Part 2

THE GLOBAL MARKETING ENVIRONMENT

2 The Global Economic Environment

In August 1998, the Russian economy imploded. The ruble plunged in value, and the government defaulted on its foreign debt obligations. Many Russians faced wage cuts and layoffs; savings were wiped out as banks collapsed. The meltdown sent shock waves through global financial markets. Russia was down, but it was not out; in the years since the crisis, Russia's economy has experienced substantial growth. By 2006, a country that had teetered on the brink of bankruptcy had posted four consecutive years of 6 percent economic growth and had amassed $250 billion in foreign currency reserves. The dramatic economic recovery can be attributed in part to record world prices for oil and gas; the energy sector is Russian's most important source of export revenue. A second explanation for the rebounding economy was politics. In 2000, Vladimir Putin succeeded Boris Yeltsin as president. Putin initiated a reform program that included a new tax code, streamlined customs regulations, slashed subsidies to state-owned enterprises, and made other improvements in the business climate. A third factor in Russia's economic rebound was the fact that price increases for imports caused by the ruble's devaluation stimulated local production of a wide range of goods. As one economist noted, "The crash of '98 really cleaned out the macroeconomy." Putin confidently predicted that national income in Russia would double by 2010.

"As the saying goes, if you are not manufacturing in China or selling in India, you are as good as finished."[2]

Dipankar Halder,
Associate Director
KSA Technopak, India

The collapse of Russia's economy in 1998 and its subsequent rebound in the first years of the new millennium vividly illustrate the dynamic nature of today's economic environment. Recall the basic definition of a **market**: people or organizations with needs and wants and both the willingness and ability to buy or sell. As noted in Chapter 1, many companies engage in global marketing in an effort to reach new customers outside the home country and thereby increase sales, profits, and market share. Today, Russia represents a major growth opportunity for global companies. Russia, along with Brazil, India, and China, are collectively referred to as **BRIC**—four fast-growing markets that represent important opportunities.[1] This chapter will identify the most salient characteristics of the world economic environment, starting with an overview of the world economy, a survey of economic system types, a discussion of stages of market development, and a review of the balance of payments. The final section of the chapter discusses foreign exchange.

1 The "BRIC" designation first appeared in a 2001 report published by Goldman Sachs, the New York-based investment bank, hedge fund, and private equity firm.

2 Saritha Rai, "Tastes of India in U.S. Wrappers," *The New York Times*, April 29, 2003, p. W7.

Russia is a nation that is being transformed by economic change. In Moscow, for example, affluent Russians can shop at boutiques that offer Versace, Burberry, Bulgari, and other exclusive brands. Although per capita gross national income (GNI) in Russia is only $3,400, Russian shoppers spend an estimated $4 billion each year on luxury goods. Flush with dollars from oil exports, in 2006 the Russian government lifted all currency controls, making the ruble freely convertible in world markets. As one observer noted, "Russia has now graduated to being a normal, if not developed, at least upwardly developing, country."

THE WORLD ECONOMY: AN OVERVIEW

The world economy has changed profoundly since World War II.[3] Perhaps the most fundamental change is the emergence of global markets; responding to new opportunities, global competitors have steadily displaced or absorbed local ones. Concurrently, the integration of the world economy has increased significantly. Economic integration stood at 10 percent at the beginning of the twentieth century; today, it is approximately 50 percent. Integration is particularly striking in the European Union (EU) and the North American Free Trade Area.

Just 60 years ago, the world was far less integrated than it is today. As evidence of the changes that have taken place, consider the automobile. Cars with European nameplates such as Renault, Citroen, Peugeot, Morris, Volvo, and others were radically different from the American Chevrolet, Ford, or Plymouth, or Japanese models from Toyota or Nissan. These were local cars built by local companies, mostly destined for local or regional markets. Even today, global and regional auto companies make cars for their home-country car buyers that are not marketed abroad. However, it is also true that the world car is a reality for Toyota, Nissan, Honda, and Ford. Product changes reflect organizational changes as well: The world's largest automakers have, for the most part, evolved into global companies.

During the past two decades, the world economic environment has become increasingly dynamic; change has been dramatic and far-reaching. To achieve success, executives and marketers must take into account the following new realities:[4]

- Capital movements have replaced trade as the driving force of the world economy.
- Production has become "uncoupled" from employment.

[3] Numerous books and articles survey this subject; see, for example, Lowell Bryan et al., *Race for the World: Strategies to Build a Great Global Firm* (Boston: Harvard Business School Press, 1999).

[4] William Greider offers a thought-provoking analysis of these new realities in *One World, Ready or Not: The Manic Logic of Global Capitalism* (New York: Simon & Schuster, 1997).

- The world economy dominates the scene; individual country economies play a subordinate role.
- The struggle between capitalism and socialism that began in 1917 is largely over.
- The growth of e-commerce diminishes the importance of national barriers and forces companies to reevaluate their business models.

The first change is the increased volume of capital movements. The dollar value of world trade is running at roughly $11 trillion per year. However, the London foreign exchange market turns over $450 billion each working day; overall, foreign exchange transactions worth approximately $1.5 trillion are booked every day—far surpassing the dollar volume of world trade in goods and services.[5] There is an inescapable conclusion in these data: Global capital movements far exceed the dollar volume of global trade. This explains the paradoxical combination of U.S. trade deficits and a strong dollar during the first half of the 1980s and again in the early twenty-first century. According to orthodox economic theory, when a country runs a deficit on its trade accounts, its currency should depreciate in value. Today, it is capital movements and trade that determine currency value.

The second change concerns the relationship between productivity and employment. **Gross domestic product (GDP)** is the total market value of final goods and services produced within a nation's borders; it is a measure of economic output. Another economic indicator, **gross national income (GNI)**, is comprised of GDP plus income generated from nonresident sources. Economic growth, as measured by GDP, reflects increases in a nation's productivity. Although employment in manufacturing remains steady or has declined, productivity continues to grow. The pattern is especially clear in American agriculture, where fewer farm employees produce more output. In the United States, manufacturing's share of GDP has declined from 19.2 percent in 1989 to 13 percent in 2004.[6] In 2001, about 13 percent of U.S. workers were employed by factories; in 1971, the figure was 26 percent. During that 30-year period, productivity has increased dramatically. Similar trends can be found in many other major industrial economies as well. One recent study of 20 large economies found that, between 1995 and 2002, more than 22 million factory jobs have been eliminated. Manufacturing is not in decline—it is *employment* in manufacturing that is in decline.[7]

The third major change is the emergence of the world economy as the dominant economic unit. Company executives and national leaders who recognize this have the greatest chance of success. For example, the real secret of the economic success of Germany and Japan is the fact that business leaders and policy makers focus on world markets and their respective countries' competitive positions in the world economy. This change has brought two questions to the fore: How does the global economy work, and who is in charge? Unfortunately, the answers to these questions are not clear-cut.

5 Alan C. Shapiro, *Multinational Financial Management*, 7th ed. (Hoboken, NJ: John Wiley & Sons, 2003), p. 137. A Eurodollar is a U.S. dollar held outside the United States. U.S. dollars are subject to U.S. banking regulations; Eurodollars are not.

6 A third economic indicator, gross national product (GNP), the total value of final goods and services produced in a country by its citizens and domestic business enterprises, plus the value of output produced by citizens working abroad, plus income generated by capital held abroad, minus transfers of net earnings by global companies operating in the country. GDP also measures economic activity; however, GDP includes all income produced within a country's borders by its residents and domestic enterprises as well as foreign-owned enterprises. Income earned by citizens working abroad is not included. For example, Ireland has attracted a great deal of foreign investment, and foreign-owned firms account for nearly 90 percent of Ireland's exports. This helps explain the fact that, in 2005, Ireland's GDP and GNP totaled €161 billion and €135 billion, respectively. However, as a practical matter, GNP, GDP, and GNI figures for many countries will be roughly the same.

7 Jon E. Hilsenrath and Rebecca Buckman, "Factory Employment Is Falling World-Wide," *The Wall Street Journal*, October 20, 2003, p. A2. Some companies have cut employment by outsourcing or subcontracting nonmanufacturing activities such as data processing, accounting, and customer service.

The fourth change is the end of the Cold War. The demise of communism as an economic and political system can be explained in a straightforward manner: Communism is not an effective economic system. The overwhelmingly superior performance of the world's market economies has given leaders in socialist countries little choice but to renounce their ideology. A key policy change in such countries has been the abandonment of futile attempts to manage national economies with a single central plan. This policy change frequently goes hand in hand with governmental efforts to foster increased public participation in matters of state by introducing democratic reforms.[8]

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

the rest of the story

Russia's Economic Rebound

Will President Putin be able to realize his vision for economic growth in Russia? Can the current recovery be sustained? Some indicators are positive; for example, foreign investment topped $13 billion in 2005, more than three times the 2002 level. Negotiations are ongoing to gain Russia admittance to the WTO. From the American perspective, issues such as market access for U.S. financial services companies and intellectual property protection are top priorities. Software, music, and video piracy are well-entrenched; annual losses from illegal software alone are estimated to be about $1.5 billion. Resolving those issues would pave the way for a lifting of U.S. economic restrictions known as the Jackson-Vanik amendments and the granting of permanent normal trade relations with Russia.

Putin hosted the 2006 Group of Eight Summit in St. Petersburg, further enhancing Russia's status on the world stage. Despite the positive publicity, however, other recent events have raised concerns in the world community. There is concern in Washington that Putin is suppressing the growth of democratic institutions. The phrase *managed democracy* describes what some call the arbitrary exercise of state power. Russia plans to limit foreign investment in strategic industries such as oil; the term *renationalization* has been applied to the process by which state-owned enterprises are acquiring rivals. *Kleptocracy* refers to rampant corruption and bribery.

Russia is so dependent on revenues from the fuel and energy sectors that a major decline in world oil prices would likely have a destabilizing effect. A related problem is the fact that Russia's energy industry is dominated by a handful of huge conglomerates. The men who run these companies are known as oligarchs; at one time, Yukos Oil's Mikhail Khodorkovsky, Sibneft's Roman Abramovich, and their peers are among Russia's ultra-rich elite. However, there is widespread resentment among the Russian citizenry about the manner in which the oligarchs gained control of their respective companies. In July 2003, the Putin government sent a message to the oligarchs by arresting billionaire businessman Platon Lebedev on charges of paying too little for a fertilizer plant that he acquired in 1994. Khodorkovsky was also arrested and his Yukos empire was forced into bankruptcy.

There are other problems as well. Putin's tax reform program was relatively easy to implement; however, further reforms may face more opposition. Russia's entrenched bureaucracy is a barrier to increased economic freedom. The banking system remains fragile and in need of reform. Tragically, in the fall of 2006, Andrei Kozlov, Russia's top banking regulator, was shot to death on the streets of Moscow. Yevgeny Yasin, a former economy minister and an advocate of liberal reforms, noted recently, "The Russian economy is constrained by bureaucratic shackles. If the economy is to grow, these chains must be dropped. If we can overcome this feudal system of using power, we will create a stimulus for strong and sustainable economic growth and improve the standards of living."

A number of Western companies have taken note of Russia's improved economic climate. For example, IKEA, the global furniture retailer, is opening dozens of new stores across Russia. France's Auchan and German retail chains Rewe and Metro are targeting the grocery market. By contrast, Wal-Mart, Carrefour, and U.K.-based Tesco do not yet have a market presence; management at these companies believes the risks and difficulties of doing business in Russia are too great.

Ultimately, Putin must ensure that the needs of ordinary Russians are satisfied and, at the same time, reign in the oligarchs, embark on governance reforms, and maintain the rule of law. If he succeeds, Putin may well be credited with creating a sustained economic miracle in Russia.

Sources: Neil Buckley, "From Shock Therapy to Retail Therapy: Russia's Middle Class Starts Spending," Financial Times, *October 31, 2006, p. 13; David Lynch, "Russia Brings Revitalized Economy to the Table,"* USA Today, *July 13, 2006, pp. 1B, 2B; Guy Chazan, "Kremlin Capitalism: Russian Car Maker Comes under Sway of Old Pal of Putin,"* The Wall Street Journal, *May 19, 2006, pp. A1, A7; Greg Hitt and Gregory L. White, "Hurdles Grow as Russia, U.S. Near Trade Deal,"* The Wall Street Journal, *April 12, 2006, p. A4; Chazan, "Russia is Flush—For Now,"* The Wall Street Journal, *November 17, 2004, p. A14; Peter Weinberg, "Russia Merits a Welcome Into the Trade Fold,"* Financial Times, *October 27, 2003, p. 13; Mark Medish, "Russia's Economic Strength Begins at Home,"* Financial Times, *September 22, 2003, p. 15; Andrew Jack and Stefan Wagstyl, "In 1998, Russia Was Nearly Bankrupt. Today It Has Reserves of $60 Bn. But Its Economic Future Remains Insecure,"* Financial Times, *August 18, 2003, p. 9; Gregory L. White and Jeanne Whalen, "Why Russian Oil Is a Sticky Business,"* The Wall Street Journal, *August 1, 2003, p. A7; Marshall Goldman, "Russia Will Pay Twice for the Fortunes of Its Oligarchs,"* Financial Times, *July 26/27, 2003, p. 10.*

8 Marcus W. Brauchli, "Poll Vaults: More Nations Embrace Democracy—and Find It Can Often Be Messy," *The Wall Street Journal,* June 25, 1996, pp. A1, A6.

Worldwide, an estimated one billion people use PCs. In the so-called information age, barriers of time and place have been subverted by a transnational cyberworld that functions "24–7." Amazon.com, eBay, Google, MySpace, and YouTube are just a few of the online pioneers that are pushing the envelope in this brave new world.

