertise in manufacturing process engineering.
- Skill in designing products for efficient manufacturing.
- Efficient distribution channels of the firms.

Cost leadership strategies are based on the premise that low price is an attractive proposition for a customer and the customers place a great emphasis on it in their buying decision. But this is not correct in all the cases, as there are times when a product might have some features which are considered essential by the customers and so they are willing to pay the extra amount for those features. Lower cost is always relative to what the competitors have to offer. Even when there is no price war, as the industry matures or grow, and price declines, the firm producing products and services at lower price remains profitable in the long run. Thus, the cost leadership strategy usually aims at a broader market. Low cost by itself is not absolute. It must be noted that cost advantage should be sustainable and it should not be easily duplicable by the rival companies.

However, low cost does not always lead to low price. Producers may price the product and services at competitive parity, by exploiting the benefits of a bigger margin than its competitors. For example, organization such as Toyota is good not only at producing high quality automobiles at a lower price but they have the brand and marketing skills to use a premium pricing policy too.

Not every condition under which markets operate is conducive to the use of the cost leadership business strategies. The following are the conditions that make such usage meaningful under the cost leadership strategy:

- The markets for the products and services operate in such a way that price-based competition is vigorous making costs an important factor.

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- The products and services are standardized and their consumption takes place in such a manner that differentiation becomes sufficient.
- The buyers may be numerous and possess a significant bargaining power to negotiate a price reduction from the supplying firm.
- There is lesser customer loyalty and the cost of switching from one seller to another is also low. This is often seen in the case of commodities or products which are highly standardized.
- There might be few available methods for differentiation to take place. Alternatively, whatever ways for differentiation are possible, it does not matter much to the customers.
- Products designed for ease of manufacturing and low-cost distribution with focus on a large base of customers.
- The entire focus is on costs and thus, firms need to operate under high degree of supervision and tight control.

Cost leadership works best when the products and service features are such that the buyers are price-sensitive and base their purchase decision primarily on it. Following are the few benefits that arise out of cost leadership strategy:

- Cost advantage acts as the best insurance against the industry competition. This strategy protects the organization from its competitors if it has a low-cost structure for its products and services.
- Powerful suppliers possess a higher bargaining power to negotiate price increase for inputs. Firms possessing cost advantage are less affected in such cases as they can absorb the price increase to some extent.
- Powerful buyers possess a higher bargaining power to effect price reduction. Firms possessing cost advantage can offer price reduction to some extent in such cases.
- The threat of cheaper substitute can be offset to some extent by lowering the prices.
- Cost advantage acts as an effective entry barrier for potential entrants who can not offer the products and services at a lower price.

Firms usually acquire cost advantages by improving its efficiencies, gaining unique access to a large source of lower cost materials, making optimal outsourcing and vertical integration decisions or avoiding some costs altogether.

If the competing firms are unable to reduce the cost of products and services, the firm may be able to sustain competitive advantage based on cost leadership.

The risks faced under the cost leadership business strategy are several. Following are the various risks associated with the cost leadership strategy:

- Organizations competing for the overall cost leadership may engage in price wars that may lead to decrease in the profit level.
- Cost advantage is imitative and does not remain for long as competitors can imitate the cost reduction techniques easily. The duplication of cost reduction techniques makes the position of the cost leader vulnerable from competitive threats.
- Severe cost reduction can dilute customer focus limit experimentation with product features and attributes. This may create a situation where cost reduction is done

for the organization's own sake and the interests of the customers are ignored. Thus, cost leadership is obviously not a market friendly approach.

- Depending on the industry structure, sometimes less efficient producers may not opt to remain in the market owing to the competitive dominance of the cost leader. In such situations, the scope for product and services may get reduced affecting the cost leader adversely.
- Technological threat is a great threat to a cost leader as these may change the rules on which an industry operates. Thus, technological breakthroughs can upset cost leadership strategies.
- The strategy is not useful in dynamic situations such as change in technology and environment. Therefore, the organization has to incur development and marketing research costs to survive in the market.
- Overemphasis on cost may make the firm lose the sight of changes in the customer needs and in the markets.

4.3.3 Differentiation Business Strategy

When the competitive advantage of a firm lies in special features incorporated into the product and services which are demanded and valued by the customers who are willing to pay for those, then the strategy adopted is known as differentiation business strategy. Customers prefer differentiated product and services when it offers them a utility that they may value and are willing to pay more for getting such a utility.

A differentiation firm may charge a premium price for its product and services, gain additional customers who value differentiation and command customer loyalty. Profits for the differentiator firm is evaluated from the difference in the premium price charged and the additional cost incurred in providing the differentiation. To an extent, the firm is able to succeed by offering differentiation by maintaining a balance between its price and costs. But it may fail if the customers are no longer interested in the differentiated features of a product or not willing to pay extra for such features. Following are the few examples of the firms using differentiation business strategies:

- In the branded salt industry, DCW Home Products aimed its brand Captain Cook, which has been sold to Corn Products now, at the quality conscious salt users. Product attributes such as free-flow, iodine content among others were highlighted along with the utility packaging. The price was in the premium category that was differentiated from the unbranded salt which was much cheaper.
- In an interesting case, packaging became the differentiator for Parle Agro when in 1985, it launched Frooti, a non-aerated, fruit-based, natural drink in a tetrapack. The customer preferred glass-bottled drinks, especially since it has maintained price parity with the popular aerated drinks.
- Gati, a multimodal transport company, differentiated its services in a highly competitive and uniform market with tangibles such as risk insurance offer for shipments, refund on failure to deliver goods on time, door-to-door pick up and delivery, time-bound operations and safe transportation. It used several service features to differentiate itself from the run-off-the-mill transporters in the unorganized sector. It charged a higher price for its differentiated services.

The key for achieving differentiation is to create value for the customer that is unmatched by the competitors at the price at which the differentiator firm offers its products and services. This is done through incorporating features and attributes in the

product and services valued by the customers. Some companies that use this strategy are Rolex, Intel and Ralph Lauren. Following are the various features that a differentiator firm may adopt:

- A firm may incorporate features that offer utility to the customers and match their tastes and preferences.
- A firm may incorporate features which lower the overall cost for the buyer using the product and services.
- A firm may incorporate features which increase the buyer satisfaction in tangible or intangible ways.
- A firm may incorporate features which can offer high quality products and services.
- A firm may incorporate features which raise the performance of the product.
- A firm may incorporate features which enable the customers to claim distinctiveness from the customers and enhance their status and prestige among the buyer commodity.
- A firm may offer a full range of products and services which is required by the customer for satisfying their needs.
- A firm may incorporate its innovative ability to find new bases for differentiation.

Differentiation strategy makes a product unique through advertising and by highlighting product's attributes and features. Uniqueness of the product influences the consumer to pay extra for the product. Therefore, differentiation helps the organization to sustain competitive edge. Apart from special attributes and service features, there could be the promise of more value for money, superior after-sales services, engineering, design and performance capability, quality manufacturing, catering to different tastes and preferences and customization to individual needs.

Normally, one may expect customers to go for product and services with lower price and comparable utility. But it must be noted that the customers and markets are not homogenous; there are many market niches and customer groups that may demand special treatment by the firms. Products and services cannot always be uniform. If they were, they may be simply the commodities that need no special brand names. Following are the major conditions under which differentiation strategy could be employed:

- The market is too large to be created by a few firms offering the standardized products and services.
- The customer needs and preferences are too diversified to be satisfied by a standard product and service.
- It is possible for the firm to charge a premium price for differentiation that is valued by the customer.
- The nature of the product and service is such that the firm can generate and sustain brand loyalty.
- There is ample scope for increasing sales for the product and services on the basis of differentiated features and premium pricing.

The differentiator firms can remain profitable through effective differentiation even if the Porter's five forces do not work. Following are the benefits of differentiation strategy:

- Through differentiation, firms are able to distinguish themselves successfully and thus, reduce the scope of competitive rivalry.

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- Customer brand loyalty too acts as a safeguard against competitors. Powerful suppliers can negotiate price increases that the firm can absorb to some extent as it has brand loyal customers who are typically less sensitive to price.
- Powerful buyers do not usually negotiate price as they have fewer options with regard to suppliers and generally have no cause for complain as they get the special features and attributes demanded. Differentiation is a market and customer-focused strategy.
- Differentiation is an expensive proposition. New entrants are normally unable to offer the similar differentiation at a comparable price. Thus, differentiation acts as a barrier for entry to the new entrants.
- Under differentiation strategy, substitute product and service suppliers also face negligible threat from established differentiator firms.

The ultimate success of a differentiation strategy lies in its ability to identify a tangible basis for customers to get associated to the products and services which a firm offers. But the more tangible the basis becomes, the greater chances of product and strategy imitation by the competitor arise. So, a firm has to rely on its core competencies to offer not so tangible differentiation which the customers can easily relate to and that can sustain at a price which they are willing to pay. Following are the risks associated with this strategy:

- Differentiation fails to work if the customer does not value it. This often takes place where unnecessary features are added for differentiation. Such instances also occur when overdifferentiation is done with little tangible benefit for the customer.
- Organizations following this strategy are more vulnerable to different competitive threats than the organizations following cost leadership strategy. For example, competitors can imitate the features of the product and sell the similar product at low cost.
- There is imminent threat from competitors who can imitate the differentiation strategy. This way, the advantages associated with the differentiation strategy are limited.
- Charging a high price for the differentiated product may cause the customers to refrain from the additional advantages of a product and service on the basis of their own cost-benefit analysis.
- Overrelying on the intrinsic product attributes that are not apparent to the customer may cause the differentiation strategy to fail.
- In case of several differentiators adopting similar differentiation strategies, the basis for distinctiveness is gradually lost.
- Customer's taste changes frequently and hence, reduces the demand of the product in the market. For example, Polo Ralph Lauren is one of the successful brands in the fashion industry. However, some young consumers have shifted to Tommy Hilfiger and other youth-oriented brands.

4.3.4 Focus Business Strategy

Focus strategy is one of the most complicated generic business strategies. Focus business strategies rely on either cost leadership or differentiation but it caters to a narrow segment of the total market. Therefore, focus strategies are also known as the niche strategies.

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It is more suitable where an organization can neither afford wide scope leadership nor a wide scope differentiation strategy. In such cases, the firms focus on its efforts and resources on a narrow but a defined segment of the market. The more commonly used bases for identifying customer groups are the demographic characteristics such as age, gender, income and occupation, geographic segmentation and lifestyles. For the identified market segment, a focused firm uses either the low-cost or differentiation strategy.

Focus is essentially concerned with identifying a narrow target of markets and customers. The firm seeking to adopt a focus strategy has to create a niche in the market where the cost leaders and differentiators are not operating. Following are the examples of the firms who adopted the focus strategies either on the basis of lower cost or differentiation:

- Philips India Ltd. launched the flat television with plasma technology featuring the distortion-free pictures and bright, accurate colours fitted with an integrated Dolby pro-logic sound system. The premium-priced TV with differentiation on technology basis was targeted at the niche market of a selective, sophisticated and technology-driven audience.
- Harvest Gold Foods India Ltd. differentiates its bread by the same brand name on the basis of geographical focus supported by competitive pricing, product attributes such as freshness and high quality, efficient distribution and transparent packaging.
- A branded jewellery business of Titan Industries operates in highly skilled craftsmen in the jewellery trade. Designs of jewellery vary across regions. Tanishq, the jewellery brand of Titan, adopted a differentiation strategy that offered a range of gold, pearl and diamond jewellery for women and men. Designs were made on the basis of continual feedback from its extensive retail network of showrooms. New designs were introduced every quarter. The brand projects itself as a reputed firm, i.e., Tata group of companies with a guarantee of purity.

The competitive advantage is generated specifically for creating the niche. This strategy is most appropriate for the small firms that have less ability or resources to engage in a nationwide marketing effort. It is also appropriate in the situations when firms have enough resources to engage in a nationwide marketing effort but the target market is small. A firm may use either a cost focus or differentiation focus. With a cost focus, a firm aims at being the lowest-cost producer in that niche or segment. Cost focus is unachievable with an industry depending on the economies of scale. With a differentiation focus, a firm creates competitive advantage through differentiation.

Focused firms have been able to not only identify but also create niches for themselves. In the course of doing research for customer needs and preferences, a firm may find a hidden niche that may not have attracted the attention of the existing firms in that industry. It is for the company to build upon the idea, design the product and service attributes and features to this niche and come up with a focus strategy. Following are the conditions that support the adoption of a focus strategy either in terms of low cost or differentiation:

- There is some type of uniqueness in the segment which could either be geographical, demographic or based on lifestyle. Only the specialized attributes and features could satisfy the requirements of such a segment.
- There are specialized requirements for using products and services that the common customers can not be expected to fulfil.

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- The niche market is big enough to be profitable for the focused firm.
- There is a promising potential for growth in the niche segment.
- The major players in the industry are not interested in the niche as it may not be crucial to their own success.
- The focusing firm has the necessary skill and expertise to serve the niche segment.
- The focusing firm can guard its company from other firms on the basis of customer relations and the loyalty it has developed and its acknowledged superiority in serving the niche segments.

A wider choice of products, greater variety in services and a rising trend to customize the products and services to cater to the niche markets are evident in the Indian markets today. Following are the benefits associated with the adoption of focus business strategy either in terms of low cost or differentiation:

- A focused firm is protected from competition to the extent that the other firms, which have a broader target, do not possess the competitive ability to cater the niche markets. A focused firm provides products and services which other firms can not provide or find it unprofitable to provide.
- Focused firms buy goods in small quantities. So, the powerful suppliers may not show much interest. But price increments until a certain limit can be absorbed and passed on to the loyal customers.
- Powerful buyers are less likely to shift to other brands as they might find other firms willing to cater the niche markets as the focused firms do.
- The competence of the focused firms acts as an effective barrier to potential entrants into the niche markets.
- A focused firm provides specialized products based on customer needs; therefore, this strategy acts as a barrier for other organizations.
- The specialization that focused firms are able to achieve in serving a niche market acts as a powerful barrier to substitute products or services which might be available in the market.

There are several risks associated with focus strategies which arise from the small size of the focused firms and its dependence on the niche markets. The risks to focused firms are real and can be seen from the fact that several firms in competitive industries find it worthwhile to focus on narrower segment. Following are the risks associated with focus business strategies either in terms of low cost or differentiation:

- Serving niche markets requires the development of distinctive competencies to serve those markets. The development of such distinctive competencies may be long-drawn and difficult process.
- Being focused means commitment to the narrow market segment. Once committed, it may be difficult for the focused firm to move on to the other segments of the market.
- The costs for the focused firm are higher as the markets are limited and the volume of production and sales are small.
- Niches are often changeable as they may disappear owing to technology or market factors. Sometimes the rising costs of niche products may cause the customers to move to the lower-priced products of cost leaders.

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- The rising competition in the market may cause cost leaders and differentiator firms to look at niche markets with greater interest thereby facing a threat to the focused firms.
- Rivals in the market may sometimes outfocus the focused firms by devising ways to serve the niche markets in a better way.
- Customer preferences might change with time, thus creating difficulties for organizations.

It must be noted that the assumptions that lower costs are possible only in larger volumes or differentiation is costlier are not always true. This is due to the developments in process technology that have made it possible to reduce the production costs of differentiator firms to match those of the cost leaders.

4.4 COMBINATION OF GENERIC BUSINESS STRATEGIES

Strategic positioning adopted by the firms by primarily being cost leaders, differentiators or focussed is open to risks. No firm can make the assumption that the benefits derived out of any business strategy are for long term. It is necessary to evaluate continuously one's position and take appropriate strategic actions to protect oneself from the threats that may arise. Indeed, the purpose of managing a firm strategically is to be aware of the changes taking place in the environment.

These generic strategies are not compatible with each other. A firm may not achieve advantage if it attempts to achieve advantage on all fronts. However, a single generic strategy is not always the best as within the same product and service customers may find multi-dimensional satisfactions such as a combination of quality, style, compatibility and price. There have been the cases in which producers manufacturing the higher quality product and services followed a single strategy and then, they suffered when another firm entered the market with a lower quality product and services which met the overall needs and preferences of the customers.

There are two issues that are based on the combination of generic business strategies, which are as follows:

- **Stuck in the middle**: One of the major issues faced by the firms while adopting the combination of generic business strategies is 'stuck in middle'. According to Michael Porter, 'To be successful over a long term, a firm must select one of the three generic strategies. With more than one single generic strategy, the firm may [be] 'stuck in the middle' and may not achieve a competitive advantage.' Porter argued that the firms which are able to acquire multiple strategies often do so by creating separate business units for each strategy. By separating the strategies into different units with different policies and cultures, a firm is less likely to be 'stuck in middle'.

  In case the firm is 'stuck in middle', it is neither a cost leader nor a differentiator. Such firms do not possess competitive advantage and are constrained to below-average performance. These firms have to strive to achieve competitive advantage either through differentiation or low-cost approach. They have to look for the niche markets where they can adopt a focused approach on the basis of either

Check Your Progress

3. List the purposes for which a business-level strategy is used.
4. How does differentiation strategy make a product unique?

low cost or differentiation. If these approaches can not be adopted, it is better for the firm to move out of its areas of core competence.

- **Choice between the strategies**: Another issue faced by the organization is whether it is necessary to use either low cost or differentiation or whether it is possible to have both the strategies at the same time.

The assumption that low-cost and differentiation strategies are mutually exclusive and if the firm uses one strategy, then it cannot adopt another strategy, is not always true. Sometimes, it is possible to adopt both, low-cost and differentiation strategies simultaneously. This is possible if products and services are provided at low cost through technologies that enable differentiation through a focus on the niche segments. The firm that produces through mass production but can use technological means to create variety in the products and services, can sometimes combine the benefits of both the strategies. The use of Computer Aided Design (CAD) and Computer Aided Manufacturing (CAM) and robot technology results in the manufacturing of small batches of products at a low cost. This process is called mass customization. Economies of scale result in the mass production of parts, components and sub-assemblies that can be used to make small batches of customized products. Flexible manufacturing systems that use mass communication allows low-volume production at relatively lower costs, thereby achieving differentiation. Thus, each generic strategy has the attributes that can help a firm to defend against competitive forces. Table 4.1 shows the comparison between the generic strategies and industry forces.

Table 4.1 *Comparison between the Generic Strategies and Industry Forces*

Industry Forces	**Generic business Strategies**		
	Cost Leadership	**Differentiation**	**Focus**
Entry Barriers	Ability to reduce price in response discourages the potential entrants.	Customer loyalty can discourage potential entrants.	Focusing develops core competencies that can act as a barrier.
Buyer Power	Ability to offer lower price to powerful buyers.	Large buyers have less power to negotiate due to few alternatives.	Large buyers have less power to negotiate due to few alternatives.
Supplier Power	Powerful suppliers possess higher bargaining power to negotiate price.	Powerful suppliers can negotiate price.	Powerful suppliers may not show much interest as focused firms buy products in small quantities.
Threat of substitutes	Can use low cost strategy to defend against the substitutes.	Customers become attached to differentiating attributes which reduce the threat of substitutes.	Specialized products and core competencies protect against the substitutes.
Rivalry	Better able to compete on price.	Brand loyalty to keep customers away from rivals.	Rivals cannot meet differentiation-focused customer needs.

