CHAPTER 2

THE GLOBAL ECONOMIC ENVIRONMENT

SUMMARY

A. The economic environment is a major determinant of global market potential and opportunity. In today's global economy, capital movements are the driving force, production is uncoupled from employment, and capitalism has vanquished communism. Based on patterns of resource allocation and ownership, the world's economies can be categorized as **market capitalism, centrally-planned capitalism, centrally-planned socialism,** and **market socialism.** The final years of the twentieth century were marked by transitions toward market capitalism in many countries that had been centrally controlled. However, great disparity still exists among the nations of the world in terms of economic freedom.

B. Countries can be categorized in terms of their stage of economic development: **low income, lower middle income, upper middle income,** and **high income. Gross domestic product (GDP) and gross national income (GNI)** are commonly used measures of economic development. The 50 poorest countries in the low-income category are sometimes referred to as **least-developed countries (LDCs).** Upper middle-income countries with high growth are often called **newly industrializing economies** (**NIEs**). Several of the world's economies are notable for their fast growth; the **BRICS** nations include Brazil, Russia, India, China, and South Africa. The **Group of Eight (G-8), Group of Twenty (G-20),** and **Organization for Economic Cooperation and Development (OECD)** represent efforts by high-income nations to promote democratic ideals and free-market policies throughout the rest of the world. Most of the world's income is located in the **Triad,** which is comprised of Japan, the United States, and Western Europe. Companies with global aspirations generally have operations in all three areas. Market potential for a product can be evaluated by determining **product saturation levels** in light of income levels.

C. A country's **balance of payments** is a record of its economic transactions with the rest of the world; this record shows whether a country has a **trade surplus** (value of exports exceeds value of imports) or a **trade deficit** (value of imports exceeds value of exports). Trade figures can be further divided into **merchandise trade** and **services trade** accounts; a country can run a surplus in both accounts, a deficit in both accounts, or a combination of the two. The U.S. merchandise trade deficit was $819 billion in 2007. However, the U.S. enjoys an annual service trade surplus. Overall, however, the United States is a debtor; China enjoys an overall trade surplus and serves as a creditor nation.

D. Foreign exchange provides a means for settling accounts across borders. The dynamics of international finance can have a significant impact on a nation's economy as well as the

fortunes of individual companies. Currencies can be subject to **devaluation** or **revaluation** as a result of actions taken by a country's central banker. Currency trading by international speculators can also lead to devaluation. When a country's economy is strong or when demand for its goods is high, its currency tends to appreciate in value. When currency values fluctuate, global firms face various types of economic exposure. Firms can manage exchange rate exposure by **hedging**.

LEARNING OBJECTIVES

1 Identify and briefly explain the major changes in the world economy that have occurred during the past 100 years

2 Compare and contrast the main types of economic systems that are found in different regions of the world

3 Explain the categories of economic development used by the World Bank and identify the key emerging country markets at each stage of development

4 Discuss the significance of balance of payments statistics for the world's major economies

5 Identify the countries that are the world's leading exporters

6 Briefly explain how exchange rates impact a company's opportunities in different parts of the world

DISCUSSION QUESTIONS

2-1. The seven criteria for describing a nation's economy introduced at the beginning of this chapter can be combined in a number of different ways. For example, the United States can be characterized as follows:

- Type of economy: Advanced industrial state
- Type of government: Democracy with a multi-party system
- Trade and capital flows: Incomplete free trade and part of trading bloc
- The commanding heights: Mix of state and private ownership
- Services provided by the state and funded through taxes: Pensions and education but not health care
- Institutions: Transparency, standards, corruption is absent, a free press and strong courts

- Markets: Free market system characterized by high risk/high reward entrepreneurial dynamism

Use the seven criteria found on pp. 32 to develop a profile of one of the BRICS nations, or any other country that interests you. What implications does this profile have for marketing opportunities in the country?

Student answers will vary by country chosen.

2-2. Why are Brazil, Russia, India, China, and South Africa (BRICS) highlighted in this chapter? Identify the current stage of economic development for each BRICS nation.

Experts predict that the BRICS nations will be key players in global trade even as their track records on human rights, environmental protections and other issues come under closer scrutiny by their trading partners.

Russia and South Africa fall within the upper-middle-income category. Brazil and China are in the lower-middle-income category while India is the only BRICS nation to be in the low-income category.

2-3. Turn to the Index of Economic Freedom (Table 2-3) and identify where the BRICS nations are ranked. How should Global Marketers use the Index as a guide to global market opportunities?

Brazil, Russia, India, and China fall within the "Mostly Unfree" category. This indicates that, while the index and what it stands for are certainly important to marketers, they are not willing to forego the business opportunities presented by these countries. South Africa however, falls within the "Moderately Free" category.

2-4. The Heritage Foundation's Index of Economic Freedom is not the only ranking that assesses countries in terms of successful economic policies. For example, the World Economic Forum (WEF; www. weformum.org) publishes an annual Global Competitiveness Report; in the 2014-2015 report, the United States ranks third, according to the WEF's metrics. By contrast, Sweden was in 10th place. According to the Index of Economic Freedom's rankings the United States and Sweden are in 12th and 23rd place, respectively. Why are the rankings so different? What criteria does each index consider?

The Heritage foundation measures trade policy, taxation policy, government consumption of economic output, monetary policy, capital flows and foreign investment, banking policy, wage and price controls, property rights, regulations, and the black market. It does take a very conventional and conservative approach to classifying economies.

On the other hand, the World Economic Forum, according to their website, states: "*The World Economic Forum is an independent, international organization incorporated as a Swiss not-for-profit foundation. We are striving towards a world-class corporate governance system where values are as important a basis as rules. Our motto is 'entrepreneurship in the global public interest'. We believe that economic progress without social development is not sustainable, while social development without* *economic progress is not feasible. Our vision for the World Economic Forum is threefold. It aims to be: the foremost organization which builds and energizes leading global communities; the creative force shaping global, regional and industry strategies; the catalyst of choice for its communities when undertaking global initiatives to improve the state the world"*

Clearly, the WEF assigns a great deal of value to measuring the values and social developments, and opportunities of a country. This strong belief system influences the WEF's country ranking – not by what it currently possesses but by what it *should* be doing.