ECONOMIC SYSTEMS

Traditionally, economists identified four main types of economic systems: market capitalism, centrally planned socialism, centrally planned capitalism, and market socialism. As shown in Figure 2-1 this classification was based on the dominant method of resource allocation (market versus command) and the dominant form of resource ownership (private versus state). Thanks to globalization, however, economic systems are harder to categorize within the confines of a four-cell matrix. Alternatively, more robust descriptive criteria include the following:[9]

- *Type of economy.* Is the nation an advanced industrial state, an emerging economy, a transition economy, or a developing nation?
- *Type of government.* Is the nation ruled by a monarchy, dictatorship, or tyrant? Is there an autocratic one-party system? Is the nation dominated by another state, or is it a democracy with a multi-party system? Is it an unstable or terrorist nation?
- *Trade and capital flows.* Is the nation characterized by almost completely free trade, incomplete free trade and part of a trading bloc? Is there a currency board or exchange controls? Is there no trade, or does the government dominated trade possibilities?
- *The commanding heights* (e.g., the transportation, communications, and energy sectors). Are these sectors state owned and operated? Is there a mix of state and private ownership? Are they all private, with or without controlled prices?
- *Services provided by the state and funded through taxes.* Are pensions, health care, and education provided? Pensions and education but not health care? Do privatized systems dominate?
- *Institutions.* Is the nation characterized by transparency, standards, the absence of corruption, and the presence of a free press and strong courts? Or is corruption a fact of life and the press dominated by the government? Are standards ignored and the court system compromised?

Figure 2-1

Economic Systems

		Resource Allocation	
		Market	Command
Resource Ownership	Private	Market capitalism	Centrally planned capitalism
	State	Market socialism	Centrally planned socialism

[9] The authors are indebted to Professor Francis J. Colella, Department of Business Administration and Economics, Simpson College, for suggesting these criteria.

- *Markets.* Does the nation have a free market system characterized by high risk/high reward entrepreneurial dynamism? Is it a free market that is dominated by monopolies, cartels, and concentrated industries? Is it a socialized market with cooperation between business, government, and labor but with little entrepreneurial support? Or is planning, including price and wage controls, dominated by the center?

Market Capitalism

Market capitalism is an economic system in which individuals and firms allocate resources and production resources are privately owned. Simply put, consumers decide what goods they desire and firms determine what and how much to produce; the role of the state in market capitalism is to promote competition among firms and ensure consumer protection. Today, market capitalism is practiced widely around the world, most notably in North America and Western Europe (see Table 2-1).

It would be a gross oversimplification, however, to assume that all market-oriented economies function in an identical manner. Economist Paul Krugman has remarked that the United States is distinguished by its competitive, "wild free-for-all" and decentralized initiative. By contrast, outsiders sometimes refer to Japan as "Japan Inc." The label can be interpreted in different ways, but it basically refers to a tightly run, highly regulated economic system that is also market oriented.

Centrally Planned Socialism

At the opposite end of the spectrum from market capitalism is **centrally planned socialism**. In this type of economic system, the state has broad powers to serve the public interest as it sees fit. State planners make "top-down" decisions about what goods and services are produced and in what quantities; consumers can spend their money on what is available. Government ownership of entire industries as well as individual enterprises is characteristic of centrally planned socialism. Because demand typically exceeds supply, the elements of the marketing mix are not used as strategic variables.[10] Little reliance is placed on product differentiation, advertising, or promotion; to eliminate "exploitation" by intermediaries, the government also controls distribution.

The clear superiority of market capitalism in delivering the goods and services that people need and want has led to its adoption in many formerly socialist

Table 2-1

Western Market Systems

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

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

countries. An ideology developed in the nineteenth century by Marx and perpetuated in the twentieth century by Lenin and others has been resoundingly refuted. As William Greider writes:

> Marxism is utterly vanquished, if not yet entirely extinct, as an alternative economic system. Capitalism is triumphant. The ideological conflict first joined in the mid-nineteenth century in response to the rise of industrial capitalism, the deep argument that has preoccupied political imagination for 150 years, is ended.[11]

For decades, the economies of China, the former Soviet Union, and India functioned according to the tenets of centrally planned socialism. All three countries are now engaged in economic reforms characterized, in varying proportions, by increased reliance on market allocation and private ownership. Even as China's leaders attempt to maintain control over society, they acknowledge the importance of economic reform. At a recent plenum, the Communist Party said that reform "is an inevitable road for invigorating the country's economy and promoting social progress, and a great pioneering undertaking without parallel in history."

Centrally Planned Capitalism and Market Socialism

In reality, market capitalism and centrally planned socialism do not exist in "pure" form. In most countries, to a greater or lesser degree, command and market resource allocation are practiced simultaneously, as are private and state resource ownership. The role of government in modern market economies varies widely. An economic system in which command resource allocation is utilized extensively in an overall environment of private resource ownership can be called **centrally planned capitalism**. A fourth variant, **market socialism**, is also possible. In such a system, market allocation policies are permitted within an overall environment of state ownership.

In Sweden, for example, where the government controls two-thirds of all expenditures, resource allocation is more "command" oriented than "market" oriented.

In 2003, the Rolling Stones' 40 Licks *CD went on sale in China. However, some of the band's most famous hits—"Brown Sugar," "Beast of Burden," "Honky Tonk Women," and "Let's Spend the Night Together"—were left off because officials viewed them as promoting social permissiveness. The Stones were scheduled to bring their fortieth anniversary tour to Beijing and Shanghai in 2003. However, the concerts were postponed due to the SARS outbreak. When Mick, Keith and company finally did perform in China in 2006, government officials ordered the band to omit five songs from its set list.*

[11] William Greider, *One World, Ready or Not*: *The Manic Logic of Global Capitalism* (New York: Simon & Schuster, 1997), p. 37.

Company	Industry Sector	State Ownership %
TellaSonera	Telecom	45
SAS	Airline	21
Nordea	Banking	20
OMX	Stock exchange	7
Vin & Spirit	Alcohol	100

Table 2-2

Examples of Government Resource Ownership in Sweden

Also, as indicated in Table 2-1, the Swedish government has significant holdings in key business sectors. Thus, Sweden's so-called "welfare state" has a hybrid economic system that incorporates elements of both centrally planned socialism and capitalism. The Swedish government is embarking on a privatization plan that calls for selling its stakes in some of the businesses in Table 2-2.[12]

As noted previously, China is an example of centrally planned socialism. However, China's Communist leadership has given considerable freedom to businesses and individuals in the Guangdong Province to operate within a market system. Today, China's private sector accounts for more than 75 percent of national output. Even so, state enterprises still receive more than two-thirds of the credit available from the country's banks.

"Countries with planned economies have never been part of economic globalization. China's economy must become a market economy."[13]

Long Yongtu, Chief WTO negotiator for China

Market reforms and nascent capitalism in many parts of the world are creating opportunities for large-scale investments by global companies. Coca-Cola returned to India in 1994, two decades after being forced out by the government. A new law allowing 100 percent foreign ownership of enterprises helped pave the way. By contrast, Cuba stands as one of the last bastions of the command

OPEN *to* discussion

Which Operating System Do You Use?

Author Thomas L. Friedman compares and contrasts various types of economic systems by drawing an analogy with the main elements of a computer system. First is the "hardware," the basic shell around a country's economy. In the Cold War era, there were three basic types of hardware: free-market capitalism, communism, and hybrid. Second is the "operating system," which Friedman compares to a country's broad economic policies. Utilizing a pun on the title of Marx's classic work *Das Kapital,* Friedman categorizes these operating systems in a continuum ranging from DOScapital 0.0 through DOScapital 6.0. The basic "economic operating system" in communist countries, as noted previously, was central planning, which is version 0.0. The liberalized economies of the United States, Hong Kong, Taiwan, and the United Kingdom appear at the other end of the continuum. Various combinations of socialism, free markets, and crony capitalism characterize the hybrid states.

For example, Friedman classifies Hungary as DOScapital 1.0, and China is running version 1.0 in rural provinces but 4.0 in Shanghai. Thailand and Indonesia are both DOScapital 3.0, and Korea is 4.0. To get the most out of its hardware and operating system, a computer needs software. In Friedman's analysis, a country's "software" is comprised of the basic institutions of a free society. These include a functioning judicial system, a free press, free speech, economic reform, civic institutions, and multiple political parties. In short, a country's software is a reflection of how well developed its legal and regulatory systems are and the degree to which laws are understood, embraced, and made workable.

As Friedman asserts, with the end of the Cold War, virtually every country in the world is using the same basic hardware: free-market capitalism. Even so, some countries have yet to find the optimum balance between software and hardware; for example, Friedman views Russia and Venezuela as "illiberal democracies" because their governments currently emphasize hardware more than software.

Sources: Thomas L. Friedman, "Needed: Iraqi Software," The New York Times, *May 7, 2003, p. A29; Friedman,* The Lexus and the Olive Tree *(New York: Anchor Books, 2000), pp. 151–152.*

12 Joel Sherwood and Terence Roth, "Defeat of Sweden's Ruling Party Clears Way for Sales of State Assets," *The Wall Street Journal,* September 19, 2006, p. A8.
13 Nicholas R. Lardy, *Integrating China into the Global Economy* (Washington, D.C.: The Brookings Institution, 2003), p. 21.

For decades, Singapore has been an important trade hub in Asia. Although efficiency, economic stability, and cleanliness have been the city-state's hallmarks, Singapore is now being remade as a cultural destination. Leaders have embarked upon an ambitious real estate development program designed to keep Singapore up-to-date and competitive with Doha, Dubai, and other popular tourist centers in the region. A striking symbol of this trend is the new Esplanade—Theaters on the Bay, adjacent to the Singapore cityscape pictured here. Another development, a mixed-use, integrated resort on the edge of the city, features thousands of apartments and villas, as well as hotels, a casino complex, and numerous retail shops.

allocation approach. Daniel Yergin and Joseph Stanislaw sum up the situation in the following way:

> Socialists are embracing capitalism, governments are selling off companies they had nationalized, and countries are seeking to entice multinational corporations expelled just two decades earlier. Today, politicians on the left admit that their governments can no longer afford the expansive welfare state. . . . The decamping of the state from the "commanding heights" marks a great divide between the 20th and 21st centuries. It is opening the doors of many formerly closed countries to trade and investment, and vastly increasing the global market.[14]

The Washington, D.C.-based Heritage Foundation, a conservative think tank, takes a more conventional approach classifying economies: It compiles a survey of more than 150 countries ranked by degree of economic freedom (Table 2-3). A number of key economic variables are considered: trade policy, taxation policy, government consumption of economic output, monetary policy, capital flows and foreign investment, banking policy, wage and price controls, property rights, regulations, and the black market. The rankings form a continuum from "free" to "repressed," with "mostly free" and "mostly unfree" in between. Hong Kong and Singapore are ranked first and second in terms of economic freedom; Burma, Iran, and North Korea are ranked lowest.

There is a high correlation between the degree of economic freedom and the extent to which a nation's mixed economy is heavily market oriented. However, the validity of the ranking has been subject to some debate. For example, author William Greider has observed that the authoritarian state capitalism practiced in Singapore deprives the nation's citizens of free speech, a free press, and free assembly. For example, in 1992, Singapore banned the import, manufacture, and sale of chewing gum because discarded wads of gum were making a mess on sidewalks, and in buildings, buses, and subway trains. Today, gum is available at pharmacies; before buying a pack, however, consumers must register their names and addresses. Greider notes, "Singaporeans are comfortably provided for by a harshly autocratic government that administers paranoid control over press and politics and an

[14] Daniel Yergin and Joseph Stanislaw, "Sale of the Century," *Financial Times Weekend*, January 24–25, 1998, p. I.

Table 2-3

Index of Economic Freedom—2006 Rankings

Free
1. Hong Kong
2. Singapore
3. Ireland
4. Luxembourg
5. Iceland
United Kingdom
7. Estonia
8. Denmark
9. Australia
New Zealand
United States
12. Canada
Finland
14. Chile
15. Switzerland
16. Cyprus
Netherlands
18. Austria
19. Germany
Sweden

Mostly Free
21. Czech Republic
22. Belgium
23. Lithuania
24. Malta
25. Bahrain
26. Barbados
27. Armenia
Bahamas
Japan
30. Botswana
Norway
Portugal
33. Spain
34. El Salvador
Slovak Republic
36. Israel
37. Taiwan
38. Slovenia
39. Latvia
40. Hungary
41. Poland
42. Italy
Trinidad and Tobago
44. France
45. South Korea
46. Cape Verde
Costa Rica
Uruguay
49. Panama
50. Kuwait
South Africa
52. Albania
Madagascar
54. Jamaica
55. Belize
Croatia
57. Greece
Jordan
Macedonia
60. Mexico
Mongolia
62. Saudi Arabia
63. Peru
64. Bulgaria
65. United Arab Emirates
66. Uganda
67. Bolivia
68. Cambodia
Georgia
Malaysia
71. Kyrgyz Republic
Thailand

Mostly Unfree
73. Lebanon
74. Bosnia and Herzegovina
Guatemala
Oman
77. Mauritius
78. Qatar
Swaziland
80. Nicaragua
81. Brazil
Mauritania
83. Moldova
Senegal
85. Guyana
Namibia
Turkey
88. Ivory Coast
Mali
90. Fiji
91. Colombia
92. Romania
Sri Lanka
94. Djibouti
Kenya
Tanzania
97. Morocco
98. Philippines
99. Lesotho
Tunisia
Ukraine
102. Burkina Faso
103. Gabon
Honduras
105. Chad
Ghana
107. Argentina
Ecuador
109. Paraguay
110. Pakistan
111. China
Zambia
113. Kazakhstan
Mozambique
115. Niger
116. Dominican Republic
117. Benin
118. Central African Republic
119. Algeria
Cameroon
121. India
122. Russia
123. Azerbaijan
Gambia
125. Nepal
Rwanda
127. Guinea
128. Egypt
129. Surinam
130. Malawi
131. Guinea-Bissau
132. Burundi
133. Ethiopia
134. Indonesia
Toga
136. Equatorial Guinea
137. Sierra Leone
Tajikistan
139. Angola
Yemen
141. Bangladesh
142. Vietnam
143. Congo, Rep.
144. Uzbekistan
145. Syria

Repressed
146. Nigeria
147. Haiti
148. Turkmenistan
149. Laos
150. Cuba
151. Belarus
152. Libya
Venezuela
154. Zimbabwe
155. Burma
156. Iran
157. North Korea

Unrated
Congo (Dem. Rep.)
Iraq
Serbia and Montenegro
Sudan

effective welfare state that keeps everyone well housed and fed, but not free."[15] As Greider's observation makes clear, some aspects of "free economies" bear more than a passing resemblance to command-style economic systems.