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4.5 TACTICS FOR BUSINESS STRATEGIES

Tactics play an important role in the growth of an organization. Most of the decisions of an organization fail because of poor tactics.

A tactic is a sub-strategy. It is a specific operating plan that explains how a strategy is to be implemented in terms of when and where it is to be put into action. Tactics are narrower in their scope and shorter in their time horizon. Therefore, tactics can be considered as a link between the creation and implementation of the available strategy. To formulate and implement any business strategy, two basic tactics are generally used which are timing and market location.

4.5.1 Timing Tactics

When to make a business strategy move is often as important as what move to make. Here, timing of the application of a business strategy becomes important. A business strategy of low cost or differentiation may be a right move but only if it is made at the right time.

The recognition of time as a strategic weapon and a source of strategic advantage came about in the late 1980s as a result of the ideas proposed by George Stalk Jr., the head of innovation and marketing at the Boston Consulting Group. Stalk considers firms as the systems whose individual parts are connected by time. According to Stalk,

> 'Time can be adopted as a critical source of competitive advantage by reducing process time and shortening the product development cycle. The planning loop denotes the time taken for manufacturing activities. Since time flows throughout any system, focusing on it results in improvements across the whole process. Time-based manufacturing concerns shortening the production run time, product-based organization of the production process and decentralized production scheduling. Time-based sales and distribution aims at eliminating delays in selling and distribution, reducing costs and improving customer service. Time-based innovation involves small product improvements, which are done more often by using cross-functional teams for product improvement and decentralized responsibility for innovative activities. Time-based strategy means attacking the competitors indirectly through surprise and gaining market share at least cost. This is different from direct attack which is done through the traditional means of cost-cutting and capacity addition that demand superior resources, are costlier and take a longer time.'

The company that manufactures and sells a new product or service first is called the pioneer or the first-mover firm. The firms that enter the industry subsequently are known as late-mover firms. Sometimes, an intermediate category of second-movers is also considered to include those firms which react immediately to the first-mover. It must be noted that howsoever quick second-movers might be to react, they are in any case late-movers. Following are the examples of first-mover firms:

- Parle, which is the first-mover in the mineral water industry in India, has attracted companies such as Coca Cola with the brand Kinley and Pepsi with the brand Aquafina. Parle dominated a major share of the mineral water market leading to its Bisleri brand and becoming generic to the product category. A case of a late-mover in this industry is Nestle which planned to introduce its brand PureLife by the end of 2000.
- In the mutual funds industry, Unit Trust of India (UTI), which was set up in 1964, is the first-mover with a clear lead of several years over other mutual funds in the public and private sectors.

- IIM, Ahmedabad is the first-mover in the autonomous institutions segment of the management education industry.

Being the first-mover is not always advantageous. Following are the examples which prove that even the late-movers have been advantageous:

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- UTI might be the first-mover but there are a number of late-movers such as Kotak Mahindra Group which has posed a stiff challenge to UTI.
- The Indian School of Business at Hyderabad is likely to challenge the dominant position of the IIMs.
- Late-movers such as ICICI Prudential Life Insurance, HDFC Standard Life Insurance and Max New York Life Insurance are likely to make life difficult for the first-mover, Life Insurance Corporation (LIC) of India.

Often the advantages of one type of firms are the disadvantages for the other. This implies that the advantages enjoyed by the late-movers may be the disadvantages for the first-mover firms. Following are the advantages that might accrue to the first-mover firms:

- They can establish a position as the market leaders. They can establish business models and gain valuable experiences that can enable them to reap the benefits of a learning curve which can help them assume cost leadership.
- Moving first in the industry results in forming early commitments to the suppliers of raw materials, new technology and distribution channels and creating cost advantages over late-movers.
- Moving first in the market constitutes a preemptive strike and creates lead for the first-mover. For the late-movers, imitation may be difficult and risky.
- First-mover develops an image of being a pioneer which helps build reputation. They create standards in different areas for all subsequent products and services in the industry.
- First-time customers are likely to remain loyal.

An organization can be a first-mover when it has enough resources to take complete advantage of the new market and secure its position in the market. Following are the disadvantages of being a first-mover in the market. But these may be the advantages for the late-movers:

- Being a pioneer is often costlier than being a follower. Pioneer firms have to spend resources on creating customer awareness and education regarding the products. Late-movers face fewer risks as the markets are already developed.
- Late-movers can imitate technological advances, skills, know-how and marketing approaches and easily eliminate the advantages that the first-mover is likely to possess.
- Technological change is often rapid creating obsolescence for the first-mover. Late-movers can ignore the technological thresholds and use the latest technology available.
- Customer loyalty is not guaranteed and can often prove to be short-lived. Late-movers can snatch the market share from the first-mover. If the first-mover has to retain market share and customer loyalty, then additional efforts have to be put in.

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- Late-movers can replicate the technological advances of the first-mover and this reduces the research and development cost.
- Late-movers can take advantage of the first-mover's natural inclination to ignore market segments.

The advantages and disadvantages for the first-mover show that good timing is important for any firm. But advantages can not just flow to the first-mover. In case the conditions are conducive to being a first-mover, then what matters are the strategies, positioning and entry barriers that the first-mover firm is able to create. It is not always that a firm has to be a first-mover even if it has the opportunity. Sometimes, fence-sitting till some other firms have tested the waters in an industry may be a prudent business strategy than jumping straight away in order to be the first-mover. Late-movers can learn from the mistakes of the first-mover and tune their business tactics accordingly. They can succeed if they possess the staying power.

4.5.2 Location Tactics

The second important aspect of business tactics is market location. This aspect deals with the issue of where to compete, i.e., the target market of the firm. Every industry has a number of firms which offer the same or substitute products or services.

One firm has the largest market share, some other firms have a relatively larger market share, a few others have a small market share and there are firms that operate only on the fringes and not in the mainstream markets.

A market location can be classified according to the role played by firms in the target market and the types of business tactics they adopt to play such a role. Marketing guru, Philip Kotler terms these tactics as competitive strategies. On the basis of the role that firms play in the target market, market location tactics could be of the following types:

- **Market leaders**: Market leaders are the firms with largest market share in the relevant product market and usually lead the industry in factors such as technological developments, product and service attributes, price benchmarks or distribution channel design. Kotler proposes the following three strategies in order to take up and retain the market leader position:
  - o Expanding the total market through new users, new uses and more usage
  - o Defending the market share through position defence, flank defence, counter-offensive defence, mobile defence and contraction defence
  - o Expanding the market share through the enhancement of operational effectiveness by the means of new product development, raising manufacturing efficiency, improving product quality, providing superior support services or increasing marketing expenditure
- **Market followers**: Market followers are the firms that imitate the market leaders but do not disturb the balance of competitive power in the industry. They prefer to avoid direct attack, keep out of the way of other firms and reap the benefits of the innovations made by the market leaders through imitation. The market followers may adopt the following broad strategies:
  - o Counterfeiter strategy which involves duplicating the market leader's product and packaging and selling it in the black market
  - o Cloner strategy which involves emulating the market leader's products, their name and packaging

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- o Imitator strategy which involves copying some things from the market leader while retaining some other attributes such as pricing, packaging or advertising
- o Adapter strategy which involves adapting one's own products to those of the market leader and selling them in different markets

- **Market challengers**: Market challengers are the firms that have the second, third or lower ranking in the industry. These firms can either challenge the market leaders or choose to follow them. When they seek to challenge the market leader, they do so with the hope of being able to gain the market share.

  The tactics adopted by the market challenger have several components. First, the challenger has to define its objective and its opponents, select a general attack strategy and then opt for a specific attack strategy. The most common objective of the challenger is to increase the market share and drive the opponent out of the industry. A general attack strategy could be of the following types:
  - o Frontal attack involving matching the opponent in terms of the products, price, promotion and distribution. It is an expensive tactic because an organization needs to have better resources than its competitor in order to maintain its position in the market.
  - o Flank attack involving challenging the weak or uncovered geographical or segmental areas of the opponents. To obtain success, a company needs to patiently attack the protected area of the market or face oppositions by established competitors.
  - o Bypassing attack involving ignoring the opponent and attacking the easier markets by means of diversifying into unrelated products, moving into new geographical areas or rising into new technologies.
  - o Encirclement attack involving a grand move to capture the market share of the opponents through different means such as launching an advertisement and making an unbeatable product offering or presenting a unique service guarantee.
  - o Guerrilla attack involving small, periodic attacks to harass and demoralize the opponent firm and eventually secure a firm foothold in the industry. This could be done by means of price-cut, price discounts, intensive comparative advertising or initiating legal action.
- **Market nichers**: These are the firms that carve out a distinct niche for themselves which has been left uncovered by other firms in the industry or a niche is of little or no interest to others. The niche strategies are similar to the focus strategies as they target a market position that is small and unique and requires special competencies in order to be served.

  There are several means by which the specialization for serving a niche market can be developed. Excelling in providing a product or service attribute, serving a distinct geographical area or offering customized products or services to a select group of customers are some such means of being a market nicher. Market nichers have to adopt the following strategies:
  - o Creating niches involves looking for ways and means by which niches can be identified or created in an industry.
  - o Expanding niches involves enhancing the coverage of the present niche to include similar market niches or new niches.
  - o Protecting niches involves shielding the niches served from attacks by other firms in the industry.

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4.5.3 Defensive Tactics

According to Porter, 'Defensive tactics emphasizes on minimizing the probability of attack, redirecting attacks to less aggressive competitors or decreasing the intensity of the attack.'

The defensive tactics reduce the short-term profitability of an organization in order to ensure long-term profitability. Following are some of the strategies used under the defensive tactics:

- **Raise structural barriers**: In this strategy, entry barriers act to block the logical avenues of attack by the challenger. Following are some of the important points that need to be considered before using this strategy:
  - o Provide enough quantity of products in every profitable market segment to block all the entry points for the competitors
  - o Prevent channel access by signing exclusive agreements with the distributors
  - o Enhance the buyer switching costs by providing low-cost training to the users
  - o Enhance the sales economies in order to minimize the unit costs
  - o Prevent imitations of the organization's products through patents and licensing
  - o Restrict outsiders from accessing the resources of an organization
  - o Entering into an alliance with suppliers for exclusive contracts
  - o Avoid suppliers that also provide services to the competitors
  - o Promote the government to raise barriers such as safety and pollution standards or favourable trade policies
- **Increase expected retaliation**: In this strategy, the organization increases its market share by cutting down the prices and comparing its promotion policy with that of the competitors. For example, to enhance the market share, an organization may introduce price reduction coupons. This strategy enhances the expected threat of revenge from the established competitors.
- **Lower the inducement for attack**: In this strategy, the organization minimizes the expectations of a competitor regarding the future profits in the industry. For example, Air Deccan intentionally keeps the prices of its cost-reducing measures.

4.6 STRATEGIES FOR INTERNATIONAL BUSINESS

An organization that is established in the international market may use some strategies to achieve success in the competitive world of international business. These strategies are as follows:

- International Strategy
- Multidomestic Strategy
- Global Strategy
- Transnational Strategy

4.6.1 International Strategy

According to the international strategy, a company can easily create its value in the international market. For this purpose, the company needs to produce those products

Check Your Progress

5. List any two generic business strategies used by firms.
6. What are the tactics that can be used to develop business strategies?

and provide those services which are valuable in foreign countries and other local companies of the country face problems in producing and providing those product and skills. For example, Microsoft designs and develops a number of software in its country and establishes its subsidiaries in foreign countries to implement distribution strategies of the company for marketing its products. Its subsidiaries are also responsible for handling customers of foreign countries.

4.6.2 Multidomestic Strategy

According to the multidomestic strategy, companies first concentrate on the domestic market of its country. Companies select a goal of achieving maximum responsiveness from its local customers. Many a times they need to modify their marketing and distributing strategies for achieving their goal. For example, some companies may introduce many new activities related to production, marketing and developing of products for attracting customers in their local markets.

4.6.3 Global Strategy

According to global strategy, a company has to follow a low-cost strategy for its business process. This means a company which uses global strategy for its business always concentrates on specific markets. It is never concerned with the entire international market for its product distribution as in the international strategy. It mainly focuses on gathering profit by reaping cost reduction in different markets according to experience curve of the market. Experience curve determines the variance in the reduction of product cost. This variance is observed by a study of production and sale of the product. According to the observation, production cost of a product is based on two factors: learning effects and economies of scale. Learning effects refer to the cost saving that comes from doing a work again and again and thus, eliminating the need for special training to a person. Economy of scale refers to the reduction in the cost of a product that arises due to its large amount of production.

Figure 4.3 shows the experience curve.

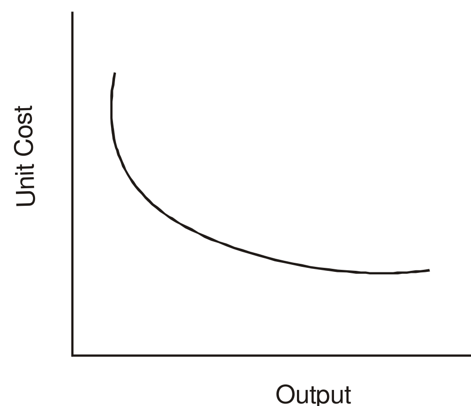

Figure 4.3 *The Experience Curve*

4.6.4 Transnational Strategy

According to transnational strategy, a company always transfer its services and products from its one market to another market, i.e., from home market to foreign subsidiaries market and vice versa. It also transfers its services and product from one foreign

subsidiary to another foreign subsidiary. Transferring of skills and products between different markets is known as global learning.

4.6.5 Advantages and Disadvantages of Different Strategies

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All the strategies such as international, multidomestic, international and transnational are related to international business and help a company to get profit in international market. However, these strategies have their own advantages and disadvantages in comparison to each other. Table 4.2 shows various advantages and disadvantages of these strategies.

Table 4.2 *Advantages and Disadvantages of Different Strategies*

Strategy	Advantages	Disadvantages
International	It allows to set up many subsidiaries in foreign countries to customize local market of the foreign country.	It forces to observe or search for valuable product that can be introuduced in the foreign market.
Multidomestic	It introduces new activities in required area such as marketing and developing of product according to the response of local customers.	It is limited to market of some specific countries.
Global	It mainly concerns about experience curve of the market to get profit according to market status.	It requires responsiveness of customers in the local market of the home country.
Transnational	It maintains global learning between markets of different countries to gain more profit.	It requires more efforts for maintaining fluent transfer of skills and products in different countries.

4.7 STRATEGY FOR GLOBAL MARKET ENTRY

International business may be affected by the global market in which many companies of different countries are involved to exchange their products with the capital of the customers. The customers may belong to different countries. This exchange of product and capital can affect the position of a company in the foreign exchange market. Position of a company in the foreign exchange market also determines the profit of the company. This means if a company has a good position in the foreign exchange market, then it shows that the company is earning profit. There are many reasons apart from obtaining good position in the foreign exchange market that inspire a company to enter the global market. Some of the reasons are:

- To acquire new opportunities for increasing life cycle of their product
- To secure required resources for producing desired product
- To get raw materials for their product development that are not available in their country

- To achieve low cost for producing a product which can be possible due to the low cost of land and labour in another country

When a company acquires globalization, then it enjoys many benefits which are as follows:

- Involvement of a company in the global market increases the economy of scale of its product. Increased economy of scale provides a good position in the global market to a company.
- When a company establishes its branches across the world, then there is a need to combine many activities such as product development, marketing and purchasing related to the product into a single unit. Unification of many activities into one unit saves cost of the company.
- Globalization of a company exposes its employees to the international environment that helps the employees to gain international experience in specific fields such as marketing and distributing.

4.7.1 Market Entry Strategy Options

A company can use one of the following options to formulate a strategy to enter the global market:

- Contractual agreement
- Export
- Joint venture
- Strategic alliance
- Subsidiary
- Turnkey project

Contractual agreement

Contractual agreements are responsible for transferring technologies and human skills, processes and trademarks. Licensing and franchising are two different contractual agreements that are mostly used to enter the global market.

Licensing is a term which is generally used in business that refers to legal establishment of a company in a foreign market. A company can use its own trademarks and technologies in the global market after getting license. Franchising refers to a process in which a company named as franchiser provides a standard package of product and services to a representative known as franchisee. Franchisee provides capital, personnel involvement and knowledge about local market to the franchiser. The main advantage of the franchising process is that a company may easily enter a well-established market using a creative franchisee because he provides effective knowledge such as type of services required by the customers of the market. The main disadvantage of franchising is the loss of control, i.e., a franchisee may misuse the trademark and services of the company in a specific market. To avoid such type of problem, a franchiser has to collect following information related to franchisee:

- Description about the appearance of the franchisee
- Documents to provide identification of a person as franchisee
- Information about experience related to the required job of the franchisee
- Historical information about litigation

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- Historical information about bankruptcy
- Details about financing arrangement related to the contract of franchisee and franchiser
- Details about obligation to purchase
- Details about initial and recurring funds that has to be paid by the franchisee

Export

Exporting means selling a product from one country to another. It can be either direct, in which the company delivers its product to the other country through shipping companies; or it can be indirect, in which the company sells its product to a distributor in its own country, who then delivers the product to customers in other countries. The advantages of exporting are:

- It helps in achieving good economy of scale.
- It is never concerned with the cost related to manufacturing of the product.

The disadvantages of exporting are:

- It causes more competition with foreign companies.
- It requires more cost for transportation of the product to foreign countries.
- It also requires creative marketing representative in foreign countries.

A company that has a high productive capacity may use export strategy which focuses on product quantity and quality.

Joint venture

A joint venture (JV) is a type of strategic alliance in which at least two companies take part in an economic activity, creating a new entity through contribution of equity, and sharing of control, revenue and expenses. The joint venture may be for one particular project or a continuing one.

The main difference between a strategic alliance and a joint venture is that the latter is a separate entity in the eyes of the law while a strategic alliance is only a relationship between different companies. The participating companies in a JV have to acknowledge each other's share in managing it and each partner has an equity position. A JV can only be created as a partnership between entities that are legally incorporated, such as companies, governments and chartered organizations.

Consortium

Consortia are similar to joint ventures except that they comprise a large number of participating companies, and they most often function in markets not supported by any of the participating companies.

Strategic alliance

A strategic alliance is used as a competitive strategy to enter the global market. It refers to a business relationship between at least two companies to achieve a common goal. All the companies that are involved in the strategic alliance also share the risks. The advantages of a strategic alliance are:

- It protects each participating company from its respective weaknesses while increasing its competitive strengths.

