The Global Economic Environment

Chapter 2

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Introduction

This chapter includes:

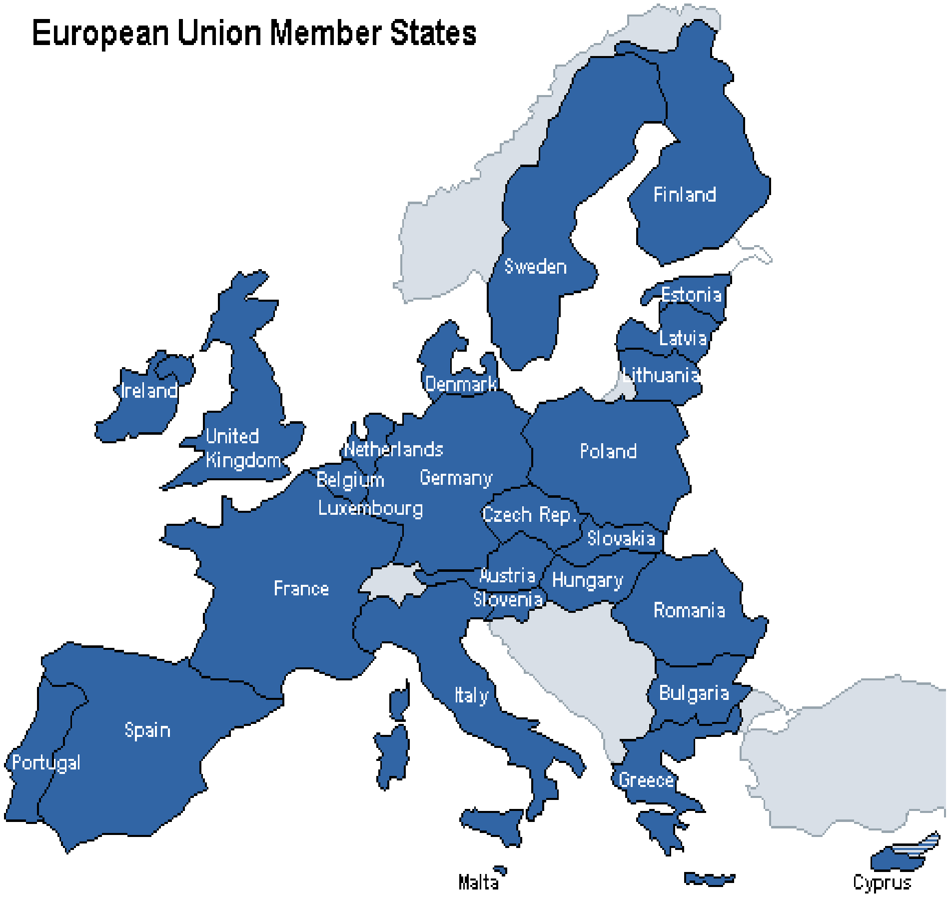
- An overview of the world economy
- A survey of economic system types
- The stages of market development
- The balance of payments

The world economy has change since ww-II. The most fundamental change is emergence of global market

- ✓ Responding new opportunities
- ✓ Global competition (how displace the local competitor

The World Economy—An Overview

- Currently, the integration of world economy has increase significantly. In the early 20th century economic integration was at 10%; today it is 50%
- EU and NAFTA are very integrated
- Global competitors have displaced or absorbed local ones



The World Economy—An Overview

- To Achieve success global marketer must take into account the following realities:
  - Capital movements have replaced trade as the driving force of the world economy
  - ➢ By 2009: the $ value of world trade was $ 25T
  - ➢ Currency trading represents the world largest market

The World Economy—An Overview

To Achieve success global marketer must take into account the following realities:

– Production has become uncoupled from employment

➢ The linkage between productivity and employment can be explained by

GDP=C+I+G+NX

Employment in manufacturing has steady or decline which productivity continue to grow.

To Achieve success global marketer must take into account the following realities:

– The world economy, not individual countries, is the dominating factor

➢ Company executive and national leaders who recognize this have the great chance of success. E.g. the real secret of economic success of japan is fact that business leader or policymakers focus on world market and their respective countries competitive position in the world economy.

