International Marketing
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Module - 2
Lecture - 7
International Business, Entry Modes, and Theories

Hi, good afternoon. Welcome back. So, now we will discuss about the international theories, couple of theories we will discuss now.

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And you need to understand these theories of international trade and this will be helpful for you to understand about the, why, what are the issues and where you should invest, where, what are the things you should take care; these theories will give you an idea. So, the first theory on this is mercantilism.

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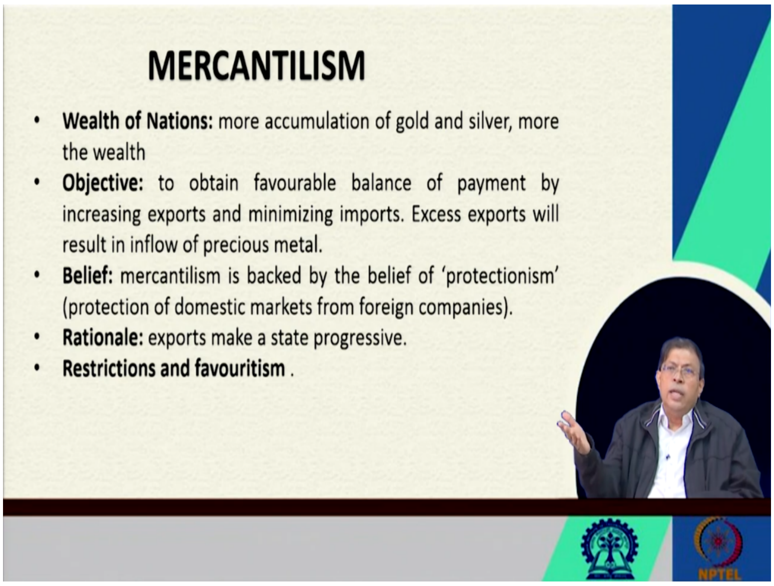

So, what is mercantilism? It is the wealth of nations, more accumulation of gold and silver, more the wealth. It was a little traditional one. The objective is; what is the objective of mercantilism? Some of the countries, they follow the mercantilism. What is that? To obtain the favourable balance of payment by increasing the export and minimising the imports. We have discussed in one of the session that what is balance of trade.

If it is more exports and less imports, it is a favourable balance of trade. If it is more imports, less exports, is a negative balance of trade. Another what we have discussed is, when the exports and imports are same, that is known as a balance of trade, when both are same. Here, in this, the countries which follow, you need to understand what is the nature of the country. So, these international financial theories will tell you that, give you a guideline that the country follows a mercantilism.

That means, they always want more favourable balance of payments. So, they will love to export more than to import. So, that is the one-line definition of that. That means, they would always like to export and earn foreign exchange and instead of importing from the international market. So, belief: so, mercantilism is backed by the belief of protectionism. That is, protect the domestic markets from the foreign company.

So, the countries which follow these principle, they always have that we will protect our domestic industries. So, there are maybe hundreds or thousands of domestic industries. We should ensure the foreign company should not come and spoil the domestic company's market share, so that they want to protect the domestic companies. The rationale: And the rationale is that exports make state more progressive.

So, they always think that if we export more and more we earn foreign exchange, we will be more progressive. So, and this is, this country typically follows some restriction and some favouritism.

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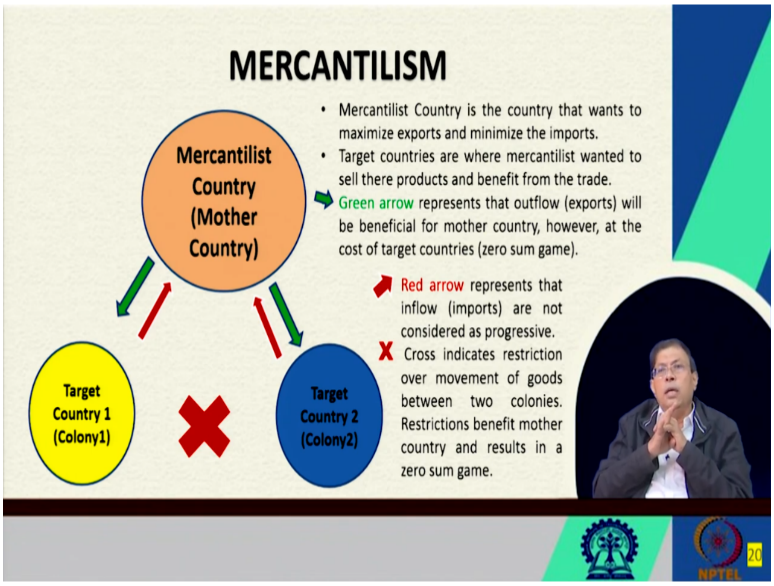

So, the mercantilism about the countries: Now, here I will show you how is a typically a block diagram. It will be easy for you to understand. Suppose a mercantilist country which is a mother country and then there are 2 colony of countries are there; these 2 colonies are also controlled by the mother country, 2 colonies. So, previously, like in British era, from the era, colonies, British colonies there in several part of the world.

So, what is typically in the mercantilist country? Is a country that wants to maximise the export and minimise the import. So, remember, the countries which follow the mercantilism, they will maximise the export and minimise the imports and they will always have a protectionism to protect the domestic industry. So, it would be very hard for you to enter to that market.