- It facilitates expansion in different global markets, reduces cost of production and marketing and enables the access of new technologies.

Subsidiary

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A subsidiary is a sub-branch of a company that may or may not be located in another in another country. The main branch of the company is known as the parent company and it holds the maximum share of the subsidiary. A main branch may have a number of subsidiaries in different countries. The combination of the main branch and its subsidiaries is called a group. When ownership of a subsidiary is not sharable, it is called a wholly owned subsidiary. Various advantages of a subsidiary are:

- Easy handling of risk related to technical competence.
- Better performance for different operations in order to achieve a good position in the global market due to well-controlled policies.
- Better marketing of a product in different countries using local employees who do not face cultural or language problems.

Turnkey project

Turnkey projects are those that are taken up by companies in foreign countries, such as construction work in the UAE. They are typically based on the 'Build, Operate and Transfer' (BOT) principle. Turnkey projects allow a company to establish itself in the global market and have fewer risks than direct investment in a foreign market. However, such projects are vulnerable to competition, and do not have any long-term stakes.

4.8 GLOBAL STRATEGIES OF BUSINESS IN INDIA

The importance of strategy has been accepted in the history of business in India as well as abroad. In fact, strategy is more important than ever, particularly for organizations that want to differentiate themselves from others.

4.8.1 Obstacles to Globalization of Indian Companies

An Indian company may use different strategies such as export, joint ventures, acquisitions and contractual agreement to attain globalization. However, there are many hurdles faced by the Indian companies in attaining globalization. These hurdles are related to following areas:

- There are a great deal of complexity in government policies and procedures.
- Certain political changes create problems in adopting modern technologies.
- An Indian product is seen as a poor quality product in the international market.
- Lack of raw materials and advanced production resources such as machines is another major problem.
- There are a large number of small size firms which are not able to compete with large companies of the country.
- Small firms have lack of experience in the international business.
- There are limited research and development technologies.
- There is tough growing competition among domestic companies.

4.8.2 Factors for Encouraging Globalization in India

Although there are a number of difficulties related to globalization of the companies, some factors also help the Indian companies in attaining globalization. These factors are as follows:

- **Human resources:** A large number of technical and scientific human skills are available in India that is one of the most important required factors in an international business. Labour cost in India being less than other countries also increases globalization prospects of an Indian company.
- **Growing domestic market:** Some Indian companies which have obtained a good position in Indian domestic market can easily enter the global market to extend their business in foreign market.
- **Expanding markets:** High population in India has resulted in the expansion of domestic market that provides many business opportunities to the Indian companies.
- **Non-Resident Indian (NRI):** A large number of NRIs may help in attaining globalization of the Indian companies because they are resourceful in terms of capital, skills and experience.
- **Competition:** Growing competition among different domestic and foreign companies provokes the Indian companies to enter in foreign market.

4.8.3 Globalization Strategies used by Indian Companies

Indian companies, which are doing business in India, need to follow various strategies to achieve globalization and enter foreign market. These globalization strategies are:

- Development of export
- Foreign investment
- Mergers and acquisitions
- Joint venture

Development of export

In comparison to other developing countries, India has a large amount of share in the foreign market for certain products. As a result, it can easily take advantage of this share and export products to foreign countries. However, India has not been able to take advantage of its large market share in foreign markets because of lack of effective export development strategy. If appropriate export development strategies are built, then India can increase its export of different products. In case of specific products, which India could easily export, other developing countries have benefited. These countries started exporting at a much later time than India. In India, fourteen product groups were determined to help in the development of export. However, certain problems such as inadequacy of product capabilities and quality have caused slow development in export.

India needs to do value-added export in order to obtain profits through export. For example, India should export tobacco in cigarette form instead of raw form. If India exports 20 million kg of tobacco in raw form then the export earnings will be Rs 100 crore. On the other hand, if India exports tobacco filled in cigarettes, then its export earnings will be Rs. 400 crore. India exports agricultural products in bulk; as a result, the earnings obtained from exporting agricultural products are not high. Value-added export is significant in case of export of products such as pepper, cardamom and tea.

Check Your Progress

7. What are the strategies followed by organizations established in the international market to achieve success?
8. State the options that can be used to formulate a strategy to enter the global market.
9. What globalization strategies are followed by Indian companies?

The products exported by India are sold at low prices in foreign markets. As a result, a large amount of marketing efforts and quality improvement is required so that Indian products sell at high prices in foreign markets. In addition, the Indian companies need to import technology or collaborate with foreign companies in order to increase the price of their products in foreign markets.

Foreign investment

The Indian companies have not been able to make a large amount of investment in foreign countries because of reasons such as government regulations and lack of global orientation. However, in recent times, there has been an increase in economic liberalization and global orientation. The Indian companies have started establishing manufacturing units in foreign countries in collaboration with foreign companies. This has helped the Indian companies in improving their international business. The companies in India have also started making investment on acquisition of foreign companies. Many small and large Indian companies have made a globalization strategy for investing money in foreign countries. These investments have been made not only to increase the product base of the companies but also to consolidate their business in the domestic market. For example, the Ballapore Industries of the Thapars established a paper mill in Indonesia. The investment of the company has been around Rs 1,800 crore. In addition, the Ballapore Industries of the Thapars have also set up a plantation on 2,50,000 hectares of land to provide pulp for the paper mill. The Ballapore Industries of the Thapars also exports the excess pulp to India keeping in mind the shortage of pulp in future.

Mergers and acquisition

Mergers and acquisitions is an important global strategy for Indian companies that allows them to enter foreign markets. An important advantage that is provided through mergers and acquisitions is that easy access to foreign market becomes possible. Mergers and acquisitions also help in easy distribution of products in foreign markets. The Vijay Mallya's UB group obtained the acquisition of a British company called Wiltshire Brewery. The UB group acquired Wiltshire Brewery because this British company had 300 pubs functioning all over Britain. The distribution of brands of beer such as Kingfisher and Kalyani, manufactured by UB group, became easier with this acquisition. Other Indian companies have also started making acquisition of foreign companies to increase their international business and enter foreign markets.

Joint venture

Joint venture is also an important global strategy employed by Indian companies to enter foreign markets and improve their international business. This global strategy has been successfully employed by various pharmaceutical companies such as Ranbaxy and Lupin. The joint venture global strategy helps Indian companies consolidate their business in domestic market along with increasing their international business.

4.9 SUMMARY

The essence of strategy formulation is an assessment of whether a company is doing the right things and how it can be more effective in what it does. Every company should be wary of becoming a prisoner of its own strategy because even the best strategies

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become obsolete sooner or later. A company should use an appropriate strategy to enter the global market according to its business level. There are many global strategies such as licensing, franchising, exporting and joint venture that are used to enter the global market. Each strategy has its own advantages and disadvantages; therefore a company should select an appropriate strategy according to its requirement. Indian companies are also trying to enter the global market using these strategies.

4.10 KEY TERMS

- **Business-level strategy:** It is a strategic management tool that helps an organization to maintain its position in the market.
- **Competitive strategies:** They are those strategies that an organization implements to compete with its competitors for achieving higher position.
- **Corporative strategies:** They are those strategies under which an organization works with one or more competitors to gain advantage over other competitors.
- **Management strategy:** It is a technique that helps a company to attain its desired goals and provides means for achieving the ends or the objectives.

4.11 ANSWERS TO 'CHECK YOUR PROGRESS'

1. According to Gluek and Jauch, 'A strategy is a unified, comprehensive and integrated plan that relates the strategic advantages of the firm to the challenges of the environment. It is designed to ensure the achievement of the basic objectives of the enterprise.'
2. The main purpose of strategy in an organization is to match the enterprise resources with the varying business conditions. It determines how the organization should be positioned in future to take advantage of the market opportunities.
3. The purposes for which a business-level strategy is used are as follows:
    - They are used to develop the course of actions adopted by firms for each of its businesses separately.
    - They serve the identified groups of customer and provide value to the customer by satisfying their needs.
    - Firms use their competencies to gain, sustain and enhance their strategic or competitive advantage.
4. Differentiation strategy makes a product unique through advertising and by highlighting a product's attributes and features. It influences the consumer to pay extra for a product.
5. The two generic business strategies used by firms are cost leadership and differentiation.
6. The various tactics for business strategies are as follows:
    - Timing tactics
    - Location tactics
    - Defensive tactics

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7. An organization that is established in the international market may use the following strategies to achieve success in the competitive world of international business:
    - International strategy
    - Multidomestic strategy
    - Global strategy
    - Transnational strategy
8. A company can use one of the following options to formulate a strategy to enter the global market:
    - Contractual agreement
    - Export
    - Joint venture
    - Strategic alliance
    - Subsidiary
    - Turnkey project
9. The globalization strategies followed by Indian companies are listed as follows:
    - Development of export
    - Foreign investment
    - Mergers and acquisitions
    - Joint venture

4.12 QUESTIONS AND EXERCISES

Short-Answer Questions

1. What do you understand by strategy?
2. How can a reliable strategy be formulated?
3. What is differentiation business strategy?
4. What are the timing tactics for business strategies?
5. State what multidomestic strategy is.

Long-Answer Questions

1. Explain the dynamic factors that determine the choice of competitive strategy.
2. Explain the cost leadership business strategy.
3. What do understand by location tactics? Explain.
4. Explain the foreign investment global strategy used by Indian companies.
5. What are the factors that encourage globalization in India?

4.13 FURTHER READING

International Business by Justin Paul.

International Business by Vyuptakesh Sharan.

MODULE - 2

UNIT 5 MERGERS AND ACQUISITIONS

NOTES

Structure

5.0 Introduction
5.1 Unit Objectives
5.2 An Overview of Mergers and Acquisitions
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 5.3.1 Reasons for Mergers
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5.0 INTRODUCTION

Mergers and Acquisitions (M & A) take place when two organizations mutually decide to come together to earn long-term profits and economies of scale. This may involve integrating the M & A transaction strategy with the organizational strategies, which is done by the Human Resource (HR) department. It is their responsibility to acquaint the new employees of the host organization with the transition phase. This phenomenon involves economic gains to the newly formed organization.

5.1 UNIT OBJECTIVES

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

- Discuss mergers and acquisitions and their emergence
- Explain the motives behind M & A
- Learn to integrate the M & A proceedings with the existing system

- Describe financial accounting of M & A
- Explain the difficulties in the M & A proceedings
- Discuss the great merger movement

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5.2 AN OVERVIEW OF MERGERS AND ACQUISITIONS

M & A are stimulated by the urge to diversify or anchor the new market rather than to dominate an industry. This diversification may decrease overhead costs or protect the organization from economic descent in its actual industry. Acquisitions may come from within the organization with the help from an external source. The primary goal of the corporate investors is profit of the shareholders so even they may be convinced of the idea of replacement of the top management.

Generally, M & A are performed in the hope of realizing economic gain. In order to derive such a satisfaction, the two organizations must see that it is worth joining each other rather than remaining apart. Some of the potential advantages of M & A are combination of complementing resources, achieving economic stability, acquiring tax advantages and eliminating inefficiencies. Acquisitions also help growth through propriety rights to services, increasing market power by buying competitors, improving weaknesses in main business areas and providing new opportunities to the managers for career growth and advancements. M & A are such complex procedures that it becomes difficult to evaluate transactions, decide associated costs and benefits and handle legal issues. The principle behind M & A is to obtain capital budgeting

5.2.1 Emergence of M & A

Multinationals got an unparalleled opportunity to invest in the Asian countries because of the sudden crash in the Asian market. Further, the desperation of the bankrupt organizations boosted their willingness to move into the Asian countries. Many countries of Asia announced themselves open for business. Western organizations aimed at outright acquisition to avoid minor problems like minority shareholders' rights, joint ventures, etc. The condition to do so seemed ideal as there was enough pressure to privatize and deregulate the market system. When a few of the conglomerates started to restructure and sell the assets, western organizations took the opportunity to takeover the Asian operations instead of being at the mercy of the local partnerships. Under the phenomena of globalization, liberalization and privatization, western organizations began mergers and acquisitions and began bidding although it lacked intensive planning and preparation.

5.2.2 Reasons for M & A

There are various reasons for an organization to merge with, acquire, or be acquired by another organization. Sometimes, organizations produce goods or services more efficiently if they combine their efforts and facilities with other organizations. The size of the merged organization can be an advantage for the management as it may be cheaper to produce goods on a larger scale. Sharing expertise may lead to efficiency or help an organization to utilize the resources that the other organization has not used properly. Also, a change in the management may make the organization more profitable. Other reasons for acquisitions may be arrogance and power. The management of an acquiring

organization may be encouraged more by the desire to manage larger organizations than by any possible gain of efficiency.

5.2.3 Motives behind M & A

The motives behind M & A are to add value to the shareholders of the organization. These motives are stated below:

- **Economies of scale**: This means that by merging two organizations duplicate departments can be reduced which may lower the cost of inputs relative to the revenue stream and thus increase profits.
- **Increased market share**: This motive makes an assumption that the host organization absorbs its major competitors and thus captures increased market share. This enables it to set market prices.
- **Cross selling**: The target organization may sell the services of the host organization to its customers and in turn the host may provide complimentary structure for the target organization.
- **Synergy**: This motive involves appropriate utilization of complementary resources.
- **Taxes**: A profitable organization may buy a loss-making organization in order to limit its tax motive.
- **Geographical or other diversification**: It is designed to level the earnings of the organization that may level the stock prices of the organization in the long-term. This may encourage the conservative investors to maintain confidence in investing in the organization. Sometimes, this may not deliver value to the shareholders.
- **Resource transfer**: Generally, the resources of an organization are unevenly distributed and by combining together the target and the host organizations, interactions between the employees may improve the asymmetry of the resources.
- **Vertical integration**: Organizations may acquire a part of supply chain management and benefits from the resources.
- **Increased market share increases market power**: Increased market shares enable an organization to increase prices. This may not concern the shareholder's interest but it does not favour the opinion of the public interest either.

Some motives may not hold the interest of the shareholders and thus may not be concerned with the shareholder's value. Such motives are stated below:

- **Diversification**: This may act as an obstacle to the industry; thus, it fails to deliver value to the organization. It is possible for an individual shareholder to surmount this obstacle by diversifying their depository at a much lesser cost than those involved in the merger.
- **Overextension**: This distorts the focus of the organization thus making it difficult to manage the operations.
- **Manager's ego**: Manager's arrogance or overconfidence about expected synergies from M & A results in overpayment to the target organization.
- **Empire building**: Managers have more power as they have to manage large organizations.
- **Manager's compensation**: Certain executive management teams have their pays based on the total profits of the organization instead of profits per share.

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5.2.4 M & A Integration Strategy

The transactions of mergers or acquisitions are not considered successful only because of the financial aspects. It is the employees of the organizations that make the difference between the realized opportunities and unfulfilled desires. This is the reason why the HR functions are expected to meet the employee expectations during this transition period and become the organization's most valued partners. Due to M & A, there are rapid changes in the organization; so it is the duty of the HR department to address cultural, organizational and other issues to the employees. This is important to gain competitive advantage and increased shareholder value. To achieve these gains, it is important to design a comprehensive HR plan. Some essentials to be included in this plan are stated below:

- The M & A team and the senior management should identify risks, clarify processes and develop tools to measure objectives during transactions.
- Designing the HR processes to address staffing, severance, outsourcing and employee support needs.
- Assessing the impact of HR plans and developing plans of implementation for the long-term HR strategy involving organizational structure, processes and technology.

Integration of the HR function with the employees of the merged organization helps in adding the value to the organization. These benefits are listed below:

- It reduces the time and expense spent on anticipating and resolving issues related to the employees.
- It helps in articulating HR policies and priorities in consonance with the organizational objectives.
- It also develops an effective and practical HR work plan.
- It provides an integrated organizational structure which includes clear definitions of staff roles.
- It helps in achieving business objectives through experienced project management.
- It gives easy access to experienced HR consultants specializing in issues that may arise during transactions.
- It provides additional staff that can support the transition and integration phases.
- Evaluation of the traditional HR plans to revise the objectives of the merged organization.
- Developing and implementing various transitional objectives in respect to the employee needs.
- Effective integration of the payroll system.

5.2.5 Financial Accounting of M & A

The two main accounting methods used in M & A are the pooling of interests and the purchase methods. The major difference between them is the value that the combined organization's balance sheet places on the assets of the acquired organization as well as the depreciation allowances and charges against income after the merger.

The transaction is simply an exchange of equity securities in the pooling of interests method. Therefore, the capital stock account of the target organization is eliminated and the acquirer issues new stock to replace it. The assets and liabilities of the two organizations

are combined together in accordance with the historical book values as on the date of acquisition. The end result of a pooling of interests transaction is that the total assets of the combined organization are equal to the sum of the assets of the individual organizations. No goodwill is generated; therefore, there are no charges against earnings. A tax-free acquisition would be reported as pooling of interests.

Under the purchase method, assets and liabilities are shown on the merged organization's records of their market values as on the acquisition date. This method is based on the idea that the final values should reflect the market values established during the bargaining process. The total liabilities of the combined organization equal the sum of the two organizations' individual liabilities. The increase in the amount of purchase prices increases the equity of the acquired organization. Accounting for the increase in the cost of the aggregate fair market values of the identifiable net assets acquired is applied only in the purchase accounting. The increase in cost is called goodwill, an asset that is charged against income and amortized over a period of 40 years. The amortization expense is deducted from the actual income but it cannot be deducted for tax purposes.

Purchase accounting results in increased depreciation charges because of inflation so the book value of most assets is usually less than fair value. For tax purposes, depreciation does not increase because the tax basis of the assets remains unchanged. Since depreciation under pooling accounting is based on the old book values of the assets, the accounting income is usually higher. As a consequence, the accounting treatment has no cash flow. Thus, value is unaffected by the accounting processes. However, some organizations may dislike the purchase method because of the goodwill created is amortized over a period of years.

5.2.6 Regulation of M & A

Both state and federal laws govern mergers and acquisitions. State law sets the procedures for the approval of mergers and establishes judicial supervision to supervise the terms of mergers so as to ensure that the shareholders of the target organization receive fair value. State law also helps the management of a target to save itself from a hostile acquisition through various financial and legal defences. Generally, state law tends to be deferential to these defences as long as the target organization does not act primarily to preserve its own condition. Courts tend to be sceptical to these defences if the management of a target organization already decides to sell the organization or replace the control. Most states allow directors at target companies to defend against acquisitions because of the threat that the acquisition may negatively affect the organization and its employees. Because of the number of state defences now available, majority of M & A are friendly and negotiated transactions.

The federal government supervises organizational consolidations to ensure that the combined size of the new organization formed after the merger does not become unlawful under the Sherman Antitrust Act. The federal government also regulates tenders through the Williams Act which asks anyone purchasing more than five per cent of an organization's shares to identify it and make certain public disclosures like an announcement of the goal of the share purchase and terms of a tender. The act also requires that an acquirer who raises its price during the term of a tender, should raise it only for the stock already tendered. This makes tender open for twenty business days and seeks that the acquirers does not commits fraud.