The World Economy—An Overview

The new realities, continued:

- 75-year struggle between capitalism and socialism has almost ended
- E-Commerce diminishes the importance of national barriers and forces companies to re-evaluate business models

Economic Systems

Resource Allocation

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

Market Capitalism

Market capitalism is an economic system in which

- individuals and firms allocate resources,
- production resources are privately owned.
- Consumers decide what goods they desire, and firms decide how much to produce;
- the state's role is to promote competition

Western Market Systems

Type of System	Key Characteristics	Countries
Anglo-Saxon	Private ownership free enterprise Minimal social safety net	US, Canada, Great Britain
Social Market Economy Model	Private ownership Inflexible employment policies, "social partners"	France, Germany, Italy
Nordic Model	Mix of state and private ownership, large safety net High taxes	Sweden, Norway

Centrally Planned Socialism

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

Centrally Planned Capitalism

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

Economic Freedom

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

Economic Freedom—2009 Rankings

Free

1. Hong Kong
2. Singapore
3. Australia
4. Ireland
5. New Zealand
6. U.S.
7. Canada
8. Denmark
9. Switzerland
10. U.K.

Repressed

169. Turkmenistan
170. São Tomé & Príncipe
171. Libya
172. Comoros
173. Dem. Rep. Congo
174. Venezuela
175. Eritrea
176. Burma
177. Cuba
178. Zimbabwe
179. North Korea

Not ranked: Afghanistan, Iraq, Liechtenstein, Sudan

Stages of Market Development

- The World Bank has defined four categories of development using Gross National Income (GNI) as a base
- Today, the focus is on **BRIC:** Brazil, Russia, India, and China

Low-Income Countries

- GNP per capita of $936 or less
- Characteristics
  - Limited industrialization
  - High percentage of population in farming
  - High birth rates
  - Low literacy rates
  - Heavy reliance on foreign aid
  - Political instability and unrest
  - Concentrated in Sub-Saharan Africa
  - India is the only BRIC country

Indian tailor

Lower-Middle-Income Countries

- GNI per capita: $936 to $3,705
- Characteristics
  – Rapidly expanding consumer markets
  – Cheap labor
  – Mature, standardized, labor-intensive industries like textiles and toys
- BRIC nation is China

Upper-Middle-Income Countries

- GNP per capita: $3,706 to $11,455
- Characteristics:
  - Rapidly industrializing, less agricultural employment
  - Increasing urbanization
  - Rising wages
  - High literacy rates and advanced education
  - Lower wage costs than advanced countries
- Also called newly industrializing economies (NIEs)
- Examples: Brazil, Russia, Malaysia, Chile, Venezuela, Hungary

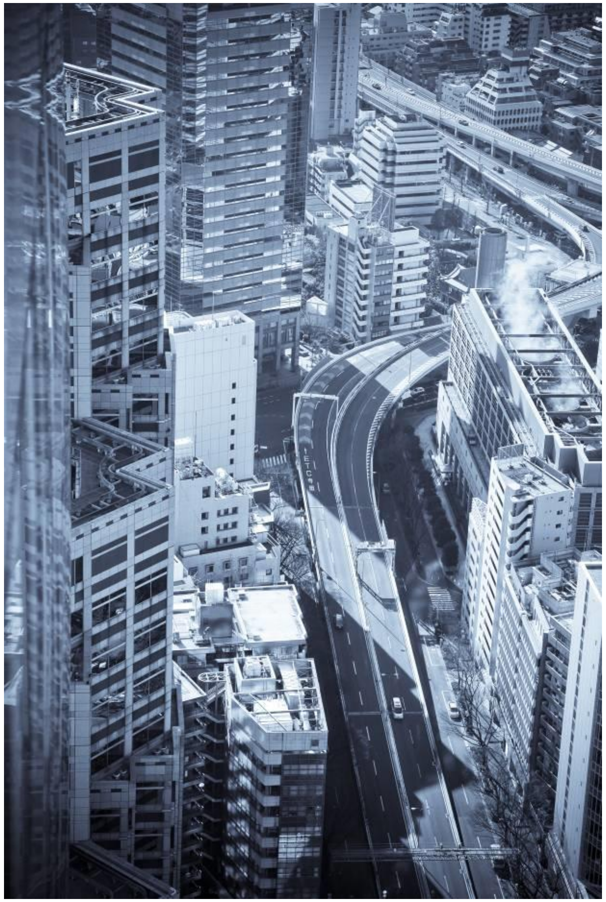
Marketing Opportunities in LDCs

- Characterized by a shortage of goods and services
- Long-term opportunities must be nurtured in these countries
  - Look beyond per capita GNP
  - Consider the LDCs collectively rather than individually
  - Consider first mover advantage
  - Set realistic deadlines

