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## CHAPTER OVERVIEW

1. HISTORICAL ROLE OF THE U.S. DOLLAR
2. DEVELOPMENT OF TODAY'S INTERNATIONAL MONETARY SYSTEM
3. FIXED VERSUS FLOATING EXCHANGE RATES
4. FOREIGN EXCHANGE AND FOREIGN EXCHANGE RATES
5. BALANCE OF PAYMENTS
6. ECONOMIC AND FINANCIAL TURMOIL AROUND THE WORLD
7. MARKETING IN THE EURO AREA

When international transactions occur, foreign exchange is the monetary mechanism allowing the transfer of funds from one nation to another. The existing international monetary system always affects companies as well as individuals whenever they buy or sell products and services traded across national boundaries. The dollar's strengths, vis-à-vis other major currencies at the dawn of this new century, affected not only foreign but also U.S. companies as well. For example, in the fourth-quarter of 2001, Amazon.com posted its first-ever profit of US\$5.1 million, thanks to reduced U.S. dollar payments on its euro-denominated debt.<sup>1</sup> Similarly, due to the stronger yen compared to the U.S. dollar in early 2008, Japanese multinational corporations, such as Toyota, reported a reduction in their profits as these companies' overseas businesses in the United States collect sales in U.S. dollars but report profit in Japanese yen. Every one-yen increase in the Japanese currency relative to the U.S. dollar is expected to trim Toyota's operating profit by around 35-billion yen (which would amount to a whopping \$350 million at 105 yen/\$).<sup>2</sup> It is obvious that the current international monetary system has a profound impact not only on individuals and companies but also on the U.S. balance of payments at the aggregate level.

This chapter examines international trade in monetary terms. In fact, the international monetary system has changed rather drastically over the years. Given the drastic realignment in recent years of the exchange rates of major currencies, including the U.S.

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<sup>1</sup>Raizel Robin, "New Age Profit," *Canadian Business*, February 18, 2002.

<sup>2</sup>"The Yen Also Rises," *Economist*, May 19, 2008.

dollar, the European euro, and the Japanese yen, the current international monetary system may well be in for a major change. The adoption of the euro as a common currency in the European Union in 1999 is just one example of the many changes to come. Although international marketers have to operate in a currently existing international monetary system for international transactions and settlements, they should understand how the scope and nature of the system has changed and how it has worked over time. Forward-looking international marketers need to be aware of the dynamics of the international monetary system.

Since the last decade—particularly, the second half of the last decade—of the twentieth century, the global financial market has been anything but stable and has proved to be one of the most turbulent periods in recent history. The seemingly unstoppable rapid economic growth of Asia came to a screeching halt in 1997, and the introduction of the euro in the European Union in 1999 has drastically changed the European economic environment. The beginning of the 21st century has not been smooth, either. As described in Chapter 2, the financial crisis in South America and the slump in the U.S. and European economies since 2001 have also made us aware how vulnerable the global economy can be. Then the worst of such vulnerability has manifested itself again in an unprecedented global recession triggered by the U.S. subprime mortgage loan-led credit crisis that has quickly spread around the world since late 2008. These events profoundly affect international marketing practices. We are convinced that these epoch-making events need your special attention and that your understanding of them will allow you to become seasoned marketing decision makers in crucial areas such as product development, brand management, and pricing, among others, when developing marketing strategy on a global basis. It is another way to tell you that you have to be up-to-the-minute with ever-changing events that could affect your understanding of the class material, let alone your future career. In this chapter, we also provide a special detailed examination of the implications of the Asian and South American financial crises and marketing in the Euro Area.

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## HISTORICAL ROLE OF THE U.S. DOLLAR



Each country also has its own currency through which it expresses the value of its products. An international monetary system is necessary because the vast majority of countries have their own monetary unit or currency that serves as a medium of exchange and store of value. The absence of a universal currency means that we must have a system that allows for the transfer of purchasing power between countries with different national currencies. For international trade settlements, the various currencies of the world must be exchanged from one to another. This is accomplished through foreign exchange markets.

Periodically, a country must review the status of its economic relations with the rest of the world in terms of its exports and imports, its exchange of various kinds of services, and its purchase and sale of different types of capital assets and other international payments, receipts and transfers. In the post-World War II period, a number of institutions came into existence to monitor and assist countries as necessary in keeping their international financial commitments. As a result, a new system of international monetary relations emerged, which promoted increased international trade through the 1950s and 1960s. In the early 1970s, however, a weakening U.S. dollar caused the existing system to show strains and eventually break down.