2-5. When the first edition of this textbook was published in 1996, the World Bank defined "low-income country" as one with per capita income of less than $501. In 2003, when the third edition of *Global Marketing* appeared, "low income" was defined as $785 or less in per capita income. As shown in Table 2-4 of this chapter, $ 1,045 is the current "low income" threshold. The other stages of development have been revised upward in a similar manner. How do you explain the upward trend in the definition of income categories during the past 20 years?

The economic systems of countries are constantly developing and changes happen rapidly. The percentage of the world's GNI for low-income countries is now at a record low as compared to the lower-middle-income countries, and the upper-middle-income countries. This suggests great gains in income per person and income distribution for those living in the low-income countries. As countries in the low-income category begin to tackle their economic, social, and political problems, more opportunities present themselves for the people living in those countries.

2-6. A friend is distressed to learn that America's merchandise trade deficit hit a record $ 700 billion in 2013. You want to cheer your friend up by demonstrating that the trade picture is not as bleak as it sounds. What do you say?

The overall trade balance reflects merchandise as well as services trade as reported in official balance of payments figures. The U.S. typically runs a trade surplus in services, which serves to offset the merchandise trade deficit.

The United States is a major service trader. As shown in Table 2-5, U.S. services exports in 2013 totaled approximately $687 billion. This represented slightly less than one-third of total U.S. exports. The U.S. services surplus stood at $225 billion. This surplus partially offset the U.S. merchandise trade deficit, which reached $701 billion in 2013.

2-7. India is not included in the Big Mac Index. Can you explain why? Using the following data, compute the price of a Big Mac in Norway, Thailand, and Mexico. What is the equivalent price in dollars? Is it higher or lower than the U.S. price? How much is the kroner (or baht or peso) over- or under valued?

- Norway price: Kroner 45; exchange rate 6.25/$1
- Thailand price: Baht 70; exchange rate 32.3/$1
- Mexico price: Peso 32; exchange rate 12.8/$1

In India the Big Mac is made of chicken, not beef. The Big Mac is also not that popular in India so India is not a good candidate to be included in the Big Mac Index.

Based on the exchange rates stated above, Norway pays 45 Kroner for a Big Mac which equals US $ 7.20 telling us that the Kroner is overvalued. However, in Thailand and Mexico the US Dollar equivalents are $ 2.17 and $ 2.50 respectively. This indicates that both the Thailand Baht and the Mexico Peso are bother undervalued.

OVERVIEW

This chapter will identify the most salient characteristics of the world economic environment, starting with an overview of the world economy. We then present a survey of economic system types, a discussion of the stages of market development, and an explanation of balance of payments. Foreign exchange is discussed in the final section of the chapter. Throughout the chapter, we will discuss the implications of the worldwide economic downturn on global marketing strategies.

ANNOTATED LECTURE/OUTLINE

THE WORLD ECONOMY—AN OVERVIEW

The world economy has changed dramatically since World War II. Perhaps the most fundamental change is the emergence of global markets; responding to new opportunities, global competitors have displaced or absorbed local ones.

The integration of the world economy has increased significantly. Economic integration was 10 percent at the beginning of the 20th century; today, it is approximately 50 percent.

During the past two decades, the world economic environment has become increasingly dynamic; change has been dramatic and far-reaching. To achieve success, executives and marketers must take into account the following new realities:

- ✓ **(Learning Objective #1)**

a) Capital movements have replaced trade as the driving force of the world economy.

b) Productivity has become “uncoupled” from employment.

c) The world economy dominates the scene; individual country economies play a subordinate role.

d) The struggle between capitalism and socialism that began in 1917 is over.

e) The growth of e-commerce diminishes the importance of national barriers and forces companies to reevaluate their business models.

The first change is the increased volume of capital movements. The dollar value of trade in goods and services was $23.4 trillion in 2013. However, the Bank for International Settlements has calculated that foreign exchange transactions worth approximately $4 trillion are booked *every day*. This works out to more than $1 quadrillion annually, a figure that far surpasses the dollar value of world trade in goods and services. An inescapable conclusion resides in these data: Global capital movements far exceed the dollar volume of global trade. In other words, *currency trading represents the world's largest market.*

The second change concerns the relationship between productivity and employment. To illustrate this relationship, it is necessary to review some basic macroeconomics. **Gross domestic product (GDP)**, a measure of a nation's economic activity, is calculated by adding consumer spending (*C*), investment spending (*I*), government purchases (*G*), and net exports (*NX*):

$$C \_ I \_ G \_ NX \_ \mathrm{GDP}$$

Economic growth, as measured by GDP, reflects increases in a nation's productivity. Until the recent economic crisis, employment in manufacturing had remained steady or declined while productivity continued to grow.

Now, employment rates have declined in countries where a bubble economy of misallocated resources in housing and real estate has collapsed. In the United States, manufacturing's share of GDP declined from 19.2 percent in 1989 to13 percent in 2009.

In 2011, manufacturing employment accounted for about 9 percent of the U.S. workforce; in 1971, the figure was 26 percent. During that 40-year period, productivity has increased dramatically. Similar trends can be found in many other major industrial economies as well.

Manufacturing is not in decline—it is *employment* in manufacturing that is in decline.

Creating new jobs is one of the most important tasks facing policymakers today.

The third major change is the emergence of the world economy as the dominant economic unit. Company executives and national leaders who recognize this have the greatest chance of success.

This change has brought two questions to the fore: How does the global economy work, and who is in charge? Unfortunately, the answers to these questions are not clear-cut.

The fourth change is the end of the Cold War. The demise of communism as an economic and political system can be explained in a straightforward manner: Communism is not an effective economic system. The overwhelmingly superior performance of the world's market economies has given leaders in socialist countries little choice but to renounce their ideology.

A key policy change in such countries has been the abandonment of futile attempts to manage national economies with a single central plan. This policy change frequently goes hand in hand with governmental efforts to foster increased public participation in matters of state by introducing democratic reforms.

Finally, the personal computer revolution and the advent of the Internet era have in some ways diminished the importance of national boundaries.

ECONOMIC SYSTEMS

- ✓ **(Learning Objective #2)**

Traditionally, there are four main types of economic systems: market capitalism, centrally planned socialism, centrally planned capitalism, and market socialism. This classification was based on the dominant method of resource allocation (market versus command) and the dominant form of resource ownership (private versus state) (see Figure 2-1).