Mistaken Assumptions about LDCs

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

High-Income Countries



Tokyo

- GNI per capita: $11,456 or more
- Also known as advanced, developed, industrialized, or postindustrial countries
- Characteristics:
  - Sustained economic growth through disciplined innovation
  - Service sector is more than 50% of GNI

High-Income Countries

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

G-8, the Group of Eight

- Goal of global economic stability and prosperity
  - U.S.
  - Japan
  - Germany
  - France
  - Britain
  - Canada
  - Italy
  - Russia (1998)

2009 G-8 Leaders in Italy

OECD, the Organization for Economic Cooperation and Development

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

The Triad

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

Product Saturation Levels

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

Balance of Payments

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

Balance of Payments

TABLE 2-5 U.S. Balance of Payments, 2003–2007 (US$ millions)

	2003	2004	2005	2006	2007
A. Current Account	**–527,514**	**–665,286**	**–791,508**	**–811,477**	**–731,214**
1. Goods Exports (BOP basis)	713,415	807,516	894,631	1,023,109	1,148,481
2. Goods Imports (BOP basis)	–1,260,717	–1,472,926	–1,677,371	–1,861,380	–1,976,853
3. Balance on Goods	*–547,302*	*–665,410*	*–782,740*	*–838,271*	*–819,373*
4. Services: Credit	302,681	344,426	380,614	422,594	497,245
5. Services: Debit	–250,276	–290,312	–314,604	–342,845	–378,130
6. Balance on Services	52,405	54,114	66,011	79,749	119,115
7. Balance on Goods and Services	*–494,897*	*–611,296*	*–716,730*	–758,522	*–700,258*
B. Capital Account	**–3,480**	**–2,369**	**–4,036**	**–3,880**	**–1,842**

Source: www.bea.gov

Top Exporters in 2004

In US$ billions			% of Total		
1.	Germany	912	1.	EU	18.1
2.	U.S.	819	2.	U.S.	12.3
3.	China	593	3.	China	8.9
4.	Japan	566	4.	Japan	8.5
5.	France	449	5.	Canada	4.8
6.	Netherlands	358	6.	S. Korea	3.8
7.	Italy	349	7.	Mexico	2.8
8.	Great Britain	347	8.	Russia	2.8
9.	Canada	317	9.	Taiwan	2.7
10.	Belgium	307	10.	Malaysia	1.9

Top Importers in 2004

In US$ billions			% of Total		
1.	U.S.	1,526	1.	U.S.	21.8
2.	Germany	717	2.	EU	18.3
3.	China	561	3.	China	8.0
4.	France	466	4.	Japan	6.9
5.	Great Britain	464	5.	Canada	4.0
6.	Japan	455	6.	South Korea	3.2
7.	Italy	351	7.	Mexico	3.0
8.	Netherlands	319	8.	Taiwan	2.4
9.	Belgium	286	9.	Switzerland	1.6
10.	Canada	280	10.	Australia	1.6

Overview of International Finance

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

Foreign Exchange Market Dynamics

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

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

Exchange Risks and Gains in Foreign Transactions

Purchasing Power Parity (PPP) The 2008 Big Mac Index

Country	Big Mac Price Converted to $	Official Exchange Rate	Over- or Undervaluation of Local Currency (%)
Switzerland	5.60	1.16/$1	+58
U.S.	3.54	–	–
Brazil	3.45	2.27/$1	–2
Euro zone	3.42	1.28/$1	+24
Japan	3.23	89.9/$1	–9
Russia	1.73	35.7/$1	–51
China	1.83	6.84/$1	–48

- Is a certain currency over/under-valued compared to another?
- Assumption is that the Big Mac in any country should equal the price of the Big Mac in the U.S. after being converted to a dollar price

Managing Economic Exposure

- ***Economic exposure*** refers to the impact of currency fluctuations on the present value of the company's future cash flows
- Two categories of economic exposure:
  - ***Transaction exposure*** is from sales/purchases
  - ***Real operating exposure*** arises when currency fluctuations, together with price changes, alter a company's future revenues and costs

Managing Economic Exposure

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

Exercises

- What is the most fundamental change in the world economy since WWII?
- What are the four main types of global economic systems?