



UNDERSTANDING BUSINESS IN THE GLOBAL ECONOMY

A Multi-Level Relationship Approach

JONATHAN S. SWIFT

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*This book is dedicated to Charles,
Georgina and Maria; perhaps they will read it someday.*

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INTRODUCTION

0.1 A MULTI-LEVEL RELATIONSHIP APPROACH

0.1.1 Relationships and International Business

This book examines aspects of the operations of International Business (IB) with specific reference to the way in which, at various levels, business relationships are underpinned by contemporary political, economic, and social activities, and how all such relationships operate within a dynamic environment. At its most basic, IB is concerned with the pursuit of business in the international, as opposed to the domestic, environment. All business (both domestic and international) is about establishing and maintaining relationships – either with individual corporate customers (generally business-to-business activities) or with a mass market – generally in business-to-consumer markets. Businesses form relationships with their customers, their suppliers, and sometimes with their competitors: a good example of this last group is the ‘code sharing’ arrangements that many airlines have, in which they co-operate with other airlines (who would normally be their direct competitors) to enable the partners to increase their global customer base, without having to invest in more routes and/or airport take-off/landing slots. In terms of international business in particular, relationships are viewed as a means of establishing an international presence, by exploiting the superior market knowledge or position of a partner already based in the target country market. Understanding the ways in which business relationships operate in the modern global economy is essential for the conduct of contemporary business.

Over the last forty years, there has been a growing realisation that IB is not merely a sub-category of economics or cross-border trade, but that it revolves around the highly complex development and maintenance of relationships. The operation and control of IB has undergone a subtle yet important change as

the ever-growing pace of globalisation has made businesses increasingly more reliant on the establishment and maintenance of a variety of complex relationships. This is a consequence of three factors: firstly, it is cheaper to retain existing customers/suppliers than to look for others; secondly, establishing long-term relationships increases the barriers to entry, thus effectively excluding competitors, and giving a competitive advantage to those already within an established relationship. Finally, it also includes the very real benefit that dealing with a local partner gives easier access to the new market, different ways of operating, and different cultures, business practices and philosophies.

The relationships that are the focus of this book are those based on an open, mutually-advantageous working relationship, in which both sides seek to develop business success for themselves, by ensuring the prosperity of their business partners. It is *not* about relationships that are based on ‘obligations’ or ‘favours’: the growing international importance of China means that there cannot be many students or international business practitioners who are unaware of the Chinese phrase *Guanxi* – defined by one writer as a “... system of personal connections that carry long-term social obligations” (Millington *et al.*, 2005:255). Such relationships can be misinterpreted by those who are not fully aware of the complex social relationships and obligations that *guanxi* places on people. With reference to the (Western) assumption that *guanxi* is merely corruption under a different name, and that it implies collusion or bribery, Millington *et al.* (2005:256) emphasise that “... a clear distinction can be drawn between gift giving within *guanxi*, which is concerned with the building of relationships, and bribery which is targeted at illicit transactions.” Most cultures have a word to describe such relational obligations or favours: in parts of Latin America, a similar concept is expressed through the phrase *enchufes*, or connections; in the UK, people speak of the ‘Old-Boy Network’, or the ‘Old School Tie’, and in the Middle East they talk of *Wasta*, while in Russia it is known as

blat. Whilst such relationships may not be strictly illegal (or at least it is difficult to identify and prosecute those involved), they are of questionable moral value, and certainly do nothing to enhance true competition in the global market place. When the participants in such relationships die, retire, or move on, they take any commercially accrued advantage with them. Thus, reliance on such networks is, if nothing else, dangerous in the medium-to-long term, and is no substitute for the sort of relationships that *are* the focus of this book.

0.1.2 The Multi-Level Approach

Many IB texts focus on economics and finance, and whilst it is important to understand the basics of international economics and finance, such a focus inevitably means that other – arguably more important – areas are dealt with in less depth. Whilst some current IB texts *do* address the concept of relationships, the majority tend to do so in terms of “Relationship Marketing” (RM), and focus on operational aspects – such as how RM affects relationships between a firm and its Commercial Agent, or supplier organisations. Whilst this is indeed an important aspect of IB relationships, it is only part of the picture, as it misses the crucial aspects of relationship development and maintenance *at a variety of levels*.

By contrast, this book differs from other texts as it adopts a multi-level relationship approach to IB, whereby relationships are examined at three levels: the ‘national’, ‘corporate’, and ‘individual’ – each of which is independent, but at the same time, influences (and is influenced by) the others. The levels can be visualised as a pyramid, with the flow of influence going from bottom to top (see [Figure 0.1](#)).

The national level provides the framework within which companies operate – this provides an indirect influence, or broad guide; at the corporate level, there is obviously a greater degree of direct relevance to relationship development, as companies seek to do business with other companies. At the apex of the pyramid (the ‘personal’ level), the relationship development depends on the way in which individuals from different companies interact with each other. Thus, the whole approach takes into account these various ‘layers’ or ‘levels’ that, taken together, help determine the development and maintenance of cross-cultural business relationships.

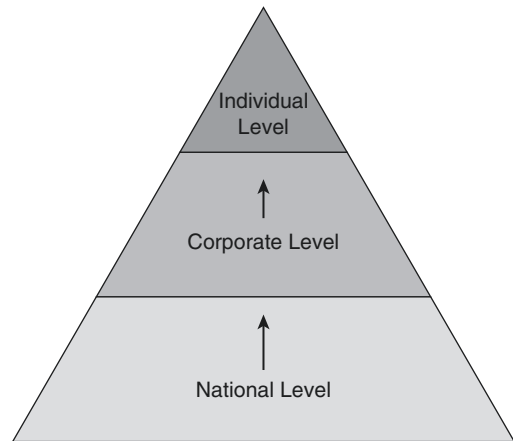


Figure 0.1 – The Multi-Level Approach to International Business

Relationships Between Countries (‘National Level’)

This comprises relations between individual countries, and is generally referred to as ‘bilateral’ relations. Relations between more than two countries are termed ‘multilateral’. Relations between nations can be located on a continuum, ranging from ‘hostile’ (the most negative), to a ‘special relationship’ (exceptionally good). Between these two extremes lie various shades of ‘warmth’, with many countries having either ‘neutral’ or ‘good/poor’ relationships with each other. Just as the business environment is subject to change, relationships can fade or blossom as a consequence of politico-economic factors. Whatever the precise nature of the relationship, it is usually based on politically-motivated, economic and/or military considerations, and as such has a significant influence on the extent and direction of trade between nations and, therefore, on relationships between companies that are involved in international trade. Some bilateral relationships such as that between the UK and the USA are what British Prime Minister Winston Churchill described as ‘Special’ – although pragmatists with experience of the US political scene are increasingly questioning whether this relationship is as special as it is frequently portrayed (Meyer, 2015). The most recent shift is to be found in the changing US focus with regard to Europe – as a consequence of the UK’s forthcoming (2017) UK vote on continued membership of the European Union (EU). This means that instead of regarding the UK as its natural ally and partner, the USA is increasingly looking to Germany as its key partner within the EU (Foster, 2015).

Good relations between countries (at the national/diplomatic level) can have a positive influence on trade. Relations between the Republic of South Africa (RSA) and Zimbabwe have been cordial since Zimbabwean independence – unlike Zimbabwean relations with much of the rest of the world; apart from the RSA (which receives just over 32.4% of Zimbabwean exports), Zimbabwe trades with the Democratic Republic of Congo (9.8% of exports), Botswana (8.8%), China (5.6%), Zambia (4.8%), Japan (4.5%), Italy (4.5%), and the USA (4.3%) (Economy Watch, 2010). Currently, the RSA is the top export and import partner for Zimbabwe (Global Edge, 2015), reflecting the fact that the RSA has consistently refused to join the international community by moving against President Robert Mugabe (Tendi, 2014).

Poor relations between governments influence trade: at the very least companies may not have access to government assistance when seeking to develop relations with companies in an ‘unfriendly’ country; more significantly, they may be actively prevented from trading if the country in question is subject to official trade embargoes. In December 2010, the Nobel Committee (based in Oslo, Norway) awarded the ‘Peace Prize’ to Chinese dissident Liu Xiaobo; an infuriated Chinese government placed an embargo on exports of salmon from Norway to China as a means of ‘punishing’ the Norwegians. Whilst this has had a negative economic consequence for Norwegian companies, it has, ironically, opened up huge opportunities for Scottish fish farmers, who have taken advantage of

the exclusion of Norwegian companies from China (Carrell, 2013).

Until the recent ‘thaw’ in relations between the USA and Cuba in April 2015 (BBC, 2015a), US companies had been prohibited from doing business with Cuba since 1962. Embargoes may only affect particular sectors, or they may cover all sectors – either way, they present an obstacle to the development of business, and as such form an important part of nation-to-nation trading developments. Consider the relations that exist between the European Union (EU) and North Korea (NK) – an authoritarian communist regime, widely condemned for its atrocities, abuses of human rights, and its ambitions to acquire nuclear weapons. NK is considered a ‘rogue’ state by much of the world, and currently attracts a range of EU sanctions.¹ Diplomatic relations between North Korea and the EU were only established in 2001,² and this poor level of national-level interaction is reflected in EU-NK trade: in 2012, EU exports to NK were valued at around €73 million, and NK exports to the EU at around €19 million – giving a total trade value of some €92 million. Compare this with trade figures for the EU and *South* Korea – a democratic country that has had good relations with most of the world for many years: in the same year trade between the two amounted to around €75 billion.¹ Approximately 68% of NK’s foreign trade is conducted with its long-standing politico-military ally – China – which in the same period was estimated to amount to around €470 million.² Other NK trading

Box 0.1

International Relations with Zimbabwe

Relations between Zimbabwe and other countries have deteriorated over the last twenty years, largely as a consequence of the excesses of corruption, and abuses of human rights since the illegal assumption of power by Mugabe – this is particularly apparent in the worsening diplomatic relations between Zimbabwe and the UK. Tendi (2014:1251), with masterful understatement, describes Anglo-Zimbabwean relations as being “... highly charged since 1980”. Others, such as Musewe (2015), are more forthright, emphasising the corruption that has held Mugabe in power, and which he continues to use to exploit the country to his advantage (and the advantage of his cronies), whilst hundreds of Zimbabweans continue to starve. There is a current United Nations (UN) embargo on the export of arms to Zimbabwe, in addition to other financial, travel, and other sanctions. A study commissioned by the World Bank (IBRD) detailed in particular the decline of Zimbabwean exports, and the country’s tourism industry; the same study, however, also suggested that since the political reforms, there was hope for the rejuvenation of the economy (Kaminski and Ng, 2011).