Alternatively, more robust descriptive criteria include the following:

- Type of economy
- Type of government
- Trade and capital flows
- The commanding heights
- Services provided by the state and funded through taxes
- Institutions
- Markets

Market Capitalism

Market capitalism is an economic system in which individuals and firms allocate resources, and production resources are privately owned. Consumers decide what goods they desire, and firms decide how much to produce; the state's role is to promote competition (see Table 2 -1).

It would be a gross oversimplification to assume that all market-orientated economies function in an identical manner.

Centrally-Planned Socialism

At the opposite end of the spectrum is **Centrally-planned socialism**. Centrally-planned socialism gives the state broad powers to serve the public as it sees fit.

State planners make "top-down" decisions about the goods and services produced and in what quantities; consumers spend money on what is available.

Government ownership of industries and individual enterprises is characteristic. Demand exceeds supply, and there is little reliance on product differentiation, advertising, or promotion. To eliminate "exploitation" by intermediaries, the government controls distribution.

Because of market capitalism's superiority, many socialist countries have adopted it; the ideology developed by Marx and perpetuated by Lenin has been resoundingly refuted.

For decades, the economies of China, the former Soviet Union, and India functioned according to the tenets of centrally planned socialism. All three countries are now engaged in economic reforms characterized, in varying proportions, by increased reliance on market allocation and private ownership.

Centrally-Planned Capitalism and Market Socialism

In reality, market capitalism and centrally-planned socialism do not exist in "pure" form. Command and market resource allocation are practiced simultaneously, as are private and state resource ownership. The role of government in modern market economies varies widely.

Centrally-planned capitalism is an economic system in which command resource allocation is used extensively in an environment of private resource ownership (e.g., Sweden).

Market socialism permits market allocation policies within an overall environment of state ownership.

Market reforms and nascent capitalism in many parts of the world are creating opportunities for large-scale investments by global companies.

The Heritage Foundation, a conservative think tank, classifies economies according to the degree of economic freedom enjoyed. The variables considered in compiling the rankings include:

- trade policy
- taxation policy
- government consumption of economic output
- monetary policy
- capital flows
- foreign investment
- banking policy

- wage and price controls
- property rights
- regulations
- the black market

The rankings form a continuum from "free" to "repressed." Hong Kong and Singapore are ranked first and second in terms of economic freedom; Zimbabwe, Cuba, and North Korea are ranked lowest (see Table 2-3).

A high correlation exists between the degree of economic freedom and the extent to which a nation's mixed economy is heavily market orientated.

STAGES OF MARKET DEVELOPMENT

- ✓ **(Learning Objective #3)**

At any point in time, individual country markets are at different stages of economic development.

The World Bank has developed a four-category classification system that uses per capita **gross national income (GNI)** as a base. Although the income definition for each of the stages is arbitrary, countries within a given category generally have a number of characteristics in common. (Table 2-4).

Today, global attention is focused on opportunities in Brazil, Russia, India, China and South Africa (collectively known as BRICS). For each of the stages of economic development, special attention is given to the BRICS countries.

Low-Income Countries

Low-income countries have a **GNI per capita of less than $1,045 or less.** The general characteristics shared by countries at this income level are:

- limited industrialization and a high percentage of the population engaged in agriculture and subsistence farming
- high birth rates
- low literacy rates
- heavy reliance on foreign aid
- political instability and unrest
- concentration in Africa south of the Sahara

Approximately 13 percent of the world's population is included in this group. Typically, these countries provided limited investment opportunities.

However, there are exceptions; for example, in Bangladesh, where per capita GNP is approximately $1,010. The garment industry has enjoyed burgeoning exports.

The newly independent countries of the former Soviet Union present an interesting situation: Incomes are low, and there is considerable economic hardship. The potential for disruption is, therefore, high.

Lower-Middle-Income Countries

The United Nations designates fifty countries in the bottom ranks of the low-income category as **least-developed countries (LDCs)**.

The term is sometimes used to indicate a contrast with **developing** (i.e., upper ranks of low-income plus lower-middle and upper-middle-income) **countries** and **developed** (high-income) **countries.**

Lower-middle-income countries are those with a GNI per capita between $1,046 and $4,125.

With a 2013 GNI per capita of $1,570, India has transitioned out of the low-income category and now is classified as a lower-middle-income country.

Consumer markets in these countries are expanding rapidly. Countries such as China, Indonesia and Thailand represent an increasing competitive threat as they mobilize their relatively cheap labor forces to serve target markets in the rest of the world.

The developing countries in the lower-middle-income category have a major competitive advantage in mature, standardized, labor-intensive light industry sectors such as footwear, textiles and toys.

Emerging Markets Briefing Book – Myanmar is Open for Business

In 2011, Myanmar, formerly known as Burma, changed course. Encouraged by Myanmar's transition from dictatorship toward economic openness and democracy, may Western governments lifted sanctions such as bans on the country's imports.

Upper-Middle-Income Countries

Upper-middle-income countries***, also known as industrializing or developing countries*** are those with GNP per capita ranging from $4,126 to $12,475.

Brazil is the largest country in Latin America in terms of the size of its economy, population, and geographic territory.

Brazil also boasts the richest reserves of natural resources in the hemisphere; China, Brazil's top trading partner, has an insatiable appetite for iron ore and other commodities.

Government policies aimed at stabilizing Brazil's macroeconomy have yielded impressive results: Brazil's GNI has grown at an average annual rate of 4 percent over the past 8 years. During the same time period, nearly 50 million Brazilians have joined the middle class as incomes and living standards have risen.

Lower-middle- and upper-middle-income countries that achieve the highest sustained rates of economic growth are sometimes referred to collectively as **newly industrializing economies**.

Overall, NIEs are characterized by greater industrial output than developing economies; heavy manufactures and refined products make up an increasing proportion of exports. Goldman Sachs, the firm that developed the BRIC framework a decade ago, has identified a new country grouping called Next-11 (N11).

Five of the N11 countries are considered NIEs. These include three lower-middle-income countries: Egypt, Indonesia, and the Philippines. Mexico and Turkey are N11 NIEs from the ranks of the upper-middle income category.