STAGES OF MARKET DEVELOPMENT

At any point in time, individual country markets are at different stages of economic development. The World Bank has developed a four-category classification system that uses per capita GNI as a base. Although the income definition for each of the stages is arbitrary, countries within a given category generally have a number of characteristics in common. Thus, the stages provide a useful basis for global market segmentation and target marketing. Table 2-4 shows the categories.

A decade ago, a number of countries in Central Europe, Latin America, and Asia were expected to experience rapid economic growth. Known as *big emerging markets* (BEMs), the list included China, India, Indonesia, South Korea, Brazil, Mexico, Argentina, South Africa, Poland, and Turkey.[16] Today, much attention is focused on opportunities in Brazil, India, and China, plus, for reasons discussed in the chapter opening, Russia. As noted, these four countries are collectively known as BRIC. Experts predict that the BRIC nations will be key players in global trade even as their track records on human rights, environmental protection, and other issues come under closer scrutiny by their trading partners. The BRIC government leaders will also come under pressure at home as their developing market economies create greater income disparity. For each of the stages of economic development discussed here, special attention is given to the BRIC countries.

Low-Income Countries

Low-income countries have a GNI per capita of less than $825. The general characteristics shared by countries at this income level are:

1. Limited industrialization and a high percentage of the population engaged in agriculture and subsistence farming
2. High birth rates
3. Low literacy rates
4. Heavy reliance on foreign aid
5. Political instability and unrest
6. Concentration in Africa south of the Sahara

Table 2-4

Stages of Market Development

Income Group by Per Capita GNI	2004 GNI ($ millions)	2004 GNI Per Capita ($)	% of World GNI	2004 Population (millions)
High-income countries GNI per capita >$10,066	32,245,297	32,112	80.05	1,004
Upper-middle-income countries GNI per capita >$3,256 but ≤$10,065	2,748,229	4,769	6.82	576
Lower-middle-income countries GNP per capita ≥$826 but ≤$3,255	4,116,012	1,686	10.22	2,442
Low-income countries GNP per capita <$825	1,187,702	507	2.95	2,343

15 Greider, pp. 36–37. See also Steve Glain, "Political Grudges? For South Korean Firms, Speaking Too Freely May Carry Steep Price," *The Wall Street Journal*, August 18, 1995, pp. A1, A10.

16 For an excellent discussion of BEMs, see Jeffrey E. Garten, *The Big Ten: The Big Emerging Markets and How They Will Change Our Lives* (New York: Basic Books, 1997).

Although about 40 percent of the world's population is included in this economic category, many low-income countries represent limited markets for products. Still, there are exceptions; for example, in Bangladesh, where per capita GNI is approximately $380, the garment industry has enjoyed burgeoning exports. Finished clothing exports to the United States alone amounted to $2.4 billion in 2002; an estimated 1.8 million Bangladeshis—mostly women—work in the industry for an average monthly wage of about $35. Bangladesh received preferential treatment under the Multifiber Arrangement (MFA), an international pact dating back to the mid-1970s that established import quotas to regulate the global trade in garments. The MFA expired at the end of 2004; some observers expected that a shakeout in the garment industry would lead to widespread unemployment and social and political unrest. However, this has not happened. The garment sector continues to thrive, due in part to Bangladesh's extremely low labor costs and new limits on Chinese textile exports to the United States.[17]

Many low-income countries have such serious economic, social, and political problems that they represent extremely limited opportunities for investment and operations. Some are low-income, no-growth countries such as Burundi and Rwanda that are beset by one disaster after another. Others were once growing, relatively stable countries that have become divided by political struggles. The result is a tinderbox or flash point environment characterized by civil strife, declining income, and, often, considerable danger to residents. Haiti is a case in point. Countries embroiled in civil wars are dangerous areas; most companies find it prudent to avoid them.

The newly independent countries of the former Soviet Union present an interesting situation: Income is declining, and there is considerable economic hardship. The potential for disruption is certainly high. Are they problem cases, or are they attractive opportunities with good potential for moving out of the low-income category? These countries present an interesting risk-reward trade-off; many companies have taken the plunge, but many others are still assessing whether to take the risk. Table 2-3 rates two low-income former Soviet republics—Turkmenistan and Belarus—as "repressed" in terms of economic freedom. This is one indication of a risky business environment. Russia itself, whose economy is at the lower end of the upper-middle income category, is below the middle of the ranking (number 122). As evidenced by the events of 1998 and as well as actions by the Putin administration to cut off supplies of natural gas to some former Soviet republics, economic and political instability are present here as well.

With 2004 per capita GNI of $620, India is the sole low-income country in the BRIC grouping. In 2007, India commemorated the sixtieth anniversary of its independence from Great Britain. For many decades, economic growth was weak. As the 1990s began, India was in the throes of economic crisis: Inflation was high, and foreign exchange reserves were low. Country leaders opened India's economy to trade and investment and dramatically improved market opportunities. Monmohan Singh was placed in charge of India's economy. Singh, former governor of the Indian central bank and finance minister, noted, "For years, India has been taking the wrong road." Accordingly, he set about dismantling the planned economy by eliminating import licensing requirements for many products, reducing tariffs, easing restrictions on foreign investment, and liberalizing the rupee. The results were impressive: Foreign exchange reserves jumped to $13 billion in 1993 from $1 billion in 1991. Singh became prime minister in 2004. Yashwant Sinha, the country's former finance minister, declared that the twenty-first century will be "the century of India."

"It may feel like the temperature has only risen a couple of degrees so far, but this heralds the end of India's economic Ice Age."[18]

Vivek Paul, Vice Chairman, Wipro

[17] Mahtab Haider, "Defying Predictions, Bangladesh's Garment Factories Thrive," *The Christian Science Monitor,* February 7, 2006, p. 4. See also Peter Fritsch, "Looming Trouble: As End of a Quota System Nears, Bangladesh Fears for Its Jobs," *The Wall Street Journal,* November 20, 2003, pp. A1, A12.

[18] Manjeet Kirpalani, "The Factories are Humming," *Business Week,* October 18, 2004, pp. 54–55.

Lower-Middle-Income Countries

The United Nations designates fifty countries in the bottom ranks of the low-income category as **least-developed countries (LDCs)**; the term is sometimes used to indicate a contrast with **developing** (i.e., upper ranks of low-income plus lower-middle and upper-middle-income) **countries** and **developed** (high-income) **countries**. **Lower-middle-income countries** are those with a GNI per capita between $826 and $3,255. Consumer markets in these countries are expanding rapidly. Countries such as China, Indonesia, and Thailand represent an increasing competitive threat as they mobilize their relatively cheap—and often highly motivated—labor forces to serve target markets in the rest of the world. The developing countries in the lower-middle-income category have a major competitive advantage in mature, standardized, labor-intensive industries, such as making toys and textiles.

China and Brazil are the BRIC nations in the lower-middle-income category. China represents the largest single destination for foreign investment in the developing world. Attracted by the country's vast size and market potential, companies in Asia, Europe, and the United States are making China a key country in their global strategies. Despite ongoing market reforms, Chinese society does not have democratic foundations. Although China has joined the WTO, trading partners are still concerned about human rights, protection of intellectual property rights, and other issues. The country's leaders must deal with China's sprawling bureaucracy while reforming the state enterprise sector. Avon, the Coca-Cola Company, Dell, Ford, General Motors, Honda, McDonald's, Motorola, Procter & Gamble, Samsung, Siemens AG, Volkswagen, and many other global companies are actively pursuing opportunities in China.

Brazil is the largest country in South America in terms of the size of its economy, population, and geographic territory. Brazil also boasts the richest reserves of natural resources in the hemisphere. Brazil has tamed hyperinflation, and liberalized trade is replacing tariff protection and an import quota system. Global companies doing business in Brazil include Electrolux, Fiat, Ford, General Motors, Nestlé, Nokia, Raytheon, Toyota, Unilever, and Whirlpool. Typical of countries at this stage of development, Brazil is a study in contrasts. Grocery distribution companies use logistics software to route their trucks; meanwhile, horse-drawn carts are still a common sight on many roads. To help them keep pace with the volatile financial environment, many local retailers have invested in modern computer and communications systems. They utilize sophisticated inventory management software to maintain financial control. Former French president Chirac underscored Brazil's importance on the world trade scene when he noted, "Geographically, Brazil is part of America. But it's European because of its culture and global because of its interests."[19]

Upper-Middle-Income Countries

Upper-middle-income countries, also known as industrializing or developing countries, are those with GNI per capita ranging from $3,256 to $10,065. In these countries, the percentage of population engaged in agriculture drops sharply as people move to the industrial sector and the degree of urbanization increases. Malaysia, Chile, Hungary, and many other countries in this stage are rapidly industrializing. They have rising wages and high rates of literacy and advanced education but significantly lower wage costs than the advanced countries. Innovative local companies can become formidable competitors and help

[19] Matt Moffett and Helene Cooper, "Silent Invasion: In Backyard of the U.S., Europe Gains Ground in Trade, Diplomacy," *The Wall Street Journal*, September 18, 1997, pp. A1, A8.

With per capita GNI of $4,030, Venezuela is considered an upper-middle-income country. Venezuela is one of the world's top oil-producing countries, and an important source of U.S. oil imports. A state-owned company, Petróleos de Venezuela S.A. (PDVSA), has operations in many different countries. For example, its CITGO Petroleum subsidiary operates 13,000 filling stations in the United States.

contribute to their nations' rapid, export-driven economic growth. Russia, with per capita GNI of $3,400, is currently the only BRIC nation in the upper-middle-income category.

Upper-middle-income countries that achieve the highest rates of economic growth are sometimes referred to collectively as **newly industrializing economies (NIEs)**. In Hungary and other upper-middle-income countries, scores of manufacturing companies have received ISO-9000 certification for documenting compliance with recognized quality standards. The influx of technology, particularly the computer revolution, creates startling juxtapositions of the old and the new in these countries.

Marketing Opportunities in LDCs and Developing Countries

Despite many problems in LDCs and developing countries, it is possible to nurture long-term market opportunities. Today, Nike produces and sells only a small portion of its output in China, but when the firm refers to China as a "two-billion-foot

Blessed with a location near the equator, Ecuador's cut-flower industry generates $345 million in sales each year. About 70 percent of Ecuador's flower harvest are exported to the United States; in all, about one-fourth of the cut roses sold in the United States come from Ecuador. For years, thanks to the Andean Trade Promotion and Drug Eradication Act, flowers from Ecuador, Colombia, Bolivia, and Peru were imported into the United States duty-free. The U.S. Congress passed the act to encourage Latin American farmers to cultivate ornamental flowers rather than plants that are part of the illegal drug trade. However, the act expired at the end of 2006; the flower trade with Peru and Colombia is covered by bilateral trade agreements. Although Ecuador's duty-free status was extended, new president Rafael Correa is opposed to free-trade talks with the United States.

market," it clearly has the future in mind. C. K. Prahalad and Allen Hammond have identified several assumptions and misconceptions about the "bottom of the pyramid" (BOP) that need to be corrected:[20]

- Mistaken assumption #1: *The poor have no money.* The aggregate buying power of poor communities can be substantial. In rural Bangladesh, for example, villagers spend considerable sums to use village phones operated by local entrepreneurs.
- Mistaken assumption #2: *The poor are too concerned with fulfilling basic needs to "waste" money on nonessential goods.* Consumers who are too poor to purchase a house do buy "luxury" items, such as television sets and gas stoves, to improve their lives.
- Mistaken assumption #3: *The goods sold in developing markets are so inexpensive that there is no room for a new market entrant to make a profit.* Because the poor often pay higher prices for many goods, there is an opportunity for efficient competitors to realize attractive margins by offering quality and low prices.
- Mistaken assumption #4: *People in BOP markets cannot use advanced technology.* Residents of rural areas can and do quickly learn to use cell phones, PCs, and similar devices.
- Mistaken assumption #5: *Global companies that target BOP markets will be criticized for exploiting the poor.* The informal economies in many poor countries are highly exploitative. A global company offering basic goods and services that improve a country's standard of living can earn a reasonable return while benefiting society.