Target countries where the mercantilist wanted to sell the products and benefits from the trade. So, you can see, there is a green arrow. The thickness of the green arrow is much more compared to the red arrow, and green arrow represents the outflow or the exports. As I told you, the mercantilism countries will always look for more amount of exports than imports. And red arrow represents the inflow of the imports.

Now you look at this block diagram. The mother country and there are 2 other countries which is typically the colony of the mother country. Now, from target country number 1, in the target country, the mother country will export lot of their goods and services to that country and may, many may import very few items from that country. So, the balance of trade will be always positive.

In this case, in the target 2 also, exactly the another colony of that mother country will also export lot of their products, so that the domestic industry in their mother country are able to generate huge revenue and the country also earns a lot of foreign exchange, and they will sell it to this country number 2; but they will import maybe very few items from that country to their mother country.

The biggest problem is that, between these 2 colonies, there will be no transaction allowed, because mother country will control, they will not allow any transaction between these 2 colonies. So, cross indicates restriction of movement of the goods between the 2 colonies. So, these restrictions benefit the mother country and results in a zero sum game. So, this is typically a mercantilism, which is previously lot of countries used to follow that. Slowly, this has not been existent right now much in the internationally.

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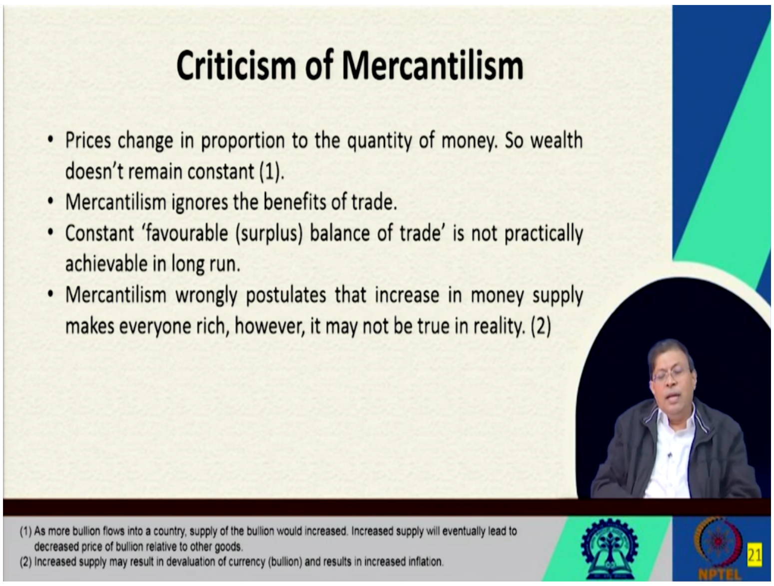

What is the criticism? Price change in proportion to the quantity of money. So, wealth does not remain constant. I have given some references there. As more bullion flows into a country, supply of bullion would increase and increased supply eventually lead to a decreased price of bullion relative to the other goods. Mercantilism ignores the benefit of the trade. Constant favourable surplus and balance of trade is not practically achievable in long run.

It is not really achievable in long run that continuously throughout that, you will import very less and export maximum; this will not really, the surplus or favourable balance of trade is not practically achievable in the long run. And mercantilism wrongly postulates that increase in money supply makes everyone reach; however, it may not be true in reality. Why? Because increase of money supply result in devaluation of the currency the bullion and results in increased inflation.

So, the theory that what we were thinking that the people will become rich actually cannot, may not happen that because the increased money supply may result devaluation of the currency and result in increased inflation. So, this is typically the criticism of the mercantilism.

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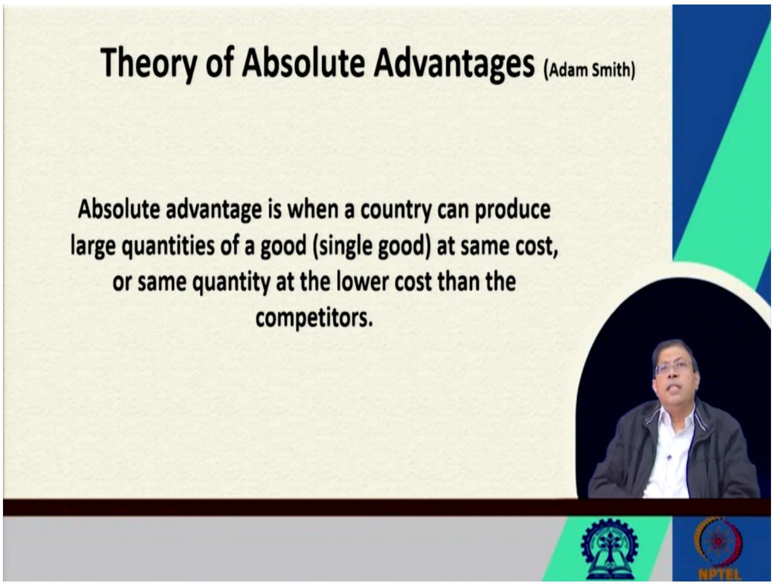

Then comes the theory of absolute advantage of Adam Smith, theory of absolute advantage. So, what is absolute advantage? The absolute advantage is when a country can produce more quantities of good, single good at same cost or same quantity at the lower cost than the competitors. So, let me explain to you much in detail.