Marketing Opportunities in LDCs and Developing Countries

Despite many problems in LDCs and developing countries, it is possible to nurture long-term market opportunities.

Although Nike sells only a small portion of its output in China, it clearly has the future in mind when it refers to China as a "two-billion-foot market."

Prahalad and Hammond have identified several assumptions and misconceptions about the "bottom of the pyramid" (BOP) that need to be corrected:

- *Mistaken assumption #1: The poor have no money*.

The aggregate buying power of poor communities can be substantial. In rural Bangladesh, for example, villagers spend considerable sums to use village phones operated by local entrepreneurs.

- *Mistaken assumption #2: The poor are too concerned with fulfilling basic needs to "waste" money on non-essential goods*.

Consumers who are too poor to purchase a house do buy "luxury" items such as television sets and gas stoves to improve their lives.

- *Mistaken assumption #3: The goods sold in developing markets are so inexpensive that there is no room for a new market entrant to make a profit.*

In reality, because the poor often pay higher prices for many goods, there is an opportunity for efficient competitors to realize attractive margins by offering quality and low prices.

- *Mistaken assumption #4: People in BOP markets cannot use advanced technology.*

Residents of rural areas can and do quickly learn to use cell phones, PCs, and similar devices.

- *Mistaken assumption #5: Global companies that target BOP markets will be criticized for exploiting the poor.*

The informal economies in many poor countries are highly exploitative. A global company offering basic goods and services that improve a country's standard of living can earn a reasonable return while benefiting society.

Innovation, Entrepreneurship, and the Global Startup – TOMS

Blake Mycoskie is an entrepreneur. He created a brand, developed several innovative products, and started a company to market them using an innovative business design. Mycoskie's innovative idea was based on his recognition of unmet needs. They were the needs of children whose parents could not afford to buy shoes.

He set up a shoe company, TOMS, with a unique business model and social mission. Each time a customer buys a pair of TOMS, the company donates a pair of shoes to a child in need. Mycoskie defines his business as "one-for-one" see Exhibit 2-9).

One of marketing's roles in developing countries is to focus resources on the task of creating and delivering products that are best suited to local needs and incomes.

Marketing can be the link that relates resources to opportunity and facilitates need satisfaction on the consumer's terms.

Some believe marketing is relevant only in affluent, industrialized countries.

- The argument: In less-developed countries the major problem is the allocation of scarce resources toward obvious production needs. Efforts should focus on production and how to increase output, not on customer needs and wants.
- The converse argument: The role of marketing – to identify people's needs and wants and to focus individual and organizational efforts to respond to these needs and wants – is the same in all countries, irrespective of level of economic development.

There is also an opportunity to help developing countries join the Internet economy. Global companies can also contribute to economic development by finding creative ways to preserve old-growth forests and other resources while creating economic opportunities for local inhabitants.

High-Income Countries

These are advanced, developed, industrialized, or postindustrial countries, having a per capita GNP of $12,476 or higher. They have reached their present income level through sustained economic growth.

The phrase "postindustrial countries" describes the United States, Sweden, Japan, and other advanced, high-income societies.

Product and market opportunities in a postindustrial society are heavily dependent upon new products and innovations.

Seven high-income countries—the United States, Japan, Germany, France, Britain, Canada, and Italy—comprise the **Group of Seven (G-7)**. Finance ministers, central bankers, and heads of state from the seven nations have worked together for more than a quarter of a century in an effort to steer the global economy in the direction of prosperity and to ensure monetary stability.

Representatives from OECD member nations work together in committees to review economic and social policies that affect world trade.

The Triad

The ascendancy of the global economy has been noted by many observers in recent years. One of the most astute is Kenichi Ohmae, former chairman of McKinsey & Company Japan. In his book *Triad Power*, Ohmae argued that successful global companies had to be equally strong in the dominant economic centers of Japan, Western Europe, and the United States.

These three regions, called the **Triad**, represented the dominant centers of the world and the location of nearly 75 percent of world income, as measured by GNP.

The **expanded Triad** includes the entire Pacific region, Canada and Mexico; and the boundary in Europe is moving eastward.

Marketing Implications of the Stages of Development

Product saturation levels or the percentage of potential buyers or households that own a particular product, can serve as a guide to marketers.

In China, product saturation levels of private motor vehicles and personal computers are quite low – 1 PC for every 6,000 people and 1 car for every 43,000 people.

BALANCE OF PAYMENTS

- ✓ **(Learning Objective #4)**

The balance of payments is a record of all economic transactions between the residents of a country and the world. It is divided into the current and capital accounts. (Table 2-5).

The current account is a measure that includes trade in merchandise and services, plus certain categories of financial transfers such as humanitarian aid.

A country with a negative current account balance has a trade deficit; that is, the outflow of money to pay for imports exceeds the inflows of money for sales of exports

A country with a positive current account balance has a trade surplus. The capital account is a record of all long-term direct investment, portfolio investment and other short- and long-term capital flows.

A country accumulates reserves when the net of its current and capital account transactions shows a surplus; it gives up reserves when the net shows a deficit.

A close examination of Table 2-5 reveals that the United States regularly posts deficits in both the current account and the trade balance in goods.

Overall, the U.S. post balance of payments deficits while important trading partners, such as China, have surpluses. (Table 2-6).

TRADE IN MERCHANDISE AND SERVICES

Thanks in part to the achievements of GATT and the WTO, world merchandise trade has grown at a faster rate than world production since the end of World War II.

According to figures compiled by the World Trade Organization, the dollar value of world trade in 2009 totaled $11.8 trillion.

- ✓ **(Learning Objective #5)**

In 2003, Germany surpassed the United States as the world's top merchandise exporter. Exports generate 40 percent of Germany's gross domestic product, and 9 million jobs are export related.

In 2009, China leapfrogged Germany in the global merchandise export rankings (see Table 2-7).

China's top-place ranking underscores its role as an export powerhouse; the country has demonstrated continued economic strength by achieving double-digit export growth.

Chinese exports to the United States have surged since China joined the World Trade Organization in 2001; in fact, policymakers in Washington are pressuring Beijing to boost the value of the yuan in an effort to stem the tide of imports.