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Check Your Progress

1. List five reasons for which mergers and acquisitions take place.
2. What are the accounting methods used in mergers and acquisitions?

5.3 MERGERS

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Merger acts as an instrument for the organizations which aim to expand their operations in order to maximize their long-term profitability. Mergers occur between the target organization that has a stronghold in the industry and the other host organization that merges with the target organization in order to achieve profits. Mergers occur by mutual agreement of the two organizations and proceed in a way that the executives of the target organization help those of the host organization to ensure that the deal is beneficial to both the parties.

5.3.1 Reasons for Mergers

There are certain events that lead to mergers:

- Lack of funds to compete with the organizations with better facilities, new equipment and a large workforce.
- A growing number of competitors who have recovered from their respective economic conditions with the help of mergers and acquisitions.
- Liberalization has weakened the economy in many Indian organizations as they have not been able to adjust with the competitive market.
- Due to technological advancements there is technical competition which makes it difficult to attain economies of scale and retain skillful personnel.
- Emergence of multinationals which have substantial resources to pose challenge to the marketshare of Indian organizations.

5.3.2 Types of Mergers

- There are three types of mergers based on the competitive relationships between the merging parties. In a horizontal merger, one organization acquires another organization that produces and sells a similar product in the same industry and thereby reduces competition between the two organizations. In a vertical merger, one organization acquires either a customer or a supplier. Conglomerate mergers involve all other acquisitions including pure conglomerate transactions, where the merging organizations have no evident relationship; geographic extension mergers, where the target organization makes the same product as the host organization but does so in a different market; and product extension mergers, where an organization producing one product buys an organization that makes a different product that requires the application of same manufacturing or marketing techniques.
- M & A raise competition for the organizations in three different concerns. These competitive concerns are listed below:
- **Horizontal mergers**: They raise three basic competitive problems. The first is the eradication of competition between the merging organizations which are significant depending on their size. The second is that the unification of the merging organizations' functions may create substantial power in the market and could enable the merged organization to increase prices by reducing output unilaterally. The third problem is that by increasing concentration in the appropriate market, the transaction may strengthen the ability of the market's remaining participants to coordinate their pricing and output decisions accordingly. The fear is not that

the organizations will engage in close collaboration but that the reduction in the number of industry members will enhance unstated coordination of behaviour.

- **Vertical mergers**: They take two basic forms: forward integration by which an organization buys a customer and backward integration by which an organization gains a supplier. Replacing market exchanges with internal transfers can give at least two major benefits. First, the vertical merger internalizes all transactions between the manufacturer and its supplier, thus converting a potentially competitive relationship into something more like a partnership. Second, internalization provides the management with more effective ways to monitor and improve performance. Vertical integration by merger does not reduce the total number of organizations operating at one level in the market, but it may change the pattern of behaviour in the industry. Whether a forward or backward integration is followed, the newly acquired organization may decide to deal only with the acquiring organization, thereby altering competition among the acquiring organization's suppliers, customers or competitors. Suppliers may lose market for their goods, retail outlets may be deprived of supplies or supplies and outlets are blocked. This raises the concern that vertical integration will harm the competitors by blocking their access to the sources of supply or the customers. Vertical mergers may also be anti-competitive because their market power may obstruct new ventures from entering the market.
- **Conglomerate mergers**: They may range from short-term joint projects to complete mergers. A conglomerate merger involves firms that operate in separate markets whether it is pure or a product line extension. Therefore, it has no direct effect on the competition. There is no reduction or other changes in the number of organizations in either the acquired or likely to be acquired organization's market. Conglomerate mergers can supply a market for the organizations, thus giving them liquidity at an open market price and with an encouragement to make new ventures. The threat of acquisition may force the existing managers to enhance their efficiency in competitive markets. Conglomerate mergers also provide opportunities to the organizations to reduce capital costs and gain efficiencies. Conglomerate mergers, however, may reduce future competition by eradicating the possibility of the acquired organization to enter market independently. A conglomerate merger may also convert a large organization into a dominant one with high competitive advantage or make it difficult for other organizations to enter the market. This type of merger may also reduce the number of smaller organizations and increase the merged organization's political hold in the market, thereby impairing the social and political objectives of retaining independent decision-making management, guaranteeing business opportunities and preserving democratic procedures.

A unique type of merger is called reverse merger which is used as a way of entering public sector without the expense and time required by an IPO. The contract method for achieving a merger is called a merger sub. The occurrence of a merger often raises concerns related to anti-trust cycles. Devices such as the Herfindahl index can analyze the impact of a merger on a market and its adverse effect could be prevented through some action. Accretive mergers are those in which the per share earnings of acquiring organization increase. This happens when an organization with a high price to earnings ratio acquires one with a low price. Dilutive mergers are the opposite of above whereby an organization's earnings per share decrease. The organization will be the one with a low price acquiring one with a high price.

The completion of a merger does not ensure that the resulting organization will succeed. In fact, many mergers result in a net loss of value due to the problems after the transition. Problems caused by incompatibility between the two organizations related to technology, equipment or organizational culture divert the resources from new investments and these problems may increase due to inadequate research or by hiding losses or liabilities by one of the partners. Overlapping subsidiaries or redundant staff if allowed to continue will result in developing inefficiency and consequently the new management may eliminate many operations or personnel, thereby losing expertise and disturbing employee culture. These problems are similar to those faced during acquisitions. For the merger not to be considered a failure, it must increase shareholder value faster as compared to the condition before the merger.

5.3.3 The Merger Process

The merger process involves the following activities:

- Considering the options of merging
- Searching for a suitable merger partner
- Taking the decision to merge with a specific partner
- Making a proposal to a suitable partner
- Negotiating merger agreements
- Formulating implementation plans

Accomplishing the implementation plan

- Reviewing and evaluation

5.3.4 Issues during the Merger Process

Some organizations are not prepared to face issues and problems that come up during the merger process. They barely have a systematic and expansive process for planning and implementation due to the following reasons:

- Often, the steps taken during the merger are in response to internal and external stress. So, there is always a consideration about the merger whether it is able to achieve the organizational objectives.
- As average organizations do not have experience in mergers, it is tough for them to identify their problems and formulate alternatives.
- The initial problems that follow mergers mark a chain of events that affects jobs and work assignments. The top management neglects the long-term effects on relevant stakeholders under the pressure of mergers.
- Mergers lead to new organizations with new management structures, so it becomes difficult to determine directions and policies.

5.3.5 Corporate Merger Strategy

State laws formulate procedures to accomplish organizational mergers. Generally, the board of directors for each organization must initially pass a resolution to adopt a plan for mergers that specifies the names of the organizations that are involved, the name of the host organization and the manner in which the shares of both the organizations are converted and any other legal provision. Each organization informs all its shareholders about the meeting to approve the merger. If the majority of shareholders approve the

plan, the directors of the organizations sign the documents of agreement and file them with the state. The secretary of the state issues a certificate of merger to authorize the new organization.

Some laws allow the directors to abandon the plan at any point up to the filing of the final documents of the agreement. States with the most liberal organizational laws allow a surviving organization to merge with the other organization without submitting the plan to its shareholders for approval, unless required, in its certificate of registration.

These laws often provide the organizations formed to obey the laws of respective states in which the two organizations lie. This makes the mergers effective. Some organizational laws require the surviving organization to buy the shares of stockholders who were against the merger.

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5.4 ACQUISITIONS

Acquisitions occur through a hostile takeover by the target organization which sells the majority of its shares to the host organization in the open market. Like mergers, acquisitions are activities through which the organizations seek economies of scale and efficiency for achieving hold in the market. All acquisitions involve one organization purchasing the other organization. There is no exchange or consolidation of stocks in the newly formed organization. Acquisitions are consistent when all its participants are satisfied with the terms and conditions of the agreement; otherwise it may turn out to be hostile. The purchase of the other organization may be with cash or stocks or a combination of both. Another possibility is that one organization acquires all the assets of the other organization.

5.4.1 Reasons for Acquisitions

There are various reasons to support an acquisition strategy which are stated below:

- The acquiring organization may be holding a unique position in the market.
- The situation may be a complete turnaround for both the organizations.
- Both the organizations may be possessing complimentary set of skills.
- The geographical positioning of the organization may favour expansion.
- There may be prospects to cut multiply costs and improve profits.
- Acquisitions may eliminate competition.
- Improvements in technology after the acquisition may increase the production line.
- Introduces both the organizations to new customer base or markets.
- Acquisition may hinder the competitors from capturing opportunities.

5.4.2 Types of Acquisitions

An acquisition can purchase the stock or other equity interests for the target organization or acquire all or a substantial amount of its assets. On this basis, the acquisitions can be divided into following categories:

- **Share purchases**: In buying shares, buyer purchases the shares of the host organization from the shareholders of the host organization. The buyer will then take on all its assets and liabilities.

Check Your Progress

3. What events lead to mergers?
4. State the issues faced during the merger process.

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- **Asset purchases**: In an asset purchase, the buyer buys the assets of the host organization from the target organization. This leaves the host organization as an empty shell and the cash it receives from the acquisition is then paid back to its shareholders through liquidation. However, one of the advantages of an asset purchase for the buyer is that it can choose the assets it requires and leave the assets and liabilities that it does not want. This leaves the host organization in a different position after the purchase, but liquidation is not usually the outcome.
- **Consolidation**: A type of combination of two companies is consolidation. In a consolidation, an entirely new organization is formed and the two original organizations cease to exist. Consolidated financial statements are prepared under the assumption that two or more organizations are actually the only one. The consolidated statements are prepared by combining the account balances of the individual firms after certain adjustments and elimination of entries.
- **Buying the voting stock**: Another way to acquire a firm is to buy the voting stock. This can be done by the agreement of the management or through tenders. In a tender, the acquiring organization offers to buy stock directly from the shareholders, thereby neglecting the management. In contrast to mergers, stock acquisition does not need stockholder voting. Shareholders who wish to keep their stocks can do so. Also, a minority of shareholders may hold out in a tender.

A horizontal acquisition takes place between two firms in the same line of business whereas a vertical merger marks expansion forward or backward in the chain of distribution towards the source of raw materials or the final consumer. A conglomerate acquisition is formed by the combination of unrelated business ventures.

A bidding organization can also buy another simply by buying all its assets. This involves an expensive legal transfer of the title and approval of the shareholders of the selling organization. An acquisition is the transfer of control from one group to another. Generally, the acquiring bidder makes an offer to the host organization.

5.4.3 Benefits of Acquisitions

There is adequate evidence that the shareholders in the acquired organizations benefit substantially. Benefits of the shareholders typically amount to 20 per cent in mergers and 30 per cent in tenders above the market prices prevailing a month prior to the acquisition agreement.

The benefits to acquire organizations are difficult to measure. The instances suggest that shareholders in the bidding organization gain less. Loss in the value subsequent to merger announcements is not unusual. This suggests that overvaluation by the bidding organization is natural. Managers may be paid incentives to increase the size of the organization at the expense of shareholder's wealth. If such a situation happens, then the acquisition activity may lead to non-economic reasons to the detriment of shareholders.

5.4.4 Hostile Acquisitions

Numerous mergers and takeovers seem friendly but they are increasingly evolving into bitter conflicts. This is due to the reason that the top-level managers want to ensure that they are saved in the event of merger. An acquisition can be referred to as coming together of two organizations in their mutual interests and combining to form a large organization. In case of conflict, one organization takes over an unwilling partner which is called a hostile acquisition. The first group may disagree with the existing policies of

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the organization. Their aim would be to replace the top management with the people who share their concerns and will implement required changes. Sometimes, they may want to takeover the management to run it efficiently and save jobs. To prevent such discrepancies, many organizations adopt complex defensive strategies. These strategies are made keeping in view the organizational laws and designed in order to wear down the potential of the aggressors. This strategy may be short-term or long-term, accordingly, but may sometimes weaken the financial liquidity of the organization.

Hostile acquisitions generally involve poorly performing organizations in mature industries. They occur when the industry refuses to permit sale of the organization in the market; then the board of directors of the target organization is opposed to the acquiring industry. In this case, the acquiring organization has two options to proceed with the acquisition—a tender offer or a proxy fight. A tender offer involves buying the stock of the host organization either directly from the organization's shareholders or from the secondary market. In a proxy fight, the acquirer convinces the shareholders of the host organization to obtain the vote of their shares. The acquiring organization hopes to assure enough proxies to gain control over the board of directors and replace the incapable management.

The management of the host organization resists takeover bids and tries either to get a higher price for the organization or protects their own self-interests. Host organization can decrease the possibility of a takeover through chartered amendments. Other defensive tactics include poison pills and dual class recapitalizations. Under the poison pills, rights are issued to the existing shareholders to purchase additional shares at a bargain price, usually half the market price, if a bidder acquires a certain percentage of outstanding shares. Dual class recapitalizations provide a new section of equity with superior voting rights. This enables the host organization's managers to gain majority control even though they do not own majority of shares.

Other preventive measures occur after an inapproachable offer is made to the host organization. The host may file suit against the bidder who violates the security laws. Alternatively, the host may engage in restructuring the assets and liabilities to make them unattractive. With asset restructuring, the target purchases assets that the bidder does not want or that may create anti-trust problems or it may sell off the assets that the suitor desires to gain. Liability restructuring manoeuvres involve issuing shares to a friendly third party to diminish the chances of the bidder to own position or leveraging up the organization with a leveraged recapitalization making it difficult for the suitor to finance the transaction.

Other tactics involve targeted shares repurchase in which the host repurchases the shares of an unfriendly suitor on a premium over the current market price. It also purchases golden parachutes which are advantageous supplemental compensation packages to the host organization's management. These packages are functional in case of a takeover and subsequent resignation of senior executives. Finally, the target may employ an exclusive self-tender. With this tactic, the host organization hopes to buy back its own stock at a premium from every appropriate suitor except the bidder.

5.5 M & A MARKETPLACE DIFFICULTIES

Small private organizations or mid-sized organizations do not have available M & A proceedings. Large organizations often maintain secrecy about their plan to buy or sell such organizations. This is due to the possibility of negative effect on the employees,

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bankers, customers and others who might have a stake in the transactions of the organization. This urge for keeping things confidential has hindered the evolution of marketplace for a vast industry. A transaction needs six to nine months to take place and this may involve slow proceedings and higher expenses. The process is slow as it involves various steps and thus consumes a lot of expenditure. The most difficult step is to locate parties with whom to conduct the transaction. Potential acquirers in industry can not effectively monitor the economy at large for acquisition opportunities even though some may work well within their organization's plans.

An industry of professional middlemen known as intermediaries, business brokers and investment bankers exists to facilitate M & A transactions. These professionals do not provide their services easily and generally resort to predetermined contracts, direct-calling campaigns and advertisements in various media. They create a one-time market for a one-time transaction while providing services to their clientele. The market inefficiencies can prove detrimental to this important sector of the economy. To meet the high costs charged by the intermediaries, the organizations have to sell their shares on relative discounts. An important and large sector of the entire economy is held back by the difficulty in conducting organizational M & A and also in raising equity or capital for the debt. Furthermore, it is difficult to sell private organizations so often.

Previous attempts to organize the M & A proceedings through computers have not been able to succeed on a large scale because they have provided mere bulletin boards, that is, static information than advertising one organization's opportunities. The need for confidentiality has rendered the concept of multiple listing of services redundant. Consequently, there is a need for a method for efficiently executing M & A transactions without compromising the confidentiality of the organizations involved. One part of the M & A process which can be improved significantly using networked computers is the improved access to data rooms during the due deliberation process.

5.6 THE GREAT MERGER MOVEMENT

The Great Merger Movement took place from 1895 to 1905. During this time, small organizations with less market share consolidated with similar organizations to form large, powerful organizations that even dominated the market. There are certain short-run and long-run factors that influence the merger movement which are stated below.

5.6.1 Short-run Factors

One of the major short-run factors that initiated the Great Merger Movement was the desire to keep the prices high. That is, with many organizations in an industry, supply of the product should remain high. When demand for the goods falls, as illustrated by the classic supply and demand model, prices also go down. To avoid decrease in prices, organizations find it profitable to manipulate the supply to face any changes in demand for the goods. This type of cooperation led to the widespread horizontal integration between the organizations of that era. Horizontal integration occurs when multiple organizations sharing the same production process combine together. As a result of merging, mass production of cheap and homogeneous products helped to earn large profits. Focussing on mass production enabled the organizations to reduce unit costs at a considerable rate. These organizations were capital-intensive and had had fixed costs. Due to the fact that advanced machines were mostly financed through bonds, the interests on these bonds were high; yet no organization agreed to accept quantity reduction during

Check Your Progress

5. What are the types of acquisitions?
6. When do hostile acquisitions take place?
7. What are the various types of middlemen that facilitate M&A transactions?

this period in spite of the panic of 1893.

5.6.2 Long-run Factors

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According to the long-run factors, the desire to keep costs low encouraged the organizations to merge and reduce their transportation costs. In addition, technological changes that took place before the Great Merger Movement increased the efficiency of plants with capital-intensive assembly lines allowing economies of scale. Thus, improved technology and better transportation facilities were the causes for the Great Merger Movement. Many of these initially successful mergers were eventually disintegrated because of the conflict between the competitors and the government. Over the time, the government backed out in face of big businesses merging together. Ironically, such acts against price fixing with competitors created a greater incentive for companies to merge under one title so that they were not competitors anymore.

5.7 SUMMARY

M & A occur due to various reasons which are always either in favour of both the organizations or just the acquiring organization. These proceedings involve a lot of challenges for the two organizations due to the rapid changes occurring in the various structures of the organization. These changes may be related to management, employee reduction, technological changes, and so on. To adapt to these changes, it is essential to cooperate with the employees through HR functions and their active participation. The M & A proceedings may benefit the organizations but sometimes they may lead to hostile acquisitions.

5.8 KEY TERMS

- **Acquisitions:** It occurs through a hostile takeover by the target organization which sells the majority of its shares to the host organization in the open market.
- **Merger:** It acts as an instrument for the organizations which aim to expand their operations in order to maximize their long-term profitability.

5.9 ANSWERS TO 'CHECK YOUR PROGRESS'

1. Mergers and acquisitions take place for the following reasons:
   - Economies of scale
   - Increased market share
   - Resource transfer
   - Geographical or other diversification
   - Increased market power
2. The two main accounting methods used in M&As are the pooling of interests and the purchase methods.
3. The following events that lead to mergers are as follows:
   - Lack of funds
   - Increased competitors

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- Liberalization and the resultant weakening of economy
- Technological advancements
- Emergence of multinationals

4. The issues faced during the merger process are as follows:
   - Internal and external stress
   - Lack of experience in handling resultant situation
   - Change in policies and directions caused by change in management
5. The types of acquisitions are as follows:
   - Share purchase
   - Asset purchase
   - Consolidation
   - Buying the voting stock
6. Hostile acquisitions generally take place when poorly performing organizations in mature industries refuses to permit their sale in the market and the board of directors of the target organization is opposed to the acquiring industry.
7. Professional middlemen known as intermediaries, business brokers and investment bankers facilitate M & A transactions.