1 www.gov.uk/government/uploads/system/uploads/attachment_data/file/441921/northkorea.pdf

2 www.trade.ec.europa.eu/doclib/docs/2006/september/tradoc_111834.pdf

partners are India, the Democratic Republic of Congo, and Saudi Arabia.

The conclusion drawn is that the state of diplomatic (national) relations between countries presents businesses with opportunities or restrictions: rather than increase the level of risk they might incur by operating in countries that have bad relations with their home country, most companies will adopt the pragmatic solution of seeking opportunities in other countries – preferably one with which their country has good relations.

Relationships Between Companies ('Corporate Level')

In general terms, if two or more nations have cordial relations at the national level, they will use this relationship to encourage the development of mutually beneficial business relationships. Business drives the economy, and a growing GDP³ brings greater wealth to a nation; increased wealth brings politico-economic strength (a key objective of every government, regardless of political persuasion), which is why politicians are interested in strengthening their respective economies. One of the key roles of government is to encourage and facilitate trade between nations (especially exports), as this will contribute to the overall wealth and development of their respective countries. Generally such help and encouragement to business is done through trade-related government departments:

Whilst governments may pave the way for business to operate internationally, it is overwhelmingly business, not government, that undertakes trade – albeit within the politico-economic-legal frameworks that

their respective governments have developed in conjunction with other governments. This is reflected in the trade that takes place within politico-economic alliances such as the EU; the combined population figures for states that are currently (2015) members of the EU, gives a total of just over 500 million people – broadly equating to the number of consumers, and therefore to levels of demand. When compared to the populations for the largest five non-EU countries (in terms of population), the combined population stands at around 3.4 *billion*.⁴ Even allowing for differences in wealth, one might expect that a large proportion of EU trade to be done with these and/or other countries: yet current statistics show that trade between EU members (known as *intra-EU* trade) accounts for 62% of the total EU trade by value.⁵

Relationships Between Individuals ('Individual Level')

This stage represents the apex of our inverted pyramid, and represents possibly the most important aspect of successful business interaction. Working within the national and corporate restrictions and opportunities identified at the previous two levels, businesses have relations with each other, but those relations are developed and maintained by individuals. Thus, despite all the previous considerations, in the final analysis a relationship can succeed or fail as a consequence of human interaction. This may be difficult enough when working with people from the same socio-cultural grouping (i.e., the parties concerned

Box 0.2

Government Help for Industry: The Republic of South Africa

In The Republic of South Africa (RSA), help to South African businesses wishing to export (and to foreign business wishing to develop a presence in South Africa), is handled by the Department of Trade & Industry (dti). The dti (RSA, 2014) explains its role as one of recognising "... the importance of promoting trade and inward investment, and building trade and investment relations. It focuses on encouraging exports, in order to leverage global growth for the development of the South African economy, through the establishment of collaborative agreements with existing trading partners and dynamic fast-growing emerging markets."

³ GDP = Gross Domestic Product - the 'value' of all goods and services produced in a given nation;

GDP is generally used as an indicator of the 'wealth' of a nation.

⁴ China (1,393,783,836), India (1,267,401,849), the USA (322,583,006), Indonesia (252,812,245), and Brazil (202,033,670) (www.worldometers.info/world-population/population-by-country/)

⁵ www.nkeconwatch.com/category/countries/eu/

share the same culture and language); it becomes considerably more difficult when such relations are conducted between people from different socio-linguistic groups – a highly probable scenario when international business is being conducted. Thus a key element of IB relations at this level is communications – a concept that is dealt with in detail in part D.

0.2 SMEs AND MULTINATIONALS IN INTERNATIONAL BUSINESS

0.2.1 SMEs and International Business

The EU classifies a ‘Small and Medium-Sized Business’ (SME) by the number of employees and/or turnover. A medium-sized enterprise has between 51 and 250 employees (with a turnover of around €50 million), and a Small Enterprise has between 11 and 50 employees (turnover of around €10 million). Companies with fewer than ten employees are generally classified as ‘micro’ enterprises, and generally have a turnover of around €2 million.⁶

It may come as a surprise to many people to learn that the majority of world trade (and by extension, international business) is carried out by SMEs, and not by MNEs. An analysis of the current literature, however, does not reflect this reality, as authors such as Sitkin and Bowen (2013:112) observe: “The lack of attention that SMEs receive in much international business analysis is a mistake: in many countries they account for a significant proportion of all trade and FDI.”

In 2009, the United Nations Conference on Trade and Development (UNCTAD) estimated that about a third of total world exports of goods and services were accounted for by multinationals, suggesting that the remaining two thirds was handled by SMEs (UNCTAD, 2009). More recently, UNCTAD (2013) estimated that around 80 percent of global exports are traded through networks of GVCs – Global Value Chains, and this can give immense opportunities to SMEs. GVCs refer to the operations of an organisation, in which, according to the Organisation for Economic Cooperation and Development (OECD), “... the different stages of the production process

are located across different countries. Globalisation motivates companies to restructure their operations internationally through outsourcing and offshoring of activities” (OECD, 2015). The trade bloc APEC (Asia Pacific Economic Cooperation) looked at the opportunities for SMEs in Global Supply Chains; in a recent study Zhang (2014) pointed out that rather than attempting to compete with multinationals, SMEs are well-placed to become involved in the GVCs created by these same large organisations. As GVCs spread across the world, they present numerous opportunities to outsource many elements of their value chain to local SMEs – which are more likely to have local market knowledge and contacts, in addition to having lower overheads (making them cheaper), and more reactive to the constantly-changing demands of the business environment. It was suggested that the “... growth of SME businesses could contribute to increased value creation, production and profits. They could nurture new business ideas, enhance productivity, improve economic structure, and lead economic development on a more resilient and sustainable path” (Zhang, 2014:6). Sitkin and Bowen (2013:112) cite Germany as a prime example of SME involvement in international business, claiming that the German *Mittlesand* (SME) accounts for “... about 70 per cent of national exports.” In the USA, it is estimated that SMEs account for 98 percent of U.S. exporters in 2012 (www.trade.gov/cs/factsheet.asp).

In addition, the involvement of SMEs in international business has also been greatly enhanced by the formation of trade blocs – such as NAFTA (The North American Free Trade Association) and the EU (European Union). This admirably illustrates one of the premises on which this book is based – that political decisions can enhance (or retard) international trade. According to the Mexican Ministry of the Economy (*Ministerio de Economía*), in 2011 SMEs accounted for 7 out of 10 formal jobs, and Mexican SMEs are particularly strong in the e-commerce and tourism sectors (NAFTA Works, 2011). In the same year the European Commission commissioned a study on the role and activities of SMEs, and concluded (amongst other things) that international SMEs are of key importance – not just in terms of the revenue

⁶ www.ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/sme-definition/index_en.htm

they bring, but also as a consequence of the numbers they employ.⁷ In the EU, where the role of the SME is considered crucial, there is considerable political interest in the activities of SMEs in terms of their contribution to international trade. In a speech given to the European Parliament Committee on International Trade (Brussels, 19 March 2014), Arancha González, the Executive Director of the International Trade Centre (ITC),⁸ said that SMEs are "... the world's most concentrated, booming and innovative engine for world trade and growth ..." (González, 2014).

The level of inter-EU trade is difficult to measure, as trading within a common market is officially not counted as exporting or importing. Leaving aside the considerable inter-EU trade that is carried out by SMEs, in 2014 it was found that there were just under 760,000 EU companies (of all sizes) involved in exporting to countries *outside* the EU. Of these, some 80% are classified as SMEs (Cernat *et al.*, 2004:4).

However, the political and technologically-driven opportunities that are increasingly being enjoyed by SMEs bring with them dangers. Rather than adopting the more traditional approach to internationalisation (through the series of 'steps' or 'stages', each of which allows them to learn at a pace with which they feel comfortable), many SMEs are increasingly embarking on a programme of what we might term 'e-globalisation' and/or may take advantage of the benefits that come with being a member of the same trade bloc; they may not, however, have amassed the valuable experiences that a more traditional route to globalisation would have brought them. They may lack in-depth knowledge of how to assess markets, environments and cultures, and consequently makes errors of judgment. This would appear to be confirmed by the report referred to earlier, in which Cernat *et al.* (2014) noted that amongst the many barriers that SMEs face when exporting, there were human resource constraints, which they defined as a "... lack of managerial skills ... and time and knowledge ..." They also cited constraints due to "... limited or asymmetric information in foreign markets and foreign rules and regulations." Finally, they pointed out that the "... domestic business environment in each Member State can cause internationalisation barriers for SMEs, such as domestic policies and administrative practices" (Cernat *et al.*, 2014:9–10).