The fastest-growing sector of world trade is trade in services. Services include travel and entertainment; education; business services, such as accounting, advertising, engineering, investment banking, and legal services; and royalties and license fees that represent payments for intellectual property. One of the major issues in trade relations between the high- and lower-income countries is trade in services.

The United States is a major service trader. As shown in Figure 2-2, U.S. services exports in 2013 totaled nearly $690 billion. This represents about one-third of total U.S. exports. The U.S. services surplus (service exports minus imports) stood at $207 billion. This surplus partially offset the U.S. merchandise trade deficit, which declined to $701 billion in 2013 from a record $835 billion in 2006. American Express, Walt Disney, IBM, Microsoft, and UPS are a few of the

U.S. companies that have experienced rapid growth in demand for their services around the world.

OVERVIEW OF INTERNATIONAL FINANCE

Foreign exchange makes it possible for a company in one country to conduct business in other countries with different currencies.

The foreign exchange market consists of a buyer's market and a seller's market where currencies are traded for both spot and future delivery on a continuous basis.

Devaluation can result from government action or an economic crisis; devaluation is a reduction in the value of a nation's currency against other currencies.

To the extent that a country sells more goods and services abroad than it buys, there will be a greater demand for its currency and a tendency for it to appreciate in value—unless the government pursues foreign-exchange policies that do not allow the currency to fluctuate. In international economics, such policies are called *mercantilism* or *competitive-currency politics* because they favor domestic industries at the expense of foreign competitors.

The Big Mac Index

One way to answer the question is to compare world prices for a single well-known product: McDonald's Big Mac hamburger. The so-called "Big Mac Index" is a 'quick and dirty' way of determining which of the world's currencies are too weak or strong.

The underlying assumption is that the price of a Big Mac in any world currency should, after being converted to dollars, equal the price of a Big Mac in the United States.

A country's currency would be overvalued if the Big Mac price (converted to $) is higher than the U.S. price. Conversely, a country's currency would be undervalued if the converted Big Mac price is lower than the U.S. price.

Economic Exposure

Economic exposure reflects the impact of currency fluctuations on a company's financial performance. Economic exposure can occur when a company's business transactions result in sales or purchases denominated in foreign currencies.

Managing Exchange Rate Exposure

- ✓ **(Learning Objective #6)**

It should be clear from this discussion that accurately forecasting exchange rate movements is a major challenge. Over the years, the search for ways of managing cash flows to eliminate or reduce exchange rate risks has resulted in the development of numerous techniques and financial strategies.

Hedging exchange rate exposure involves establishing an offsetting currency position such that the loss or gain of one currency position is offset by a corresponding gain or loss in some other currency.

External hedging methods for managing both transaction and translation exposure require companies to participate in the foreign currency market. Specific hedging tools include forward contracts and currency options.

Internal hedging methods include price adjustment clauses and intra-corporate borrowing or lending in foreign currencies.

The forward market is a mechanism for buying and selling currencies at a preset price for future delivery.

For a foreign currency, **option** is best for such situations. A **put option** gives the buyer the right, not the obligation, to sell a specified number of foreign currency units at a fixed price, up to the option's expiration date.

Conversely, a **call option** is the right, but not the obligation, to buy the foreign currency. In other words, the U.S. company locks in the value of the contract in dollars. Thus, if the project is granted, the future foreign currency cash inflow has been hedged by means of the put option. If the project is *not* granted, the company can trade the put option in the options market without exercising it; remember: options are rights, not obligations.

CASES

Case 2 -1: Venezuela after Chavez: The Case for Economic Freedom

Overview: Although the Soviet Union is long gone, there are still plenty of examples of countries where government leaders attempt to control the economy. Venezuela is a case in point. Venezuela's rich oil reserves provided resources for Chavez to rally popular support with voters.

Chavez died in 2013 and by 2015, with oil prices plummeting; Venezuela faced an economic crisis that deepened with every passing week. Venezuela's inflation rate is currently 60 percent, the highest in the world.

2-8. President Chavez held office for 14 years, despite all the shortages in Venezuela's economy. How do you explain this?

> Chavez had a strong disdain for American politicians and told Venezuelans that "US capitalism is broken." He convinced the people of Venezuela that they needed something different. Although student answers may vary, the above should be part of their answers.

2-9. Many Venezuelans proclaim themselves to be "Chavistas," despite the country's problems. How do you explain this?

Student answers will vary.

2-10. Can Venezuela afford to maintain its Petrocaribe program of subsidized oil exports?

With oil prices plummeting and their inflation rate of 60%, the highest in the world, they cannot continue this program.

Case 2-2: A Day in the Life of a Contracts Analyst at Cargill

Overview: Glynis Gallagher works as a contracts analyst at Cargill Risk Management based in Minnesota. Cargill is a truly global company: With operations in more than 60 countries, it markets food, agriculture, financial, and industrial products and services to customers worldwide. Revenues totaled $ 134.9 billion in 2014, making Cargill the largest privately owned company in the United States. Gallaghers business unit works with customers to provide commodities hedges through swaps and structured products. The commodities in question are often agricultural commodities including grains like corn, wheat, and soybeans, as well as beef and other animal proteins.

Discussion Questions

2-11. What knowledge and skills are required to be successful as a credit risk analyst?

Gallagher's degree in marketing also included courses in math and finance. She these courses gave her a solid foundation in order to understand portfolio exposures, fee schedules, and financing options she utilizes everyday.
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2-12. What do you think is the best part of Gallagher's job? The most challenging part?

Student answers will vary.

2-13. If you were in Gallagher's position, what would your next career move be?

Student answers will vary.

TEACHING TOOLS AND EXERCISES

Additional Cases

"Cherries With Charm: Turkey's Alara Agri" by Michael R. Pearce and Jordan Mitchell, June 2009. *HBS*: 909A19-PDF-ENG.

"Pan Boricua: Developing a Market Strategy for the Hispanic Market in the United States" by Victor Quinones; Julia Sagebien; Marisol Perez-Savelli; Eva Perez; Jennifer Catinchi *HBS*: 909A20-PDF-ENG

"Global Wine War 2009: New World versus Old." Christopher A. Bartlett, *HBS,* 910405.

Out-Of-Class Reading: Assign the following seminal article on marketing and ask students to apply the concepts presented to global marketing.