5.10 QUESTIONS AND EXERCISES

Short-Answer Questions

1. Write a short note on mergers and acquisitions.
2. Why do mergers and acquisitions take place?
3. How does the corporate merger strategy take place?
4. State the asset purchases type of acquisition.

Long-Answer Questions

1. Explain the motives behind mergers and acquisitions.
2. Explain the essentials that need to be included in the HR plan.
3. Explain the regulations related to mergers and acquisitions.
4. Explain the benefits of acquisitions.
5. Explain the marketplace difficulties in mergers and acquisitions.
6. Explain the long-run factors for the Great Merger Movement.

5.11 FURTHER READING

http://en.wikipedia.org/wiki/Merger

http://www.frost.com/prod/servlet/mcon-challenges-mergers.pag

http://www.answers.com/topic/mergers-and-acquisitions

http://www.mercerhr.com/summary.jhtml?idContent=1000340

http://www.businesslink.gov.uk/bdotg/action/layer?TopicId=1074407579

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UNIT 6 GLOBAL BRANDS AND ORGANIZATIONAL BEHAVIOUR

Structure

6.0 Introduction
6.1 Unit Objectives
6.2 Concept of Global Brands
6.2.1 Activities for Building a Great Global Brand
6.3 Strategies for Global Brands
6.4 Building International Brands
6.5 Global Customer Behaviour
6.6 Global Scenario of Organizational Behaviour
6.7 Approaches to Organizational Behaviour
6.8 Summary
6.9 Key Terms
6.10 Answers to 'Check Your Progress'
6.11 Questions and Exercises
6.12 Further Reading

6.0 INTRODUCTION

The effect of globalization on brands has been impressive. Organizations need to develop their brands in order to establish themselves in the international market. When an organization establishes itself in the international market, then it achieves a great deal of success in the long run. However, before operating in an international environment the organizations need to build a proper strategy. If the organization does not have any proper plan, then there is every possibility that it may vanish from the international market.

6.1 UNIT OBJECTIVES

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

- Explain the global brands and its activities in the international environment
- Describe the strategies for the global brands
- Explain global customers and the organizational behaviour
- Explain the various approaches of organizational behaviour

6.2 CONCEPT OF GLOBAL BRANDS

Global brand is a buzzword that has emerged in the new millennium. Most of the organizations are now interested in establishing their brands in the global market. However, many organizations, relatively smaller in size, are not interested in branding. Instead of

branding, they are more interested in other important issues such as paying their bills and finding new customers.

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The effect that globalization has had on brands has been spectacular. Branding helps the organization to create an image in the international arena. The organization that does not have any brand name can very easily fade out of the market. Therefore, in order to maintain a firm grip on the international market, the organization has to build its brand in the global market.

6.2.1 Activities for Building a Great Global Brand

The organization in order to build a great global brand must:

- Define its target customer group accurately.
- Analyze the requirements of the customers in an effective manner.
- Give its brand a dynamic personality because the customers want to have fun while they explore the products.
- Try to create a good name for the brand in the minds of the customers. A strong brand boost stock value as well as sales of a particular brand of an organization.
- Deliver on its promises because the customers come to buy a particular brand of the organization because it offers them a value that no one else can give.

6.3 STRATEGIES FOR GLOBAL BRANDS

The organization that wants to develop its brands in the global markets has to build certain strategies. These strategies are as follows:

- Brand domain
- Brand reputation
- Brand affinity
- Brand recognition

Brand domain

In brand domains, there are individuals who are experts in one or more aspects of the brand domain such as products, services, media and distribution. A brand domain specialist tries to anticipate the various domain developments in the international markets. This requires an in-depth knowledge of the technologies that shapes the brand domain as well as of consumer behaviour and needs. The lifeblood of a brand domain specialist is innovation and creative use of its resources.

Brand reputation

In the process of brand reputation, there are individuals who specialize in developing specific qualities of their brands in order to support their authenticity, credibility and reliability over the competitors of an organization. A brand reputation specialist needs to have some kind of experience before developing the specific qualities of a product. A brand reputation specialist must live up to the expectations of the organization. A brand reputation specialist has to have a very good understanding of the product in order to convince the consumers that the brand is in some way superior.

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Brand affinity

In brand affinity, there are individuals that bond with consumers based on a range of affinity aspects. A brand affinity specialist needs to build a good relationship with the customers. This means that a brand affinity specialist needs to have a distinct appeal to consumers and be able to communicate with them effectively.

Brand recognition

In the process of brand recognition, there are individuals who try to instil the brand name of a product in the consumers. The brand recognition specialist convinces the consumers that his brand is somehow different from the other brands that are provided by other organizations. A brand recognition specialist must have very good communication skills so that he can effectively communicate with the customers.

6.4 BUILDING INTERNATIONAL BRANDS

Most of the organizations try to become major players in the global markets. However, one of the key challenges they face is building global brands in the overseas market. Brands help the organizations to gain higher market share in a crowded market place as they convey an assurance of quality and reliability. Strong brands also enable the companies to attract qualified employees in other countries and have a higher bargaining power with the suppliers.

The organizations in order to build global brands must have a very strong vision as to what they want to achieve by branding their products in the international arena. During the process of building their brands, the organization must not come face to face with the established brands of the other organizations. Global brands can be built only on the basis of a distinctive advantage and by avoiding price as a competitive weapon. For example, Sri Lanka has long been known for the quality of its Ceylon Tea. However, over the years, with the sale of tea in auctions and the blending of teas by the multinational organizations, the identity of Ceylon Tea has progressively weakened. Therefore, the Sri Lankan tea industry decided to change this situation by creating a brand of pure Ceylon Tea, carefully plucked, processed, stored and packed and sold in tea bags under the Dilmah brand. Today, Dilmah is a well-established brand in markets such as Australia and Vietnam.

6.5 GLOBAL CUSTOMER BEHAVIOUR

Customer behaviour, which is considered a complex phenomenon, is very difficult to define in absolute terms. It is primarily a combination of responses to external and internal physiology.

Whenever customers buy something, for example, a car, both the buyer and the seller sign a contract that specifies the terms of the sales agreement. Similarly, most people, when they begin a working relationship with an organization formulate a psychological contract with their employer. A psychological contract is the overall set of expectations that an individual holds with respect to his or her contributions to the organization and the organization's response to those contributions. A psychological contract is not written down like a legal contract.

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An organization while branding their products in the international market must keep in mind the behaviour of the customers. It is very important for the organizations to analyze the behaviour of the customers because if the customers are not satisfied with the quality of the product, then the sales of the product of the organization may go down.

6.6 GLOBAL SCENARIO OF ORGANIZATIONAL BEHAVIOUR

Due to globalization of economy, many organizations now operate in more than one country and add new dimensions to organizational behaviour while responding to different social, political and economic environments. Therefore, communication and control become difficult. The various conditions that the organizations face while operating in an international environment are:

- Social conditions
- Political conditions
- Economic conditions
- Managing an international workforce
- Cultural shock

Social conditions

In many countries due to poorly developed resources, there is a shortage of managerial personnel, scientists and technicians. Hence, skills need to be temporarily imported from other countries and training programmes need to be developed to prepare the local workers. The training helps the skilled people to develop others and these trained locals become the nucleus for developing more people.

Another significant social condition in many countries is that the local culture is not familiar with the advanced technology. A few countries are agriculture dominated and a few others are dominated by manufacturing industries. Naturally, the nature of their culture and work life will be different.

Political conditions

Political conditions that have a significant effect on organizational behaviour include instability of the government, restricting industries to a particular area and nationalistic drives such as self-sufficiency in latest technologies. When the government is unstable, organizations become cautious about further investments. This organizational instability leaves workers insecure and causes them to be passive and low in taking any initiatives.

Moreover, a nationalistic drive impels locals to run their country and their organizations themselves without any interference from foreign nationals.

In some nations, organized labour is mostly an arm of the authoritarian state and in some other nations, labour is somewhat independent. In some nations, State tends to involve itself in collective bargaining and other practices that affect the workers. For example, workers' participation in management is either restricted or permitted by law in different countries.

Check Your Progress

1. What strategies can be followed to develop global brands?
2. What are the factors that must be considered while building a brand at the global level?

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Economic conditions

The most significant economic conditions in less developed nations are low per capita income and rapid inflation. Inflation makes the economic life of workers insecure when compared to developed countries.

The different socio-economic and political conditions existing in different countries influence the introduction of advanced technology and sophisticated organizational systems. A developed country can easily adopt advanced technology when compared to a less developed country. These limiting conditions cannot be changed rapidly because they are too well established and woven into the whole social fabric of a nation.

Managing an international workforce

Whenever an organization expands its operations to other countries, it tends to become multicultural and face the challenge of blending various cultures together. The managerial personnel entering another nation need to adjust their leadership styles, communication patterns and other practices to fit in their host country. Their role is to provide a fusion of cultures in which the employees from both countries adjust to the new situation seeking a greater productivity for the benefit of both the organization and the people of the country in which it operates.

Cultural shock

When employees enter another nation they tend to suffer cultural shock which is the insecurity and disorientation caused by encountering a different culture. They may not know how to act, may fear losing face and self-confidence or may become emotionally upset. Cultural shock is virtually universal. Some of the reasons for cultural shock are as follows:

- Different management philosophies
- New language
- Alternative food, dress, availability of goods
- Attitude towards work and productivity
- Separation from family, friends and colleagues
- Unique currency system

6.7 APPROACHES TO ORGANIZATIONAL BEHAVIOUR

There are mainly four approaches to organizational behaviour. They are:

- Human resources approach
- Contingency approach
- Productivity approach
- Systems approach

Human resources approach

The human resources approach is concerned with the growth and development of people towards higher levels of competency, creativity and fulfilment because people are the

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central resource in any organization. This approach helps the employees become better in terms of work and responsibility and tries to create a climate in which they can contribute to the best of their improved abilities. This approach is also known as 'supportive approach' because the manager's primary role changes from controlling the employees to providing an active support for their growth and performance.

Contingency approach

The contingency approach to organizational behaviour implies that different situations require different behavioural practices instead of following a traditional approach for all situations. Each situation must be analyzed carefully to determine the significant variables that exist in order to establish the more effective practices. The strength of this approach is that it encourages analysis of each situation prior to action. Thus, it helps to use all the current knowledge about people in the organization in the most appropriate manner.

Productivity approach

Productivity is a ratio that compares units of output with units of input. It is often measured in terms of economic inputs and outputs. Productivity is considered to be improved if more outputs can be produced from the same amount of inputs. However, besides economic inputs and outputs, human and social inputs and outputs are also important.

Systems approach

A system is an interrelated part of an organization or a society that interacts with everyone related to that organization or society and functions as a whole. Within the organization, 'people' employ 'technology' in performing the 'task' they are responsible for while the 'structure' of the organization serves as a basis for coordinating all their different activities. The systems view emphasizes the interdependence of each of these elements within the organization if the organization as a whole is to function effectively. The other key aspect of the systems view of organization is its emphasis on the interaction between the organization and its broader environment which consists of social, economic, cultural and political environment within which they operate.

Organizations are dependent upon their surrounding environment in two main ways: First, the organization requires 'inputs' from the environment in the form of raw material, people, money, ideas and so on. The organization itself can be thought of as performing certain 'transformation' processes on its inputs in order to create outputs in the form of products or services. Second, the organization depends on environment such as public to accept its output. The systems view of organization thus emphasizes on the key interdependencies that organizations must manage. Within themselves the organizations must trade off the interdependencies among people, tasks, technology and structure in order to perform their transformation processes effectively and efficiently. Organizations must also recognize their interdependence with the broader environments within which they exist.

Check Your Progress

3. List the conditions that organizations face while operating in an international environment.
4. State the four approaches to organizational behaviour.

6.8 SUMMARY

A global brand needs to provide relevant meaning and experience to people across multiple societies. To do so, the brand strategy needs to be devised in a manner that takes into account the brand's own capabilities and competencies, the strategies of competing brands and the outlook of consumers. Rather than giving importance to

developing brands across the overseas market, the organizations must also consider the behaviour of the customers in the international market in order to achieve success in the long run. An organization faces various issues while operating in an international environment, that is, the social, political and economic conditions.

6.9 KEY TERMS

- **Customer behaviour:** It is the study of when, why, how, and where people do or do not buy a product.
- **Global brands:** They are brands, such as Coca-Cola, PepsiCo, Frito-Lay and McDonalds, that are recognized throughout much of the world.
- **System:** It is an interrelated part of an organization or a society that interacts with everyone related to that organization or society and functions as a whole.

6.10 ANSWERS TO 'CHECK YOUR PROGRESS'

1. These strategies can be followed to develop global brands:
    - Brand domain
    - Brand reputation
    - Brand affinity
    - Brand recognition
2. The factors that must be considered while building a brand at the global level are as follows:
    - Strong vision
    - Distinctive advantage
    - Avoiding price as a competitive weapon
    - Customer behaviour
3. The conditions that organizations face while operating in an international environment are as follows:
    - Social conditions
    - Political conditions
    - Economic conditions
    - Managing an international workforce
    - Cultural shock
4. The four approaches to organizational behaviour are as follows:
    - Human resources approach
    - Contingency approach
    - Productivity approach
    - Systems approach

6.11 QUESTIONS AND EXERCISES

Short-Answer Questions

1. What do you mean by global brands?
2. What do you mean by global customer behaviour?
3. What do you understand by the global scenario of organizational behaviour?
4. What are the reasons for the cultural shock?
5. What do you mean by organizational behaviour?

Long-Answer Questions

1. What are the different activities of global brands?
2. What are the strategies for global brands?
3. State the various conditions that the organizations face while operating in an international environment.
4. What are the various approaches of organizational behaviour?

6.12 FURTHER READING

International Business by Justin Paul.

International Business by Vyuptakesh Sharan.

UNIT 7 SUPPLY CHAIN MANAGEMENT AND GLOBAL DISTRIBUTION SYSTEM

NOTES

Structure

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  7.3.1 Functions of Supply Chain Management
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  7.4.1 Phases of Supply Chain Management
  7.4.2 Strategic Supply Management Activities
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7.6 Supply Chain Management Strategy
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7.0 INTRODUCTION

Supply chain management is a new buzzword in the corporate world, which has emerged to solve the problems arising from the complexities in the supply chain of the organizations. Since the beginning of the 1990s, there has been a great change in the supply chain of the organization. This is due to the liberalization policy of various economies all over the world and revolutionary innovations in the field of science and technology. A supply chain is a network of facilities and distribution systems of the organization. It performs

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the functions of procurement of materials, transformation of materials into the intermediate and finished products and the distribution of final products to the customers. Supply chains exist in both service and manufacturing organizations.

The global distribution system is the process of delivering goods to the dealers and customers at all the geographical locations of the world. It is essential for the organization to maintain its distribution cost. For this purpose, the organization should plan its distribution network while considering factors such as materials handling, storage of goods and facility location. When these factors are determined, the various possible paths by which products can be transported to various customers are easier to decide.

7.1 UNIT OBJECTIVES

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

- Understand the emerging discipline of supply chain management
- Identify the prerequisites and types of supply chain management
- Explain the global distribution of products in the international market
- Explain the various methods of global distribution
- Describe the role of transportation in global distribution
- Explain the standards and testing practices in global distribution

7.2 SUPPLY CHAIN

Supply chain is a network which includes vendors of raw materials, plants that transform those materials into useful products and distribution centres that deliver them to the customers. It encompasses all the activities associated with the flow and transformation of goods from raw materials.

According to D. W. Dobler and D. N. Burt,

'Supply chain is the upstream of the organization's value chain and is responsible for ensuring that the right materials, services and technology are purchased from the right sources at the right time, in the right quality. The value chain is a series of organization's extending all the way back to organizations, which extract materials from mother earth and performs a series of value-adding activities and fabricate the finished goods or service purchased by the ultimate customer.'

According to Jayashankar, 'Supply chain is a network of autonomous or

semi-autonomous business entities collectively responsible for procurement, manufacturing, and distribution activities associated with one or more families of related products.'

According to Ganeshan and Harrison, 'A supply chain is a network of facilities and distribution options that performs the functions of procurement of materials, transformation of these materials into intermediate and finished products, and the distribution of these finished products to customers.'

According to T. Davis, 'The supply chain is the network of organizations that are involved through upstream and downstream linkages in the different processes and

activities that produce value in the form of products and services in the hands of ultimate customers.'

According to a Journal of Business Logistics, 'Supply chain is viewed as a whole, a single entity rather than fragmented groups, each performing its own function.'

An organization's supply chain includes all the internal functions and external suppliers that help in identifying and fulfilling the needs for materials, equipment and services in an efficient manner. Thus, the supply chain system plays a key role in helping the organization satisfy its role in its supply chain.

7.3 NATURE AND CONCEPT OF SUPPLY CHAIN MANAGEMENT

The phase from the 1990s onwards is recognized as the era of supply chain management. During this period, the organizations needed a mechanism which can integrate the functions and networks in the supply chain. Supply chain management emerged as a strategy through which the supply chain networks and functions may be integrated.

Supply chain management is the integration of all the important business processes. It involves the management and coordination of the movement of products, services and information through the entire supply chain process from acquiring raw materials through the delivery of the products to supplying final products to the consumer. It involves the interaction and coordination of many organizations and service industries in the fields of manufacturing, warehousing, selling, transportation, distribution and information systems and management.

Mentzer et al. proposed the broad and rather general definition of supply chain management. According to Mentzer, 'Supply chain management is defined as the systematic, strategic coordination of the traditional business functions and the tactics across these business functions within a particular company and across businesses within the supply chain, for the purposes of improving the long-term performance of the individual companies and the supply chain as a whole.'

According to Agrawal, 'Supply chain management is an external integration of interrelated functions of the organizations with its channel members, vendors and all third-party logistics service providers who contribute in the flow of goods such as raw materials, semi-finished and finished products and related information from the point of inception to the point of consumption with efficiency.'

In other words, supply chain management is an integrated management of various functions in the areas of materials, operations, distributions, marketing and services after sales. These functions are focussed on the customers with a view to achieve synergy of various processes in the organization to optimize the total cost. Supply chain management helps in making available the right quantity and quality of products at the right time, the right place and in the right physical form at an optimized cost. Thus, supply chain management helps in providing the best customer service in a cost-efficient manner.

Figure 7.1 shows the supply chain management model.