In summary therefore, it is increasingly apparent that the internet, e-commerce, and single markets (as in cross-national trading blocs) has given a huge impetus to SMEs to increase their international involvement. And such companies are increasingly taking advantage of this technology – so much so that we might speculate as to whether the days of the 'traditional' route to internationalisation are numbered, and that the global marketplace will increasingly fragment into a series of small, focused markets, each serviced by a group of competitor SMEs that has the market knowledge, cultural and linguistic skills, and technological sophistication to react quickly to changes in both the environment and demand patterns.

0.2.2 Multinationals and International Business

Multinational Enterprises (MNEs) have not been dealt with separately in this book, but references to their activities are included throughout. There are two reasons for this: one is that MNEs – also referred to as Multinational Corporations (MNCs), and Transnational Corporations (TNCs) – have an inherent advantage when working in the international environment, as they tend to employ people from all over the world, and these employees can choose to work in countries other than their own. This means that the average MNE has a truly global perspective, and some of the issues discussed in this book (such as cross-cultural communication difficulties, international management, and business relationship development) are far less significant due to the eclectic mix of staff, and the fact that, within an MNE, most international links may well be with other branches/subsidiaries of the same parent organisation. MNEs employ people from many different cultural-linguistic groups, but in any given country the majority of employees are natives of that country, which means that they are already well acquainted with the environment, the market culture, ways of doing business, major competitors, and managerial style. Hence there is no need to specifically link MNEs to these issues. Thus, whilst all of what is said in this book is of relevance to MNEs, it is assumed that as they operate differently to Small-and-Medium Sized Enterprises (SMEs), and have access to greater

⁷ www.naftamexico.net/wp-content/uploads/2011/11/nov11.pdf

⁸ The International Trade Centre (ITC) is a subsidiary organisation of the World Trade Organisation (WTO) and UNCTAD.

resources and personnel from many cultural and linguistic backgrounds, much of this book is only *indirectly* related to MNE operations; thus to include a separate chapter dedicated solely to MNEs would considerably increase the length of the book, whilst adding little of practical value.

0.3 CHAPTER STRUCTURE

0.3.1 General

Each chapter begins by listing the appropriate ‘Learning Outcomes’, which are designed to show you what you should have learned when you have finished reading the chapter, the case study (if one is included in the chapter), and the review questions at the end. There then follows an introduction that outlines the salient features of the chapter – this will allow tutors to quickly assess where and how the chapter will fit into the overall programme of study that their students are following. Chapters are divided into a numbers of sections, each of which deals with a distinct (but related) topic; each section concludes with a statement, observation, or task, related to one or more aspects of the material covered in that section, entitled “Consider this.” It is designed to be tackled on an individual basis (followed later by class discussion) or in small groups, and can be used in lectures, seminars, or for general discussion. Where practical, the “Consider this” section will involve you undertaking some form of research yourself – the rationale being to engage you in a practical problem, one that will allow you to make the connection between the theoretical concepts studied in the chapter, and the reality of everyday life.

At the end of each chapter, there is an “International Business Summary” section, in which the salient points of the chapter are assessed in relation to IB activities. This is followed by review questions that examine your understanding of the key issues dealt with in the chapter. In addition, there is a “Further Reading” list, and finally – in all but [Chapters 1](#) and [3](#) – a case study.

0.3.2 Websites

Whilst the text is extensively referenced throughout, this book also makes use of appropriate websites; there is little point in providing you with a detailed

analysis of the activities of, for example, the World Trade Organisation (WTO), when simply by accessing the WTO website, the organisations’ explanation of its own activities can be read in detail. It should be noted, however, that only those websites that have official and/or academic status are recommended: this is to hopefully guard against the dubious quality and pedigree of much material placed on the internet today. Recommended websites include those of the United Nations (UN) and its various functional organisations (the International Monetary Fund – IMF), the World Trade Organisation (WTO) and the EU Commission. Government websites are treated with caution, as whilst some are excellent, others are merely propaganda vehicles for their respective governments. However good they may be, websites do not replace discussion, but provide backup in the form of extensive factual information, allowing you to study a particular topic/organisation/concept of your choice, to a level and at a time and place of your choosing.

0.3.3 Case Studies

Whilst most contemporary texts have case studies, this book differs in that it has case studies based on a variety of topics, featuring a number of different countries, and of varying lengths – although most are best described as ‘long’. They deal with complex issues that require a full knowledge of the relevant facts before an informed discussion can take place. Cases are focused on a variety of aspects of international business, and present a wide range of scenarios, based on different organisations, industry sectors, and countries. Not all chapters have a case study, as it was felt more appropriate to include other activities in certain chapters; those that do finish with case studies are:

[Chapter 2](#): ‘The International Exploitation of a Non-Renewable Resource: Politics and Power in the 19th-Century Peruvian Guano Industry’

[Chapter 3](#): ‘The European Union?’

[Chapter 4](#): ‘BSE and the European Export Ban on British Beef’

[Chapter 5](#): ‘The EURO: Bringing Europe Together or Tearing it Apart?’

[Chapter 6](#): ‘The Olde Distillery: A Singular Single Malt’

- [Chapter 7](#): 'Developing Business Relationships in Slovakia'
- [Chapter 8](#): 'Attracting Students to Study Abroad: What to say, to Whom, When, and How?'
- [Chapter 9](#): 'Language and Culture: Doing Business in Romania'
- [Chapter 10](#): 'Singaporean Expatriates Working in France'

0.3.4 Further Reading

This provides a list of selected readings that allow you to explore the issues raised in the chapter in greater depth. They generally comprise articles from academic journals, but may also include reports such as those produced by the UN, EU, or other official organisations.

Part

I

THE BACKGROUND TO INTERNATIONAL BUSINESS

Part I of this book provides a background to international business, and comprises two chapters – the first explores the reasons why nations trade with each other, and the second gives a brief history of the development of international trade. This underpinning is essential to an understanding of the way trade (and by extension international business) has developed; an historical context provides you with the reasons why international business has developed in the way it has, and should enable you to more fully understand the ways in which international business has, throughout its development, been interlinked with politico-economic and military considerations. In the view of the author, insufficient attention is generally given to explaining this background, which is a pity as not only is it interesting in its own right, but it helps place the rest of the book in a wider historical context – sadly lacking in many other texts. As the Italian diplomat, philosopher, historian, politician, and writer Niccolò Machiavelli observed:

“Whoever wishes to foresee the future must consult the past; for human events ever resemble those of preceding times”

Machiavelli, Niccolò (1513) “Natives of the Same Country Preserve for all Time the same Characteristics” in chapter 43 of *Discourses on the First Ten Books of Titus Livius*.

CHAPTER 1: WHY NATIONS TRADE

This chapter examines why countries encourage trade with each other and the concepts associated with particular viewpoints; as early societies valued precious metals such as gold and silver, and as the world’s

resources were limited, it was considered important for a nation to build up its resources of gold and silver, through trading with other nations – and receiving payment for goods in precious metals. This was the basis on which the philosophy of ‘Mercantilism’ developed. Next, we turn our attention to later theories, starting with the concept of ‘Absolute Advantage’, first proposed by Adam Smith in 1776, and by David Ricardo, who put forward his theory of ‘Comparative Advantage’ some forty years later. Since Ricardo, there have been a series of trade theories, each of which has increasingly recognised the importance of the interdependence of a number of inter-related factors – generally based around the efficient utilisation of land, labour, and capital. This chapter finishes with the link between trade and national growth.

CHAPTER 2: THE DEVELOPMENT OF INTERNATIONAL TRADE

The development of international trade is next placed in an historical context, with an examination of the relationship between the development of trade and the various forces that were employed by nations to guarantee free trade. From the early trading Empires of the Romans and Chinese, to the Colonial Empires of the British, French, Portuguese, and Spanish, international trade routes were safeguarded by military power, which meant governmental acquiescence, if not direct support. The mechanisms of international trade were highly influenced by technological developments – in many instances the emergence of new technologies provided new trading opportunities.

Technological innovations made possible an increase in the breadth and scope of trade, and brought countries into contact with new ideas and products. We look at the expansion and consolidation of various colonial empires, and the Industrial Revolution and the wide-ranging effects this had on both the motivation to trade (increased productivity) and the ability to trade (enhanced transportation and communications). The European Empires are the focus of national trading patterns in the next section, and the way in

which colonial and economic expansion ultimately contributed to the outbreak of World War I. There is particular emphasis on the interrelationship between politics and economics in the creation (and maintenance) of protectionism and in particular, on the post-World War II period, which saw the establishment of international regulatory bodies such as the United Nations (UN), International Monetary Fund (IMF), and the General Agreement on Tariffs and Trade/World Trade Organisation (GATT/WTO).

LEARNING OUTCOMES:

On completion of this chapter, students should be able to:

- critically evaluate the reasons why countries trade with each other;
- explain how trade theory has developed over the centuries;
- undertake a comparative analysis of the relevance of the various trade theories and practices, as they apply today;
- critically discuss the link between trade and national growth.

1.1 INTRODUCTION

The first thing to note is that this chapter refers to *trade* as opposed to *business*. Trade generally refers to the movement of goods between nations, whilst business includes trade, but is more far-reaching, as it comprises different forms of business alliances and co-operative ventures, direct and indirect foreign investments, and the organisation and management of the people involved. As early trading relationships were rather basic and straightforward, the focus was always on trade rather than business in the widest sense: hence the title of the chapter.

A key question to ask, therefore, is what is the role of government in trade, and why is it different in some countries? Why are some countries more economically developed and advanced in terms of international trade than others? The answer to these and many other questions is generally to be found in the historical development of business, and the ways in which countries have influenced (and sometimes directed) business objectives, generally as a consequence of the available resources. This is not a new process as it has been going on for centuries; however, to fully appreciate many current aspects of international business (IB), we must begin by examine the starting point of all

IB activities – which is International Trade (IT). ‘Why do nations trade?’ is an important question, as there must be some compelling reason for international activity, as IT is a complex, expensive, and risk-laden process. Thus, the decision to trade internationally is likely to be a consequence of the various forms of motivation (or perceived benefit) that exert an influence on both countries and companies.