Theodore Levitt, "Marketing Myopia," *Harvard Business Review* 80, no. 7/8 (July-August 2004), pp. 138-149.

Internet Exercise: Have students go to **http://finance.yahoo.com/currency?u**. This site offers a foreign exchange calculator that allows easy comparison of currency exchange rates. Students will select a few currencies such as the Thai baht, the Chinese yuan, the Malaysian ringed, and Indonesian rupee and compare exchange rates.

Activity: Either in groups or individually, students should begin preparing their Cultural and Economic Analysis and Marketing Plan as noted in Chapter 1.

Videos:
This video was produced by the Tuck School of Business at Dartmouth. He explains how people in the Western world, India for example, weigh more heavily on advertisement than people in America do. The presenter explains that cultural awareness and cultural knowledge are necessary prerequisites to be successful in a global market. At the end he gives advice to students including learning another language, and becoming informed of another culture, developing empathy, etc. These traits will help you open up more to managing a global business. 3 ½ minutes long.

Link: http://www.youtube.com/watch?v=fbBMOjoMDA4&feature=relmfu

Film: Have students watch the movie "Wall Street." Although not dealing directly with international finance, the film gives students insight into various financial dealings and transactions and the potential outcomes associated.

SUGGESTED READINGS

Books

Enghold, Christopher. *Doing Business in Asia's Booming China Triangle*. Upper Saddle River, NJ: Prentice Hall, 1994.

Finger, Michael J. *Institutions and Trade Policy.* Northampton, MA: Edward Elgar, 2002.

Garten, Jeffrey E. *The Big Ten: The Big Emerging Markets and How They Will Change Our Lives.* New York: BasicBooks, 1997.

Isaak, Robert A. *Managing World Economic Change.* Upper Saddle River, NJ: Prentice Hall, Inc., 1995.

Kennedy, Paul. *The Rise and Fall of Great Powers.* New York: Random House, 1987.

McCue, Sarah. *Force to Force: Building Profitable E-Commerce Strategies.* Mason, OH: Thomson Higher Education, 2006.

Roberts, Paul C., and Karen Le Follette Araujo. *The Capitalist Revolution in Latin America.* Oxford: Oxford University Press, 1997.

Shapiro, Alan C. *Multinational Financial Management*, 5th ed. Upper Saddle River, NJ: Prentice Hall, Inc., 1995.

Porter, Michael E. *The Competitive Advantage of Nations.* New York: The Free Press, 1990.

Thurow, Lester. *Head to Head: The Coming Economic Battle Among Japan, Europe, and America.* New York: William Morrow and Company, Inc., 1992.

Articles

Cavusgil, S. Tamer. "Measuring the Potential of Emerging Markets: An Indexing Approach." *Business Horizons* 40, no. 1 (January/February 1997), pp. 87-91.

Czinkota, Michael R. "The World Trade Organization – Perspectives and Prospects," *Journal of International Marketing* 3, no. 1 (1995), pp. 85-92.

Dowlah, C.A.F. "The Future of the Readymade Clothing Industry in the Post-Uruguay Round World." *World Economy* 22, no. 7 (September 1999), pp. 933-953.

Golden, Peggy A., Patricia M. Doney, Denise M. Johnson, and Jerald R. Smith, "The Dynamics of a Marketing Orientation in Transition Economies: A Study of Russian Firms," *Journal of International Marketing* 3, no. 2 (1995), pp. 29-49.

Kaikati, Jack G., George M. Sullivan, John M. Virgo, T. R. Carr, and Katherine S. Virgo, "The Price of International Business Morality: Twenty Years under the Foreign Corrupt Practices Act," *Journal of Business Ethics* 26, no. 3 (2000), pp. 213-222.

Knight, Gary and S. Tamer Cavusgil. “Innovation, Organizational Capabilities and the Born Global Firm,” *Journal of International Business Studies* 35, no. 2 (2004), pp. 121-141.

Prowse, Michael. “Is America in Decline?” *Harvard Business Review* 70, no. 4 (July/August 1992), pp. 36-37.

Swift, Time and Mudambi, Ram, "Leveraging Knowledge and Competencies Across Space: The Next Frontier in International Business" Journal of International Management Volume 17, Issue 3, September 2011, Pages 186–189.

Yan, Rick, "To Reach China's Consumers, Adapt to *Guo Qing*," *Harvard Business Review* 72, no. 5 (September/October 1994), pp. 66-74.

Global Marketing

WARREN J. KEEGAN MARK C. GREEN

NINTH EDITION

The Global Economic Environment

Chapter 2

Learning Objectives

1. Identify and briefly explain major changes in the world economy over the last 100 years
2. Compare and contrast types of economic systems that are found in the different regions of the world
3. Explain the stages of economic development used by the World Bank and identify the key emerging country markets at each stage of development
4. Discuss the significance balance of payments for the world's major economies
5. Identify the countries that are leading exporters
6. Briefly explain how exchange rates impact a company's opportunities in different parts around the world

The World Economy—An Overview

- In the early 20th century economic integration was at 10%; today it is 50%
- EU and NAFTA are very integrated
- Global competitors have displaced or absorbed local ones

The World Economy—An Overview

- The new realities:
  - Capital movements have replaced trade as the driving force of the world economy
  - Production has become uncoupled from employment
  - The world economy, not individual countries, is the dominating factor

The World Economy—An Overview

The new realities, continued:

- The struggle between capitalism and socialism began in 1917 is over
- E-Commerce diminishes the importance of national barriers and forces companies to re-evaluate business models

Zeroing in on Economic Systems

- Globalization has made it harder to pigeonhole economies within the four-cell matrix
- Also consider:
  - Type of economy: advanced industrial state, emerging or transition economy, or developing nation?

Zeroing in on Economic Systems

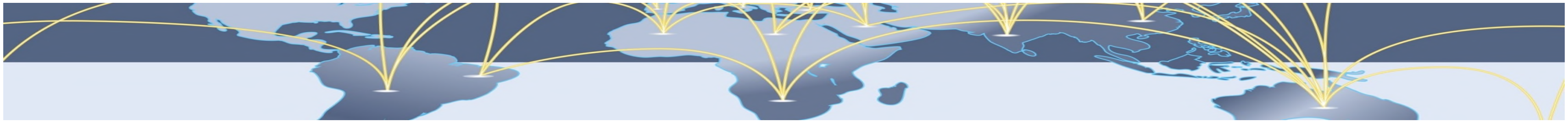
- Type of Government: Monarchy, dictatorship, tyrant? One-party system? Dominated by another state? Democracy? Terrorist?
- Trade and capital flows: Free trade, part of trading bloc? Currency board or exchange controls?
- The commanding heights: Transportation, communications & energy sectors. State, private, or mixed ownership?