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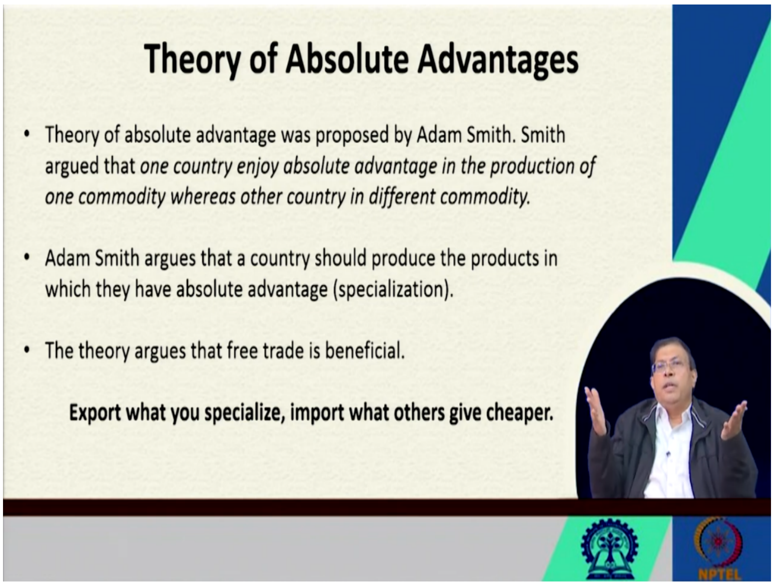

The theory of absolute advantage was proposed by Adam Smith. Smith argued that the country enjoys absolute advantage in the production of 1 commodity, whereas the other country in different commodity. So, this is very important like; just read once again; Smith said that 1 country enjoys absolute advantage in the production of 1 commodity, whereas the other country has an advantage for some other commodity.

Adam Smith argues that a country should produce the products in which they have absolute advantage. So, he argues that we should, the country should produce the products which has got an absolute advantage, that what is the specialization. The theory argues that the free trade is beneficial. Export what you specialize, imports what others give cheaper. Very simple line to understand this theory of absolute advantage. Export what you specialize; that means, where you have an absolute advantage, you export that. Import what is available by the others to give you at a lower cost.

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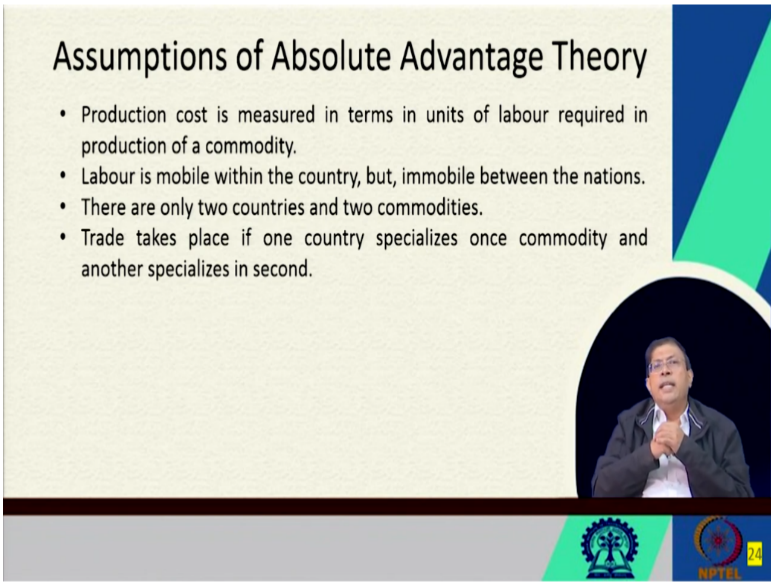

Assumptions of absolute advantage theory. So, the production cost is measured in terms of units of labour required in a production of commodity. Labour is mobile within the country but immobile between the nations, because it is within the country the labour can move but is immobile, you cannot move the labour outside the country, because then it needs the restriction of visa and so many other things are there.

There are only 2 countries and 2 commodities and trade takes place if 1 country specializes 1 commodity and the other specializes in the second commodity. I will give you an example of that.

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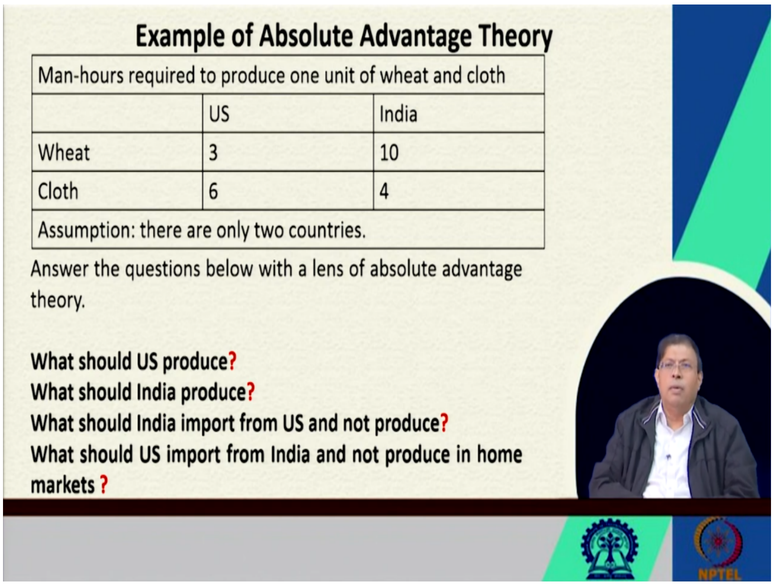

See, this example will make you very clear. See, I have given here the example between US and India to make it very simple for you. Man-hours required to produce 1 unit of wheat and cloth. Look at the wheat; US takes only 3 man-hours to produce 1 unit of wheat, India needs 10 man-hours to produce 1 unit of wheat.