There are many such incentives to trade; the first of these is the most obvious – the scarcity/abundance of natural resources: when one country has a surplus of a certain product – usually a naturally-occurring product, such as coal, oil, gold, or wood. A country uses what it needs, and trades the surplus with other countries to acquire that which it does not have at all, or which it may have only in quantities insufficient to satisfy domestic demand. As we will see later ([Chapter 6](#) ‘International Banking and Finance’), early societies valued precious metals such as gold and silver, and as the supply of these was limited, it was considered important for a nation to build up its resources of gold and silver by trading with other nations – and receiving payment for goods in precious metals. This concept was the basis on which the philosophy of ‘Mercantilism’ was founded, and is one that lasted for hundreds of years (see ‘Mercantilism’, section 1.3 on page 13).

We examine other trade theories, starting with the concept of ‘Absolute Advantage’, (section 1.4 on page 14), first proposed by Adam Smith in 1776, and David Ricardo (1817) (section 1.5), and the more recent trade theories, each of which has recognised the importance of the interdependence of a number of inter-related factors – generally land, labour, and capital. It is apparent that as the world has become increasingly complex in its composition, and as relationships between countries have developed into sophisticated politico-economic-cultural examples of global interdependence, trade theory has developed to reflect these changing emphases. Today, international trade is as dependent on the role of government in facilitating

trade as it is on the companies that actually trade. There has been a blurring of the differences between political and trading relations – an obvious example of this is the EU, which started life as a purely economic trading bloc, but which now has its own parliament, representatives at the United Nations, Commissioners, Trade Representatives, and Ambassadors. At each of the stages through which it has developed, from the European Coal and Steel Community, through the Common Market and the European Economic Community, to the European Union, it has a long-term objective, which is political unity within Europe (Booker and North, 2005:1). In essence, it could be argued that trading blocs are increasingly less about trade and more about politics, human rights, international justice, and the free movement of people. This is very far from the original intention of allowing Free Trade between a group of like-minded countries. There then follows an examination of the so-called ‘Asian Tigers’, BRICs (Brazil, Russia, India, China), and CIVETS. The chapter finishes with a practical exercise designed to familiarise you with some of the data that will be used throughout the text. The chapter concludes by examining the role of international trade in national growth.

1.2 NATURAL RESOURCE ADVANTAGE

A natural advantage means that a country is the only (or one of a few) major world extractors/producers of a ‘natural’ commodity. A natural commodity generally refers to extractives such as precious metals (gold, silver, diamonds), energy (oil, coal, natural gas), or specific crops. If a country can produce more of a given commodity than it requires for domestic consumption, it can dispose of the excess in return for money or specific goods of which it has comparatively little. This surplus/lack of natural resources is possibly the oldest motivator in determining trading relations at a national level: around 1,500 BC the early Aztec civilisation in what is modern-day Mexico traded in jade, carved shells, and pottery, for which they had developed a level of expertise (Vaillant, 1965). Some three thousand years later, in the 1590s “... over a million pounds of currants from the Mediterranean were being imported into London” Joll (1980:76). Grapes were not widely-grown in England, yet were

in abundance in the Mediterranean, thus prompting the trade.

A natural advantage places a country in a strong competitive position, as despite technology and engineering it is difficult (and expensive) to replicate artificially that which has been produced by nature. Thus, the producer country has a natural advantage in terms of a given commodity; for example, Saudi Arabia has immense oil reserves, and the fact that most of the world has a high demand for oil, and the number of countries that both produce and export oil in appreciable quantities is comparatively small, places Saudi Arabia in an enviable position. Synthetic oil, nitrates, and rubber have been produced since before World War II, but were difficult and expensive to produce. The Axis powers (Germany and Japan) spent considerable resources on the production of synthetic rubber and oil during World War II. This was particularly true with regard to Germany, which had its supplies interrupted by the Allied blockade and aerial bombing, and as a consequence developed a synthetic oil and chemicals industry. Despite the relative success of all combatants to produce synthetic substitutes, following the conclusion of hostilities, most countries reverted to using the natural commodity.

This natural advantage that the oil-producing nations have is based on an accident of geology and political history. Geology has determined the rock formations that contain oil, and political history has determined that the portion of the earth’s surface over these oil-bearing rock formations has fallen within the political control of countries such as Russia, Saudi Arabia, or Nigeria. Saudi Arabia exports nearly twice as much oil and related products as does the next largest exporter, Russia, giving it a natural advantage in world terms. Furthermore, oil is the strategic ‘lifeblood’ of nations, as without it, much of the world’s energy production would be impossible. Without oil, most economies would collapse as they rely on it for the production and transportation of goods and services. It is no coincidence that the massive industrial expansion of China since 2000 (Miel, 2012) has led to a huge growth in demand for raw materials, especially oil, to feed this expansion. Oil has not just given the main producer/exporter nations a natural advantage in economic terms, but has also placed them in a strong politico-strategic bargaining position. This advantage was formalised in September 1960 with the creation of OPEC (The Organisation of Petroleum

Exporting Countries), a politico-economic ‘club’ of varied membership (see www.pec.org). This unity (albeit fragile at times) allows members to co-ordinate the production, export, and subsequent pricing of oil to their advantage. OPEC has used its collective bargaining power on a number of occasions to force up the price of oil – generally through cutting production. This memorably happened during 1973–1974, and led to what was termed the ‘Oil Crisis’, resulting in many governments introducing energy-saving measures. In the UK, for example, this led to the ‘three-day week’, in which public offices, shops, schools, and factories were restricted in their opening times, in an attempt to reduce the amount of energy they consumed. It was closely followed by another major increase in the price of oil in 1979 – again, a politico-economic move, engineered by OPEC. This, according to economists such as Todaro (1994), led directly to the phenomenal rise in financial debt obligations by some of the developing nations, which in turn led them to borrow even more heavily to service their debt obligations (O’Brien, 1991; Hughes, 1992).

Whilst there is an over-supply of a particular commodity in one part of the world, there are countries that lack (in either relative or absolute terms) specific commodities and are forced to trade to acquire them. It is interesting to note that the majority of the top *exporter* countries are *developing* nations. Some ten years prior to its entry into the WTO in 2001, China began the strategic switch from a largely agricultural economy to be a producer of manufactured goods. It has managed to complete this process in approximately twenty-five years – as compared with the similar re-focusing of the British economy during the Industrial Revolution, which took around 100 years to complete. Ironically, China’s huge reserves of raw materials might have been sufficient for its needs had the country not undergone such a massive industrialisation programme, and in such a relatively short space of time. China is one of the largest producers of aluminium in the world, and amongst the major four producers of lead, tin, and of zinc. Other key metals include scarce ‘rare earths’ (scandium, yttrium, and various lanthanides) that are essential to the production of many high-technology products, such as computers and precision-guided weapons. It is noticeable that China does not feature as a major exporter of any of these categories, preferring instead to retain most if not all of its domestic production. Although Chinese

production of ‘rare earths’ accounts for some 97% of the total world production (Dombey, 2010), the Chinese have recently cut exports of these extractives. In addition to the Chinese demand for raw materials as constituent elements in the production of goods, there is an equally strong demand for the production of energy to power the factories in which these goods are made. The near-vertiginous growth in demand for automobiles – up to 18 million produced in 2011 – has increased demand for oil, and in response, the Chinese government is purchasing as much oil, gas, and various minerals from around the world as it can (Wolf, 2003; Mallet, 2005; Van de Looy, 2006; Hölscher *et al.*, 2008). Predictions of Chinese demand for primary energy suggest that by 2020, the country will require around 2,000 million tons of what are described as ‘oil equivalents’ – a composite figure that includes coal, oil, and gas (Tsui, 2005). One source suggested that China is spending “... 35 times as much on crude oil as it did eight years ago, and 23 times as much on copper” (Browne, 2008). Estimates by the International Energy Authority predict a jump in Chinese demand for energy of 75% between 2008 and 2035, and a ten-fold increase in demand for cars within the same period (Pfeifer, 2010).

Notwithstanding such politically-motivated economic anomalies, the concept of natural advantage, the principal reason for trade for thousands of years, (and one that is still applicable today in certain circumstances) is simple. As Hill observes, climate and “... natural-resource endowments explain why Ghana exports cocoa, Brazil exports coffee, Saudi Arabia exports oil ...” He does, however, conclude that “... much of the observed pattern of international trade is more difficult to explain” (2003:141). It is, therefore, to these ‘more difficult’ patterns that we must now turn to find the other reasons that may prompt a country to become involved in international trade – the first of these being the philosophy generally described as ‘Mercantilism’.

1.3 MERCANTILISM

This was a key trading philosophy for centuries and was based on the assumption that national wealth was related to a nation’s reserves of gold and silver and other precious metals. The greater the level of reserves, the greater the wealth of the nation, an approach that

ultimately led to the adoption of ‘The Gold Standard’, in which national currencies were pegged to the supply of gold held in a country’s central bank. The key to wealth was the accumulation of gold and silver, and countries that did not have such deposits (in the ground) could accumulate these precious metals through trade. An early example of this was the trading relations between the Romans Empire and the Chinese, who traded their silk for Roman gold – *only* for gold – allowing them to build up extensive reserves of the precious metal. Maximising exports, whilst at the same time trying to reduce imports through taxes, tariffs, and embargoes, was a key tenet of mercantilism, as it perfectly reinforced the concept of building up ones’ resources at the expense of others. As world gold supplies were limited, mercantile logic implied that a nation might prosper only at the expense of other nations, and this led to a rush to exploit reserves of precious metals which, in turn, led to the establishment of a colonial presence in various areas of the world. The Spanish American Empire, more than any other, was built on this hunger for gold and silver. Reports of the fabulous gold and silver wealth of the Americas encouraged expeditions from Spain, led by men such as Hernán Cortés and Francisco Pizarro, whose prime motive was the exploitation of these precious metals, and territorial conquest.