Zeroing in on Economic Systems

– Services provided by the state or state funded: Pensions, health care, education.

– Institutions: Country characterized by transparency, standards, absence of corruption? Standards ignored and court system compromised?

– Markets: Entrepreneurial high risk/high reward? Socialized market? Government dominated price and wage controls?

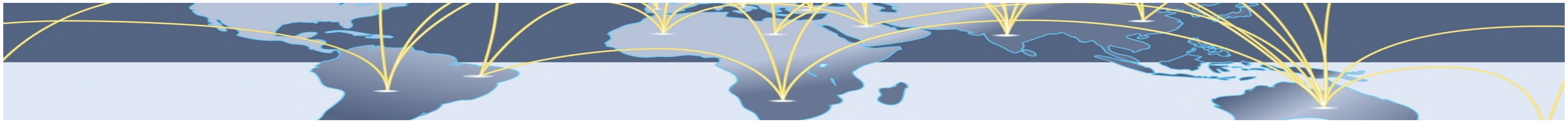


Economic Systems

Resource Ownership	Resource Allocation: *Market*	Resource Allocation: *Command*
Private	Market Capitalism	Centrally Planned Capitalism
State	Market Socialism	Centrally Planned Socialism

Market Capitalism

- Individuals and firms allocate resources
- Production resources are privately owned
- Driven by consumers
- Government's role is to promote competition among firms and ensure consumer protection



Western Market Systems

Type of System	Key Characteristics	Countries
Anglo-Saxon model	Private ownership; free enterprise economy; capitalism; minimal social safety net; highly flexible employment policies	United States, Canada, Great Britain
Social market economy model	Private ownership; "social partners" orientation that includes employer groups, unions, and banks; unions and corporations are involved in government, and vice versa; inflexible employment policies	Germany, France, Italy
Nordic model	Mix of state ownership and private ownership; high taxes; some market regulation; generous social safety net	Sweden, Norway

Centrally Planned Socialism

- Opposite of market capitalism
- State holds broad powers to serve the public interest; decides what goods and services are produced and in what quantities
- Consumers can spend only what is available
- Government owns entire industries and controls distribution
- Demand typically exceeds supply
- Little reliance on product differentiation, advertising, pricing strategy
- China, India, and the former USSR now moving towards some market allocation and private ownership

Centrally Planned Capitalism

- Economic system in which command resource allocation is used extensively in an environment of private resource ownership
- Example:
  - Swedish government controls 2/3s of all spending; a hybrid of CPS and capitalism (Market Socialism)
  - Swedish government plans move towards privatization

Economic Freedom

- Rankings of economic freedom among countries
  - “free” “mostly free” “mostly unfree” “repressed”
- Variables considered include such things as:
  - Trade policy
  - Taxation policy
  - Capital flows and foreign investment
  - Banking policy
  - Wage and price controls
  - Property rights
  - Black market

Economic Freedom—
2015 Rankings

Free

1. Hong Kong
2. Singapore
3. New Zealand
4. Australia
5. Switzerland
6. Canada
7. Chile
8. Estonia
9. Ireland
10. Mauritius
11. Denmark
12. United States

Repressed

169. Argentina
170. Republic of Congo
171. Iran
172. Turkmenistan
173. Equatorial Guinea
174. Eritrea
175. Zimbabwe
176. Venezuela
177. Cuba
178. North Korea

Not ranked: Afghanistan, Iraq, Kosovo, Libya, Liechtenstein, Somalia, Sudan, Syria

Stages of Market Development

- The World Bank has defined four categories of development using Gross National Income (GNI) as a base
- **BEMs**, identified 10 years ago, were countries in Central Europe, Latin America, and Asia that were to have rapid economic growth
- Today, the focus is on **BRICS:** Brazil, Russia, India, China and South Africa

Low-Income Countries

- GNI per capita of $1,045 or less
- Characteristics
  - Limited industrialization
  - High percentage of population in farming
  - High birth rates
  - Low literacy rates
  - Heavy reliance on foreign aid
  - Political instability and unrest
  - Concentrated in Sub-Saharan Africa

Lower-Middle-Income Countries

- GNI per capita: $1,046 to $4,125
- Characteristics
  - Rapidly expanding consumer markets
  - Cheap motivated labor
  - Mature, standardized, labor-intensive industries like footwear, textiles and toys
- 50 bottom-ranked countries are LDCs—least developed countries
- India is the only BRIC nation

Upper-Middle-Income Countries

Venezuelans have to cope with a shortage of goods as oil prices have dropped.

GNP per capita: $4,126 to $12,745

Characteristics:

- Rapidly industrializing, less agricultural employment
- Increasing urbanization
- Rising wages
- High literacy rates and advanced education
- Lower wage costs than advanced countries

- Also called industrializing or developing economies
- BRICS: Brazil, China, South Africa
- Other countries: Malaysia, Chile, Venezuela, Mexico

Newly Industrializing Economies (NIEs)

- Lower-middle and upper income economies with the highest sustained rates of economic growth
  - Greater industrial output that developing economies
  - Exports of manufactured and refined products
  - Next -11 (N-11) a new country grouping identified by Goldman Sachs
    - NIEs include Egypt, Indonesia, the Philippines, (lower-middle income) Mexico, and Turkey (upper-middle income)

Mistaken Assumptions about LDCs

1. The poor have no money.
2. The poor will not "waste" money on non-essential goods.
3. Entering developing markets is fruitless because goods there are too cheap to make a profit.
4. People in BOP (bottom of the pyramid) countries cannot use technology.
5. Global companies doing business in BOP countries will be seen as exploiting the poor.

