

# International Business

## Question 01

There are many theories related to international trade. Adam Smith and David Ricardo have been explained three main classic theories of international trade. Among them, absolute advantage and comparative advantage are widely discussed classic international trade theories. Adam Smith and David Ricardo build up these theories based on many assumptions.

Absolute advantage.

Absolute advantage refer that a country has an ability to produce a good by using fewer resources over another country. Main reason for absolute advantage of the country most probably natural endowment of the country (Hill, 2008). As an example, extracting oil is the main income generator of Saudi Arabia. For some of the countries, even though there is an oil resource, it is required considerable exploration and high cost technology to drill and extract it. On the other hand, United State has the largest and richest farm land in the world. Compared to other countries, it is much easier to grow corn and wheat in United States. Country like Zambia has the world best copper mines. If every country has a good which requires to others and it can be produced lesser resources within the country compared to other country, then it can be easily identified that every part get advantage from the trade. However, it is incomplete to consider trade only in term of geography and absolute advantage. According to David Ricardo, comparative advantage play significant role in international trade (Daniels, Radebaugh and Sullivan, 2008).

Comparative advantage

Country has comparative advantage means that a product can be made at a lower cost compared regarding other goods. When it comes to comparative advantage, concept of opportunity cost need to be considered. As an example, if country like US prioritize to produce corn, they need to allocate their human resources, financial resources and land to that and cannot allocate those resources to produce other product like oil. Thus, US has to give up the opportunity to produce corn. However, in this kind of scenario, cost need to be quantified in terms of other goods. When assume country need to use its resources to produce both oil and corn, companies produce either oil or copper need to analysis how long it takes to extract one barrel of oil and to harvest a bushel of corn. Based on that, opportunity cost of select one over other can be identified.

Table 01 – how many hours it takes to produce oil and corn

Country	Oil production (Barrels)	Corn production (Bushels)
Saudi Arabia	60	10
United state	20	60

(Based on the assumption)

Advantages and disadvantages

Advantages of absolute advantage theory

Saving cost – absolute advantage strategy help to country to save the cost by specializing to produce the product which has lower production cost and decreasing produce the product which has higher production cost. As an example, Saudi Arabia has ability to produce 60 oil barrels and 10 bushels of corn while US can produce 20 oil barrel and 60 bushels of corn. Therefore, US specialize on producing corn while Saudi Arabia specialize on producing oil and it economically get benefits for both countries.

Growth of international trade – international trade is really important to provide some products which are not produced in the country. Absolute advantage theory focus on producing certain specialized products which can produce lesser production cost, the country can export that products and import other product. This environment create good opportunity to grow international trade.

Increase of foreign investment – Absolute advantage cause to increase the foreign investment. Foreign investors tempt to invest more on products which country specialized on due to growth of international trade. And this will create new job opportunities for people.

Disadvantages of absolute advantage theory

More factors of production – Many factors are required to produce a good such as capital, human resources, space and etc. generally, product cannot be evaluated only based on absolute advantage since in one country, there need to be one or more inputs for production and another country number of inputs can be changed. This issue is further analyze in factor abandon theory of international trade.

Inter vs intra industry trade - Many countries conduct on intra industry trade which trade similar kind of goods. As an example, some countries import and export automobile spare parts at the

same time. This kind of trade can be happened based on the economic power and economic of scale (Doole and Lowe, 2012).

Absence of absolute advantage – The absolute advantage is evaluated based on the simple appraisal such as labor productivity. This comparison will be not enough to evaluate the industry and sometimes some advance evaluation need to evaluate the industry (Diasz, 2017). Even though, some countries have natural resources, sometimes developing countries cannot gain absolute advantage due to lack of technology and financial capital. Thus, some developing countries face difficulties to trade in international level and gain benefits. Therefore, without enough certain resources, countries couldn't realize absolute advantage.

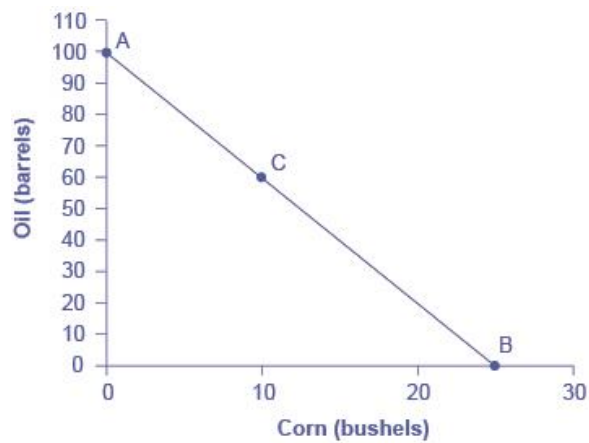
### Advantages of comparative advantage theory

Provide better understanding about opportunity cost.