Whilst the initial objectives of such adventurers were based on economic considerations or territorial acquisitions, these objectives were increasingly lost in the seemingly-endless administrative requirements of Empire. A colonial administrative infrastructure developed to oversee the mining and refining of the precious metals, and to regulate the organisation of exports and the communities that relied on this trade. The routes along which the commodities were shipped back to the mother country increasingly required defence from attack and cargo seizure – hence some form of military presence was needed. If these routes crossed the oceans – and they generally did – then defence was best provided by a strong navy. Thus, the initial desire to exploit mineral wealth in far flung corners of the globe led to the establishment of colonial empires, run by expatriate administrators and defended by powerful naval forces. The chief colonial powers were all European, and generally those that had well-established naval forces: the British, Dutch, French, Portuguese, and Spanish. Of these, the two that ultimately achieved positions

of greatest strength and global influence were the British and Spanish. Despite the fact that both these Empires have long since passed their height of economic significance, they have left a linguistic trace of their historical influence in the way that the English and Spanish languages are so widely spoken throughout the globe.

1.4 ABSOLUTE ADVANTAGE

1.4.1 Introduction

In 1776, Adam Smith published his seminal work *An Inquiry into the Nature and Cause of the Wealth of Nations*, in which he suggested that countries could gain the greatest advantage from focusing on those products/commodities in which they possessed an *absolute advantage* when compared to other countries. In this sense, an absolute advantage meant that the country in question was able to produce at a lower cost than other countries. Lower costs are determined by a number of factors, such as the cost of labour in the production of the product, the adoption of new technology, or the availability of capital (money) to develop the industry. In 1908, in the USA, the Ford automotive production line took advantage of technological developments to mass-produce cars and drastically reduce the cost of the labour involved. This revolutionary approach to production allowed Ford to produce vast numbers of cars – such as the ‘Model T’ – and to sell them at highly competitive prices.

The Industrial Revolution, born in England, allowed British industry to take advantage of industrialisation to drive down labour costs and increase output. Ironically, although historians set great store on dates as important chronological ‘milestones’ of development, there is a lack of agreement as to exactly when the Industrial Revolution – arguably the precursor to modern society – began (Kennedy, 1990:185). Some suggest that the process of industrialisation had started by the 1700s, and was well underway by 1780 (Hill, 1978). There were certain factors that, taken together, allowed a country to industrialise.

1.4.2 Availability of Natural Resources

The availability of the major natural resources needed for the process of industrialisation, such as coal, wood, iron ore, and water are major considerations. Coal was

a key factor in the ability of a country to industrialise: Wrigley (1990) suggests that it was the lack of coal that prevented The Netherlands from industrialising, despite having an urban, educated, and literate population. Professor A.J.P. Taylor (1954) underlines the importance of coal, citing production figures for the period 1850–1914, and pointing out that, four years before the outbreak of WWI, Great Britain was still ahead of all other major European powers in terms of coal production. It was only beaten by the USA, which had developed a robust coal mining industry in a relatively short time, coming from an output of 3.4 million tons in 1860, to beat British production by 88 million tons in 1910 (Taylor, 1954: p.xxix).

Coal, iron ore, and water were the basic ingredients needed for the production of steel (a vital commodity for industrialisation), in addition to the means of transportation – canals were linked to the river systems. Both Britain and Germany underwent an extensive period of canal building around this time. British efforts tended to be focused on purely commercial considerations, and included a highly-integrated network of canals, in the main concentrated around the Midlands (Birmingham) and the North West (Manchester). The Manchester Ship Canal, which connected landlocked Manchester to the North Sea, was of major importance to the industrial development of the city and the surrounding area, allowing the importation of raw cotton directly to the factories, even though the city was far from the coast. It also allowed the subsequent export of finished goods, directly from the factory or warehouse to overseas destinations. By contrast, the Germans put their efforts into the construction of the much wider and deeper Kiel Canal, which took eight years to build, and linked the North and Baltic Seas. From the outset, the Kiel Canal was built with a dual purpose in mind – to allow both commercial shipping and the German Navy to pass from one sea to the other, unobserved, and at a reduced transit distance of around 200 miles.¹

These factor conditions were present throughout most of Europe (to one degree or another), but to have a positive impact on industrialisation, they were only significant when linked to three other major considerations.

1.4.3 The Latest Technology

When the latest technological developments were applied to trade, this resulted in significant increases in efficiency and savings in time and money. Key amongst these innovations had been the invention of the steam engine in 1775 by James Watt. The rapid growth in world trade in the 19th century depended heavily on advances in marine technology, specifically the use of the steam engine. Once this had been adapted for use in ships it reduced dependence on the wind and greatly increased the efficiency of maritime transportation. However, this was not a universal panacea. Robinson (1974), for example, suggests that German industry had relatively little need of steam power, having a more than adequate supply of water power. Furthermore, he suggests that steam power was generally to be found where there were also extensive supplies of coal – an observation that is arguably consistent with Porter’s ‘Factor Endowment’ concept (see section 1.9.2. ‘Factor Endowment’). The effectiveness of applied technology was reflected in the fact that the period 1850–1914 saw a three-fold increase in world trade. This was motivated by the increase in world population (and demand levels), but was only made possible through the technological innovations that allowed producers to meet these demands quickly and more efficiently.

1.4.4 Economic Unity and Openness

The level of economic unity in each country (as expressed in terms of the degree of political fragmentation and tariffs) was important as it helped provide the conditions under which a ‘critical mass’ might develop – in this case the politico-economic factors that, taken together, gave impetus to national growth. At this time Britain was a unified economic entity, as the country’s monetary system had been unified and regulated under a central Bank of England since 1694. In addition, the country had taken measures to radically overhaul its tariff system, such as abolishing the Corn Laws – these were tariffs that had been introduced in 1815 to protect the price of domestic-grown corn by making foreign imports more expensive. The Importation Act (1846), which

¹ For a time-lapse film journey through the Kiel Canal, see: www.kiel-canal.de/flvplayer

repealed the tariffs on corn, led to riots in London but as it ultimately helped increase the level of international Free Trade, it could be judged as ultimately being of benefit. By reducing tariff levels overall, the country could also take advantage of cheaper imports of raw materials – a key requirement in the manufacturing process, as we saw earlier with regard to modern Chinese industry.

1.4.5 Capital Investment

The international capital flows necessary to fund industrialisation were directed largely *towards* Britain as investors were eager to back success. The saying ‘success breeds success’ is particularly apposite – investors will naturally invest their money where it is most likely to provide the best return. This meant that generally speaking, those regions/countries that had not achieved a certain level of industrialisation would be unlikely to acquire significant capital inflows in the short term.

Over the years, there have been many examples of various commodities used to explain the theory of absolute advantage, ranging from wheat to olive oil, cork, and textiles. The basic premise is one of focusing on that which a country produces cheapest, and producing a surplus to act as the basis for exports. [Table 1.1](#) presents an imaginary scenario, showing three countries that each produce a product in which they have an absolute advantage. Country A has an absolute advantage in the production of cars, country B, in the production of beer, and country C, in the production of shirts.

Based on the theory of absolute advantage, each country should focus on the production and export of that which they can make most cost-effectively: ‘A’

should supply cars, ‘B’ beer, and ‘C’ shirts. However, the theory is based on economic logic, which presents a problem as the decision to purchase a product or service is frequently subject to political interference (at the level of the nation state), commercial pressures (at the corporate level), and the vagaries of consumer behaviour (at the individual level). For instance, if countries A and B are both members of the same trading block, but country C is not, then the shirts imported into countries A and B from country C may be subject to tariff duties.² Depending on the level of tariff that these shirts attract, it might be cheaper for country A to buy their shirts from country B. In 2005, for example, a study found that the EU was imposing tariffs of up to 300% on sugar imports from developing countries – the report also claimed that due to this, Malawi had lost an estimated US \$32 million in foreign exchange earnings (Menon, 2005). A study of the Brazilian steel industry suggested that: “Brazil’s huge iron-ore reserves and the efficiency of its steel makers mean it can turn out steel slab at around \$100 a tonne, less than half what it costs to make in America ...” (*The Economist*, 2002a). This is the main reason why the USA imposed a series of tariffs on imported steel in 2002. There are other trade barriers that might make it impossible to import any goods from a particular country: embargoes (bans) or quotas (limits) are ways in which countries can interfere in this seemingly logical process of trade, as dictated by the theory of absolute advantage.

In addition to tariffs (which can be classified as politico-economic barriers to the free flow of goods between nations), trade may also be influenced by the historical legacy of poor international relations between countries – generally as a consequence of armed conflict, or a clash of political ideologies. These are different to tariffs as they are not deliberately imposed as part of government policy, but are an economic consequence of a national attitude, point of view, or feeling on the part of governments and/or consumers. In the latter case it is the consumer who decides that they do not wish to purchase products from a particular country; so whilst there may be no actual embargo on products from this country, nor even a tariff to add to the retail price, the products in question are unlikely to sell widely. If there is little or

Table 1.1 – Production Price

	Cars (per unit)	Beer (per litre)	Shirts (per unit)
Country A	£2,500	35p	£8.00
Country B	£5,900	10p	£6.00
Country C	£4,200	50p	£1.50

² A tariff is a tax on imports, imposed by the government of the country into which the products are being imported.

no consumer demand for these products, then their importation might eventually cease.