Despite the difficult economic conditions in parts of Southeast Asia, Latin America, Africa, and Eastern Europe, many nations in these regions will evolve into attractive markets. One of marketing's roles in developing countries is to focus resources on the task of creating and delivering products that are best suited to local needs and incomes. Appropriate marketing communications techniques can also be applied to accelerate acceptance of these products. Marketing can

[20] C. K. Prahalad and Allen Hammond, "Serving the World's Poor, Profitably," *Harvard Business Review* 80, no. 9 (September 2002), pp. 48–57.

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

An interesting debate in marketing is whether it has any relevance to the process of economic development. Some people believe that marketing is relevant only in affluent, industrialized countries, where the major problem is directing society's resources into ever-changing output or production to satisfy a dynamic marketplace. In the less-developed country, the argument goes, the major problem is the allocation of scarce resources toward obvious production needs. Efforts should focus on production and how to increase output, not on customer needs and wants.

Conversely, it can be argued that the process of focusing an organization's resources on environmental opportunities is a process of universal relevance. The role of marketing—to identify people's needs and wants and to focus individual and organizational efforts to respond to these needs and wants—is the same in all countries, irrespective of the level of economic development. When global marketers respond to the needs of rural residents in emerging markets, such as China and India, they are also more likely to gain all-important government support and approval.

For example, pursuing alternative sources of energy, such as wind and solar power, is important for two reasons: the lack of coal reserves in many countries and concerns that heavy reliance on fossil fuels contributes to global warming. Similarly, people everywhere need affordable, safe drinking water. Recognizing this fact, Nestlé launched Pure Life bottled water in Pakistan. The price was set at about $0.35 a bottle, and advertising promised "Pure safety. Pure trust. The ideal water." Pure Life quickly captured 50 percent of the bottled water market in Pakistan; the brand has been rolled out in dozens of other low-income countries.[21] The Coca-Cola Company recently began to address dietary and health needs in low-income countries by developing Vitango, a beverage product that can help fight anemia, blindness, and other ailments related to malnutrition.

There is also an opportunity to help developing countries join the Internet economy. Intel chairman Craig Barrett has been visiting villages in China and India and launching programs to provide Internet access and computer training. One aspect of Intel's World Ahead initiative is the development of a $550 computer that is powered by a car battery. Similarly, Hewlett-Packard engineers are working to develop solar-powered communication devices that can link remote areas to the Internet.[22] Meanwhile, at the Massachusetts Institute of Technology's Media Lab, a project called One Laptop Per Child has the goal of developing a laptop computer that governments in developing countries can buy for $100.[23]

"Sustainable energy pioneers who focus on the base of the pyramid could set the stage for one of the biggest bonanzas in the history of commerce, since extensive adoption and experience in developing markets would almost certainly lead to dramatic improvements in cost and quality."

Stuart L. Hart and Clayton M. Christensen[24]

Global companies can also contribute to economic development by finding creative ways to preserve old-growth forests and other resources while creating economic opportunities for local inhabitants. In Brazil, for example, DaimlerChrysler works with a cooperative of farmers who transform coconut husks into natural rubber to be used in auto seats, headrests, and sun visors. French luxury-goods marketer Hermès has created a line of handbags called "Amazonia" made of latex extracted by traditional rubber tappers. Both DaimlerChrysler and Hermès are responding to the opportunity to promote

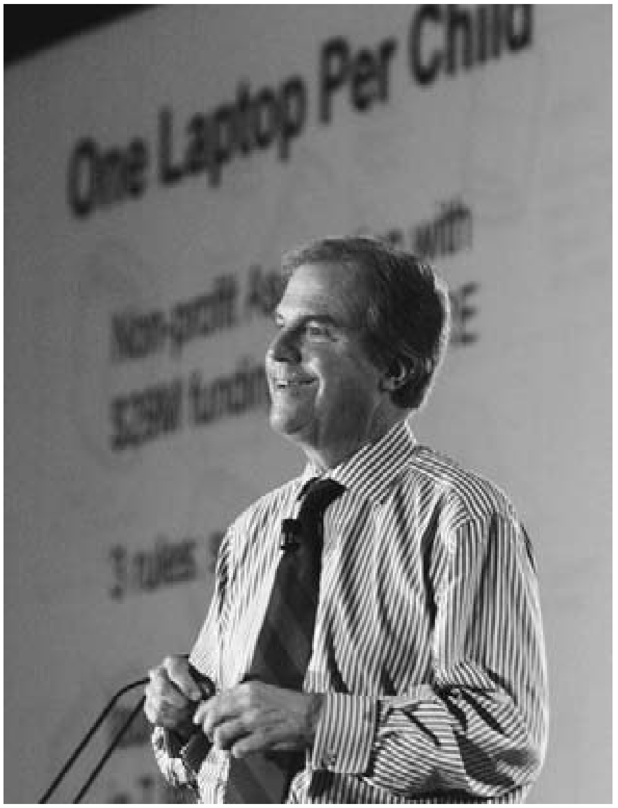
21 Ernest Beck, "Populist Perrier? Nestlé Pitches Bottled Water to World's Poor," *Asian The Wall Street Journal,* June 18, 1999, p. B1.

22 Jason Dean and Peter Wonacott, "Tech Firms Woo 'Next Billion' Users," *The Wall Street Journal,* November 3, 2006, p. A2. See also David Kirkpatrick, "Looking for Profits in Poverty," *Fortune,* February 5, 2001, pp. 174–176.

23 Steve Stecklow, "The $100 Laptop Moves Closer to Reality," *The Wall Street Journal,* November 14, 2005, pp. B1, B2.

24 Stuart L. Hart and Clayton M. Christensen, "The Great Leap: Driving Innovation from the Base of the Pyramid," *MIT Sloan Management Review* 44, no. 1 (Fall 2002), p. 56.

The One Laptop Per Child initiative was started by Nicholas Negroponte, the former director of MIT's Media Lab. Negroponte recently reached an agreement with the government of Libya to supply all 1.2 million Libyan school children with wireless laptop computers by 2008. The total purchase price is $250 million, and includes one server per school and technical support. Negroponte also has tentative agreements with Brazil, Argentina, Nigeria, and Thailand. One Laptop Per Child was recently featured on the CBS news magazine 60 Minutes; the DVD of the segment is must-see viewing for students of global marketing.



themselves as environmentally conscious while appealing to "green"-oriented consumers. As Isabela Fortes, director of a company in Rio de Janeiro that retrains forest workers, notes, "You can only prevent forest people from destroying the jungle by giving them viable economic alternatives."[25]

India's Suzlon Energy has become a major player in the wind-turbine industry. Historically, India's power distribution system has been inefficient and inconsistent; users pay high prices for electricity but still must endure blackouts on a regular basis. Moreover, burning coal to generate electricity can have serious environmental consequences. For these reasons, industrial users in India seeking alternative sources of energy are Suzlon's primary customers. Suzlon is also thinking globally: The company has opened a turbine-blade factory in Minnesota, where it also operates a wind farm.[26]

[25] Miriam Jordan, "From the Amazon to Your Armrest," *The Wall Street Journal,* May 1, 2001, pp. B1, B4.
[26] Keith Bradsher, "The Ascent of Wind Power," *The New York Times,* September 28, 2006, pp. C1, C4.

According to the World Bank, approximately 25 percent of the world's population lives on less than $2 per day. In Brazil, Latin America's largest market, low-income consumers comprise 87 percent of the population and account for 512 billion reals—$240 billion—in annual income. The balance of Brazil's population accounts for 454 billion reals. Nestlé's competitors in Brazil include both local and global brands. Sales of Nestlé's Bono brand cookies increased 40 percent in Brazil after both the serving size and the price were decreased.

High-Income Countries

High-income countries, also known as advanced, developed, industrialized, or postindustrial countries, are those with GNI per capita of $10,066 or higher. With the exception of a few oil-rich nations, the countries in this category reached their present income level through a process of sustained economic growth.

The phrase *postindustrial countries* was first used by Daniel Bell of Harvard to describe the United States, Sweden, Japan, and other advanced, high-income societies. Bell suggests that there is a difference between the industrial and the postindustrial societies that goes beyond mere measures of income. Bell's thesis is that the sources of innovation in postindustrial societies are derived increasingly from the codification of theoretical knowledge rather than from "random" inventions. Other characteristics are the importance of the service sector (more than 50 percent of GNI); the crucial importance of information processing and exchange; and the ascendancy of knowledge over capital as the key strategic resource, of intellectual technology over machine technology, of scientists and professionals over engineers and semiskilled workers. Other aspects of the postindustrial society are an orientation toward the future and the importance of interpersonal relationships in the functioning of society.

Product and market opportunities in a postindustrial society are more heavily dependent upon new products and innovations than in industrial societies. Ownership levels for basic products are extremely high in most households. Organizations seeking to grow often face a difficult task if they attempt to expand their share of existing markets. Alternatively, they can endeavor to create new markets. Today, for example, global companies in a range of communication-related industries are seeking to create new e-commerce markets for interactive forms of electronic communication. A case in point is Barry Diller's IAC/InterActiveCorp, which includes Ask.com, Expedia.com, Hotels.com, and other Internet businesses.

South Korea occupies a unique position among the high-income countries in that it is the only one classified as an emerging market by influential stock market indexes. South Korea is home to Samsung Electronics, LG Group, Kia Motors Corporation, Daewoo Corporation, Hyundai Corporation, and other well-known

When Russian president Vladimir Putin hosted the Group of Eight Summit in Saint Petersburg in 2006, he took advantage of the opportunity to show his country to the world in a positive light. The PR effort included a two-hour television broadcast during which Putin answered questions submitted from around the world via the Internet. Despite Putin's public efforts, some observers fear that, behind the scenes, the Kremlin is attempting to reassert state control over Russia's energy sector and other strategic assets. The figure on Putin's laptop depicts the Bronze Horseman, a statue near St. Isaac's Cathedral that faces the Neva River. The monument was commissioned by Catherine the Great in tribute to Peter the Great, who founded Saint Petersburg as Russia's "Window on the West."

global enterprises. In place of substantial barriers to free trade, South Korea has initiated major reforms in its political and economic system in response to the "Asian flu." Even so, investors note the political risk posed by North Korea. Another concern is inconsistent treatment of foreign investors by the government. For example, authorities recently raided the local offices of French retailer Carrefour. If the indexes do eventually reclassify South Korea as a "developed" market, the change would trigger a wave of investment inflows.[27]

Seven high-income countries—the United States, Japan, Germany, France, Britain, Canada, and Italy—comprise the **Group of Seven (G-7)**. Finance ministers, central bankers, and heads of state from the seven nations have worked together for a quarter of a century in an effort to steer the global economy in the direction of prosperity and to ensure monetary stability. Whenever a global crisis looms—be it the Latin American debt crisis of the 1980s or Russia's struggle to transform its economy in the 1990s—representatives from the G-7 nations gather and try to coordinate policy. Starting in the mid-1990s, Russia began attending the G-7 summit meetings. In 1998, Russia became a full participant, giving rise to the **Group of Eight (G-8)**.

Another institution comprised of high-income countries is the **Organization for Economic Cooperation and Development** (**OECD**; www.oecd.org). The 30 nations that belong to the OECD believe in market-allocation economic systems and pluralistic democracy. The organization has been variously described as an "economic think tank" and a "rich-man's club"; in any event, the OECD's fundamental task is to "enable its members to achieve the highest sustainable economic growth and improve the economic and social well-being of their populations." Today's organization is based in Paris and evolved from a group of European nations that worked together after World War II to rebuild the region's economy. Canada and the United States have been members since 1961; Japan joined in 1964. Evidence of the increasing importance of the BRIC group is the fact that Brazil, Russia, India, and China have all formally announced their intention to join the OECD. Applicants must demonstrate progress toward economic reform.

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

[27] Ian McDonald and Karen Richardson, "For South Korea, 'Emerging' Label Can Be a Burden," *The Wall Street Journal*, July 12, 2006, p. C1.

presides over a council that meets regularly and has decision-making power. Committees comprised of specialists from member countries provide a forum for discussion of trade and other issues. Consultation, peer pressure, and diplomacy are the keys to helping member nations candidly assess their own economic policies and actions. The OECD publishes country surveys and an annual economic outlook. Recently, the OECD has become more focused on global issues, social policy, and labor market deregulation. For example, the OECD tackled the vexing problem of bribery; the goal is to establish a treaty aimed at outlawing bribery of foreign officials.[28]

OPEN *to* discussion

Is Ireland Truly a "Celtic Tiger"?

The term *tiger* has frequently been used to describe fast-growing economies in Asia. For years, Hong Kong, Singapore, Taiwan, and South Korea were considered tigers because they posted double-digit rates of economic growth. As the decade of the 1990s came to an end, however, the Asian "economic miracle" had given way to hard times. Concurrently, some observers began calling Ireland the "Celtic Tiger." Riding the wave of the technology boom of the late 1990s, Ireland's economy grew at an annual rate of 9.6 percent. Lured by low corporate tax rates and a skilled workforce, companies from the United States, the United Kingdom, Germany, and Japan established subsidiaries in Ireland. The country best known for exports such as Waterford crystal, Guinness stout, *Riverdance*, and U2 had been transformed into a preferred location for high-tech manufacturing. More than 500 U.S. companies created tens of thousands of jobs as Intel, Motorola, and Gateway built factories to keep pace with burgeoning global demand for personal computers and other high-tech products. Before long, however, there were signs that Ireland's economic bubble might burst. The country's infrastructure was showing signs of stress, labor was in short supply, and inflation soared. By mid-2000, the pot of gold at the end of the rainbow gave way to gray and gloom. As the U.S. economy slowed down and the technology sector slumped, the impact on Ireland was immediate. Exports fell as foreign companies severely curtailed operations in Ireland or even closed down altogether.