Cloth: US takes 6 man-hours to produce 1 unit of cloth, whereas India needs 4 man-hours to make 1 unit of cloth. See the difference between wheat and cloth. US is having absolute advantage because they need only 3 man-hours to produce 1 unit of cloth, whereas India needs 10 man-hours to make 1 unit of cloth; 1 unit of wheat, sorry. In the cloth, US having a disadvantage; US takes 6 man-hours to make 1 unit of cloth, but India takes only 4 man-hours to make 1 unit of cloth.

So, assumption, there are only; so, in this case, we have assumed 2 assumptions that there are only 2 countries and 2 products wheat and cloth to make the Adam Smith's theory of absolute advantage to make clear to you. So, answer the question below with the lens of absolute advantage. What US should produce? What India should produce? What India should import from US and not produce? What should US produce and India not produce in home market? So, that we should answer.

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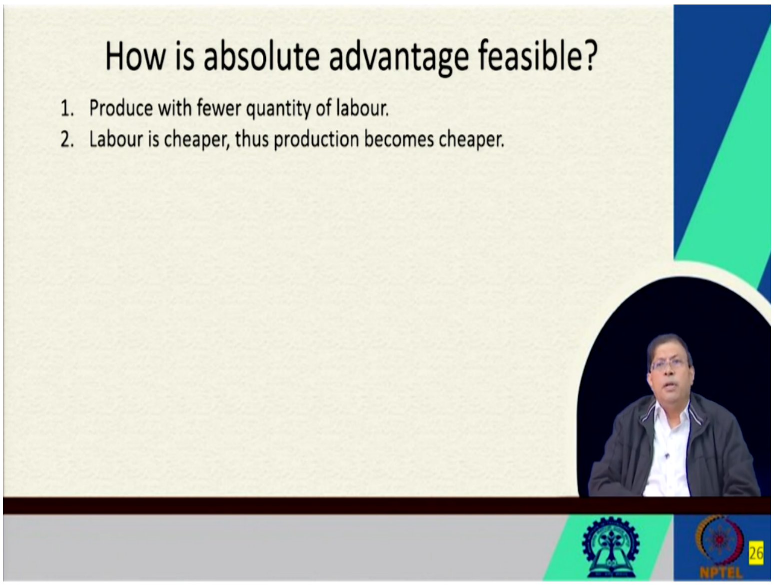

So, this, here, you look at this; and let me go to the previous slide. Here, you can see that India can produce, here what US should produce? US should produce the wheat because they have an absolute advantage in there. What India should produce? India should produce the clothes because they have an advantage, they produce a cloth in less. What India should import from US? India should import the wheat from US, not produce in India.

What US should import? US should import clothes from India and not produce in US. So, that is typically the answer from this. So, how is the absolute advantage feasible? Produce with fewer quantity of labour. Labour is cheaper, thus production becomes cheaper. So, that is known as a theory of absolute advantage.

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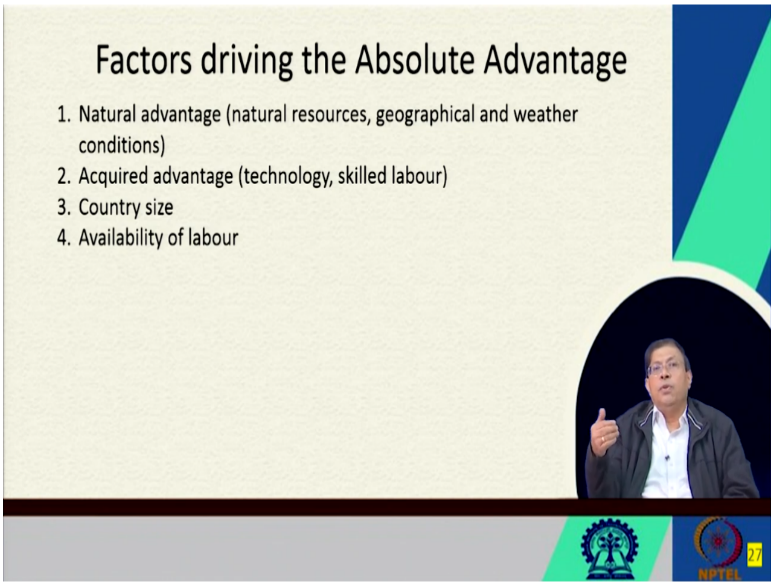

Factors driving the theory of absolute advantage are the natural advantage like natural resources, geographical weather condition; these are the natural advantage. What is some countries having an acquired advantage like technology, skilled labour, like we have in India, we have the acquired advantage of the information technology knowledge. So, that is an acquired advantage what we have acquired in years compared to any other country.

So, all information technology products should be provided by India because it is an acquired advantage for you. Size of the country and availability of the labour is also the driving force behind this absolute advantage.

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So, comparative: There is a theory, next theory is the comparative advantage theory. This is propounded by David Ricardo, which says country's ability to produce products and services at a lower opportunity cost. So, let me explain to you in the next slide.