Low price is not the only way in which a nation may achieve an absolute advantage – the quality of the goods it produces is another major consideration, and this is not as easy to attack as a price-based advantage. For years the US and German high-technology sectors managed to stay ahead of their Japanese rivals, as they had a reputation for good quality products. This was all the more effective as from the end of World War II until the mid-1970s the Japanese suffered from a reputation as poor quality copyists. It was only after many years of encouraging consumers to try Japanese products (by enticing them through low prices and added ‘extras’ such as car radios) that the Japanese reputation for poor quality began to change, in particular in the electronics and vehicles sectors (Mikes, 1983). Today, the wheel has turned full circle, and companies such as Sony and Toyota are proud to boast of their Japanese heritage. The extent of their success is reflected in the general perceptions of the quality of Japanese electronic goods.

On a final note, whilst the theory of absolute advantage is still relevant in some instances as an explanation of globalisation, it is, ironically, the very success of globalisation that has destroyed the ability of many countries to *maintain* their advantage for a significant period of time. As indicated previously, a major determinant of the cost of production is the cost of labour, so countries that can reduce their labour costs gain an advantage as they can sell their products more cheaply than those of their competitors. China is a good example of this, as the country produces a high percentage of the world’s manufactured goods, based on the advantage of low labour costs. However, whilst developing countries may initially be able to compete on price, they tend to lose this advantage as their economies develop, and people demand higher wages and better working conditions. This generally leads to an upward spiral of costs, which may result in price rises throughout the economy. Just such a situation is happening today in China, with increasing wage costs as a consequence of inflation and the soaring price of accommodation in the larger cities such as Shanghai and Beijing. In Hefei (Anhui province in southeast China), the price of housing rose by 50% in 2009 (Dyer, 2010), and the ‘knock-on’ effect is that workers can put pressure on employers into giving wage increases – which are ultimately passed on to

the end user. Once a country has begun to lose its cost advantage, another nation that can produce at a lower price is likely to use this lower price to gain an absolute advantage, and the cycle begins again. This is currently happening with regard to China (Brown, 2011); as Jacob (2013) notes: “Double-digit wage increases in China and a shortage of factory labour have prompted several companies to move to cheaper countries such as Vietnam, Bangladesh and Indonesia.” In other words, an absolute advantage gained through the ability to produce at a low price is a transient advantage, as its success usually results in the loss of the very factor on which the advantage was initially based. Despite political interference in the form of tariffs, and the unwillingness of consumers to always base their purchase decision on logic, the theory of absolute advantage remains a useful explanation of *some* aspects of international trade to this day.

1.5 COMPARATIVE ADVANTAGE

However, what happens when a country can achieve an absolute advantage in many or all areas? Should it continue to produce and export goods from *all* these areas, or should it focus its efforts? This was the question posed by the British economist David Ricardo in his book *Principles of Political Economy and Taxation*, published in 1817. Ricardo pointed out that certain countries were able to achieve advantages in a number of sectors simultaneously: a case in point was Great Britain, which had moved from a predominately agrarian to an industrialised economy. By 1815, having defeated the Dutch, French, and Spanish in a series of wars over the preceding fifty years, Great Britain had emerged as the dominant power in Europe. Added to this, the country’s place at the forefront of the Industrial Revolution allowed it to achieve world dominance in a variety of technologically-based sectors, including engineering, steel-production, manufacturing, shipbuilding, armaments, and railways. At the height of its world dominance (around 1900), Britain was the greatest politico-economic power in the world, with an Empire on which it was said, that ‘the sun never set’. It would, therefore, be difficult to identify one sector in particular in which the country had an absolute advantage, as it seemed to have an advantage in all. According to Ricardo, under such circumstances, the ideal was to

compare the sectors in which an advantage was held, in order to see the *greatest* level of advantage: hence the term ‘comparative advantage’.

Ricardo’s theory differs from that of Smith as, rather than examining the *cost* of production, Ricardo focused on the *efficiency* of production, claiming that the greatest comparative advantage to be gained lay in the level of efficiency. Many authors have demonstrated the logic behind the theory of comparative advantage, and it is cited as underpinning the concept of Free Trade. Hill (2003:147), for example, compares the production of cocoa and rice in Ghana and South Korea, respectively. He points out that, whilst Ghana has an absolute advantage in the production of both commodities, Ghana “... can produce 4 times as much cocoa as South Korea, but only 1.5 times as much rice. Ghana is *comparatively* more efficient at producing cocoa than it is at producing rice.” The message is clear – Ghana should focus its resources on the production of cocoa and purchase its rice from abroad, possibly from South Korea. Advocates of Free Trade cite the logic of comparative advantage, pointing out that it makes a country focus its efforts in specific sectors. Just as no company would seek to dominate all segments of the market in which it operates, but uses its limited resources to specialise in specific segments, countries should adopt a similar approach. Countries such as Switzerland are successful because they specialise in a limited range of goods and services, and it is this specialisation that gives them a competitive advantage (Kay, 2003).

Whilst the economic logic may be sound, there are strategic and competitive considerations related to the theory of comparative advantage. For example, if a country were to focus on the production of product A at the expense of product B, this may be acceptable

provided that product B is not of strategic importance to the nation. Strategic products are generally those that without which the country cannot function properly – such as energy, armaments, and communications, but may also include agricultural machinery, foodstuffs, medicines, and transportation. The point is that if, as a consequence of comparative advantage, a country becomes reliant on other countries for such products, they place themselves in a dangerous position. In the event of an international trade dispute, the producer of strategic products has a strong advantage.

1.6 FACTOR PROPORTIONS THEORY

In the 1930s, two Swedish economists, Eli Heckscher and Bertil Ohlin, suggested a variation on the theory of comparative advantage, by pointing out that there were other factors to be taken into consideration, such as the level and type of resources available to nations. In their theory, known as the ‘Factor Proportions’ (FP) theory, they identified the key factors (or ‘resources’) as labour, land, capital, and natural resources (Ohlin, 1933). Their hypothesis was that each country exports the commodity that makes greatest use of its most abundant resources. The issue of natural resources has already been discussed at the start of this chapter; barring new discoveries of oil (such as the recent discoveries of vast quantities of ‘shale gas’ in the USA from 2010) or new mineral deposits, most reserves have been calculated with considerable accuracy. Land cannot be divorced from the natural resources that underlie it, which explains why some countries become embroiled in territorial disputes.

Box 1.1

Nitrates and the War of the Pacific (1879–1883)

Where land contains mineral or other deposits, it has frequently been the direct cause of armed conflict throughout the centuries. Prior to the War of The Pacific (1879–1883), Bolivia had a coastline, which gave it access to maritime trade, and which also contained valuable nitrate fields; deposits that were also found in Peruvian territory to the north of the Bolivian littoral. As a consequence of losing the war they fought against Chile, both Bolivia and Peru lost their coastal territories containing these nitrate deposits. The Chilean annexation of all Bolivia’s coastline, and a large part of the southern Peruvian coastal territory, was a direct consequence of the existence of nitrate deposits in these regions. Some sixty years later, Peru was in dispute with Ecuador over the Condor mountain range which forms the border between the two countries, which was said to contain gold and uranium deposits. The discovery of oil in the disputed territory in 1995 added further to the conflict.

The issue of land is not just related to the commercial value of what lies beneath the soil, or which crops can be grown, as land is also a potentially valuable geo-strategic asset to a nation as a consequence of its geographic position. A case in point is Singapore, as its position at the southernmost tip of the Malay Peninsula places it close to some of the world's busiest shipping lanes. The Singaporean government has taken advantage of the country's strategic position by developing the country as a major centre of shipping and related services. This has attracted significant numbers of shipping and freight companies to develop container facilities, warehouses, and other services there (see: www.mpa.gov.sg/), so the geographical position of Singapore has ultimately led to the development of a critical mass of shipping and shipping-related industries.

There are many examples of land as a strategic asset – Gibraltar commands the entrance to the Mediterranean Sea, and historically gave Britain an influential role in controlling trade in and out of the Mediterranean. The Suez Canal connects the Red Sea with the Mediterranean, eliminating the need for shipping to go all around the Cape of Good Hope, thus reducing journey times (and related costs) dramatically; the Panama Canal serves a similar strategic role, connecting the Caribbean and Pacific Ocean. The Crimean Peninsula, a sovereign part of the Ukraine, was unilaterally invaded and annexed by Russia in 2014, as it contains the key naval base of Sevastopol, from which it is comparatively easy to dominate the whole of the Black Sea. Another example of land as a strategic consideration is the position of the Czech Republic in the centre of Europe – connecting East and West. It is no accident that car manufacturers such as VW, chose to set up production plants there – giving them a central location in Europe from which to export finished vehicles to numerous destinations.

Labour and capital are two other elements of the Factor Proportions theory. Labour has been discussed earlier, but only in terms of showing how low costs can help achieve an absolute advantage. Perhaps of equal importance is the extent to which a workforce is educated and trained. Rather than low wage levels, which as previously observed may only provide a transient advantage, an educated and skilled workforce provides a nation with a high degree of flexibility. In the World Economic Forum's 2013 Global Competitiveness rankings, Switzerland came first for the second year

in succession, due to its strengths in "... innovation and labour market efficiency ..." in addition to the "... sophistication of its business sector ... top-notch scientific research institutions." The report suggested that these factors are further enhanced by "... a business sector that offers excellent on-the-job-training opportunities ...", the ability to adapt to the latest technologies, and labour markets "... that balance employee protection with business efficiency" (Schwab, 2013:12). Similarly, it was largely a consequence of education and training that helped Japan achieve its competitive advantages in the 1970s. Training and flexibility are linked to the issue of productivity (as demonstrated by the examples of Japan and Finland), and it was the issue of productivity that led to the first major empirical test (and subsequent criticism), of the FP theory – a criticism generally referred to as the Leontief Paradox.