A potential bright spot for Ireland is Media Lab Europe, which opened in July 2000 in Dublin in a building that once was the site of a Guinness brewery. Media Lab Europe is an offshoot of the original Media Lab that was established at the Massachusetts Institute of Technology (MIT) more than 20 years ago. The Media Lab is a research facility; in exchange for sponsorship contributions of $5 million or more, global companies such as BT, Intel, the LEGO Group, and Swatch AG get a first look at the lab's innovations in such areas as robotic design, speech synthesis, and holographic imaging. Total corporate funding for the original lab has passed the $500 million mark, and 50 new companies have been spun off after being incubated at the lab.

The Irish government allocated nearly $50 million in funding to establish Media Lab Europe, including a $10 million payment to MIT for the right to use the Media Lab name. Government officials believe the investment will pay off by strengthening the country's position in advanced information-technology research. By the end of 2001, several organizational sponsors had signed on and pledged an additional $7.5 million in support. However, there were problems. For one thing, some researchers at MIT have been reluctant to move their work to Ireland. By mid-2001, only six researchers and about two dozen research associates, assistants, and graduate students were working in a facility designed to accommodate 250 people.

> *"We're transitioning the nation from being a supplier and producer of other people's ideas to a place where you can actually do that development."*
>
> Enda Connolly, Industrial Development Agency of Ireland

Some Irish academics are offended by the notion that Ireland needs outside help; critics also question whether the lab will contribute to economic growth to the extent envisioned by the government. To placate such critics, the government has increased funding for local research efforts. Science Foundation Ireland (SFI) is an initiative funded by the Irish government to create an economic base in information technology, telecommunications, and biotechnology. Currently, more than 100 scientists from around the globe are conducting research at Irish universities; a typical SFI research grant provides €1 million in annual support for five years. The Irish government hopes that, attracted by the skills and talent of students graduating from local universities, global companies currently operating in Ireland will increase their level of investment. Ultimately, the government hopes to create its own world-class companies.

Visit the Web site

www.medialabeurope.org

Sources: Glenn R. Simpson, "Wearing of the Green: Irish Subsidiary Lets Microsoft Slash Taxes in U.S. and Europe," The Wall Street Journal *November 11, 2005, pp. A1, 10; John Murray Brown, "Ireland Extends Its Hospitality to Top Scientists,"* Financial Times, *November 8, 2003, p. 12; Alana Cowell, "Ireland, Once a Celtic Tiger, Slackens Its Stride,"* The New York Times, *February 19, 2003, pp. C1, C4; Saritha Rai, "Rift in India Leads M.I.T. to Abandon a Media Lab,"* The New York Times, *May 8, 2003, p. C4; David Armstrong, "Many Irish Eyes Aren't Smiling on MIT Import,"* The Wall Street Journal, *July 5, 2001, pp. B1, B4; Jeffrey R. Young, "MIT's Media Lab, a Media Darling, Seeks Global Role and New Missions,"* The Chronicle of Higher Education *(October 12, 2001), pp. A41-A43; Christopher Rhoads, "U.S. Slowdown Muffles the Volume of Ireland's Boom,"* The Wall Street Journal, *March 6, 2001, p. A18; Mike Burns, "High-Tech Shudders for the Celtic Tiger,"* Europe, *no. 406 (May 2001), pp. 14–15; Stewart Brand,* The Media Lab: Inventing the Future at M.I.T. *(New York: Viking Penguin, 1988).*

[28] Michael Hershman, "A Blow Against Bribery," *Financial Times,* February 28, 1998, p. 14.

When he's not fronting the world's greatest rock band, U2's Bono promotes debt cancellation for developing countries as a means of fostering sound economic policies. Bono is a key figure in several advocacy organizations. DATA (debt, AIDS, trade, Africa) is a lobbying group that helped influence the G-8's decision to provide an additional $25 billion in aid to sub-Saharan Africa by 2010. ONE (The Campaign to Make Poverty History) is a constellation of several nongovernmental organizations united in an effort to generate grassroots interest in policy issues via alternative media such as YouTube and MySpace. EDUN Apparel's goal is to "make ethical fashion sexy"; garments sold under the EDUN label are designed in New York City, sewn in developing countries, and distributed through upscale retailers such as Anthropologie and Harvey Nichols. Finally, Bono was instrumental in launching Project (Red), a marketing initiative with Apple, American Express, GAP, and other corporate partners. A percentage of profits from sales of RED-branded product is donated to the Global Fund to Fight AIDS.

The Triad

The ascendancy of the global economy has been noted by many observers in recent years. One of the most astute is Kenichi Ohmae, former chairman of McKinsey & Company Japan. His 1985 book *Triad Power* represented one of the first attempts to develop a coherent conceptualization of the new emerging order. Ohmae argued that successful global companies had to be equally strong in Japan, Western Europe, and the United States. These three regions, which Ohmae collectively called the **Triad**, represented the dominant economic centers of the world. Today, about two-thirds of world income as measured by GNI is located in the Triad. Ohmae has recently revised his view of the world; in the **expanded Triad**, the Japanese leg encompasses the entire Pacific region; the American leg includes Canada and Mexico; and the boundary in Europe is moving eastward. Coca-Cola is a perfect illustration of a company with a balanced revenue stream. Approximately one-quarter of the company's revenues are generated in Asia; another 25 percent come from Europe, Eurasia, and the Middle East. North America accounts for about 40 percent.

Marketing Implications of the Stages of Development

The stages of economic development described previously can serve as a guide to marketers in evaluating **product saturation levels**, or the percentage of potential

LESSONS from the global marketplace

Currency Crisis in Mexico

On December 20, 1994, the Bank of Mexico embarked on a course of action that sent shock waves around the world. A combination of circumstances, including a $28 billion current-account deficit, dwindling reserves, the murder of presidential candidate Donaldo Colosio, and eroding investor confidence, forced the Bank of Mexico to devalue the peso. The Clinton administration quickly arranged $20 billion in loans and loan guarantees, secured in part by some of Mexico's $7 billion in annual oil export revenues. Opponents of NAFTA—notably Ross Perot—seized the opportunity to denounce both the loans and the trade agreement. The devalued peso, critics predicted, would make U.S. exports to Mexico more expensive and reduce the $2 billion trade surplus that the United States enjoys with Mexico. NAFTA opponents also noted that increased imports of Mexican goods into the United States would constitute a new threat to U.S. jobs.

The Bank of Mexico's decision to devalue the peso meant that the Mexican currency declined nearly 40 percent relative to key currencies such as the dollar, the mark, and the yen. One immediate effect of the devaluation was a sharp decline in Mexican purchases of U.S. imports. For example, Westinghouse and Lennox had been aggressively selling air conditioners after NAFTA reduced tariffs; sales quickly slowed down after the devaluation. McDonald's, KFC, Dunkin' Donuts, and other U.S. restaurant chains were also hard hit as they were forced to raise prices. Many franchisors had contracted to pay rent for their facilities in dollars; after the devaluation, franchisors who couldn't pay the rent were forced to shut down. Simply put, the purchasing power of Mexican consumers was cut nearly in half. To reduce the risk of inflation, the Mexican government pledged to cut spending and allow interest rates to rise. Meanwhile, investors who had poured money into Mexico since the late 1980s, lured by the promise of low inflation and a stable currency, faced huge declines in the value of their holdings.

For many manufacturing companies, the weaker peso wreaked havoc with 1995 sales forecasts. GM, for example, had hoped to export 15,000 vehicles to Mexico in 1995, a goal rendered unattainable by the financial crisis. Ford raised vehicle prices in Mexico; the increases applied to vehicles built in Mexico as well as those imported from Canada and the United States. Shares of Avon Products, whose Mexican sales comprise 11 percent of the company's $4 billion in annual revenue, declined sharply on Wall Street. Hoping to calm investors' fears, company executives predicted that a decline in Mexican sales would be offset in 1995 by gains in other countries.

Supporters and opponents of NAFTA debated the long-term effects of the devaluation. Harley Shaiken, a labor professor at the University of California and NAFTA critic, noted, "It will have a dual impact: It will diminish the market for U.S. goods in Mexico, but the more sizable impact will be the transfer of production to Mexico. It's going to make Mexico less desirable as a place to sell things and far more desirable as a place to make things." Persons holding opposing views acknowledged that the devaluation cut Mexican wages in dollar terms. However, NAFTA supporters have pointed out that labor's percentage of total cost in autos and auto parts, which constitute Mexico's largest export sector, is relatively low. Despite the devaluation, NAFTA supporters denied that there would be a "giant sucking sound" caused by an exodus of U.S. jobs south of the border. In 2004, the tenth anniversary of NAFTA, policy makers and the general public were still divided. Perhaps the best assessment came from a recent report by the Carnegie Endowment of International Peace which noted, "NAFTA has been neither the disaster its opponents predicted nor the savior hailed by its supporters."

Sources: James Cox, "10 Years Ago, NAFTA Was Born," USA Today, *December 31, 2003, p. 3B; Craig Torres, "Headed South: Mexico's Devaluation Stuns Latin America—and U.S. Investors,"* The Wall Street Journal, *December 22, 1994, pp. A1, A12; "Ford Lifts Prices, Avon Tries to Calm Holders, Dina Estimates Loss as Peso Fallout Continues,"* The Wall Street Journal, *January 13, 1995; Michael Clements and Bill Montague, "Will Peso's Fall Prove Perot Right?"* USA Today, *January 17, 1995, pp. B1, B2.*

buyers or households who own a particular product. In countries with low per capita income, product saturation levels for many products are low. For example, India's teledensity—a measure of ownership of private telephones—is only about 20 percent of the population. In China, saturation levels of private motor vehicles and personal computers are quite low; there is only one car or light truck for every 43,000 Chinese, and only one PC for every 6,000 people. In Poland in 2001, there were 21 cars per 100 compared with 49 in the 15-nation European Union; in 2002, Poland had 11 PCs per 100 people. In the EU, the ratio was 34 PCs per 100 people.[29]

BALANCE OF PAYMENTS

The **balance of payments** is a record of all economic transactions between the residents of a country and the rest of the world. Table 2-5 shows the U.S. balance of payments statistics for the period 2002 to 2006. International trade data for the United

[29] Stefan Wagstyl, "The Next Investment Wave: Companies in East and West Prepare for the Risks and Opportunities of an Enlarged EU," *Financial Times,* April 27, 2004, p. 13.

Table 2-5

U.S. Balance of Payments, 2002–2006 (US$ billions)

	2002	2003	2004	2005	2006
A. Current Account	**–472,466**	**–527,514**	**–665,286**	**–791,508**	**–811,477**
1. Goods exports (BoP basis)	682,422	713,415	807,516	894,631	1,023,109
2. Goods imports (BoP basis)	–1,164,720	–1,260,717	–1,472,926	–1,677,371	–1,861,380
3. Balance on goods	*–482,298*	*–547,302*	*–665,410*	*–782,740*	*–838,271*
4. Services: Credit	292,299	302,681	344,426	380,614	422,594
5. Services: Debit	–231,069	–250,276	–290,312	–314,604	–342,845
6. Balance on services	*61,230*	*52,405*	*54,114*	*66,011*	*79,749*
7. Balance on goods and services	*–421,068*	*–494,897*	*–611,296*	*–716,730*	*–758,522*
B. Capital Account					

Source: www.bea.gov.

States is available from the U.S. Bureau of Economic Analysis (www.bea.gov); the bureau's interactive Web site enables users to generate customized reports. The International Monetary Fund's *Balance of Payments Statistics Yearbook* provides trade statistics and summaries of economic activity for all countries in the world.[30]

The balance of payments is divided into the current and capital accounts. The **current account** is a broad measure that includes **merchandise trade** (i.e., manufactured goods) and **services trade** (i.e., intangible, experience-based economic output) plus certain categories of financial transfers such as humanitarian aid. A country with a negative current account balance has a **trade deficit**; that is, the outflow of money to pay for imports exceeds the inflow of money for sales of exports. Conversely, a country with a positive current account balance has a **trade surplus**. The **capital account** is a record of all long-term direct investment, portfolio investment, and other short- and long-term capital flows. The minus signs signify outflows of cash; for example, in Table 2-6, line 2 shows an outflow of $1.86 trillion in 2006 that represents payment for U.S. merchandise imports. (Other entries not shown in Table 2-5 represent changes in net errors and omissions, foreign liabilities, and reserves.) These are the entries that make the balance of payments balance. In general, a country accumulates reserves when the net of its current and capital account transactions shows a surplus; it gives up reserves when the net shows a deficit. The important fact to recognize about the overall balance of payments is that it is always in balance. Imbalances occur in subsets of the overall balance. For example, a commonly reported balance is the trade balance on goods (line 3 in Table 2-5).

A close examination of Table 2-5 reveals that the United States regularly posts deficits in both the current account and the trade balance in goods. The United States' growing trade deficit reflects a number of factors, including increased imports from China, a seemingly insatiable consumer demand for imported goods, and the enormous cost of military operations in the Middle East. Table 2-6

Table 2-6

U.S. Goods and Services Trade with Brazil, India, and China 2005 (US$ billions)

	China	India	Brazil
1. U.S. goods exports to	41,799	7,972	15,174
2. Goods imports from	–243,472	–18,803	–24,434
3. Balance on goods	*–201,673*	*–10,831*	*–9,260*
4. U.S. services exports to	9,105	5,152	5,871
5. Services imports from	–6,537	–3,571	–2,097
6. U.S. balance on services	*2,568*	*1,581*	*3,774*
7. U.S. balance on goods and services	*–199,105*	*–9,250*	*–5,486*

Source: www.bea.gov.