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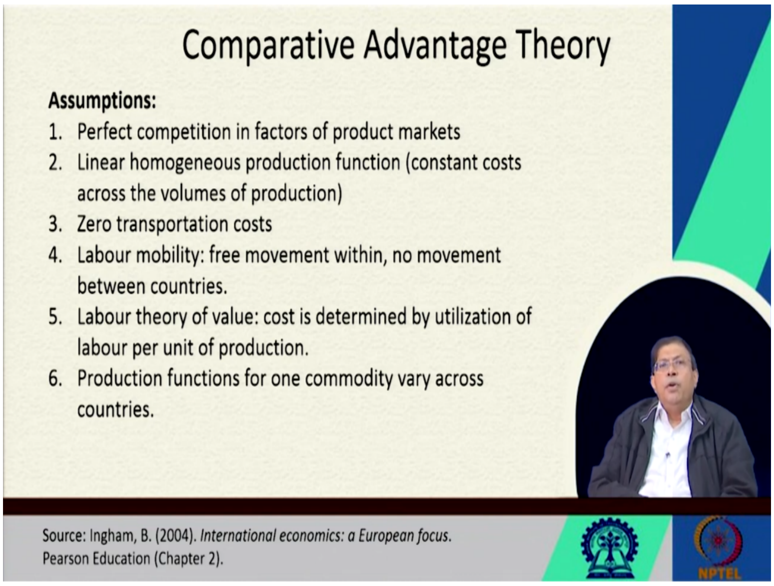

Assumptions: Perfect competition in factors of product markets; linear homogeneous production function, constant costs across the volumes of production; zero transportation cost; labour mobility, free movement within and no movement between the countries; labour theory value, cost is determined by the utilization of labour per unit production; production functions for 1 community vary across the countries. The source, I have mentioned the source here, International Economics, that source. That is a comparative advantage theory.

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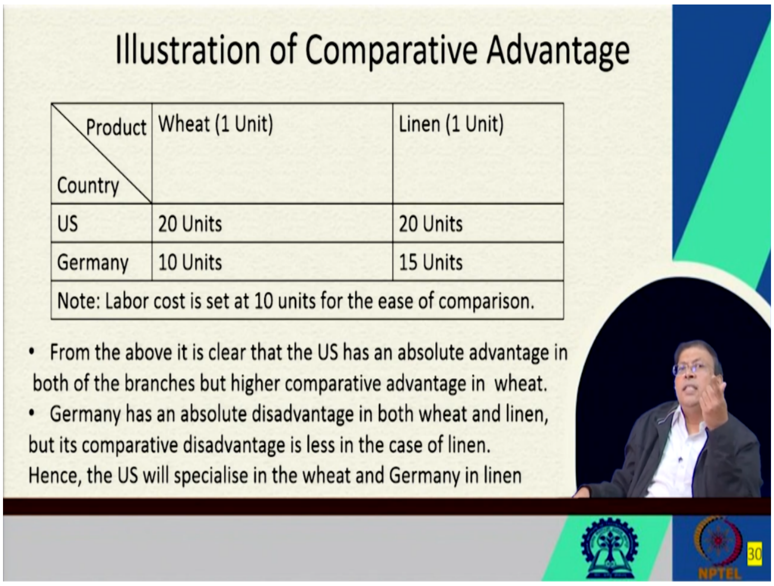

Now, let me explain you with an example, which will be very easy for you to understand with the example. Here I have given the example of wheat and linen between US and Germany. So, US here, that US makes 1 unit of wheat, the country here, and the linen, it takes 20 units. And the Germany takes 10 and 15 units. So, labour cost is set at 10 units for ease of comparison. So, 1 labour cost is set at 10 units for the ease of comparison.

So, from the above, it is clear that US has an absolute advantage in both the branches but higher comparative advantage in wheat. Germany has an absolute disadvantage in both wheat and linen but it is comparative disadvantage is less in case of linen. Hence, the US will specialize in wheat and Germany with linen. So, this is known as an illustration of a comparative advantage. So, look at this chart once again; let me repeat.

You look at this and see that Germany; if you look at this US and Germany, 20 units of labour, 10 units for these or labour cost is set at 10 units of each. So, 2 units of labour are required to make 1 unit of wheat and 2 units of labour is required to make 1 unit of linen for US. In Germany, they have 1 unit of labour, 10 units for the labour cost has been given; 10 units I can produce 1 wheat, 1 unit of wheat, whereas in 15 units, I can produce 1 unit of linen.

From this above, we can see that US have an absolute advantage, both the things. See that both the things, advantage in both the branches but higher comparative advantage in wheat, whereas Germany has an absolute advantage in both wheat and linen but its comparative advantage is less in case of linen. Hence, the US will specialise in wheat and Germany will specialise in linen.

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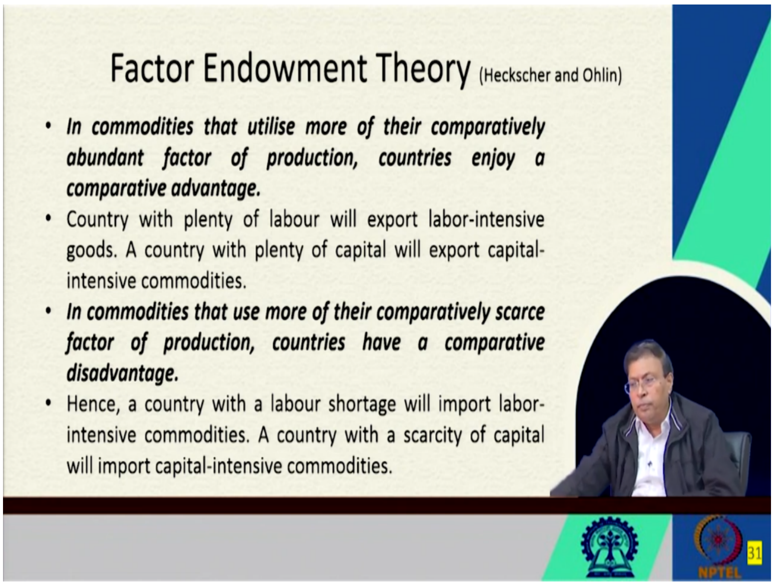

Then comes the next theory which is known as the factor endowment theory. These are all international finance theories. And here in this theory, it says that in commodities that utilise more of their comparatively abundant factor of production, countries enjoy comparative advantage. So, I will give you little bit of example with that. Country with plenty of labour, the country, suppose like India, we do have plenty of labour available.