1.7 THE LEONTIEF PARADOX

In 1954, Professor Wassily Leontief published an examination of the 1947 trade flows into and out of the USA – a manufacturing nation that, by common consent, was deemed to be capital rich, but with relatively high labour costs. Based on the FP theory, the USA (with an advantage in capital-intensive industries) should have focused on the export of those commodities that were produced in these capital-intensive industries, and imported those commodities from labour-intensive industries (in which the USA was at a cost disadvantage). Paradoxically, Leontief found the opposite to be true: the USA exported labour-intensive commodities and imported capital-intensive commodities. He found that US imports were, on average, 30% more capital-intensive than US exports. However, critics such as Swerling (1953) suggested that 1947 was not a typical trading year, as the USA was only just beginning to re-establish a global economic presence following the end of WWII. Studies in other countries also appeared to confirm the paradox: for example, Tatemoto and Ichimura (1959) looked at Japanese trade flows and found that, although the country was labour-intensive, it exported capital-intensive goods. Wahl (1961) examined Canadian trade flows, which also confirmed the paradox. A decade later Robert Baldwin (1971) studied US inflows–outflows using trade data from 1962: he found that US imports were, on average, 27% more capital-intensive than US exports.

Despite many studies over the years, there is still disagreement as to the validity of the Leontief Paradox: those who have sought to either defend or refute it cite ‘special circumstances’ in defence of their stance. The problem is that there are so many variables to take into consideration, such as the history of trading relations between the countries under examination, the year in which the study was undertaken, the type/sector of industry used in the comparison, exchange rates, and the comparative levels of development. Leontief himself suggested that the paradox existed because US workers were more efficient than their foreign counterparts – he suggested up to three times more efficient. Furthermore, the FP theory assumes that the level of technological development is the same across the countries under comparison – a highly unlikely supposition, bearing in mind the varying levels of technological development throughout the world.

1.8 NEW TRADE THEORY

The New Trade Theory (NTT) dates from the early 1980s, and is based around the concept of economies of scale, in conjunction with what has been described as the ‘first mover’ advantage (Helpman and Krugman, 1985). As with previous theories studied, there is an assumption that certain countries are able to specialise in certain products – a theme that has emerged in most of the theories of international trade, and which is generally accepted to have no small measure of credence. In addition to specialising in a particular product, if a country can also achieve economies of scale in the production of that product, then the country in question should be able to establish itself as a market leader, and use its position to erect barriers to entry to competitors. The position of market leader can be linked to the development of a ‘critical mass’ – expressed in terms of market share, turnover, consumer recognition, and respect, or other measures of the extent to which it dominates the sector in which it operates. This is particularly true in high-technology industries (such as aerospace or pharmaceuticals) in which the financial barriers to entry that a first mover can erect can be formidable. Furthermore, whilst barriers to entry are erected to dissuade or prevent competitors from entering the market, at the same time services and related industries are attracted to

the country. This reinforces the ‘critical mass’, which in turn further reinforces the level of specialisation that the country provides. Achieving this critical mass can be of great strategic–economic benefit to a nation, which explains why many companies seek assistance from their respective governments to help them achieve first mover status, or to attack those foreign companies that have already achieved this status. A McKinsey report explained that the Chinese competitive advantage in the manufacture of high-tech goods, such as colour televisions, was based on “... lower taxes, import duties and raw materials costs, a competitive environment and a critical mass of component manufacturers” (McGregor, 2002). An analysis of Chinese industry a year later summed up the combination of factors admirably, saying that ‘cheap labour, foreign investment and rapid industrialisation’ had made China the ‘workshop of the world’ (Roberts and Kynge, 2003).

The US aircraft industry, born during the early 1900s, saw significant expansion and development in the 1920s and 1930s. However, despite the growing economic power of the USA, it still faced strong competition from the UK, France, and Germany, and to a lesser extent, Italy and the Netherlands. It was only really during WWII, with the recognition by the US government that the aircraft industry would be a major contributor to the war effort, that the real expansion of the US aircraft industry began. US government financial support during the war was initially for the development of military aircraft, but in view of the potentially dual military-civilian nature of many airframes, much of the investment in military design was also of benefit in the civilian market. From the 1950s, the global aircraft industry was dominated by the USA through a variety of companies, many of which had been initially focused on production for the military. Companies such as Beechcraft, Bell, Boeing, Cessna, Convair, Douglas, General Dynamics, Grumman, Fairchild, Huey, Hughes, Learjet, Lockheed, Martin, McDonnell, Northrop, Piper, and Sikorsky represented the global dominance of this sector by the USA. Their wealth of expertise and experience, backed up by the related and supporting industries that served the sector, led to economies of scale and a focus of talent and specialisation within the USA. Added to this was the high level of market share that the USA commanded, and the ‘first mover’ advantage that allowed them to keep much of the European competition out of the US and, increasingly,

the European markets. Over the years, some US companies chose to focus on specialist areas: the helicopter market was the preserve of Bell, Huey, and Sikorsky, and the small aircraft sector was targeted by Beechcraft, Cessna, Learjet, and Piper. The military market (a highly lucrative sector in view of cold war tensions), was the domain of Boeing, Douglas, General Dynamics, Grumman, Fairchild, Hughes, Lockheed, Martin, McDonnell, and Northrop. There was also a degree of consolidation within the industry, with the merger of McDonnell and Douglas, followed later by the take-over of this merged company by Boeing.

As a consequence of its position as a major producer of both civilian *and* military aircraft, Boeing could dominate both the civilian and military sectors; furthermore, within the civilian market, it could produce a variety of aircraft to suit all possible airline requirements. Their wartime industrial manufacturing experience, combined with US industrial and political influence, meant that they were able to make and sell aircraft on a scale unimagined by most other competitors. Furthermore, unlike their main competitors such as the British, Germans, and French, US manufacturing facilities had not suffered large-scale destruction during WWII, nor did they lack finance to invest in future aircraft prototypes. As Gardner (1981) explains, in the immediate post-war period, the British aircraft industry was highly fragmented, with twenty-seven airframe design companies and eight aircraft engine companies, and a government that was woefully short of capital for investment. And capital was needed urgently for investment in a number of new technological innovations that were fast becoming essential for the industry – the jet engine and aviation electronics (avionics), to name but two.

Thus, the fragmentation of production, coupled with a lack of capital for investment in an increasingly technologically-dependent sector, put the UK at a considerable disadvantage. These factors, combined with the growing economic power of the USA, helped the US aircraft sector (as typified by Boeing) to establish a world dominance in aircraft production, and to remain virtually unchallenged for some twenty-five years. There was no real threat to the position of Boeing until the emergence, in 1970, of Airbus – a manufacturing consortia subsidised by the British, French, German, and Spanish governments. The justification given by the European governments for their intervention in the market was that Boeing had

‘first mover’ advantages, and had used its economies of scale to erect barriers to entry – thus preventing fair competition. Consequently, any competitors would have to receive financial support at first if they were to develop beyond infancy. Naturally this level of government support infuriated the Americans, and led to arguments and threats with the dispute coming to a head in 1987, when Airbus won 277 orders for its new A320. With this, Airbus had captured nearly a quarter of the world commercial jet market, and became the world number one supplier, beating Boeing into second place for the first time in the latter’s post-war history. Boeing, supported by the US government, tried to negotiate with the EU, but after acrimonious exchanges with the then EU Trade Commissioner took the dispute to the WTO in 2005 (Rushe, 2005). It claimed that Airbus had received four categories of direct or indirect subsidy from the EU governments concerned: (1) ‘Launch Aid’, (2) loans from the European Investment Bank, (3) infrastructure and infrastructure-related grants, and (4) research and technological development funding. All of which, the Americans claimed, gave Airbus an unfair competitive advantage, particularly as the interest rates on loans meant that Airbus could take huge commercial risks – far greater than had it been self-funded. Phil Condit, the Chairman of Boeing, said in 2000: “I have no problem with governments saying, ‘We will loan you money for launch’, as long as it’s paid back on commercial terms. I don’t think it’s appropriate that there be risk transfer – that the governments accept the risk of an unsuccessful programme. The company must accept that risk” (Lorenz, 2000). Airbus subsidies were ruled illegal by the WTO in August 2010. Despite the technical and innovative design expertise that undoubtedly exists within Airbus Industrie, the company would not have achieved the position it occupies today had it not been heavily subsidised by the governments involved.

Similar examples exist in the pharmaceutical and IT sectors, both of which are of strategic interest to governments, and both of which require very heavy injections of capital, especially in the initial stages of development. In the pharmaceuticals sector, this is principally due to the inordinately high research and development (R&D) costs of new drugs. DiMasi *et al.* (2003) studied R&D costs for ten pharmaceutical companies, and claimed that the average cost per drug was US \$802 million by the time it reached the production stage; whilst this might seem excessive, a later study

by Adams and Brantner (2010) put the cost at around US \$1 billion. Given the scale of the costs involved, it is small wonder that first mover advantage generally lies with companies based in developed countries, which can afford the capital outlay, such as France, Germany, the Netherlands, Switzerland, the UK, and the USA.

1.9 THE COMPETITIVE ADVANTAGE OF NATIONS

1.9.1 Introduction

Whilst the theories examined so far might explain how countries can use their position of advantage when developing trading, with the exception of 'natural advantage', few have explained *how* countries come to be in their advantageous position in the first place. For instance, how does a country develop the 'critical mass' referred to in the New Trade Theory?