[30] Balance of payments data are available from a number of different sources, each of which may show slightly different figures for a given line item.

shows a record of goods and services trade between the United States and Brazil, India, and China for 2005. A comparison of lines 4 and 5 in the two tables shows a bright spot from the U.S. perspective: The United States has maintained services trade surplus with the rest of the world. Overall, however, the United States posts balance of payments deficits while important trading partners, such as China, have surpluses. China offsets its trade surpluses with an outflow of capital, while the United States offsets its trade deficit with an inflow of capital. As trading partners, U.S. consumers and businesses own an increasing quantity of foreign products, while foreign investors own more U.S. land, real estate, and government securities. Foreign-owned U.S. assets total $2.5 trillion; in 2005, the United States borrowed 6 percent of its output in goods and services from foreign countries.[31] Some policy makers in Washington are becoming alarmed about the U.S. trade deficit with China, which reached $200 billion in 2005.

TRADE IN MERCHANDISE AND SERVICES

Thanks in part to the achievements of GATT and the WTO, world merchandise trade has grown at a faster rate than world production since the end of World War II. Put differently, import and export growth has outpaced the rate of increase in GNP. According to figures compiled by the WTO, the dollar value of world trade in 2004 totaled $11 trillion. In 2004, GNP increased at an average rate of 3.7 percent; by contrast, the volume of merchandise exports increased by about 9 percent. The top exporting and importing countries are shown in Table 2-7. In 2003, Germany surpassed the United States as the world's top merchandise exporter. German manufacturers of all sizes have benefited from global economic growth because they provide the motors, machines, vehicles, and other capital goods that are required to build factories and country infrastructures; worldwide, machinery and transport equipment constitute approximately one-third of global exports. Today, exports generate 40 percent of Germany's GDP, and 9 million jobs are export related. In addition, annual sales by the foreign subsidiaries of German-based companies are $1.5 billion.[32]

China's third place in the export rankings underscores its role as an export powerhouse. Even in the face of Asia's economic downturn in the late 1990s and the SARS outbreak, China demonstrated continued economic strength by achieving double-digit export growth. Chinese exports to the United States have surged since

Table 2-7

Top Exporters and Importers in World Merchandise Trade, 2004 (US$ billions)

Leading Exporters	2004	Leading Importers	2004
1. Germany	912	1. United States	1,526
2. United States	819	2. Germany	717
3. China	593	3. China	561
4. Japan	566	4. France	466
5. France	449	5. Great Britain	464
6. Netherlands	358	6. Japan	455
7. Italy	349	7. Italy	351
8. Great Britain	347	8. Netherlands	319
9. Canada	317	9. Belgium	286
10. Belgium	307	10. Canada	280

Source: WTO Publications.

31 David Wessel, "Counting on a Miracle with U.S. Debt," *The Wall Street Journal*, September 29, 2005, p. A2.
32 Bertrand Benoit and Richard Milne, "Germany's Best-Kept Secret: How Its Exporters Are Beating the World," *Financial Times*, May 19, 2006, p. 11.

Table 2-8

Top Exporters and Importers in World Merchandise Trade, 2004 (percentage of total)

Leading Exporters	2004	Leading Importers	2004
1. European Union	18.1	1. United States	21.8
2. United States	12.3	2. European Union	18.3
3. China	8.9	3. China	8.0
4. Japan	8.5	4. Japan	6.9
5. Canada	4.8	5. Canada	4.0
6. South Korea	3.8	6. South Korea	3.2
7. Mexico	2.8	7. Mexico	3.0
8. Russia	2.8	8. Taiwan	2.4
9. Taiwan	2.7	9. Switzerland	1.6
10. Malaysia	1.9	10. Australia	1.6

Source: WTO Publications.

China joined the WTO in 2001; in fact, policy makers in Washington are pressuring Beijing to boost the value of the yuan in an effort to stem the tide of imports.

Table 2-8 provides a different perspective on global trade. The EU is treated as a single entity with imports and exports that exclude intraregional trade among the 25 nations that were EU members at the end of 2006. South Korea, Mexico, and Russia appear in the top 10 exporter rankings; South Korea and Mexico also rank in the top 10 importers table. Figures are cited as a percentage of the world total.

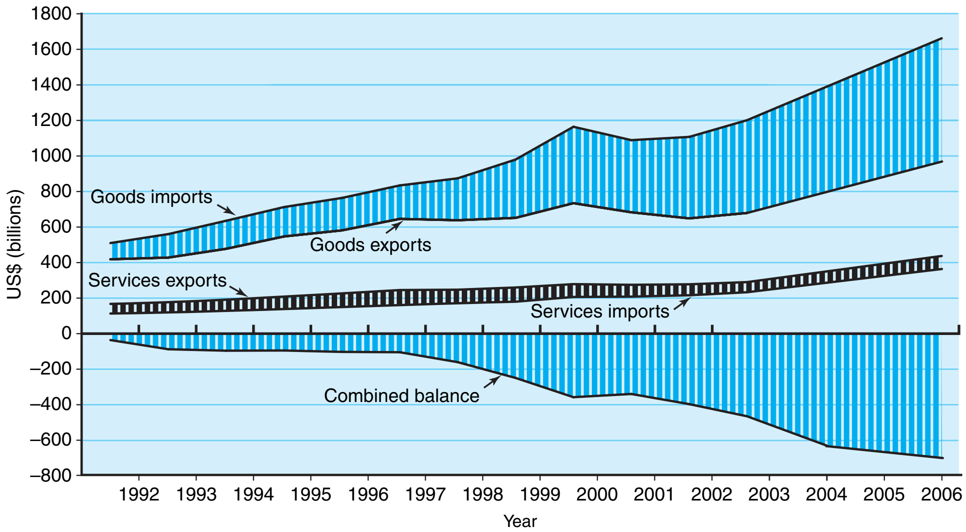
The fastest-growing sector of world trade is trade in services. Services include travel and entertainment; education; business services such as engineering, accounting, and legal services; and payments of royalties and license fees. One of the major issues in trade relations between the high- and lower-income countries is trade in services. As a group, low-, lower-middle, and even upper-middle-income countries are lax in enforcing international copyrights and protecting intellectual property and patent laws. As a result, countries that export service products such as computer software, music, and video entertainment suffer a loss of income. According to a recent Global Software Piracy Study conducted by the Business Software Association, annual worldwide losses due to software piracy amount to approximately $29 billion. In China alone, software piracy cost the industry an estimated $3.6 billion in lost sales in 2005.

The United States is a major service trader. As shown in Figure 2-2, U.S. services exports in 2006 totaled $422 billion. This represents more than one-quarter of total U.S. exports. The U.S. services surplus (service exports minus imports) stood at $80 billion. This surplus partially offset the U.S. merchandise trade deficit,

Figure 2-2

U.S. Trade Balance on Services and on Merchandise Trade (US$ billions)

Source: U.S. Census Bureau.



which reached $658 billion in 2006. American Express, Walt Disney, IBM, and Microsoft are a few of the U.S. companies currently enjoying rapid growth in demand for their services around the world.

OVERVIEW OF INTERNATIONAL FINANCE

Foreign exchange makes it possible for a company in one country to conduct business in other countries with different currencies. However, foreign exchange is an aspect of global marketing that involves certain financial risks, decisions, and activities that are completely different than those facing a domestic marketer. Moreover, those risks can be even higher in developing markets such as Thailand, Malaysia, and South Korea. When a company conducts business within a single country or region with customers and suppliers paying in the same currency, there is no exchange risk. All prices, payments, receipts, assets, and liabilities are in the given currency. However, when conducting business across boundaries in countries with different currencies, a company is thrust into the turbulent world of exchange risk.

The foreign exchange market consists literally of a buyer's and a seller's market where currencies are traded for both spot and future delivery on a continuous basis. The *spot* market is for immediate delivery; the market for future delivery is called the *forward* market. This is a true market where prices are based on the combined forces of supply and demand that come into play at the moment of any transaction. Who are the participants in this market? First, a country's central bank can buy and sell currencies in the foreign exchange market and government securities in an effort to influence exchange rates. For example, in the five-year period between 2001 and 2006, China bought more than $250 billion in U.S. Treasury bonds. Such purchases help ensure that China's currency is relatively weak compared to the U.S. dollar.[33] Second, some of the trading in the foreign exchange market takes the form of transactions needed to settle accounts for the global trade in goods and services. For example, because Porsche is a German company, the dollars spent on Porsche automobiles by American car buyers must be converted to euros. Finally, currency speculators also participate in the foreign exchange market.

Devaluation can result from government action that decrees a reduction in the value of the local currency against other currencies. In 1994, for example, the Chinese devalued the yuan (also known as *renminbhi* or "people's money"). The immediate result was to ensure the low-cost position of Chinese exporters. However, the action also set the stage for the 1997 devaluations of the Thai baht, Malaysian ringgit, and Indonesian rupiah; the expression "beggar thy neighbor" is sometimes used to describe devaluations designed to increase export competitiveness.

To the extent that a country sells more goods and services abroad than it buys, there will be a greater demand for its currency and a tendency for it to appreciate in value—unless government policy makers do not allow the currency to fluctuate. In 2005, the Chinese government responded to pressure from its trading partners by adopting a policy of **revaluation** to strengthen the yuan against the dollar and other currencies. A stronger yuan would make China's exports to the United States more expensive while making U.S. exports to China less expensive. The net result would be a reduction in China's trade surplus with the United States. The initial 2.1 percent increase in the yuan's value was not expected to have much impact on prices; some experts believe the yuan is undervalued by 20 percent or more (see Case 2-2).[34]

Table 2-9 shows how fluctuating currency values can affect financial risk, depending on the terms of payment specified in the contract. Suppose, at the time

[33] Mark Whitehouse, "U.S. Foreign Debt Shows Its Teeth as Rates Climb," *The Wall Street Journal*, September 25, 2006, p. A9.
[34] Sue Kirchhoff, "First Step: China Will Stop Pegging Yuan to Dollar," *USA Today*, July 22, 2005, pp. 1b, 2B.

Table 2-9

Exchange Risks and Gains in Foreign Transactions

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

a deal is made, the exchange rate is €1.10 equals $1.00. How is a U.S. exporter affected if the dollar strengthens against the euro (e.g., trades at €1.25 equals $1.00) and the contract specifies payment in dollars? What happens if the dollar weakens (e.g., €0.85 equals $1.00)? Conversely, what if the European buyer contracts to pay in euros rather than dollars?

Purchasing Power Parity

Given that currencies fluctuate in value, a reasonable question to ask is whether a given currency is over- or undervalued compared with another. Recall from the previous discussion that the currency's value could reflect government policy (as in the case of China) or market forces. One way to answer the question is to compare world prices for a single well-known product: McDonald's Big Mac hamburger. The so-called Big Mac Index is a "quick and dirty" way of determining which of the world's currencies are too weak or strong. The underlying assumption is that the price of a Big Mac in any world currency should, after being converted to dollars, equal the price of a Big Mac in the United States. (Similar indexes have been proposed based on the price of Starbucks coffee and IKEA furniture). A country's currency would be overvalued if the Big Mac price (converted to dollars) is higher than the U.S. price. Conversely, a country's currency would be undervalued if the converted Big Mac price is lower than the U.S. price. Economists use the concept of **purchasing power parity (PPP)** when adjusting national income data to improve comparability. Table 2-10 shows the Big Mac Index for selected countries in 2006. The first column of figures shows the price of a Big Mac converted from the local currency to dollars at the prevailing exchange rate on May 22, 2006. Thus, we can see that the Chinese yuan is undervalued against the dollar by about 58 percent. In other words, based on the U.S price for a Big Mac, the yuan/dollar exchange rate ought to be ¥3.39/$1.00 rather than ¥8.03 to $1.00.[35] India is not included in the index. Can you explain why?

Table 2-10

The 2006 Big Mac Index

Country	Big Mac Price Converted to $	Official Exchange Rate	Over- or Undervaluation of Local Currency (%)
Switzerland	5.21	1.21/$1.00	+68
Euro zone	3.77	1.28/$1.00	+22
United States	3.10	—	—
Brazil	2.78	2.30/$1.00	–10
Japan	2.23	112.00/$1.00	–28
Russia	1.77	27.10/$1.00	–43
China	1.31	8.03/$1.00	–58

Source: Adapted from "McCurrencies," *Economist,* May 27, 2006.

[35] The authors acknowledge that the PPP theory-based-Big Mac Index is simplistic; as noted in this section, exchange rates are also affected by interest rate differentials and monetary and fiscal policies—not just prices.

Economic Exposure

Economic exposure refers to the impact of currency fluctuations on the present value of a company's expected future cash flows. Economic exposure can occur when a company's transactions result in sales or purchases denominated in foreign currencies. Diageo, for example, faces transaction exposure to the extent that it accepts payment for exports of Scotch whiskey at one exchange rate but actually settles its accounts at a different rate of exchange.[36] Economic exposure is directly proportional to the amount of business a company conducts outside the home market. Obviously, currency exposure is a critical issue for Nestlé, with 98 percent of annual sales taking place outside Switzerland. Among countries in the euro zone, GlaxoSmithKline, DaimlerChrysler, BP, Sanofi-Aventis, Royal Dutch Shell, Astra Zeneca, and SABMiller all generate more than one-third of total sales in the U.S. market. Given the current weakness of the dollar relative to the euro, all of these companies face potential economic exposure. By comparison, GE generates about 50 percent of its revenues in the domestic United States market, so the relative extent of GE's exposure is less than that of Nestlé. Even so, as noted in its annual report, GE does face economic exposure:

> When countries or regions experience currency and/or economic stress, we often have increased exposure to certain risks, but also often have new profit opportunities. Potential increased risks include, among other things, high receivable delinquencies and bad debts, delays or cancellations of sales and orders principally related to power and aircraft equipment, higher local currency financing costs and slowdown in established financial services activities.[37]

In dealing with the economic exposure introduced by currency fluctuations, a key issue is whether the company can use price as a strategic tool for maintaining its profit margins. Can the company adjust prices in response to a rise or fall of foreign exchange rates in various markets? That depends on the price elasticity of demand. The less price sensitive the demand, the greater the flexibility a company has in responding to exchange rate changes. In the late 1980s, for example, Porsche raised prices in the United States three times in response to the weak dollar. The result: Porsche's U.S. sales dropped precipitously, from 30,000 vehicles in 1986 to 4,500 vehicles in 1992. Clearly, U.S. luxury car buyers were exhibiting elastic demand curves for pricey German sports cars!