So, the country with plenty of labour will export labour-intensive goods, a country with plenty of capital will export capital-intensive goods. So, you need to be very careful. When you go for an Indian national marketing, you have to look at these: What is the factor? What are the advantages of that country is having? The country is having; you should not produce something which is very labour-intensive in a country where the country has got; you should introduce only the plenty of labour-intensive goods.

So, if it is a very labour-intensive good, you should produce in a country where the labour is available. And where a country with a plenty of capital, will export the capital-intensive commodities. In commodities that use more their comparatively scarce factors of production, countries have a comparative disadvantage. Hence, a country with a labour shortage will import labour-intensive commodities.

A country with a scarcity of capital will import capital-intensive commodities. You understand, one is a labour-intensive, another is a capital-intensive. So, the country who is a labour shortage will import the labour-intensive commodities in their country because it is their; they do not have labour, so, what they will do? They will import the products commodities which is labour-intensive commodity; so, they will import it to their country.

A country where is a scarcity of capital is there, so, they will import more capital-intensive commodities to that country. So, this is typically the factor endowment. So, a factor endowment represents how many resources a country has its disposal to be utilized for manufacturing, resources such as labour, land, money, entrepreneurship. Countries with large or diverse factors of endowments are typically more wealthy and able to produce more goods than the countries with small factor endowments.

So, factor endowments also affect the opportunity cost of searching or specializing and in producing certain goods relatives to other. As a result, the difference and variation in countries endowment, factors endowment theory states that economic reasoning that these different breakdowns of capital to labour will determine a country's comparative advantage. A comparative advantage exists when the opportunity cost of specialization is lower than that of other nations.

So, again I am repeating. A comparative advantage exists when the opportunity cost of specialization is lower than that of the other nations. The existence of a comparative advantage is in turn affected by things such as abundance of productivity, cost of labour, land, capital. Other factors also might influence the country's comparative advantage in practical terms such as highly developed financial system and all those. So, these are the way about to explain about this factor endowment theory.

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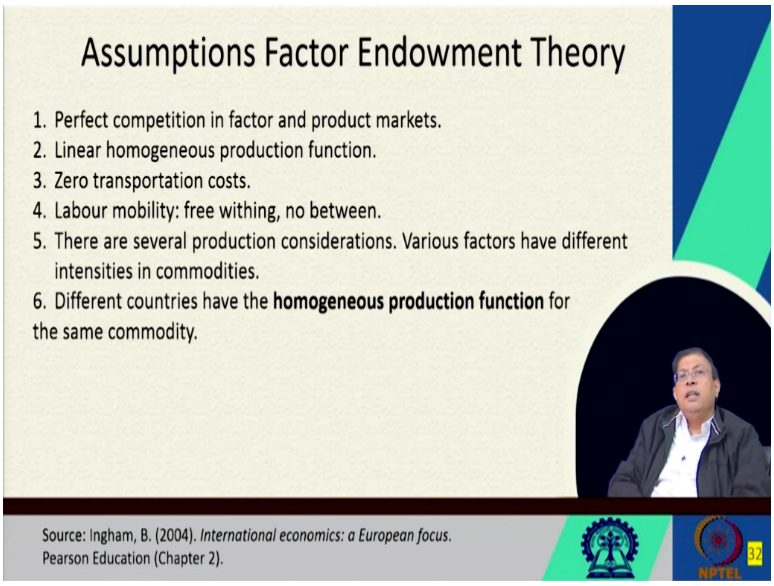

Assumptions in the factor endowment theory: If perfect competition in factor or product markets; linear homogeneous production function; zero transportation cost; labour mobility, free within, no between. There are several production considerations. Various factors have been different intensities of commodities. Different countries have homogeneous production function in the same country. So, that is about this theory.

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Examples: Even with the most sophisticated leather preparation and making leather footwear is still a pretty labour-intensive industry. You know this, we produce in our country in like Agra, in UP, in various cities in UP, they have a various labour leather industries are there. We know any sophisticated leather preparation and making leather footwear is still a labour-intensive industry. This is a very sophisticated but still labour-intensive industry.

Other items like a computer memory chips, requires some highly skilled personnel but rely on large amount of cash or manufacture, development and facilities. The concept of factor proportion is extremely valuable for comparing the manufacturing process.