It was in answer to questions such as this that Michael Porter (1998) first proposed his theory of international competitive advantage, in his book *The Competitive Advantage of Nations*. In this, Porter examined how nations develop a competitive advantage in a specific industrial sector, and how this advantage is both maintained and enhanced through a variety of inputs (or determinants). He identified four key areas that would allow a nation to develop a competitive advantage: (1) Factor Endowment, (2) Demand Conditions, (3) Firm Strategy, Structure, and Rivalry, and (4) Related and Supporting Industries, and the model he developed is generally referred to as Porter's Diamond (Porter, 1998:71–72). The four determinants of this model are mutually reinforcing and interdependent; one is unlikely to significantly influence national competitive advantage without the others. Porter used his model to illustrate the ways in which a nation builds and maintains a competitive advantage in a given industrial sector.

1.9.2 Factor Endowment

This refers to the national position in terms of the level of production necessary to compete in a given industry, and is usually expressed as a variety of

factors – either those that come naturally, or those that are 'man-made'. Factor conditions include all those factors that contribute to the development of the industry under consideration – the 'factors of production'. Porter's assessment would appear to confirm at least part of the Factor Proportions Theory. These may be natural factors, such as topography, terrain, or climatic conditions; they might include the availability of finance, a developed national infrastructure, or many others. Porter (1998:74–75) divided Factor Endowment into five broad categories:

1. Human resources
2. Physical resources
3. Knowledge resources
4. Capital resources
5. Infrastructure.

1.9.3 Demand Conditions

Initially, this relates to the level of domestic demand for the industry's product/service. If there is no domestic demand, then it is highly unlikely that the industry will survive, let alone develop further. In other words, there has to be a reason that the industry develops in the first place. Wool has been in demand for centuries, which explains why countries such as Great Britain had built up a strong wool trade since medieval times, and its commercial importance was recognised by Parliament, which sought to promote the industry.³ Demand conditions are divided into three sub-groups by Porter (1998:86–89):

1. Home demand composition.
2. Demand size and pattern of growth.
3. Internationalisation of domestic demand.

1.9.4 Related and Supporting Industries

These relate to the presence of what Porter (1998:100–107) describes as internationally competitive "... supplier industries or related industries ...", and are a third broad determinant of national advantage. For example, he suggests (p.100) that "Competitive advantage in some supplier industries confers potential advantages on a nation's firms in many other industries, because they produce inputs that are widely used and

³ This close link between the early wool trade and Parliament is reflected in the fact that the Lord Chancellor (the Chief Minister of Justice) sits on a 'woolsack' in the UK Parliament.

important to innovation or to internationalization.” With regard to supplier industries, he notes (p.101) that the presence of internationally competitive supplier industries “... creates advantages in downstream industries in many ways. The first is via efficient, early, rapid, and sometimes preferential access to the most cost-effective inputs.” He suggests (p.103) that the ‘process of innovation and upgrading’ is the most important benefit, as it allows the development of “... close working relationships between world-class suppliers and the industry. Suppliers help firms perceive new methods and opportunities to apply new technology.” Turning now to related industries, this refers to “... those in which firms can co-ordinate or share activities in the value chain when competing ... Sharing of activities can occur in technology development, manufacturing, distribution, marketing, or service” (p.105).

Once an industry is established in a specific geographical location, and receives domestic (and/or international) recognition, other related and supporting industries gravitate to this area to serve the industry. Their presence tends to reinforce the ‘critical mass’, and adds further to the competitive strength of the nation as a whole in terms of this particular sector. Historical examples include the German steel industry, located in the Ruhr, and led by the Krupp company; at the height of its commercial success, the Krupp empire produced most of the artillery (and supporting munitions) for the German Armed Forces during WWI and WWII. The company had units that dealt with chemicals, heavy machinery, oil refineries, rubber, road-building machinery, and aircraft, to name but a few. The concentration of heavy industry in the Ruhr, with a nucleus at the city of Essen, was supported by an extensive rail network, for which Krupp supplied most of the rails and carriages, and, in return, this network was used to export finished goods all over the world (Manchester, 1970).

1.9.5 Firm Strategy, Structure, and Rivalry

This is the last of the four broad determinants, and is focused on the “... context in which firms are created, organized and managed as well as the nature of domestic rivalry” (Porter, 1998:107). Porter explains this determinant as comprising many “... aspects of a nation, too numerous to generalize, influence the ways in which firms are organized and managed” (p.109).

These include the social structure of society, and the way that this influences the hierarchical structure of a firm; the international orientation of industry and society in general; the level of foreign language skills and attitudes towards foreign language learning; the attitudes towards competition; and the educational system. As the world economy is largely interlinked, the levels of direct competition faced by individual companies, sectors, or countries forces greater efficiency, competitiveness, and innovation. These, in turn, help to increase further the competitive advantage enjoyed.

A good example of Porter’s four ‘factors’ is to be found in the UK Potteries region of Staffordshire, UK. As its name implies, the Potteries is the centre of British ceramic production, with many world famous names based there, such as Wedgwood, and Spode. There has always been a demand for plates and cups for as long as people have eaten – thus the second of Porter’s two factors (demand conditions) was satisfied. With regard to what Porter calls ‘factor conditions’, the potteries (which comprise the six towns of Stoke, Hanley, Tunstall, Burslem, Fenton, and Longton) are built on an area of natural clay, of a type suited to the production of pottery. In addition to this, the area has an abundant supply of both coal and water – via the heavy rainfall and the River Trent. The clay was used to make the pottery, and the coal was used to heat the pottery kilns in which the pottery was ‘fired’ (baked). The water was mixed with the clay and used to cool the kilns when necessary, and the rivers (and later the canals) were used to ship the finished products all over the world. As a consequence of this ideal location, the region attracted a growing number of pottery companies, in addition to a plethora of companies that provided services to the pottery industry – such as specialist paint and dye manufacturers (the ‘Related & Supporting’ industries referred to by Porter).

1.9.6 Government and Chance

Porter also suggested two more determinants: the role of government and luck, or what he referred to as ‘chance’. Whilst the internal management of companies is a corporate decision, it has to reflect the environment in which it operates, and it is in this respect that government, through the level and type of restrictions (or ‘red tape’) that it imposes, can help or

hinder industrial development. Some twenty years ago, commentators were suggesting that ‘labour-market’ rigidities in Western Europe directly contributed to high levels of inflexibility and unemployment (*The Economist*, 1994; Siebert, 1997). Little appears to have changed, as *The Economist* returned to this theme in 2015, suggesting that labour mobility was a prime cause of unemployment in Europe – only just under 3% of Europeans have moved to live and work in another EU country (*The Economist*, 2015); this is all the more ironic, as one of the prime objectives of the Single European Market (SEM) when it was launched in 1992 was the ‘free movement’ of goods and people. Reasons for this lack of mobility include “Language barriers, cultural differences and non-transferable qualifications....”.

By placing as few restrictions on business as possible, governments can help industry develop; conversely, increasing restrictions will reduce the positive benefits to be gained from these other factors, and is likely to result in reduced competitiveness, and this may lead some companies to consider re-locating abroad. Examples of how bureaucratic restrictions can hinder the development of business are increasingly found in the much-trumpeted European Single market, created in 1992 to enhance the free movement of goods/services and people. It is, ironically, not quite as ‘open’ as its supporters would suggest, as an analysis of European bureaucratic restrictions, published in 2004, found that the region as a whole suffered from a lack of entrepreneurial flair, which was attributed to a growing reticence to take risks. This, it was claimed, was a direct result of a toughening of “... the rules on

corporate governance, directors and officers’ liability, and product safety, combined with an increasingly litigious environment ...” (Tieman, 2004). It is, however, not just the EU that suffers from over-regulation: a report in *The Economist* (2012) claimed that the US government was in danger of ‘over-regulating’ the pharmaceutical industry, leading many companies to withdraw new drugs from the testing process which had become too expensive.

The role of luck or chance in business has been studied by many authors; Barney (1997) suggests that whilst luck is a variable in the development of competitive advantage, it can only become an important variable if a company is adequately prepared to take advantage of such luck when it presents itself. Thus ‘luck’ or ‘chance’ is only of value when a company’s internal and external organisation and structure are able to exploit this luck. Without this managerial capacity to take advantage of the dynamism that generally accompanies it, ‘luck’ or ‘chance’ becomes nothing more than a missed business opportunity.

By contrast, Powell (1992), for example, suggested that strategic alignments, rather than luck, are keys to attaining a competitive advantage. Lado *et al.* (1992) agree, suggesting that the identification and application of a company’s ‘distinctive competencies’ is, in fact, of greater value. However, Ma (2002:525) suggests that both strategy and an element of luck combine under certain circumstances: “In addition to effective strategic maneuvering and well-run internal management, luck often plays a non-trivial role as a determinant of competitive advantage and firm performance.”

Box 1.2

A Missed Business Opportunity: Decca Records Rejecting ‘The Beatles’

Surely one of the most spectacular examples of an unlucky ‘missed opportunity’ must be the case of Decca Records. In 1962, Dick Rowe was given a set of audio tapes by a new band, with a view to signing them for Decca. He rejected the band, explaining to their manager: “Not to mince words ... we don’t like your boy’s sound. Groups are out: four-piece groups with guitars particularly are finished” (Tibballs, 1999:165). It was lucky that the manager in question, Brian Epstein, subsequently sent the tapes to the recording department of HMV in Oxford Street, London, where they were enthusiastically received by a sound engineer who happened to know the record producer George Martin at Parlophone (a division of EMI), and who agreed to give the band an audition. The ‘boys’ to whom Rowe had referred were The Beatles – later to become the biggest rock group of the 20th century, and the greatest influence on popular music and fashion for decades, and to provide EMI with considerable profits over subsequent years. Figures are hard to come by, but one source (Pietzsch, 2015) suggests that in the five years since they had signed with EMI, the Beatles had almost ‘doubled’ the company’s profits.