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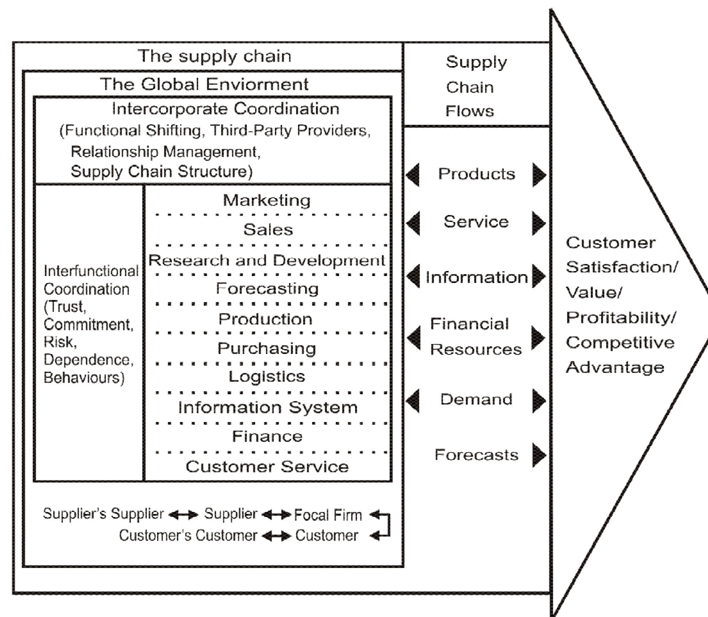

Figure 7.1 *Supply Chain Management Model*

The supply chain model represents the coordination of product which flows across organizational functions and various organizations to achieve competitive advantage and profitability.

Following are the prevalent features of supply chain management that helps in providing the competitive edge to the organization:

- **Single entity**: For a variety of planning and control functions across the supply chain, the responsibility is given to the single or particular group or person. For instance, a group consisting of the representatives from purchase, manufacturing, distribution and sales could be the entity for finalizing the plans for marketing, dispatch, production and procurement. The single entity helps in reducing the administrative delays in the supply chain.
- **Inventory perspective**: Traditionally, the inventories have been viewed as an intermediary to reduce the coordination requirements across several activities. Nowadays, inventory is viewed as an intermediary to be used as a last resort after ensuring proper information sharing and coordination. It is essential for an organization to quantify the level of inventory so as to protect themselves in uncertain conditions such as stock-out situations. This results in an efficient system which is more responsive in the long run of business. Some of the key measures that may enable this perspective of inventory in supply chain management are as follows:
    - o Improving flexibility
    - o Reducing lead times
    - o Reducing uncertainties
    - o Improving quality
- **Strategic decision making**: The decisions in the supply chain are viewed as having strategic implications rather than just operational ones. For example, rather than being concerned with just sourcing trucks from the market, the organization may consider long-term contracts with transporters or investing in their

infrastructure to suit the organization's purpose. This facilitates smoother and more reliable transport mode in the long run.

- **Systems approach**: The supply chain from vendor to customer is viewed as a single integrated system rather than many subsystems interfacing with each other. For example, traditionally the efforts may have aimed at developing better interfaces between marketing and production or sourcing and conversion. While this facilitates smooth operational functioning and issues such as outsourcing which significantly cut across both sourcing and conversion may not be considered. The integrated concept of supply chain may enable such situations.
- **Better performance**: In various activities of the supply chain, it is important to focus on performing the best activity. This has certain implications on the outsourcing and even insourcing business activities and building effective partnerships.
- **Supply chain relationships**: The concept of supply chain emphasizes on the harmonious relationships among the members of the organization such as vendors, channel participants and all third parties that provide services to the organization. The contributions of supply chain members are significant for the performance of the organization. For instance, the experts in supply chain management suggest limited number of vendors with high level of motivation to take appropriate actions for achieving the objectives of the buying organization.
- **Flexible approach**: Nowadays, organizations design their supply chain for bringing flexibility in the supply chain system. Since the business conditions are certain to change, the supply chain configuration must be flexible.

7.3.1 Functions of Supply Chain Management

In today's competitive market, supply chain management considers the principle of providing goods and services to the customers on time. It is essential for any organization to manage its supply chain so as to survive in the cut-throat competition. In case, the organization does not manage its supply chain, then its delivery chain fails which results in customer dissatisfaction and business loss. Apart from this, supply chain performs the following functions:

- **Minimizing uncertainty**: It is necessary to minimize various types of uncertainties such as supply and process for effective supply chain management. Supply uncertainty arises because of the unreliability of vendors while processing uncertainty arises because of the internal processes such as machine breakdowns and uncertain production of goods.
- **Reducing lead times**: Lead times at the stages of procurement and distribution of goods can be reduced by faster transportation modes, proper and efficient planning of organizational activities and advanced technologies.
- **Managing demand**: Uncertainty and variations in demand can be managed with promotion and branding of goods. This helps in proper control of the supply chain network.
- **Improving process quality**: There are various techniques such as statistical process control, root cause analysis of poor quality and improving the capability of process for improving the quality process.
- **Competing on service**: The main advantage of supply chain management for long-term competitive advantage is service aspects of value delivery to the customer.

- **Initiatives at an industry level**: It is important to take initiatives to deal with poor infrastructure. The initiatives at industry level put emphasis on transport and warehouse insufficiencies.

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7.4 PREREQUISITES FOR SUPPLY CHAIN MANAGEMENT

The top-level management of an organization must realize that supply chain is a much broader concept.

The prerequisites that must be considered by the organization to implement supply chain are:

- Supply chain requires the understanding and commitment of the top-level management.
- There must be effective and efficient communication between the functional units of an organization.
- All the functional units of an organization must be related to each other. There must be a cross-relationship between the various functional units of the organization.
- The top-level management must provide constant support, guidance and training to the employees to resolve the expected conflicts in the organization.

7.4.1 Phases of Supply Chain Management

The phases of supply chain management require many perspectives and input that can be best obtained through the cross-functional approach. A cross-functional approach to supply chain management helps in reducing the total cost of all the functional areas of the organization that are affected by the procurement of materials, equipment and services. Following are the four phases of supply chain management:

- **Generation of requirements**: It is a critical activity that results in the identification of the optimal materials and services. It includes the purchases along with the development of the specifications and statements of the work describing these supply chain requirements. Supply chain management must be involved during the generation of requirements to ensure that all the commercial issues such as cost of goods, availability and substitutes receive appropriate consideration.
- **Sourcing**: The objective of sourcing is the identification and selection of the supplier whose cost, qualities, technologies, dependability and services meet the requirements of the organization. The development of supply chain management alliances is a sourcing activity.
- **Pricing**: The objective of pricing is the development of prices that appropriately rewards the supplier for its efforts and results in the lowest total costs of ownership for the customer organization. One of the significant roles of supply chain management is to determine the price during the pricing phase.
- **Post-award activities**: It ensures that the organization receives the ordered products on time and at a specific price and in the specific quantity. Post-award activities include development of supplier, technical assistance and troubleshooting.

Check Your Progress

1. State how Jayashankar has defined a supply chain.
2. Why is the phase from 1990 onward considered the era of supply chain management?
3. List five features of a supply chain that provide a competitive edge to an organization.

7.4.2 Strategic Supply Management Activities

The development and management of the strategic supply chain activities and networks are the most challenging and exciting aspects of supply chain management. It improves the supply chain relationships so as to attain a sustainable competitive advantage. Supply chain management must focus on the following ten strategic activities:

- **Environment monitoring**: It must understand the markets and monitor the environment to identify the organizational threats and opportunities. These threats and opportunities include material shortages that affect one or more industries which supply the organization. Shortages affect both, the price and availability of purchased materials and supplies. The organization must take actions to minimize the impact of such shortages by monitoring the changes in the environment.
- **Integrated supply strategy**: It must develop and manage the organization's supply strategy as an integrated series of unrelated strategies. The technology and marketing and production strategies are the inputs to the integrated supply strategy.
- **Commodity strategies**: It must develop and update sound commodity supply strategies. The following activities must be performed in order to ensure the effectiveness of the organization's commodity strategies:
- **Strategy updating**: The organizations must recognize materials, equipment and services that are strategic in nature and develop strategic plans for obtaining them. The organizations must react quickly by improving and updating its commodity strategies by taking appropriate steps.
  - o **Technology access and control**: The organizations must identify the critical or strategic technologies developed by suppliers with the organization's funds. The organizations must take actions to protect the technologies that yield a competitive advantage, and ensure that they are not transferred to competitors.
  - o **Supply management Organization**: The internal supply chain management of an organization must concentrate on improving the effectiveness and efficiency of an organization.
  - o **Risk management**: It involves taking action for reducing the possibility of any disruption in the supply of products and increase in their price.
- **Data management**: Supply chain management must emphasize on the collection and application of data with the aim of facilitating strategic supply planning. The strategic supply planning requires data related to process which functions within the functional and company boundaries. The supply chain management alone should not be responsible for planning, controlling and compiling the supply. Data must also be considered for analyzing the each supplier relationship.

7.5 TYPES OF SUPPLY CHAIN MANAGEMENT

Based on the scope of organization, there are two types of supply chain, interorganization and intraorganization. The interorganizational supply chain includes sharing of information with buyers, suppliers and competitors in order to increase sales. In interorganization supply chain, the information is shared within the organization whereas in intraorganization supply chain, the information is shared within and outside the organization. Intraorganizational information sharing is done at two levels, data-level and business

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process-level. In data-level information sharing, all distribution sources must be properly connected with supply chain. The data can be recovered from one database such as Enterprise Resource Planning (ERP) to update another database. This approach is easy to implement, as application changes in data transactions are not needed. In business process-level information sharing, techniques such as Application Programming Interface (API) are applied to data transactions for developing particular integration modules. This approach is challenging because it deals with various difficulties while integrating different data transactions applications.

Generally, intraorganizational information sharing employs middleware technology while interorganizational information sharing employs collaboration technology. The middleware technology offers interoperational services such as business transactions and shared directories among various organizations. The middleware technology also acts as a backbone for using the data into ERP and supply chain management systems. The interorganization information sharing techniques helps in collaborating with different shareholders. According to Amit and Zott, ' Interorganization collaboration requires sharing critical business information with buyers, suppliers and even rivals and is a concern to those seeking to add value from the increasing scale and scope of electronic applications.' A shift in traditional interorganizational systems (IOS) is required for achieving efficient supply, development and procurement of goods. The shift in IOS can be motivated by reducing the cost.

Collaboration is an important technique which helps in managing the performance of supply chain that requires maintaining organizational boundaries and cooperative relationships. According to Kanter and Philips , 'Collaboration implies shared responsibilities, resources and benefits and the creation of value through common information exchange between organizations.'

7.6 SUPPLY CHAIN MANAGEMENT STRATEGY

Strategy is a very broad term which explains the holistic view of organizations and market. In today's competitive scenario, it is essential for an organization to select a good supply chain strategy. Organizations should select its corporate strategy by considering the following three main objectives:

- **Cost reduction**: It aims at reducing the variable cost incurred during the movement and storage of goods. The best strategy can be formulated by evaluating various available alternatives and selecting the best among them such as selecting the best warehouse location and transportation modes from different warehouse locations. The organizational strategy should aim at reducing the cost and maximizing the profits.
- **Capital reduction**: It aims at reducing the level of capital or investment made in the organization. The best strategy can be formulated by considering various alternatives such as selecting the Just-in-Time (JIT) technique instead of stocking to inventory.
- **Service improvement**: It involves identifying the cost which is incurred on the services offered to the customers by the organization. The cost increases with the increase in the customer services provided by the organization. Therefore, the organization should design an effective strategy for providing customer service in order to survive in the competition.

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The creation of corporate strategy starts with a clear expression of the organizational objectives. A corporate strategy focuses on the efforts of the organization to meet the demand of the customers. Corporate strategy considers choices and commitments related to markets and the nature of the organization. The corporate vision for an effective supply chain needs to consider the four components, i.e., customer, markets, competitors and organization itself, for a good strategy.

7.6.1 Cost Efficiency Across the Supply Chain Network

There are four main considerations in managing the supply chain: customer service, facility location, inventory decisions and transportation decisions. All these considerations are interrelated and should be planned properly in order to be cost-efficient. These considerations have the following impact on the supply chain of an organization:

- **Customer service goals**: The services offered to the customers affect the supply chain directly. If the organization is offering lower level of customer services, then there is no need of expensive techniques and high level of inventory. On the other hand, higher levels of customer service needs expensive techniques and high level of inventory.
- **Facility location strategy**: The facility location considers the cost associated in the movement of products from plant to vendor, warehouses and customers. Facility location strategy helps in determining the demand of customers to be served directly from plants to vendors and affects the total distribution cost of goods.
- **Inventory decisions**: These are related to the maintenance of inventory level in the organization.
- **Transport strategy**: Transportation decisions are related to the selection of transportation mode and the size of shipment. The transportation decisions are affected by the location of warehouse, that is, whether it is near to the market or not.

The decisions related to the customer service level, facility location, inventory and transportation decisions, should be properly taken as they affect the probability, cash flow and return on investment of the organization.

7.7 SUPPLY CHAIN POLICIES

There are certain supply chain policies which an organization has to follow in order to manage the supply chain effectively. It is very difficult for an organization to create an efficient supply chain as it demands heavy investment. So, while designing its supply chain, the organization must consider the following supply chain bottlenecks and remedies:

- The main problem which arises in designing an effective supply chain is the management of inventory. This inventory problem in the supply chain can be solved by making inventory available in the situation of uncertainties. The level of inventory in the organization should neither be high nor low.
- Another problem related with the distribution network is selecting appropriate location of warehouses and distribution centres. This problem in creating the supply chain network can be solved by making proper distribution strategy.

Check Your Progress

4. What are the prerequisites of a supply chain?
5. State any one difference between interorganization and intraorganization.
6. How do customer service goals affect a supply chain network?

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- The third problem deals with the way in which the success of supply chain is measured. Many organizations keep on applying the outdated financial yardsticks such as profits and revenues as the only indicator for the success of their project. This problem can be solved by not only focusing on the profits but also by balancing the supply chain.
- The biggest problem in supply chain is to bring flexibility in all the organizational processes starting from manufacturing to warehousing. The biggest challenge before the supply chain members such as vendors and transporters is to be flexible in relationships. This problem can destroy the supply chain. A flexible approach towards demand helps the organization in minimizing the levels of inventory in the supply or demand flow channels.
- The last problem in supply chain focuses on the relationships among the supply chain members. If the understanding among the supply chain members is not good, then it affects the supply chain of the organization. The solution for this particular problem is that an organization should have a limited number of vendors along with their high level of motivation. This is because the motivation helps in taking appropriate actions in attaining the organizational objectives.

There are various ways to solve and avoid these supply chain problems, but one thing that must be considered is the preventive action. The companies should discuss the various issues such as flexibility and barriers between the organization and their supply chain partners. Therefore, an organization should design an effective strategy to deal with problems related to supply chain.

7.8 GLOBAL DISTRIBUTION

An organization for the purpose of marketing their goods or products to the various geographical locations of the world has to establish global distribution channels. The global distribution of the products has become easier with the development of the Internet. However, the Internet cannot be used as a substitute for marketing the products. There are professional agents and distributors who are willing to promote the goods of the organization in the international markets. If an organization has the capability and sound financial resources, then it can set up its market at the overseas locations.

7.8.1 Methods for Promoting Products and Services

There are various methods that an organization can use in order to promote its goods and services. These are:

- **Direct sale**: Some of the organizations promote their goods through trade shows, overseas contact making trips and by establishing offices overseas. Organizations also use these methods in order to make contacts with the potential customers.
- **Local marketing intermediaries**: The organizations which want to promote their products in the international market hire some of the local organizations that are specialized and professional. The main task of these types of organizations is to provide customer contacts to the organization.
- **Foreign marketing intermediaries**: The organizations which want to promote their goods in the overseas markets hire some of the foreign organizations or individuals.

- **Foreign trade organizations**: Sometimes, to market the goods, the help of foreign government agencies is required. But, if an organization takes the help of the foreign trade organizations to market their products, then they may not be able to come in direct contact with the potential buyers.

7.9 FACILITY LOCATION

Location is an important factor for any organization that gives form, structure and shape to the overall supply chain. A supply chain can be defined as a network of facilities that aids in obtaining materials, transforming these materials into finished products and distribution of these products to customers. Decisions related to location involve determining the number of facilities, revenues generated from that location and its accessibility from the site of production. Facility location consists of the elements such as vendors, transporters and customers in the supply chain network. There are two types of facility locations:

- Single facility location
- Multiple facility location

Single Facility Location

The contemporary approaches for solving the location problems are more mathematical than conceptual in nature. Single facility location means locating a single plant, terminal and warehouse or retail or service point which are commonly identified by the exact centre-of-gravity method which is also known as grid method. The only location factors considered in the single facility location are transportation rate and point volume. Following is the method of solving location problem:

The location of the facility should be located at a point where source and demand points and amount of goods to be moved are known. The total transportation cost needs to be minimized to determine the optimum location facility. This cost is calculated by multiplying amount of goods, the shipment rate and the distance between source and destination. That is: Min. TC = $\sum_i V_i R_i d_i$

Where,

TC = Total transportation cost

V_i = Amount of goods at one point i

R_i = Shipment rate for point i

d_i = Distance between the source and destination i.

The facility location is found by solving two equations for the coordinates of the location. These coordinates are ‘X and‘Y and are calculated as follows:

$$\overline{X} = \frac{_i \; V_i R_i X_i/d_i}{V_i R_i/d_i} \quad \text{and} \quad \overline{Y} = \frac{_i \; V_i R_i Y_i/d_i}{V_i R_i/d_i}$$

Where, $\overline{X}$, $\overline{Y}$ = coordinate points of the located facility

X_i, Y_i = cordinate points of source and demand points

The distance d_i is estimated as follows:

$$d_i = K\sqrt{\left(X_i - \overline{X}\right) + \left(Y_i - \overline{Y}\right)}$$

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Where, K is known as scaling factor, which is used for converting one unit of a coordinate point into a more common distance measuring units such as miles or kilometres. Following is the process to determine minimum TC:

1. Determine the X, Y coordinate points for each source of goods and destination point, shipment rate and amount of goods.
2. Approximate the coordinates of initial location and calculate the value of $\bar{X}$, $\bar{Y}$ as follows:

$$\bar{X} = \frac{\sum_i V_i R_i X_i}{\sum_i V_i R_i} \quad \text{and} \quad \bar{Y} = \frac{\sum_i V_i R_i Y_i}{\sum_i V_i R_i}$$

3. Calculate d_i by using the values of coordinate points $\bar{X}$, $\bar{Y}$ from step 2.
4. Put the value of d_i into the centre-of-gravity equations and find the new values of revised $\bar{X}$, $\bar{Y}$ coordinates.
5. Recalculate d_i based on the revised X, Y coordinates.
6. Repeatedly calculate X, Y coordinates until they do not change for successive iterations, or the change is so less that by continuing the calculations no significant result can be achieved.
7. In the end, calculate the total cost for the best location facility as shown in the above equation for calculating Min. TC.