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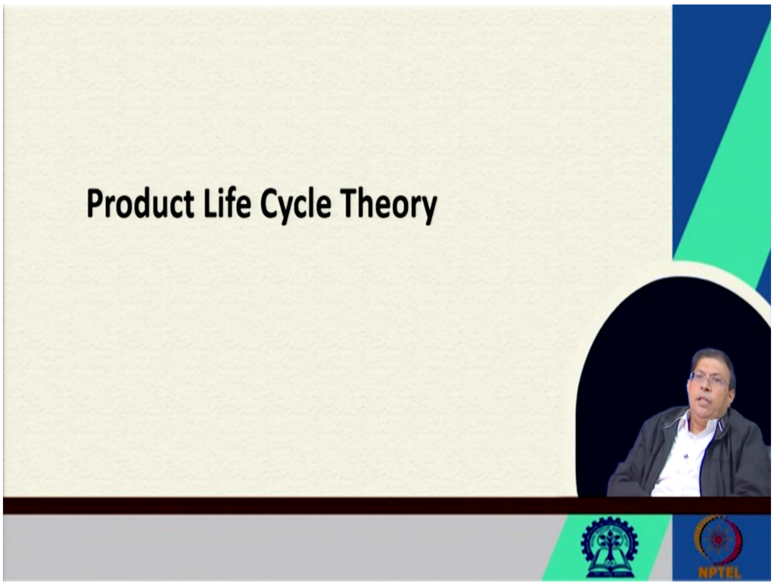

So, that should be about all the theories. Now, we will start with the product life cycle theory. So, that is a very important and I will try to give you the first what is typically a product life cycle.

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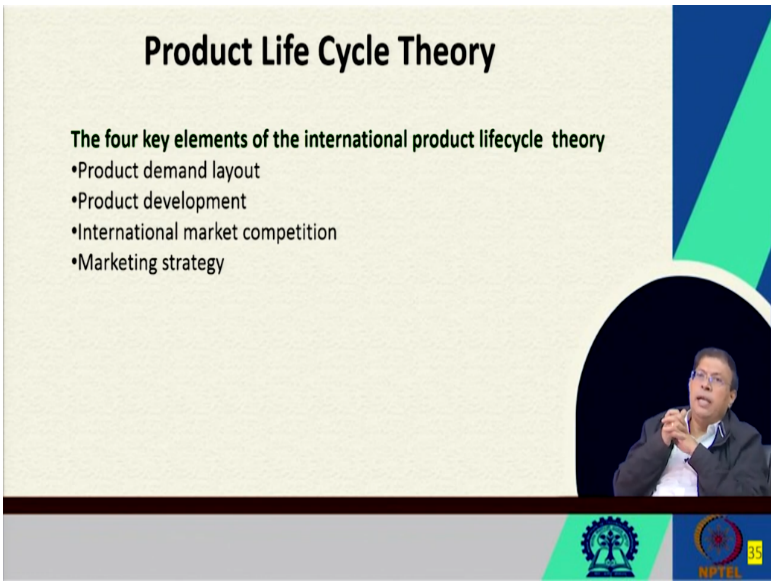

The guys who have studied the basics of marketing, you must have gone through what is a product life cycle, but I will give you some more heads up on this product life cycle. So, there are 4 key elements. So, before I just touched first about the international product life cycle and then I will first explain you what is a typical domestic product life cycle and then I will explain you the international product life cycle; step by step I will take you.

So, the product and demand layout, product development, international market competition, marketing strategy; these are the 4 key elements. Why these are the 4 key elements? If you look at the product demand layout, the product demand layout, suppose you are operating in 20 different countries, so, product demand layout in each of these countries will be totally different.

In some country require a large amount, some country require less amount; so, product demand is totally different. So, product development is also another very crucial factor in this product life cycle because how you develop the product and for which of the countries and when the product; so, all those things are one other critical parameters in that. Then international marketing competition; what the competition you face in country X, Y, Z may not be the competition what you face in country, other 4 countries.

So, the international competition how they have geared up, based on that, your product life cycle will depend on that; and then, typically the marketing strategy on that.

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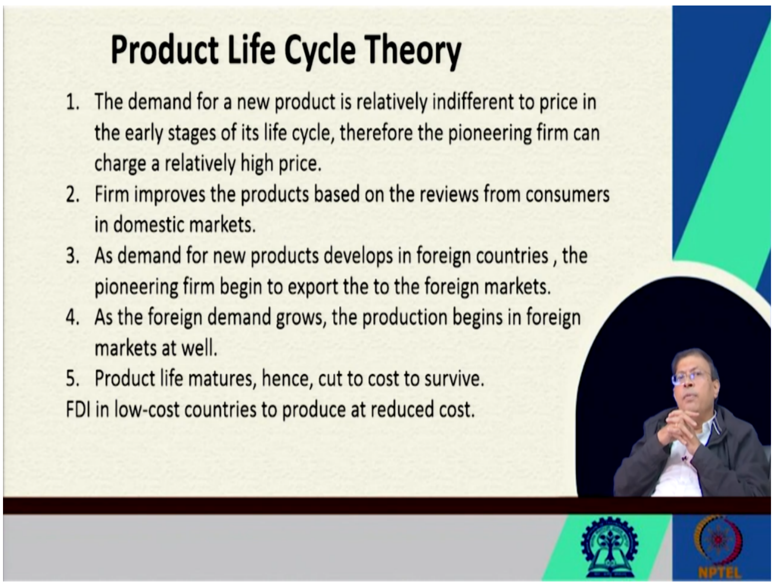

So, the product life cycle theory, the demand of a new product is relatively indifferent to price in the early stages. I will draw, I will show you some of the graphs which will be very easy for you to understand. And therefore, pioneering firm can charge relatively high price. Firms improves the product based on the reviews from the consumers at the domestic market. As demand of new product develops in foreign markets, the pioneering firm begin to export to the foreign markets.