Managing Exchange Rate Exposure

It should be clear from this discussion that the difficulty of accurately forecasting exchange rate movements is a major challenge to global marketers. Over the years, the search for ways of managing cash flows to eliminate or reduce exchange rate risks has resulted in the development of numerous techniques and financial strategies. For example, it may be desirable to sell products in the company's home country currency. When this is not possible, techniques are available to reduce both transaction and operating exposure.

Hedging exchange rate exposure involves establishing an offsetting currency position such that the loss or gain of one currency position is offset by a corresponding gain or loss in some other currency. The practice is common among global companies that sell products and maintain operations in different countries. Today, for example, Porsche relies on currency hedging rather than price increases to boost pretax profits on sales of its automobiles. Porsche manufactures all its cars in Europe but generates about 45 percent of its sales in the United

[36] John Willman, "Currency Squeeze on Guinness," *Financial Times–Weekend Money* (September 27–28, 1997), p. 5.
[37] *General Electric 2004 Annual Report*, p. 58.

States. Thus, Porsche faces economic exposure stemming from the relative value of the dollar to the euro. Porsche is *fully hedged*; that is, it takes currency positions to protect all earnings from foreign-exchange movements.[38]

If company forecasts indicate that the value of the foreign currency will weaken against the home currency, it can hedge to protect against potential transaction losses. Conversely, for predictions that the foreign currency will appreciate (strengthen) against the home currency, then a gain, rather than a loss, can be expected on foreign transactions when revenues are converted into the home currency. Given this expectation, the best decision may be not to hedge at all. (The operative word is *may*; many companies hedge anyway unless management is convinced the foreign currency will strengthen.) Porsche has profited by (correctly) betting on a weak dollar.

External hedging methods for managing both transaction and translation exposure require companies to participate in the foreign currency market. Specific hedging tools include forward contracts and currency options. *Internal hedging methods* include price adjustment clauses and intracorporate borrowing or lending in foreign currencies.

The **forward market** is a mechanism for buying and selling currencies at a preset price for future delivery. If it is known that a certain amount of foreign currency is going to be paid out or received at some future date, a company can insure itself against exchange loss by buying or selling forward. With a forward contract, the company can lock in a specific fixed exchange rate for a future date and immunize itself from the loss (or gain) caused by the exchange rate fluctuation. By consulting sources such as *Financial Times*, *The Wall Street Journal*, or www.ozforex.com, it is possible to determine exchange rates on any given day. In addition to spot prices, 30-, 60-, and 180-day forward prices are quoted for dozens of world currencies.

Companies use the forward market when the currency exposure is known in advance (e.g., when a firm contract of sale exists). In some situations, however, companies are not certain about the future foreign currency cash inflow or outflow. Consider the risk exposure of a U.S. company that bids for a foreign project but won't know if the project will be granted until sometime later. The company needs to protect the dollar value of the contract by hedging the *potential* foreign currency cash inflow that will be generated if the company turns out to be the winning bidder. In such an instance, forward contracts are not the appropriate hedging tool.

A foreign currency **option** is best for such situations. A **put option** gives the buyer the right, not the obligation, to sell a specified number of foreign currency units at a fixed price, up to the option's expiration date. (Conversely, a **call option** is the right, but not the obligation, to buy the foreign currency.) In the example of bidding on the foreign project, the company can take out a put option to sell the foreign currency for dollars at a set price in the future. In other words, the U.S. company locks in the value of the contract in dollars. Thus, if the project is granted, the future foreign currency cash inflow has been hedged by means of the put option. If the project is *not* granted, the company can trade the put option in the options market without exercising it; remember, options are rights, not obligations. The only money the company stands to lose is the difference between what it paid for the option and what it receives upon selling it.

Financial officers of global firms can avoid economic exposure altogether by demanding a particular currency as the payment for its foreign sales. As noted, a U.S.-based company might demand U.S. dollars as the payment currency for its foreign sales. This, however, does not eliminate currency risk; it simply shifts that risk to the customers. In common practice, companies typically attempt to invoice exports (receivables) in strong currencies and imports (payables) in weak currencies. However, in today's highly competitive world market, such practice may reduce a company's competitive edge.

[38] Stephen Power, "Porsche Powers Profit with Currency Play," *The Wall Street Journal*, December 8, 2004, p. C3.

summary

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

Countries can be categorized in terms of their stage of economic development: **low income, lower-middle income, upper-middle income,** and **high income. Gross domestic product** (**GDP**) and **gross national income** (**GNI**) are commonly used measures of economic development. The fifty poorest countries in the low-income category are sometimes referred to as **least-developed countries** (LDCs). Upper-middle-income countries with high growth rates are often called **newly industrializing economies** (NIEs). Several of the world's economies are notable for their fast growth; the **BRIC** nations include Brazil (lower-middle income), Russia (upper-middle income), India (low income), and China (lower-middle income).

The **Group of Seven (G-7), Group of Eight (G-8),** and **Organization for Economic Cooperation and Development (OECD)** represent efforts by high-income nations to promote democratic ideals and free-market policies throughout the rest of the world. Most of the world's income is located in the **Triad**, which is comprised of Japan, the United States, and Western Europe. Companies with global aspirations generally have operations in all three areas. Market potential for a product can be evaluated by determining **product saturation levels** in light of income levels.

A country's **balance of payments** is a record of its economic transactions with the rest of the world; this record shows whether a country has a **trade surplus** (value of exports exceeds value of imports) or a **trade deficit** (value of imports exceeds value of exports). Trade figures can be further divided into **merchandise trade** and **services trade** accounts; a country can run a surplus in both accounts, a deficit in both accounts, or a combination of the two. The U.S. merchandise trade deficit was $780 billion in 2005. However, the United States enjoys an annual service trade surplus. Overall, the United States is a debtor; Japan enjoys an overall trade surplus and serves as a creditor nation.

Foreign exchange provides a means for settling accounts across borders. The dynamics of international finance can have a significant impact on a nation's economy as well as the fortunes of individual companies. Currencies can be subject to **devaluation** or **revaluation** as a result of actions taken by a country's central bank. Currency trading by international speculators can also lead to devaluation. When currency values fluctuate, global firms face various types of economic exposure. Firms can manage exchange rate exposure by **hedging**.

discussion questions

1. Explain the difference between **market capitalism**, **centrally planned capitalism**, **centrally planned socialism**, and **market socialism**. Give an example of a country that illustrates each type of system.
2. Why are Brazil, Russia, India, and China (BRIC) highlighted in this chapter? Identify the current stage of economic development for each BRIC nation.
3. Turn to the Index of Economic Freedom (Table 2-3) and identify where the BRIC nations are ranked. What does the result tell you in terms of the relevance of the index to global marketers?
4. A manufacturer of satellite dishes is assessing the world market potential for his products. He asks you if he should consider developing countries as potential markets. How would you advise him?
5. A friend is distressed to learn that America's merchandise trade deficit hit a record $780 billion in 2005. You want to cheer your friend up by demonstrating that the trade picture is not as bleak as it sounds. What do you say?

build your global marketing skills

1. The BRIC countries (Brazil, Russia, India, and China) discussed in this chapter are frequently in the news. Choose one of the countries to study during the semester; keep a current events journal with notes or pasted-up articles from the press. What economic issues identified in the chapter continue to affect trade prospects in your country? What new issues, if any, have developed?

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

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

Use the seven criteria found on pp. 44–45 to develop a profile of one of the BRIC nations, or any other country that interests you. How does this profile impact marketing opportunities in the country?

sharpen your critical thinking skills

1. The Heritage Foundation's *Index of Economic Freedom* is not the only ranking that assesses countries in terms of successful economic policies. For example, the World Economic Forum (WEF; www.weforum.org) publishes an annual *Global Competitiveness Report*; in the 2006–2007 report, the United States ranks in sixth place according to the WEF's metrics. By contrast, Sweden is in third place. According to the *Index of Economic Freedom*'s rankings, the United States and Sweden are in tenth place and nineteenth place, respectively. Why are the rankings so different? What criteria does each index consider?

web resources

Economist magazine's Web site offers briefings on more than 60 countries representing all stages of development at:

www.economist.com/countries

The U.S. Census Bureau compiles data on U.S. trade and makes it available on the Web. You can find this data under the headings "FT900" and "Supplement" at:

www.census.gov/foreign-trade/www

The United States Bureau of Economic Analysis posts a great deal of information about the U.S. economy. You can access the database at:

www.bea.doc.gov

suggested reading

C. K. Prahalad, *The Fortune at the Bottom of the Pyramid: Eradicating Poverty Through Profits* (Philadelphia: Wharton Press, 2006). The book includes a 35 minute video CD with case studies from India, Brazil, and other emerging markets.

Case 2-1

From Communism to Capitalism: Vietnam's Economic Transformation

In October 2001, U.S. President George Bush signed an agreement that created a U.S.-Vietnam free trade area. The signing marked yet another milestone along Vietnam's path toward a more open market, the timeline for which includes the following:

- In February 1994, U.S. President Bill Clinton ended America's 19-year economic embargo of Vietnam and opened the door for U.S. companies to target the world's twelfth most populous country.
- In July 1995, President Clinton reestablished diplomatic relations with Vietnam. In the absence of diplomatic relations, many Vietnamese manufactured exports to the United States faced prohibitive tariffs.
- In 1995, Vietnam joined the Association of Southeast Asian Nations (ASEAN).
- In 1998, the White House announced that it would exempt Vietnam from the Jackson-Vanik amendment. The exemption meant that, pending congressional approval, American companies investing in Vietnam could apply for financial assistance from the Overseas Private Investment Corporation (OPIC) and the Export-Import Bank.
- In July 2000, U.S. President Bill Clinton signed a trade pact with Vietnam.
- The Asia-Pacific Economic Cooperation (APEC) Summit was held in Hanoi in November 2006.
- Vietnam joined the WTO in 2007.

After being ratified by Congress, President Clinton's actions in the mid-1990s established normal trading relations (NTR) between the two countries. In particular, Vietnam benefited from an immediate lowering of duties on a number of goods produced by its light industry sector (see Figure 1). Vietnamese tariffs and quotas on imports from the United States would be lowered more gradually. A number of U.S. companies immediately seized the opportunity. As Brian Watson, a Hong Kong-based deputy regional director for the McCann-Erickson advertising agency, said in the mid-1990s, "Vietnam is the next great frontier. There is an enormous amount of interest among clients. Every meeting starts with a question about going into Vietnam."

While the U.S. business community hailed the U.S. government's initiatives, many American firms found themselves playing catch up; by the early 1990s, many non-U.S. global companies had preceded the Americans into Vietnam. For example, South Korean industrial giant Daewoo was a key investor; other companies with major commitments included Sony, Toshiba, Honda, Peugeot, and British Petroleum. Carrier was among the first U.S. companies to legally market in Vietnam in 1994; the company's window air conditioners appeared in stores in Hanoi and

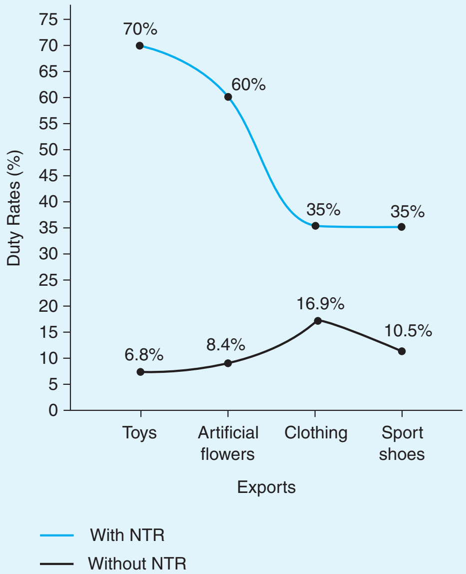


Figure 1

Duty Rates Vietnamese Exports to the United States with and Without NTR

Source: Vietnam Economic Times.

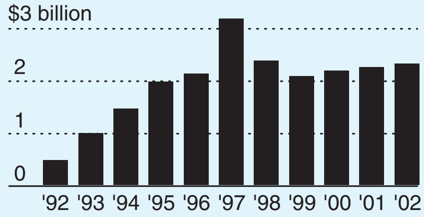


Figure 2

Foreign Direct Invesment in Vietnam, 1992–2002

Ho Chi Minh City. Gillette began shipping razor blades and disposable razors, and AT&T began selling home and office telephone products through a distributor in Taiwan. ExxonMobil began exploring for oil, Caterpillar set up equipment-leasing operations, and the Otis Elevator division of United Technologies joined in the construction boom. J.Walter Thompson, Ogilvy & Mather, and Backer Spielvogel Bates Worldwide became the first Western ad agencies to open liaison offices in Vietnam.