The single location model is useful for determining facility location. The single location model helps in finding the best solution to a location problem and views the actual problem of finding best location facility realistically to make it easy to be understood by the management.

Assumptions of a Single Location Model

Any model will exhibit some shortcomings when applied to real-life situation. To make single location facility model useful, following assumptions are considered:

- Demand volumes are assumed to be concentrated at one point. The centre-of-gravity which is the average location of the weight of an object is used as the demand cluster. This may result in some error in calculating the transportation costs for the demand cluster instead of calculating the individual demand points.
- A single facility location model helps find a location based on the variable costs. The model makes no distinction between the differences in capital cost such as labour cost and inventory carrying cost.
- Total transportation costs are usually assumed to increase proportionately with the distance; however, most transport rates include a fixed and a variable component that vary with the distance.

Multiple Facility Location

Many organizations find multiple facility location more complex than single facility location. In multiple facility location, two or more single facility locations are located nearby or additional location facilities are found where at least one single facility location already exists. This problem is common for most organizations, since most organizations have

more than one facility location in their manufacturing systems. The multiple facility location problems are concerned with the following types of issues:

- How many warehouses should be there in a manufacturing system?
- How large should be the warehouse and where should it be located?
- Which products should be stocked in the warehouse and which products should be shipped directly from plants, vendors or ports to the customers?

Several types of location methods such as exact, simulation and heuristic help you answer above questions. These methods are listed as:

- **Exact methods**: These procedures determine either a mathematically optimum solution to the location problem or an accurate solution because of which these are used to solve most of the problem of location. But when applied to practical problems, this approach can result in long computer run time and huge memory requirements..
- **Multiple centre-of-gravity approach**: This approach is applied in a multi-location format to solve the multiple facility location problems. In this case, since more than one facility is to be located, it is necessary to assign the origin and destination points to the arbitrary locations. This forms cluster of points equal to the number of facilities being located. Then, an exact centre-of-gravity location is determined for each of the cluster. The process of allocating points to the facilities can be done in by following steps:
    - o Form the clusters by grouping the points which are closest to each other.
    - o After determining the centre-of-gravity locations , the points are reassigned to these locations.
    - o New centre-of-gravity locations are found for the new calculated clusters. The process is continued until there is no further change in successive iteration and the value center-of-gravity is more or less same for particular cluster.
    - o This completes the computations for a specified number of facilities to be located. This iteration can be repeated for different number of facilities.
    - o As the number of facilities increases, the transportation costs in turn start declining. In trade-off with this decreasing transportation, there is eventually an increase in the total fixed cost and system inventory carrying costs. The best solution is the one that minimizes the sum of all these transportation costs.
- **Mixed integer linear programming**: This is the most popular method used in commercial location models. Mixed integer linear programming enables a manager to handle fixed costs of an organization in an optimal way. For example, when a warehouse location problem occurs, it requires determining which warehouse location and the size of warehouse will be most profitable. The researchers apply the technique of decomposing a problem into as many sub-problems as there are products and eliminating parts of the problem which are irrelevant to the solution. Then, the data relationships are approximated in forms which complement the solution approach to achieve the acceptable run time of a computer and memory requirements.
- **Simulation method**: It refers to the mathematical representation of the organizational manufacturing system by algebraic and logic statements which can be manipulated with the help of a computer. When the realistic information of

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economic and statistical relationships is known, the simulation method is used to evaluate the impact of various factors such as location and size of warehouse. This method helps find the best network of warehouses through repeated application of the model, given different warehouse and allocation pattern choices. The more experienced the manager, the better the network of warehouses.

- **Heuristic methods**: Heuristic means those principles or concepts that contribute in reducing the average time to search for a solution. These methods are also known as 'thumb rules'. When applied to problems of location, the thumb rules enable the manager to obtain better solutions from several alternatives quickly. These methods have been used often in solving the warehouse location problems such as warehouse storage and handling costs.

These multiple facility location methods have been quite helpful in the decision-making functions of a manager. These methods have been applied in various industries such as distribution networks, defence, retail, consumer goods and industries that are operating in both domestic and international markets.

Benefits of the Multiple Location Models

Large scale multiple facility locations assist in decision making to the manager. Defence, retail and consumer goods have applied this model. Multiple location models help a manager to take several decisions and provides following benefits:

- These helps in taking decision to solve a problem of great consequence to the management.
- They are strong enough to replicate a wide variety of networks in acceptable detail for planning purposes.
- There application is not too costly because the benefits received from them far exceed their application costs.
- The data required by them are easily available in most organizations.

Limitations of the Multiple Location Models

The multiple location models like every other model suffer from certain drawbacks, as these are complex and difficult to operate and manage. Following are the limitations of multiple location models:

- Non-linear and discontinuous cost relationships often result in mathematical difficulties such as difficulty in performing an accurate calculation.
- More attention needs to be given to the integration of revenue effects of the network design process.
- The models are not easily accessible to the managers and planners; so these cannot be used frequently by the managers for tactical planning and budgeting.

7.10 STOCKING POLICY

In today's competitive scenario, no organization can bear a stock-out situation, so it is necessary for an organization to store the available inventory in such a way that its physical attributes can be preserved and protected. Traditionally, storages and warehouses are the places where inventory can be stored and protected from the changing weather, seasonal demand variation and gap in demand and supply.

7.10.1 Storage and Warehouses

Storage is the place where raw material and semi-finished goods are stored, whereas warehouse is the place where finished goods are stored.

According to Glaskowsky et al.,

'Storages are godowns for keeping and storing raw materials, components, semi-finished goods, tools, maintenance, repairing and operating equipment and supplies related to the production function. The primary use of storages occurs in relation to and usually in advance of various production processes. It is unusual for finished goods in condition to be delivered to customers of an organization to be stored for any length of time. This may occur, however, in situations where the organization has, for one reason or another, produced or purchased an extremely large amount of a particular product at one time and must store some portion of this amount for later sale of use.'

Normally, storages are located near production plants or location facilities. Most of the organizations use storage because of the following reasons:

- Seasonal demand and supply design to level out the production activities
- Stockpiling of strategic materials
- Supplies resulting from speculative purchasing decision

In the words of Johnson and Wood,

'Warehouses are the godowns for keeping and storing finished goods facilitating the marketing and distribution functions of the enterprise. In other words, warehouses are used to store goods, for varying amounts of time, during their journeys between points of production and wholesale or retail outlets.'

Generally, the warehouses are located near the market for smooth and quick flow of finished goods to the customers.

7.10.2 Stocking Policies and Tips

The main aim of organizations is to make available quality goods in the market at low cost on time. To achieve this aim, it is necessary for the organization to store the inventory properly. Generally, organizations prefer storage and warehouses to store the goods and organizations should consider the following stocking or storage points:

- Do not smoke or drink alcohol at the storage place.
- Do not play music or musical instruments at the storage place.
- Some items such as drugs, stolen items, explosives, firearms and used tires are prohibited from being stored.
- Items that produce any kind of odour should not be kept at the storage place.

The store managers should keep following tips in their mind for keeping the goods in storage units:

- Store the items in the boxes of same size and shape because uniform-sized boxes take less storage space.
- Proper care is necessary for the stored items. For example, if you are storing leather items, then store leather items under conditions that are necessary for storing leather in good condition.
- Always label the items stored in the different boxes as that will help in determining the material inside without opening.

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- Always leave a space between the boxes containing the items and the wall for proper ventilation.
- Pack the stored items as tight as possible because it prevents the items from moisture and dust.
- Use high quality locks to secure the items in storage because these types of locks are difficult to break and they provide maximum protection.
- Use wooden boards underneath the furniture and boxes because they prevent condensation which may damage the stored items.

7.11 MATERIALS HANDLING

Materials handling is an art and science of moving, packaging and storing the goods in any condition such as raw materials, semi-finished and finished products. According to Owens, [materials handling is]

'Much more than just a collection of equipment used for the particular purposes within the operations. The major issue is how these equipment are used, the specific functions [are] performed, the manner and sequence in which they are performed, the logic that manages and controls them and the relationship among equipment, employees and job.'

Materials handling is the main component of the organizational system for movement of goods. From the viewpoint of organization, material handling ascertains the movement of raw materials from the sources of production to destinations. Handling helps in material movement by means of least expenditure of time and effort to achieve maximum logistical productivity and efficiency. According to Bowersox and Closs, 'Material handling cannot be avoided in the performance of logistics. It should, however, be minimized.' There are certain materials handling requirements in a logistics system during complete journey of goods from the place of emergence to the place of utilization. Figure 7.2 shows a graphical representation of the materials handling requirements.

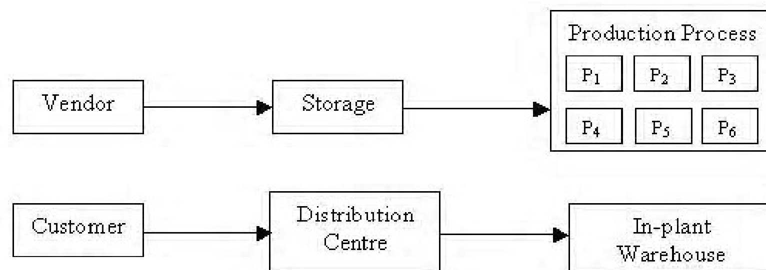

***Figure 7.2** Materials Handling Requirements*

7.11.1 Objectives of Materials Handling

Material handling is the process of transporting finished or semi-finished goods from the site of production to the destination. The main objectives of materials handling are as follows:

- Minimizing the wastage of machine and total time to load the order for transportation material
- Minimizing the total replenishment cycle time by speedy marshalling and movement of goods

Check Your Progress

7. Name any one bottleneck that should be considered while designing a supply chain.
8. List the two types of facility locations.
9. Define what storage is.

- Uninterrupted production and distribution schedules to prevent movement bottlenecks such as loading and unloading
- Protecting goods from breakages and damages during the movement of goods
- Providing safety to workers with safer working conditions
- Ensuring better customer service and satisfaction
- Improving productivity and efficiency by reducing the materials handling cost

7.11.2 Principles of Materials Handling

Materials handling is a branch of engineering and concerned with the movement of the materials between two or more different points. It is essential for any organization to follow certain principles of materials handling. The whole arrangement of packaging the products and transporting them from production site to destination is called system. The College-Industry Council on Materials Handling Education has given the following list of materials handling principles which are:

- The 'orientation principle' takes one look at the whole system to learn how and why it operates.
- The 'requirement principle' deals with what the system is expected to do.
- The 'integrated system principle' ascertains that all storage and handling operations are coordinated.
- The 'standardization principle' emphasizes that it is advantageous to standardize the least possible number of packages or wraps.
- The 'just-in-time principle' ascertains that the products are not moved until required.
- The 'unit-load principle' emphasizes on the importance of materials handling in large blocks such as unit loads.
- The 'minimum travel principle' ascertains that the systems should be set in such a way that loads travel the shortest distances.
- The 'space utilization principle' focuses on the best use of available space in godowns.
- Another principle is the 'ergonomics principle' that lays stress on the manufacturing and materials handling systems which protect workers from performing difficult and repetitive functions that ultimately result in injuries or disability.
- The 'energy principle' enables you to reduce the energy consumption by materials handling activities.
- The 'ecology principle' requires devising those systems which are environment friendly.
- The 'mechanization principle' lays stress on the utilization of machines, wherever justified, to replace human effort.
- The 'automation principle' deals with the development of equipment which is pre-programmed or self-controlled and used for efficient utilization of whole system.
- The 'flexibility principle' is important for those systems where the organizational tasks keep on changing from time to time.
- The 'simplification principle' facilitates prevention of complicated materials handling systems.

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7.11.3 Materials Handling Equipment

There is a variety of equipment used in materials handling. Different industrial sectors have different requirements and therefore, they use different equipment. The equipment used in materials handling can be categorized into the following three groups:

- **Mechanized materials handling systems**: These systems adopt a wide range of materials handling equipment. Some of them are as follows:
  - o **Forklift trucks**: With the development of pallets and containers, forklift trucks are one of the most commonly used mechanized materials handling systems. The pallets and containers are designed to adjust fork tines or blades, which can lift the containers. The fork lift trucks are available in different types such as high flow lifting, low/medium/high load capacity, fast or slow movement and indoor/outdoor uses.
  - o **Tow tractors**: These are used in those organizations where large volumes of goods are required to be moved. These tractors have a number of tracking trailers loaded with either palletized or nonpalletized items. They can be used either in combination with fork lift trucks or can be moved by labour.
  - o **Cranes**: It is a tower fitted with cables and pulleys that is used to lift materials. Cranes are used in construction industry and to manufacture heavy equipment. Cranes need large and open spaces for lifting and transporting the materials. Cranes are of different types such as ceiling mounted, portable and self-powered. The material lifting capacity of some cranes can go up to 5,000 kgs.
  - o **Hand-powered equipment**: In today's mechanical age, hand-powered equipment are still widely used. They are used in the situations where material weighs less, the available space is limited or it is not economically feasible to employ mechanically powered equipment. Hand truck, rolling ladders and carts, rolling cages and load buggies and hand pallet trucks are some of the hand-powered equipment.
- **Semi-automated materials handling systems**: These systems supplement mechanical systems by automating specific handling requirements. Some of the semi-automated materials handling systems are as follows:
  - o **Automated guided vehicle systems (AGVS)**: The performance of this system is similar to that of a mechanized tractor or rider pallet truck. The only difference is that AGVS needs no operator, that is, it is automatically routed and positioned at the destination without operator's intervention. It is based on optical or magnetic guidance system. In optical application, a tape is placed on the warehouse floor and the equipment is guided by a light beam that focuses on the path the equipment must follow and the magnetic AGVS follows a magnetically charged wire installed on the floor.
  - o **Sortations**: The automated sortation devices are used in combination with conveyors. As products are selected in the warehouse and conveyorized out, they must be sorted to specific shipment docks. Automated sortation facilitates the reduction of labour and a significant increase in speed and accuracy of material handling system
  - o **Robotics**: The robot is a humanlike electronic machine which is programmed by microprocessors. It is possible to programme the robots to function as an expert system which is capable of implementing various decision based on given situation automatically in the materials handling process.

- **Automated handling system**: In recent times, efforts have been made to develop fully automated handling system. Automatic Storage /Retrieval (AS/R) systems are examples of automated handling system. The AS/R systems vary in complexity, depending on the products and quantities involved. If the system is supposed to handle large quantities of large number of products, then the complexity of AS/R is more, compared to the AS/R where less number of products are handled.

7.12 ROLE OF TRANSPORTATION IN GLOBAL DISTRIBUTION

An organizations part is not over after marketing its goods in the overseas market. It has to keep in mind that the goods it produces must reach its destination on a specified period of time. For this purpose, an organization has to select proper transportation channels through which it can deliver its products on time. Transportation which is a process involved in supply chain management plays a vital role in the supply chain process because the place of production and consumption are not always same and the organization needs to transport goods from the production place to the place of consumption. The objective of supply chain management is to make quality goods available in the market at the right time. Planning the movement of goods and appropriate usage of transportation alternatives helps in attaining the logistic objective.

Generally, the share of transportation cost is about 40 per cent of the total logistic cost. Hence, reducing the logistic cost requires efficient utilization of transportation facilities and trade-off cost with other elements such as inventory and storage costs. In India, railways and roadways are used for transporting domestic freight cargo, whereas seaways and airways are used for international freight cargo. Normally, corporate enterprises prefer transportation alternatives according to the different movement functions. Table 7.1 shows different transportation alternatives preferred by organizations.

Table 7.1 *Transportation Alternatives Preferred by Organizations*

Functional Requirements	Origin to Destination	Preferred Alternative
Production Scheduling	Vendors-to-Plant and Plant-to-Plant	Rail or Road
Replenishing Stock	Plant-to-Warehouse	Rail or Road
Balancing Stock	Warehouse-to-Warehouse	Road
Distribution Service	Warehouse-to-Customer	Road
Export and Import	Country-to-Country	Sea and Air
Emergency Service	Plant-to-Customer	Air

7.12.1 Transportation Alternatives

Transportation alternatives, which are also called transportation modes, are the means by which companies carry goods from one place to another. Figure 7.3 shows the different alternatives of transportation.

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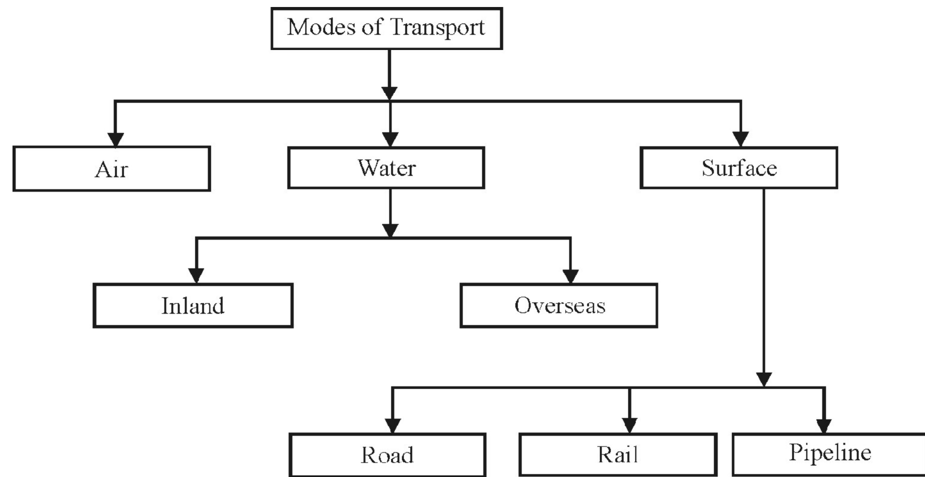

Figure 7.3 *Transportation Alternatives*

Following are the different alternatives of transportation:

- **Air**: Transfer of goods through aeroplanes is called air transportation. Air is a less time-consuming alternative of transportation and preferred for transporting perishable goods like flowers, vegetables and milk and milk products. Air transportation is becoming more popular as the freight of this alternative is higher than other transportation alternatives.
- **Roadways**: The movement of goods through road is called road transportation. Organizations prefer road transport for their logistic functions because cost of road transportation is less compared to water and air transport. This alternative transportation provides more flexible services than other transportation alternatives. The popularity of this alternative is increasing due to continuous improvement in the conditions of roads and vehicles. Road transport helps in reducing the transit time and total cost.
- **Railways**: The reason for considering railways as primary asset is that it can carry large quantity of freight. Organizations prefer railways for large shipments and long distance transportation because the rail tariff is low in comparison to other transportation alternatives. The goods such as cement, petroleum, food grains and fertilizers are transported from production plant to warehouses through railways. There have been lots of technical and commercial changes in railways such as speed and wheel-based axles.
- **Seaways**: Transportation of goods through water is called seaways transportation. Shipping is one of the most globalized industries in the market because most of the foreign trade is carried through water transport. The transportation cost of this alternative is less but it lacks in speed.
- **Pipelines**: Pipelines are the best alternative for transporting petroleum and gas products. This alternative is unique in comparison to other alternatives. The main drawback of pipelines transportation is that it is not suitable for transporting all types of commodities.