So, once you develop the product for the domestic market, then you start marketing to the international market. And in the international market, when there is a demand starts, the pioneering firm starts to export to the foreign market. As the foreign market demands grows, the production begins in the foreign market also. Then you start, instead of producing domestically, you start producing in the foreign market. Product life matures but cut to cost to survive. So, FDI in low cost countries to produce at reduced costs. FDI is foreign direct investment.

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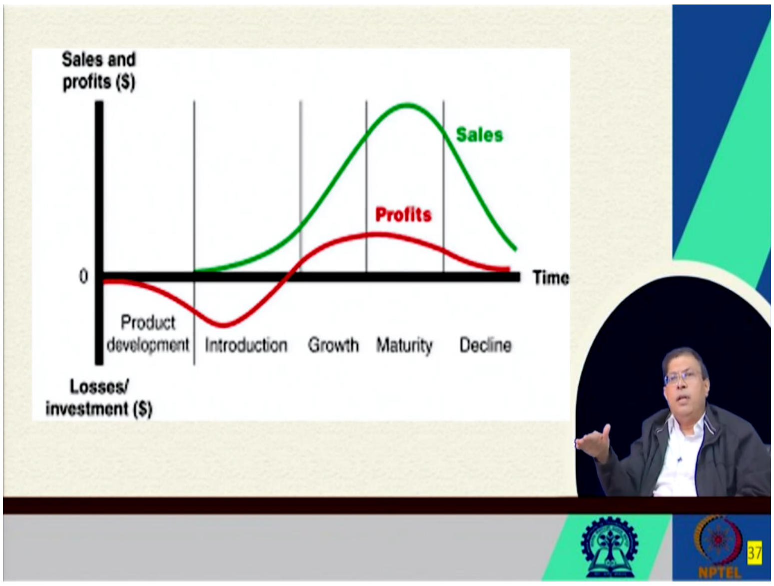

So, this slide, I will explain you about the typical product life cycle, how it looks. There are 2 curves here. You see that; one is a green which is the sales or revenue and the another is the profit. So, there are various stages. On the y-axis is the sales and profit and the x-axis is the time. You see in the x-axis, there is a time required for the product development. Then is a time required for the introduction of the product, when you introduce a product at the marketplace.

Then comes the growth phase, then comes the maturity phase and then comes the decline phase of a product. So, this is typically a product life cycle, how it looks. Now, look at the first the red curve which is profits. See, once you start the development, so you are not generating. You start suppose a development from these; you start development and there is only cost; that means, your R and D cost, your design costs, all the costs are there.

And then, the complete the product development cost, there is no revenue is coming. You are starting a completely. And then, you start; once the product is ready, you start, introduce; and you see the green curve there and it starts from that point, you introduce the product from that. And then, when you introduce the product there, in that, you introduce a product in that and it starts, slowly starts selling. Why?

Because in that introductions phase, you start, see, promotional activities. That means, you start various promotions in the television, ATL promotion or above the line promotions or the BTL, below the line promotions; all these promotions you start during that period. So, still you are making; your revenue is very low. See the green, this revenue is just started picking up, is very small, but you have introduced already the product and then your all marketing expenses promotional expenses are there and you are not able to really make any money.

See that slowly, see, the product once takes a certain volume, you start making a money. So, that point is very crucial, because right from the product development onwards, you are incurring only cost, there is no profit coming from the product. Product starts once; and the product is not that the day 1 you start and then immediately it starts increasing the volume; it does not happen.

So, it is typically, in a normal product, in most of the products, the typically, the product life cycle starts with that initially very few sales and slowly the sales grow, and then slowly once the sales grows, you start making money. So, here comes your introduction phase where your company is making losses, you are not making money but your sales are not adequate. Slowly the sales are picking up and then slowly you see the rate curve, the profit curve slowly goes positive and then you start making the profit.

And then the sales started growing; it is the growth phase. What is the most important is the growth phase, where your sales and profit, both starts growing, see the nature. And the next stage is the maturity stage, the product has reached in maturity. That means, there is no further sales are happening. The product has reached maturity and then the product starts, after the maturity, the products start decline.

That means, with the time, the product sales also decline; as the sales declines, profit also declines. So, this is, the initial phase of product development is typically the company or the investments or the losses. Once the volume picks up, sales volume picks up; and it does not pick up in 1 day, it takes some time; that is why you see the slope of the curve; it takes time.

And then, once it reaches, it starts making profit and then it reaches the growth, company's profit also increases, it reaches the maturity, profit increases and slowly the product becomes phased out because now the competition has come up with a new product which is much more beneficial and much more value addition for the consumers. So, consumer is not trying out with your product and they are discarding your product.

So, typically the sales is falling down, profit is also falling down. So, this is typically the product life cycle. So, you can take any product into this and you can see the product life cycle, analyse that. You can take simple example of a Maruti 800 car, where the Maruti 800 car was introduced in 1984 and then slowly, if you see, look at that, introduction cost, product development and introduction, there is a huge cost for Maruti built their entire distribution network through the country.

And then, sales started flowing; and then the Maruti 800 reached its peak; and then there are several competitors came at the marketplace to compete with Maruti, say Hyundai's what is called the Santro came at the marketplace, then Hyundai's, various cars of Tata Motors and every other company came into the marketplace. So, the sales for Maruti 800 started falling down and the profits also falling down. So, they decline and they have phased out the product. So, we will come back more in the next slide. Thank you. Thank you very much.