In view of the fact that 60 percent of Vietnam's population is under the age of 25, it is no surprise that PepsiCo and the Coca-Cola Company were also quick to make moves in Vietnam. At the time of the official announcement about ending the embargo, McCann-Erickson had already produced a TV commercial for Coca-Cola that included the global slogan "Always"; likewise, Ogilvy & Mather had a Pepsi ad ready for TV. Coca-Cola is building a $20 million bottling plant outside of Hanoi, but was denied permission to build in Ho Chi Minh City (formerly Saigon). Pepsi's joint venture with a Vietnamese firm in Ho Chi Minh City is bottling Pepsi; local production began within hours of President Clinton's 1994 announcement. To supply the market in the south, Coca-Cola imported canned soda from Singapore. As a result, a can of Coke costs twice as much as a bottle of Pepsi.

Experts agree that the Vietnamese market holds tremendous potential over the long term. It may be two decades before Vietnam reaches the level of economic development found in Thailand today. Meanwhile, the country's location in the heart of Asia and the presence of an ample low-wage workforce are powerful magnets for foreign companies. By the end of 1999, France ranked first in foreign investment while Japan was the top trading partner. Overall foreign direct investment peaked at about $3.1 billion in 1997 after rising steadily since the early 1990s (see Figure 2). After falling to about $2.1 billion in 1999, investment rebounded to $2.3 billion in 2002. As encouraging as those figures are, however, investment levels in China are much higher.

There are still many challenges for companies seeking to invest in Vietnam. The population is very poor, with a 2004 annual per capita GNI of only about $540. However, urbanites with savings estimated at $1 billion to $2 billion comprise one quarter of the population. The infrastructure is undeveloped: Only 10 percent of roads are paved, electricity sources are unreliable, there is less than one telephone per 100 people, and the banking system is undeveloped. The Communist Party of Vietnam (CPV) is struggling to adapt to the principles of a market economy, and the layers of bureaucracy built up over decades of communist rule slow the pace of change. A key agency is the State Committee for Cooperation and Investment (SCCI); as Vu Tien Phuc, a deputy director of the agency, explained, "Every authority would like to have the last say. We have to improve the investment climate." William Ratliff, an analyst with the Hoover Institute, points out that the question for Vietnam is "whether it's possible to carry on free-market reforms and maintain absolute political power."

Yvonne Gupwell, a business consultant who was born in Vietnam, believes that "The biggest mistake companies make is they think because the Vietnamese are so polite, they're a little bit dim. The Vietnamese are poor, but they are not mentally poor at all." Statistics support this view; for example, adult literacy is nearly 90 percent. An emerging entrepreneurial class has developed a taste for expensive products such as Nikon cameras and Ray Ban sunglasses, both of which are available in stores. Notes Do Duc Dinh of the Institute on the World Economy, "There is a huge unofficial economy. For most people, we can live only 5 days or 10 days a month on our salary. But people build houses. Where does the money come from? Even in government ministries, there are two sets of books—one for the official money and one for unofficial."

"In 1996, you were told where to invest, and you also had to build the road, the school, the hospital. You said, 'Thank you very much; my new address is Malaysia.' "

A foreign businessman in Vietnam

Euphoria over Vietnam's potential showed signs of waning at the end of the 1990s. Part of the problem was the "currency contagion" that struck Asia in mid-1997; Asian countries that had been major investors were forced to scale back their activities in Vietnam. More generally, many companies were finding it difficult to make a profit. Cross-border smuggling from Thailand depressed legitimate sales of products produced locally by Procter & Gamble, Unilever, American Standard, and other companies. Foreign companies were also frustrated by the shallow pool of qualified local managers. It was also clear that China was attracting a great deal of foreign investment away from other countries in the region.

Today, many companies are discovering that Vietnam is an excellent source of low-cost labor. Burgeoning apparel and textile exports to the United States led to an agreement on export quotas in 2003. The fledgling tech sector also appears to hold great promise. Vietnam's universities turn out graduates who are highly trained in information technology. One company, Glass Egg Digital Media, provides software-writing services to leading global video game developers such as France's Infogames and U.S.-based Electronic Arts. Glass Egg founder Phil Tran pays programmers annual salaries of about $4,000, tens of thousands less than programmers in the United States are paid.

Although still strongly influenced by Communist hard-liners, the bureaucrats in Hanoi have demonstrated an increased willingness to adopt much-needed reforms to foreign investment laws. In January 2000, for example, the regulatory environment improved with the enactment of an enterprise law that streamlined the process of market entry and setting up a business; a stock market was also opened. Increasingly, decisions about foreign investment are being made at the provincial level, and local officials are offering incentives and issuing import licenses more quickly. Investors in many industry sectors are now able to set up wholly foreign-owned firms; previously, the government rarely approved such arrangements. Instead, foreign companies were encouraged to form joint ventures with state-owned enterprises. The improved investment climate helps explain why a number of foreign automakers, including Ford, GM, Toyota, and DaimlerChrysler, have established operations in Vietnam. Noted one local businessman approvingly, "In the past, it was absolutely horrendous to set up a private company. Now, 99 percent of the difficulties are gone."

> *"The reform is definitely irreversible. Any attempt to come back to a centrally planned economy, to overplay the state sector, is economically irrational, inefficient and, psychologically, is counterproductive."*
>
> Le Dang Doanh, advisor to the Vietnam government

Vietnam's free trade area agreement with the United States entered into force in December 2001. The effect was immediate: The value of U.S. imports from Vietnam more than doubled in 2002, to nearly $2.4 billion. At the end of 2003, the two nations signed an air services agreement that will make it easy for travelers to book flights to Vietnam. The agreement comes as Vietnam's government is marketing the country as an attractive vacation destination. Despite such positive news, however, many problems remain. For example, Vietnam's legal system is still bewildering, and regulations can change on a moment's notice. Relations between the new trading partners have shown some signs of strain, as evidenced by U.S. charges that Vietnam has been dumping catfish in the U.S. market at artificially low prices.

Visit the Web site
www.vietnam-ustrade.org

Discussion Questions

1. Assess the market opportunities in Vietnam for both consumer-products companies and industrial-products companies. What is the nature of the opportunity?
2. Nike and several other well-known American companies are sourcing some of their production in Vietnam, thereby taking advantage of a labor force that is paid the equivalent of $2 per day or less. Are goods labeled "Made in Vietnam" likely to find widespread acceptance among American consumers?
3. Some critics have argued that Cuba is more deserving of diplomatic and trade relations with the United States than Vietnam. What are some of the factors behind this argument?

An excellent video overview is found in "Visions of a New Vietnam." The progam was originally aired on the Nightly Business Report; we recommend viewing the DVD in conjunction with the case discussion.

Sources: Keith Bradsher, "Vietnam's Roaring Economy Is Set for World Stage," *The New York Times,* October 25, 2006, pp. A1, C4; Joseph Erlich, "Vietnam's Trade-War Wounds," *The Wall Street Journal,* August 26, 2005, p. A10; Dan Reed, "Ex-Enemies Make a Deal," *USA Today,* December 9, 2003, p. 5B; Reginald Chua and Margot Cohen, "Vietnamese Tiger Growls Again; Investors Want a Change of Stripes," *The Wall Street Journal,* March 13, 2003, p. A10; Margot Cohen, "Foreign Investors Take New Look at Vietnam and Like What They See," *The Wall Street Journal,* January 28, 2003, pp. A14; Amy Kamzin, "Vietnam's Change of Heart," *Financial Times,* August 28, 2002, p. 13; Bruce Knecht, "Vietnam Taps Videogame Talent," *The New York Times,* October 21, 2001, p. B5; Frederik Balfour, "Back on the Radar Screen," *Business Week,* November 20, 2000, pp. 56–57; Wayne Arnold, "Clearing the Decks for a Trade Pact's Riches," *The New York Times,* August 27, 2000, Section 3, pp. 1, 12; Samantha Marshall, "Vietnam Pullout: This Time, Investors Pack Up Gear, Stymied by Bureaucracy, Lack of Reforms," *The Wall Street Journal,* June 30, 1998, p. A15; Marshall, "P&G Squabbles with Vietnamese Partner," *The Wall Street Journal,* February 27, 1998, p. A10; Reginald Chua, "Vietnam Frustrate Foreign Investors as Leaders Waffle on Market Economy," *The Wall Street Journal,* November 25, 1996, p. A10; "Vietnam," *Economist,* July 8, 1995, pp. 1–18 (survey); William J. Ardrey, Anthony Pecotich, and Clifford J. Schultz, "American Involvement in Vietnam, Part II: Prospects for U.S. Business in a New Era, "*Business Horizons* 38 (March/April 1995), pp. 21–27; Edward A. Gargan, "For U.S. Business,

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Case 2-2

Is China's Currency Too Strong?

In July 2005, the Peoples Bank of China announced the end of a 10-year effort to peg the value of the Chinese currency, the yuan, to the value of the U.S. dollar. Instead, the yuan would be linked to a basket of several foreign currencies. The announcement signaled Beijing's decision to abandon a policy of fixed exchange rates, according to which 8.28 yuan equaled $1, and adopt a policy of flexible rates. In short, by ending the peg, China's central bank was finally allowing the yuan to float.

The United States and other key trading partners had been urging such an action for years. *The New York Times* called the Chinese central bank's decision "the most hotly anticipated event for the foreign-exchange world in years." Many economists believed that the yuan had been undervalued relative to the dollar and other currencies by as much as 40 percent, and this weakness was cited as one of the factors contributing to growing trade deficits with China. For example, the U.S. trade deficit with China was more than $200 billion in 2006. This had occurred, it was argued, because the Chinese government had deliberately manipulated its currency to give Chinese exports a price advantage compared to goods from the United States and other countries.

Some observers favored a quick change in the yuan's value; others argued for a go-slow, gradualist approach. The immediate result of the revaluation was a 2.1 percent increase in the yuan's value, to 8.11 yuan equals $1. The stronger yuan was expected to have a ripple effect on the economies of China's top trading partners. For one thing, it was likely to result in increased prices for Chinese exports to the United States and elsewhere. This would be good news to some of the 12,000 members of the National Association of Manufacturers (N.A.M.). Many small factory owners in the United States are worried about competing with low-priced Chinese goods. However, a stronger yuan could be bad news for Wal-Mart and other retailers that buy billions of dollars worth of goods from China each year. Likewise, American-based global companies such as Whirlpool that source manufactured goods in China might be forced to raise prices.

By mid-2007, the yuan had appreciated about 8.5 percent against the dollar. However, that was not enough to satisfy some policymakers. Impatient with the slow pace of the revaluation, some members of the U.S. Congress introduced legislation designed to punish China for its currency policy. One bill, co-sponsored by Senate Finance Chairman Max Baucus, a democrat, and Charles Grassley, the Republican Senator from Iowa, was contingent on the U.S. Treasury Department determining that a "currency misalignment" had occurred. Following such a finding, the United States would impose fines in the form of antidumping penalties and the Chinese government would have six months to make the required currency adjustments. If China didn't take action, the U.S. trade representative would request dispute settlement at the WTO. A final ruling would be issued in 2010.

The introduction of the Congressional bill raised several questions. For example, it was unclear whether a dispute involving currency issues was a legitimate trade issue that the WTO would agree to hear. Another issue was whether it was possible to determine exactly how much the yuan would have to appreciate for it to be fairly aligned with the dollar.

Some observers warned that the Baucus-Grassley bill and others like it could undermine the trade relationship between the United States and China and actually harm U.S. companies that do business with China. Since joining the WTO in 2001, China has become America's fourth-largest export market. According to a study by the American Chamber of Commerce in China, American companies sold $61 billion worth of goods to China in 2005. Chamber chairman James Zimmerman noted, "A revalued yuan will not force the Chinese to buy American goods and services." Others warned that Chinese companies could diversify their export base by expanding trade with other countries. A trade war was another possibility. Scott Miller, director of trade policy for Procter & Gamble, said, "You can't rule out a backlash. That ought to be part of the calculus that lawmakers should consider." Some observers raised concerns that, in retaliation for trade sanctions, China might restrict market access for American goods.

Discussion Questions

1. Consumer goods, including shoes and electronics, represent about 80 percent of U.S. imports from China. American consumers have saved an estimated $600 billion over the past 10 years by buying inexpensive Chinese goods. If the Chinese government revalues the yuan by 20 percent or more and American consumers pay higher prices, is this a desirable outcome?
2. Protectionist sentiments in the United States are fueled by the argument that China is to blame for the flood of imports, the giant U.S. current account deficit, and downward pressure on wages in some industries. Do you agree?

3. Do you think an aggressive legislative posture with respect to China's currency is the best approach for any trade partner to take?

Sources: John McCary and Andrew Batson, "Punishing China: Will It Fly?" *The Wall Street Journal*, June 23–24, 2007, p. A4; Wu Yi, "It's Win-Win on U.S. China Trade," *The Wall Street Journal*, May 17, 2007, p. A21; Martin Wolf, "How China Has Managed to Keep the Renminbi Pinned Down," *Financial Times*, October 11, 2006, p. 13; E. S. Browning, "Yuan Move Might Stir Big Ripples," *The Wall Street Journal*, July 25, 2005, pp. C1, C4; Sue Kirchhoff, "First Step: China Will Stop Pegging Yuan to Dollar," *USA Today*, July 22, 2005, pp. 1B, 2B; Keith Bradsher, "A Chinese Revaluation May Not Help U.S.," *The New York Times*, January 4, 2005, pp. C1, C5.