The U.S. trade deficit has pushed the value of the U.S. dollar downward in the last forty years. Since 1960, the dollar has fallen by approximately two-thirds against the euro (using Germany's currency as a proxy before 1999) and the Japanese yen.<sup>3</sup> Despite this long-term trend, the value of the dollar also fluctuates up and down significantly in

<sup>3</sup>“The Passing of the Buck?” *Economist*, December 4, 2004. pp. 71–73.

the short and intermediate term, and it remains stronger than commonly expected. Whether a strong dollar is in the best interest of the United States or not is debatable, but a strong dollar certainly reflects global confidence in U.S. economic leadership. However, the dollar could become an overvalued currency and make the current account deficits unsustainably large. A sharp downward shift of dollar value could have an enormous impact on global economy. During the annual G8 Summit meetings in June 2002, one of the most urgent issues was whether enough had been done to cushion against a collapse of the dollar.<sup>4</sup>

For example, within two years after the euro's introduction in 1999, the dollar appreciated 20 percent against the euro. However, from 2001 to 2008, the dollar kept depreciating against the euro by as much as 60 percent because of the weak U.S. economy, increased fear of rising U.S. inflation rates, uncertainty about the aftermath of a U.S.-led war with Iraq, and rising oil prices.

Because of the weakening of the dollar and other issues, the monetary stability of the world became unsettled beginning with the 1970s and continuing into the early 1980s. As the 1980s advanced, the U.S. economy stabilized and the value of the dollar against other currencies climbed to an all-time high. This caused U.S. exports to become costlier, and foreign imports to become cheaper, resulting in an adverse trade balance. In the fall of 1985, leading industrialized countries joined the United States effort to intervene in the foreign exchange markets to decrease the value of the dollar. The dollar had steadily fallen and remained weak since mid-1980s. However, the current severe global recession has demonstrated an unexpected aspect of the dollar: When the global economy is in an unprecedented level of turmoil as it has been since late 2008, the world still considers the U.S. dollar as a last-resort currency to hold on to. As a result, the dollar has since appreciated dramatically against most other foreign currencies but depreciated against Japanese yen. For example, as of February 4, 2009, the U.S. dollar appreciated 15 percent against euro, 39 percent against Australian dollar, and a whopping 46 percent against Korean won, and depreciated almost 20 percent against Japanese yen from a year earlier. Clearly, the currency market has been far from stable.

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## ◆ ◆ ◆ ◆ ◆ ◆ ◆ ◆ ◆ ◆ DEVELOPMENT OF TODAY'S INTERNATIONAL MONETARY SYSTEM

### The Bretton Woods Conference

Post-World War II developments had long-range effects on international financial arrangements, the role of gold, and the problems of adjustment of balance of payments disequilibria. Following World War II, there was a strong desire to adhere to goals that would bring economic prosperity and hopefully a long-term peace to the world. The negotiations to establish the postwar international monetary system took place at the resort of Bretton Woods in New Hampshire in 1944. The negotiators at Bretton Woods recommended the following:<sup>5</sup>

Each nation should be at liberty to use macroeconomic policies for full employment.

1. Free floating exchange rates could not work. Their ineffectiveness had been demonstrated in the interwar years. The extremes of both permanently fixed and floating rates should be avoided.
2. A monetary system was needed that would recognize that exchange rates were both a national and international concern.

In order to avoid both the rigidity of a fixed exchange rate system and the chaos of freely floating exchange rates, the Bretton Woods Agreement provided for an

<sup>4</sup>Jesper Koll, "Dangers of a Falling Dollar," *Wall Street Journal*, June 12, 2002.

<sup>5</sup>Carlo Cottarelli and Curzio Giannini, *Credibility without Rules?—Monetary Framework in the Post-Bretton Woods Era*, Washington, D.C.: International Monetary Fund, 1997.

adjustable peg. Under this system, currencies were to establish par values in terms of gold, but there was to be little, if any, convertibility of the currencies for gold. Each government was responsible for monitoring its own currency to see that it did not float beyond 1 percent above or below its established par value. As a nation's currency attained or approached either limit, its central bank intervened in the world financial markets to prevent the rate from passing the limit.