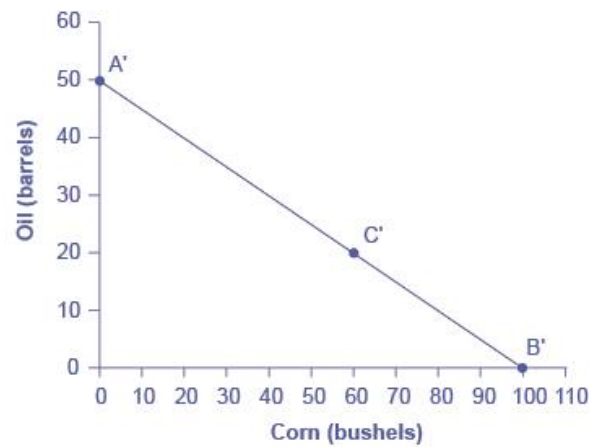
Table 02 – production possibilities

Country	Oil production using 100 labor hours (Barrels)	Corn production using 100 worker hours (Bushels)
Saudi Arabia	100	25
United state	50	100

Figure 01- production possibilities frontier



(a) Saudi Arabia



(b) The United States

As illustrated above figure, US can produce 100 corn bushels or 50 oil barrels by using similar level of resources. Therefore, as illustrated slope of above graph ( $1/2$ ), opportunity cost of one oil barrel is two bushels of corn. Considering Saudi Arabia aspect, opportunity cost of producing one oil barrel is loss of  $1/4$  of a corn bushel. Therefore, this theory give better understanding about the opportunity cost.

Flexibility of the theory- Theory can use any number of products and countries. Further, different specialization can be evaluated through this.

Advantage is measurable- Comparative advantage theory provide the quantifiable value of the advantage. Therefore, this theory can be used to policy development regarding international trade. Further, it provide scientific foundation for economic policy decision making.

Disadvantages of comparative advantage strategy.

Many factors such as income distribution in the country, international capital movement, price fluctuations are influenced to international trade. However, this theory does not consider those factors. Further, trade between identical countries that does not relatively advantage over another are not explained through this theory. Further, this theory only consider few factors such as labor hours.

Both these theories are based on few assumptions such as there is perfect mobility of production between countries, economic conditions of two countries are similar and transportation cost has been ignored (Cateora, 2009). Due to these assumption, practical applicability of the theories is questionable.

## **Question 02**

Cultural analysis and impact of cultural differences between countries need to be evaluated to make decisions related to international trade. The Self- Reference Criteria (SRC) support to conduct cultural analysis and business decision making. These cultural aspects change country to country. It is really important to understand the SRC for the firm to plan strategies to move to new international markets. There are many factors that contribute overall culture of the country such as history, religious belief, education level, aesthetic appreciation and etc.

Some firms expect its products will be successful in international market without any adaptation after they success in domestic market. Therefore, self-reference criteria is the primary obstacle that firms face when enter to the international market first time. SRC defines as an unconscious reference to one's own cultural values, experiences and knowledge as a basis for decisions (Cateora, 2009). Companies take wrong business decisions in international market by considering that it can be managed same as domestic market.

Professor Lars Perner has explained that SRC refer individual's tendency to use their values and behaviors of their own culture to evaluate another culture (Eden and Ackermann, 2011). Ethnocentrism is also closely connected with SRC. Ethnocentrism mean the individual's tendency to consider their culture is superior than others culture (Eden and Ackermann, 2011). Some of American managers has this problem in the beginning of 21<sup>st</sup> centenary, America dominated world economy in that era. This attitude can be a serious issue when working with the members of another culture. Therefore, both ethnocentrism and SRC reduce the opportunity to firms to be successful in international market.

When people face pressure situation or a problem, most of the time they tend to response naturally that they practice their whole life time and basis of the knowledge that they get in their lifetime. Only people who are really well on handling pressure, are the ones who think and react. Even in business world, some companies follow same kind of strategies to negotiations, promotions or conflict management since it is more comfortable for them. Therefore, their strategies can be failed in international market and there is a high possibility to occur conflicts.

One advertisement used by Nestle for KitKat in UK and Italy failed in Italy due to cultural difference. Same as in 1996, when McDonald's started operations in India, it didn't success much since 40% of Indian are vegetarian. Further, fish or frozen meat were not eaten by remaining meat eaters. Therefore, company had to change their prime products and used separate tools and kitchen for burgers and other foods adopted according to Indian culture. Therefore, company had to allocate huge additional cost for that (Johnson, Whittington, Scholes, Angwin and Regner, 2014).

Marketing mix for different market need to be designed according to values and behaviors of that culture. It is really important to have a good awareness about the cultural differences in new market and need to be sensitive their values and behaviors. Therefore, it is really important to conduct cultural study of the market before enter to the market and isolate the effect of self-reference

criteria. It need to be minimize the making business decision based on own cultural experience and knowledge. In 1966, James Lee introduced four steps method to deal with SRC. Those four steps are as follow.