Figure 7.4 shows the features of different transportation modes.

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Factor/ Mode	Cost	Damage in transmit	Speed	Reliability/ Timely delivery	Coverage	Bulk Shipment Capacity	Value Added Service Capacity	Frequency	Availability
Railways	3	4	3	3	3	4	3	3	4
Roadways	4	3	4	4	4	3	4	5	5
Airways	5	2	5	5	5	2	5	4	3
Seaways	2	5	2	1	1	5	2	2	2
Pipelines	1	1	1	2	2	1	1	1	1

Figure 7.4 *Features of Different Transportation Modes*

Note: *1 indicates the lowest value in transportation factors and modes. 5 indicates the highest value in transportation factors and modes.*

- **Animal drawn vehicles**: Goods are also transported with the help of animals such as elephant, horses, mules, donkey and ox. Generally, this alternative of transportation is useful in the villages as roads are not properly built. For example, in hilly areas, yaks and mules are used for the movement of goods and in plain areas horses, elephants and donkeys are preferred.

7.12.2 Importance of Transportation

Effective transportation is essential for the growth and progress of any organization because all the organizational activities such as mining, manufacturing and banking depend upon transportation. If there are inadequate facilities for transporting goods, then all other organizational activities suffer. Transportation is important because of the following reasons:

- It ensures the timely movement of goods from warehouses to customers.
- It makes core competency by preventing stock-out situation.
- It helps in providing protective storage to goods during transit.

7.13 STANDARDS AND TESTING PRACTICES IN GLOBAL DISTRIBUTION

Standards are the foundation manufacturing designs of an organization. Testing practices provide assurance to the customers that a product has met health, safety and environmental standards and government regulations. If the organizations do not comply with national or regional standards and testing requirements, then they can find themselves out of the national and international markets.

To prevent the misuse of the standards and practices, World Trade Organization (WTO) has developed a standard that is known as ISO 9000 international quality assurance standard.

Check Your Progress

10. What is materials handling?
11. What are the functional requirements of transportation in global distribution?
12. State the purpose of testing practices.

7.13.1 ISO 9000

The full form of ISO is International Organization for Standardization. ISO is an organization located in Geneva, Switzerland. The term 'iso' is derived from a Greek word 'isos' which means equal, homogeneous, or uniform. The main idea behind the development of ISO 9000 is to maintain uniformity in the existing quality standards such as BSI or British standards and DIN or German standards, prevailing in different countries. The origin of

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ISO 9000 began with the launch of Technical Committee 176 in 1979 and terminated in the ISO 9000 series issued in 1987.

Nowadays, various countries have adopted ISO 9000 series under their respective national standards. India has adopted ISO 9000 as IS 14000 series, United States of America has adopted it as ANSI/ASQC Q90 series and European Union has adopted it as European Norm (EN) 29000 series.

The ISO 9000 standards consist of six parts ISO 8402, ISO 9000, ISO 9001, ISO 9002, ISO 9003 and ISO 9004. Instead of product standardization and certification, ISO 9000 is meant for system standardization. ISO standards do not replace the product standards; it only supplements the existing product standards.

7.13.2 Benefits of ISO 9000

Following are the important benefits of ISO 9000:

ISO 9000 certification has become minimum requirement for the organizations that wants to participate globally in the industry competition.

- All the operations required for obtaining ISO 9000 certification and maintaining the certification results in reorganization of the quality management system which improves the quality of the product.
- ISO 9000 also helps in minimizing the total costs of an organization by minimizing rework, warranty work, repair and scrap.
- ISO 9000 emphasizes customer satisfaction that results in improving overall results of an organization along with improvement in customer relations.
- ISO 9000 also helps in motivating an organization to maintain employee relations and their empowerment and organizational development.

7.14 SUMMARY

Supply chain management is the most recent addition to the discipline of management due to its ability to provide best possible customer service in a cost-efficient manner. The success of supply chain management depends upon the contribution from other supply chain members for achieving the organizational objectives and core competency. It is essential for any organization to take preventive action in order to deal with various problems that are likely to arise in the supply chain. Supply chains help the organizations in reducing uncertainties and in managing demand. Due to its overwhelming contribution, many organizations use it as a tool to attain a competitive edge in the market.

Global distribution is a process of promoting goods at various geographical locations of the world in order to attract a greater number of potential customers. In order to promote their goods in the overseas market, organizations make use of certain methods such as materials handling and stocking policy. If an organization is promoting goods in the international market, then it must provide quality goods to the customers. The WTO has developed a standard known as ISO 9000 to check the quality of goods.

7.15 KEY TERMS

- **Global distribution system:** It is the process of delivering goods to the dealers and customers at all the geographical locations of the world.

- **Simulation method**: It refers to the mathematical representation of the organizational manufacturing system by algebraic and logic statements which can be manipulated with the help of a computer.
- **Supply chain management (SCM):** It is a network of facilities and distribution options that performs the functions of procurement of materials, transformation of these materials into intermediate and finished products, and the distribution of these finished products to customers.

7.16 ANSWERS TO 'CHECK YOUR PROGRESS'

1. According to Jayashankar, 'Supply chain is a network of autonomous or semi-autonomous business entities collectively responsible for procurement, manufacturing, and distribution activities associated with one or more families of related products.'
2. The phase from the 1990s onwards is recognized as the era of supply chain management. During this period, the organizations needed a mechanism which can integrate the functions and networks in the supply chain. Supply chain management emerged as a strategy through which the supply chain networks and functions may be integrated.
3. The five features of a supply chain that provide a competitive edge to an organization are as follows:
   - Single entity
   - Inventory perspective
   - Strategic decision making
   - Systems approach
   - Better performance
4. The prerequisites of a supply chain are as follows:
   - Understanding and commitment of top-level management
   - Effective and efficient communication between functional units of an organization
   - Existence of cross-relationship between the functional units
   - Provision of constant support, guidance and training to the employees by top-level management to resolve conflicts
5. In interorganization supply chain, the information is shared within the organization whereas in intraorganization supply chain, the information is shared within and outside the organization.
6. Customer service goals affect a supply chain network because the services offered to the customers affect the supply chain directly. If the organization is offering lower level of customer services, then there is no need of expensive techniques and high level of inventory. On the other hand, higher levels of customer service needs expensive techniques and high level of inventory.
7. One bottleneck that should be considered while designing a supply chain is the management of inventory. This inventory problem in the supply chain can be solved by making inventory available in the situation of uncertainties. The level of inventory in the organization should neither be high nor low.

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8. There are two types of facility locations:
   - Single facility location
   - Multiple facility location
9. Storage is the place where raw material and semi-finished goods are stored, whereas warehouse is the place where finished goods are stored.
10. Materials handling is an art and science of moving, packaging and storing the goods in any condition such as raw materials, semi-finished and finished products.
11. The functional requirements of transportation in global distribution are as follows:
    - Production scheduling
    - Replenishing stock
    - Balancing stock
    - Distribution stock
    - Export and import
    - Emergency service
12. Testing practices provide assurance to the customers that a product has met health, safety and environmental standards and government regulations. If the organizations do not comply with national or regional standards and testing requirements, then they can find themselves out of the national and international markets.

7.17 QUESTIONS AND EXERCISES

Short-Answer Questions

1. Define supply chain.
2. Describe the features of supply chain management.
3. List the functions of supply chain management.
4. What are the different phases in the supply chain management?
5. What do you understand by facility location?
6. Define what by stocking policy is.
7. What is the role of transportation in global distribution?

Long-Answer Questions

1. Explain the concept of supply chain management.
2. Describe the different types of supply chain management.
3. Explain the concept of efficiency across the supply chain network.
4. Discuss are the supply chain policies.
5. Analyse the different standards and testing practices in global distribution.

7.18 FURTHER READING

Logistics and Supply Chain Management by D.K. Agrawal.

International Business by Vyuptakesh Sharan.

UNIT 8 GLOBALIZATION

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Structure

8.0 Introduction
8.1 Unit Objectives
8.2 Introduction to Globalization
  8.2.1 Levels of Globalization
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8.0 INTRODUCTION

Globalization is a term that is used to describe the changes in societies and the world economy, which are the result of dramatically increased trade and cultural exchange between various countries and their companies. In other words, the globalization of business, competitive market and continuous innovations are the factors that have forced the business world to change their strategies for managing business.

8.1 UNIT OBJECTIVES

After going throught this unit, you will be able to:

- Explaining the basic concept of globalization
- Describing different approaches to globalization
- Explaining different levels and drivers of globalization

8.2 INTRODUCTION TO GLOBALIZATION

Globalization can be defined as a process of making something worldwide in its scope or application. Globalization includes a set of processes which leads to the integration of economic, cultural, political and social systems across geographic boundaries. The main aim of globalization is to make the product or service successful in many countries without doing any modification. In terms of international business, globalization refers to the international exchange or sharing of labour forces, products, ideas and knowledge. It

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can also be defined as the efforts of businesses to expand their operations to new countries and businesses. The process of globalization is becoming very common in international business because of the increasing integration of world markets for goods, services and capital. Globalization causes generalized expansion of international economical activities which include increased international trade, growth of international or foreign investment and international migration. Globalization allows the integration of economies of different countries around the world. This integration occurs as the technological advances result in increasing flow of capital and migration of people across the borders. Meaning of globalization varies according to the type of business and industry. For example, an exporting company define globalization as delivering a product in many countries around the world and a communication company defines globalization as an opportunity to communicate across many countries. In general, globalization always refers to the global economy and market of the world, i.e., to a standard which can not be affected by the economy of any specific country. Nowadays globalization is increasing day by day because of advanced technologies related to communication such as the Internet. Trade liberalization and financial investment of companies in foreign market are also encouraging globalization.

8.2.1 Levels of Globalization

Globalization most often refers to the increasing degree of connection between various countries and their economies. International businesses generally operate at one of four basic levels of globalization. These levels are as follows:

- **Multidomestic company:** This is the first level of globalization. At this level, the business consists of several independent units that operate in different countries. At this level of globalization, there is very little communication between the independent units of a company which are located in different countries.
- **International company:** This is the second level of globalization. At this level, an international company maintains a headquarters in one country and the branches of the company are located in different countries. The operation of the branches located in different countries are controlled or coordinated by the headquarters.
- **Transnational company:** This is the third level of globalization. A transnational company consists of loosely integrated business units in different countries. At this level of globalization, the company focuses on making the products that can suit the needs of the people of the country in which the company is located.
- **Truly global company:** This is the fourth and last level of globalization. At this level of globalization, the company views the entire world as a single business market. The company develops an overall strategy for its various operations around the world.

8.2.2 Advantages of Globalization

Globalization has following advantages for companies:

- It results in better interaction between people who are related to different countries.
- It provides quick transformation of products and information from one county to another country.
- It helps a company deliver its new product in the international market as soon as possible.
- It also solves the problem related to unemployment in highly populated countries.

8.3 DIFFERENT APPROACHES RELATED TO GLOBALIZATION

According to Kirkbride, you can use different approaches on the basis of various factors such as social relation, transaction, interaction and power that affect globalization of a company. These different approaches are as follows:

- Globalist Approach
- Sceptic Approach
- Transformational Approach
- Anti-globalist Approach

8.3.1 Globalist Approach

This approach recognizes the existence of globalization and supports the fact that it will be emerging substantially in the future also. This approach also describes the various stages evolving from the activities around the globe in relation with the business. The various stages in the industrial evolution are:

- **Stage one**: In early times, the people managing globalization or the globalizers were convinced with the mover advantage approach towards the expansion and management of the industry. This involved managing activities like legal services, real estate agents, etc. The actual leaders of this stage were the visionaries. There were certain issues related to this stage like political hurdles, regulation of policies, competitive reactions, building global skills of working and timing of the launch of this global venture.
- **Stage two**: In this stage, the industry started favouring the globalizers and their presence in every sphere increased because they acted as the leading players of the industry. This stage dealt with the improvement and enhancement of the financial services of the industry. These actions resulted in some major alliances and acquisitions in the industry but there were certain issues related to the identification of globalization logic. Some organizations could not associate with the basic idea of globalization and its effect on the economy. They could not relate with the organizations in the market who shared similar techniques with them. Such organizations failed to develop their brand and thus could not define a strategy to expand their share in the market. They were unable to find strategic partners to develop relevant processes for increasing profitability.
- **Stage three**: This stage represented the consolidation of industries globally. Eventually, regional or small-scale organizations also started participating in globalization. Thus, the global strategists started realizing their importance in the industry as the number of participants increased. Progress in this direction was shown by the airlines industry when they launched their operations globally. This further boosted the integration of organizations with the global strategy. In this stage, problems arose when the efficiency of the work in the industry was not according to the desired targets. Thus, it became essential to increase the efficiency in productivity, both quantitatively and qualitatively, in order to develop a global organization.
- **Stage four**: Until this stage, the organizations were rising up to the standards of global markets but then, hectic competition began in the industry. Each industry

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was dominated by four to ten competitors. This competition gave rise to the non-market forces like the consultancy organizations. This also encouraged the development of the learning organizations. Globalization compelled the organizations to develop and refine global strategies and approaches for managing the non-market forces.

8.3.2 Sceptic Approach

This approach is based on the premises that there is no clear definition of globalization, its articulation and terms of its nature. Thus, it is a myth. To support these conclusions, sceptics considered a range of historical, economic and political aspects. Globalization took place in the early stages of development of the modern industrial technology. The driving forces behind the process of globalization are still states and markets because of the concentration of global investments and trades in the developed countries. The developing countries are barely involved in this process. The powers of the developed nations have been strengthened through these global phenomena. Globalization is not different from regionalization or internationalization, so its future prospects may be marred by regional clashes. This approach concludes that the process of globalization is not new, still evolving but damaging the harmony simultaneously.

8.3.3 Transformational Approach

This approach argues that globalization represents an acceptable level of global interconnection. The powers of the governments are reconstructed in accordance with the globalization strategies. Globalization leads to a new world order that transforms the political outlook of the industry as well as the country. The outcome of this process will lead to simultaneous global integration and fragmentation. This approach lays emphasis on the dynamism of the diverse flow and counter-flow processes that originate from the increased migration of people, products and ideas. This results in complex global system fostering local, economical and societal transformation.

8.3.4 Anti-globalist approach

This approach considers globalization as a phenomenon that results in negative outputs. This is because inequalities between the nations have increased following globalization and the organizations, like the International Monetary Fund (IMF) and the World Bank, work in coordination with only the elite class, especially of the developed countries. The free market or open market policies promoted by these organizations are ineffective and inappropriate. It also points out that privatization of services has led to the rise in expenses and lower quality services in poor regions.

Check Your Progress

1. State any two advantages of globalization for companies.
2. What are the different approaches related to globalization?
3. What do the following concepts mean?
   - Globalization of markets
   - Globalization of production

8.4 DRIVERS OF GLOBALIZATION

The globalization is being driven by some of the environmental and systemic issues which are:

- Globalization of the markets
- Globalization of production
- Falling Barriers to trade and investment
- Technological innovation

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8.4.1 Globalization of the Markets

Globalization of the markets refers to the merging of national markets into one huge global marketplace. Nowadays, selling goods internationally is easier due to falling barriers to cross-border trade. An organization does not have to be as large in size as a multinational corporation to derive benefits from globalization of markets. It is important for an organization to offer a standard product worldwide. However, there are very significant differences that still exist between various national markets such as consumer tastes, preferences, legal regulations and cultural systems.

8.4.2 Globalization of Production

Globalization of production refers to the sourcing of goods and services from locations around the world to take advantage of differences in the cost and quality factors of production. The main aim of an organization is to compete more effectively in the international market by offering a product with good quality and low cost. For example, Adidas is considered one of the leading marketers of athletic shoes and apparel in the world. The company has some overseas organizations where it has achieved a very high rate of production with low cost.

8.4.3 Falling Barriers to Trade and Investment

The falling of barriers to international trade enables the organizations to view the world as their market. The lowering of barrier to trade and investments also allows the organizations to set up market for their products in the international arena. Therefore, an organization might design a product in one country, produce component parts in two other countries, assemble the product in another country and then export the finished product around the world. The lowering of trade barriers has facilitated globalization of production of an organization.

8.4.4 Technological Innovation

Technological changes or innovations have achieved a great degree of advances in communication, information processing and transportation technology including the Internet and the World Wide Web. The most important innovation has been the development in microprocessing following which global communications have been revolutionized aided by developments in satellite, optical fibre, wireless technologies and the Internet. Besides, innovations have occurred in the field of transportation technology. The development of commercial jet aircraft has reduced the time needed to get from one location to another.

8.5 SUMMARY

Globalization is the collection of processes that can be used to make anything popular worldwide in its scope or application without any modification. The area of international business is also affected by this concept. Globalization is used to make the domestic organizations famous worldwide. International business can operate at four levels of globalization. These levels are multidomestic company, international company, transnational company and truly global company. There are four approaches that can affect the globalization of organizations. These are: globalist approach, scepticist approach, transformationalist approach and anti-globalist approach.

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8.6 KEY TERMS

- **Anti-globalist approach:** It is an approach that considers globalization as a phenomenon that results in negative outputs.
- **Globalization:** It can be defined as a process of making something worldwide in its scope or application and includes a set of processes which leads to the integration of economic, cultural, political and social systems across geographic boundaries.

8.7 ANSWERS TO 'CHECK YOUR PROGRESS'

1. Globalization has following advantages for companies:
    - It results in better interaction between people who are related to different countries.
    - It provides quick transformation of products and information from one county to another country.
2. The different approaches related to globalization are as follows:
    - Globalist approach
    - Sceptic approach
    - Transformational approach
    - Anti-globalist approach
3. Globalization of the markets refers to the merging of national markets into one huge global marketplace. Globalization of production refers to the sourcing of goods and services from locations around the world to take advantage of differences in the cost and quality factors of production.

8.8 QUESTIONS AND EXERCISES

Short-Answer Questions

1. What is the difference between multidomestic company and international company?
2. What is the difference between transnational company and truly global company?
3. What are the advantages of globalization?
4. What is the difference between sceptic and transformational approach to globalization?

Long-Answer Questions

1. Explain all the levels of globalization.
2. Explain the different approaches related to globalization.
3. Explain the following terms:
    A. Globalization of the markets
    B. Globalization of production
    C. Falling barriers to trade and investment
    D. Technological innovation

8.9 FURTHER READING

International Business—Concept, Environment and Strategy by V Sharan.

International Business by Justin Paul.

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