High-Income Countries

- GNI per capita: $12,476 or more
- Also known as advanced, developed, industrialized, or postindustrial countries
- Characteristics:
  - Sustained economic growth through disciplined innovation
  - Service sector is more than 50% of GNI
  - Households have high ownership levels of basic products

High-Income Countries

- Characteristics, continued:
  - Importance of information processing and exchange
  - Ascendancy of knowledge over capital, intellectual over machine technology, scientists and professionals over engineers and semiskilled workers
  - Future oriented
  - Importance of interpersonal relationships

G-7, the Group of Seven

- Goal of global economic stability and prosperity
  - U.S.
  - Japan
  - Germany
  - France
  - Britain
  - Canada
  - Italy

Russia joined in 1998 changing the group to the G-8 but its membership was suspended in 2014 after it annexed the Crimean peninsula.

G-20, Group of Twenty

- Established in 1999
- Finance Ministers and central bank governors of 19 countries and the EU
- Russia remains a member, unlike in the G-7.

OECD, the Organization for Economic Cooperation and Development

- 34 nations
- Post-WW II European origin; based in Paris
- Canada, U.S. (1961), Japan (1964)
- Promotes economic growth and social well-being
- Focuses on world trade, global issues, labor market deregulation
  - Anti-bribery conventions

The Triad

- U.S., Western Europe, and Japan
- Represents 75% of world income
- Expanded Triad includes all of North America and the Pacific Rim and most of Eastern Europe
- Global companies should be equally strong in each part

Product Saturation Levels

- The percent of potential buyers or households who own a product
- India: 20% of people have telephones
- Autos: 1 per 43,000 Chinese, 21 per 100 Poles, 49 per EU adults, 8 per 1,000 Indians, 200 out of 1,000 in Russia, 565 out of 1,000 in Germany
- Computers: 1 PC per 6,000 Chinese; 11 PCs per 100 Poles; 34 PCs per 100 EU citizen

Balance of Payments

- Record of all economic transactions between the residents of a country and the rest of the world
  - Current account–record of all recurring trade in merchandise and services, and humanitarian aid
    - trade deficit—negative current account
    - trade surplus—positive current account
  - Capital account–record of all long-term direct investment, portfolio investment, and capital flows

Balance of Payments

	2009	2010	2011	2012	2013
A. Current Account	**–376,551**	**–470,898**	**–465,926**	**–460,749**	**–400,254**
1. Goods Exports	1,069,491	1,288,882	1,497,406	1,561,540	1,592,784
2. Goods Imports	–1,575,400	–1,934,006	–2,235,819	–2,303,785	–2,294,453
3. *Balance on Goods*	*–505,910*	*–645,124*	*–738,413*	*–742,095*	*–701,669*
4. Services: Credit	505,547	553,603	605,961	654,850	687,410
5. Services: Debit	–380,909	–403,216	–427,428	–450,360	–462,134
6. *Balance on Services*	124,637	150,387	178,533	204,490	225,276
7. *Balance on Goods and Services*	*–381,272*	*–494,737*	*–559,880*	*–537,605*	*–476,392*
B. Capital Account	**–140**	**–152**	**–1,159**	**6,904**	**–412**

Overview of International Finance

- Foreign exchange allows companies to do business globally with different currencies
- Exchange risk occurs when the value of a currency changes as it is traded
- Spot market: immediate delivery
- Forward market: future delivery
- Currency market participants include countries' central banks, companies that convert foreign currency into their home currencies, currency speculators

Overview of International Finance

- Devaluation: the reduction of a nation's currency against other currencies
- Mercantilism or Competitive-currency politics: Countries do not allow their currency to fluctuate
- Revaluation: A nation allows its currency to strengthen

U.S. Goods and Services Trade with BRIC, 2013 (US $ Millions)

	China	India	Brazil	Russia
1. U.S. Goods Exports to	122,838	22,225	44,072	11,136
2. Goods Imports from	–441,616	–42,014	–27,221	–27,086
3. *Balance on Goods*	*–318,778*	*–19,789*	*16,852*	*–15,949*
4. U.S. Services Exports to	37,761	13,470	26,640	NA
5. Services Imports from	–14,327	–19,041	–7,346	NA
6. *U.S. Balance on Services*	*23,434*	*–5,571*	*19,293*	*NA*
7. *U.S. Balance on Goods and Services*	*–295,344*	*–25,360*	*36,145*	*NA*

Top Exporters and Importers in World Merchandise Trade, 2012

Leading Exporters	2012	Leading Importers	2012
1. China	$2,049	1. United States	$2,336
2. United States	1,546	2. China	1,818
3. Germany	1,407	3. Germany	1,167
4. Japan	799	4. Japan	886
5. Netherlands	656	5. United Kingdom	960

Overview of International Finance

- Foreign exchange makes it possible to do business across the boundary of a national currency
- Currency of various countries are traded for both immediate (spot) and future (forward) delivery
- Currency risk adds turbulence to global commerce

Foreign Exchange Market Dynamics

- Supply and Demand interaction
  - Country sells more goods/services than it buys
  - There is a greater demand for the currency
  - The currency will appreciate in value

TABLE 2-8 Exchange Risks and Gains in Foreign Transactions

	$1,000,000 Contract		€1,100,000 Contract	
Foreign Contract Exchange Rates	U.S. Seller Receives	European Buyer Pays	U.S. Seller Receives	European Buyer Pays
€1.25 = $1	$1,000,000	€1,250,000	$880,000	€1,100,000
€1.10 = $1	$1,000,000	€1,100,000	$1,000,000	€1,100,000
€1.00 = $1	$1,000,000	€1,000,000	$1,100,000	€1,100,000
€0.85 = $1	$1,000,000	€850,000	$1,294,118	€1,100,000

Managing Economic Exposure

- ***Economic exposure*** refers to the impact of currency fluctuations on the present value of the company's financial performance.
- Occurs when sales are in a foreign currency
  - Nestlé generates 98% of sales outside home country
  - Euro zone companies GlaxoSmithKline, Daimler AG, BP, for example, generate 1/3 of sales in the U.S.

Managing Economic Exposure

- Numerous techniques and strategies have been developed to reduce exchange rate risk
  - ***Hedging*** involves balancing the risk of loss in one currency with a corresponding gain in another currency
  - ***Forward Contracts*** set the price of the exchange rate at some point in the future to eliminate some risk

Looking Ahead to Chapter 3

- The Global Trade Environment