1. Define a business problem regarding to home country's values, trait, habits and norms.
2. Define a business problem regarding to foreign country's values, trait, habits and norms.
3. Compare above two aspects and identify the impact of SRC for the business problem and carefully evaluate how it complicate patterns.
4. Isolate the influence of SRC for the problem and redefine the problem to solve for the foreign market situation (Hill, 2008).

First and second steps this process in really important to identify the biasness of own culture. Even though, there are some practical issues with this mechanism, still this approach can be used to identify and isolate SRC before enter to international market.

At the time of Unilever started its operations in Brazil and company wanted to introduce laundry detergent to the market. However, one of the biggest challenge that company faced was Brazilian people didn't use washing machine at that time and there was not enough awareness of the product. There were huge population of people who suffered from poverty and people washed their clothes by the river in the rural areas. Therefore, Unilever first developed a soap to eliminate self-referential criterion. They made the plastic packaging of the soaps which can use comfortably in washing clothes on rivers, and then introduced small pack of detergent powder for an affordable price which make suitable for the maximum number of low-income populations lives in rural areas. This was the one of most successful approach used by the company to eliminate the impact of the SRC and recognized the presence of influence of local culture ((Johnson et. al. 2014)

Therefore firms need to conduct proper cultural study and need to adopt its marketing mix according to foreign market's values, behaviors, habits and traits to be successful in that market.

### **Question 3**

CIC holdings is a company which operates in agricultural industry in Sri Lanka which expect to export its agricultural products to international markets such as China. Company has an agricultural product portfolio including rice, grains, dairy products, farm products and high tech agricultural products.

Without access to the domestic markets of another country, there is no other way to conduct international trade. World Trade organization and many other organizations promote free trade facilities among countries. However, importing countries impose certain obstacles, even though they pay attention and promote free trade. Mainly countries put some barriers to free trade to protect local industries, avoid dumping behavior and as a solution for balance of payment deficit. Similar to other countries, Sri Lanka also has two main type of trade barriers such as tariff barriers and non-tariff barriers.

Tariff barriers.

Custom duties are the most commonly used obstacle to market access. Governments most often use this tariff to protect domestic industry from foreign competitors and to increase government revenues. Now a days, countries are moving from high tariff to VAT which is based on the value of the product (Hill, 2018).

Non-Tariff barriers

This type of barriers are obstacle that restrict import and export via method except of imposition of normal tariff. There are many type of non-tariff barriers such as quantitative restrictions, quota, exchange controls, technical regulation and etc. The overall impact of non-tariff barriers for international trade has been identified relatively higher compared to tariff (Hill, 2008).

According to China's trade policy, their Non-tariff measures mainly focus on anti-dumping duties, sanitary and phytosanitary issues, technical trade barriers, protection of intellectual properties, export restriction etc .

Agricultural exports covered in the study (tea, fish and fisheries and fruits and vegetables) are mostly burdened by NTMs, compared to tariffs. With regard to NTMs, the commonly cited problems faced by agricultural exporters to China revolves around high sanitary and phytosanitary (SPS) requirements compared to other export markets, and the lack of mutual recognition of standards and certificates. For example, tea exports to China are subject to rare-earth content testing, which is unique to China and not a requirement in other markets. Moreover, the exact particulars of this standard are not clear. It is also revealed that testing for rare-earth content is problematic as the available testing facilities in Sri Lanka are insufficient – the current facilities can only specify if rare-earth content is present or not in tea, but the levels of rare-earth cannot be



determined as per se Chinese requirements. Moreover, China does not recognize testing and certificates provided by Sri Lanka, while testing in China is considered to be time-consuming and complex.

Issues relating to quarantine and testing/certification are reported across other agricultural export categories as major impediments, as well as lack of transparency with regard to the food safety regulations. The frequency of test reports and the levels/limits required in China are considered to be greater than in any other markets. The lack of necessary testing facilities in Sri Lanka to meet testing and certification requirements applicable to China is also highlighted as a major concern.

Sri Lankan exporters face both tariff barriers and non-tariff barriers when entering the Chinese market. An FTA, which does not address NTMs, may not be sufficient in delivering the expected trade gains for Sri Lanka. Therefore, it is imperative for China-Sri Lanka trade negotiations to simultaneously address both tariff barriers and NTMs. Given that the agreement with China is going to be a comprehensive one, SPS/TBT issues will be taken into account during the negotiations. Some of the key issues to figure in negotiations, include but are not limited to, (a) addressing NTMs in addition to tariff concessions as a priority, (b) setting up Chinese accredited testing laboratories in Sri Lanka whilst (c) enhancing capacities and efficiencies of testing laboratories in the country which China may consider assisting under the umbrella of economic and technical cooperation, (d) striking Mutual Recognition Agreements (MRAs) on standards, (d) translating all trade-related documents/ regulations/ information into English, (e) appointing nodal points in both countries to handle issues at the point of clearance; and (f) establishing better relationships/coordination between relevant respective competent authorities to facilitate trade.

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