Under this system, a country experiencing a balance-of-payments deficit would normally experience devaluation pressure on its current value. The country's authorities would defend its currency by using its foreign currency reserves, primarily U.S. dollars, to purchase its own currency on the open market to push its value back up to its par value. A country experiencing a balance-of-payments surplus would do the opposite and sell its currency on the open market. An institution called the **International Monetary Fund (IMF)** was established at Bretton Woods to oversee the newly agreed-upon monetary system. If a country experienced a fundamental or long-term disequilibrium in its balance of payments, it could alter its peg by up to 10 percent from its initial par value without approval from the International Monetary Fund. Adjustment beyond 10 percent required IMF approval.

In the 1960s, the United States began to experience sequential balance of payments deficits, resulting in downward pressure on the dollar. Since the U.S. government was obligated to maintain the dollar at its par value, it had to spend much of its gold and foreign currency reserves in order to purchase dollars on the world financial markets. In addition, the U.S. dollar was the reserve currency, convertible to gold under the Bretton Woods Agreement; the U.S. Treasury was obligated to convert dollars to gold upon demand by foreign central banks.

Furthermore, many central banks engaged in massive dollar purchases on the foreign exchange markets to counteract the downward pressure on the dollar and related upward pressure on their own currencies. The continued defense of the dollar left central banks around the world with massive quantities of dollars. These countries, knowing that the dollars they held were in fact convertible to gold with the U.S. Treasury, attempted to hold back, demanding gold in exchange. However, it became clear by 1971 that the dollar was quite overvalued, and devaluation of the dollar versus gold was inevitable. Central banks increasingly presented U.S. dollar balances to the U.S. Treasury for conversion to gold, and gold flowed out of the U.S. vaults at an alarming rate.

This situation led President Richard Nixon to suspend the convertibility of the dollar to gold on August 15, 1971. This effectively ended the exchange rate regime begun at Bretton Woods more than twenty-five years earlier.

The International Monetary Fund (IMF) oversees the international monetary system. The IMF was a specialized agency within the United Nations, established to promote international monetary cooperation and to facilitate the expansion of trade, and in turn to contribute to increased employment and improved economic conditions in all member countries.

Its purposes are defined in the following terms:<sup>6</sup>

To promote international monetary cooperation through a permanent institution, providing the machinery for consultations and collaboration on international monetary problems.

1. To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income, and to the development of the productive resources of all members as primary objectives of economic policy.

## The International Monetary Fund

<sup>6</sup>International Monetary Fund, *The Role and Function of the International Monetary Fund* (Washington, D.C.: International Monetary Fund, 1985).

2. To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.
3. To assist in the establishment of a multilateral system of payments in respect to current transactions between members and in the elimination of foreign exchange restrictions that hamper the growth of world trade.
4. To give confidence to members by making the general resources of the fund temporarily available to them under adequate safeguards, thus providing them with the opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.
5. In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balance of payments to members.

Today the IMF has 186 members.<sup>7</sup> Its accomplishments include sustaining a rapidly increasing volume of trade and investment and displaying flexibility in adapting to changes in international commerce. To an extent, the IMF served as an international central bank to help countries during periods of temporary balance of payments difficulties, by protecting their rates of exchange. This helped countries avoid the placement of foreign exchange controls and other trade barriers.

As time passed, it became evident that the IMF's resources for providing short-term accommodation to countries in monetary difficulties were not sufficient. To resolve the situation, and to reduce upward pressure on the U.S. dollar by countries holding dollar reserves, the fund created special drawing rights in 1969. **Special drawing rights (SDRs)** are special account entries on the IMF books designed to provide additional liquidity to support growing world trade. The value of SDRs is determined by a weighted average of a basket of four currencies: the U.S. dollar, the Japanese yen, the European Union's euro, and the British pound. Although SDRs are a form of fiat money and not convertible to gold, their gold value is guaranteed, which helps to ensure their acceptability.

Participant nations may use SDRs as a source of currency in a spot transaction, as a loan for clearing a financial obligation, as security for a loan, as a swap against a currency, or in a forward exchange operation. A nation with a balance of payment problem may use its SDRs to obtain usable currency from another nation designated by the fund. By providing a mechanism for international monetary cooperation, working to reduce restrictions to trade and investment flows, and helping members with their short-term balance of payment difficulties, the IMF makes a significant and unique contribution to economic stability and improved living standards throughout the world.

In the wake of the 1997–1998 Asian financial crisis, the IMF worked on policies to overcome or even prevent future crisis. After 1997, the external payments situation was stabilized through IMF-led aid programs, and financial packages were being geared to encourage the adoption of policies that could prevent crises in selected developing countries. Backed by an IMF quota increase of \$90 billion, the IMF would make a contingent short-term line of credit available before a crisis breaks out, but only if a country adopts certain policies that would limit its vulnerability. The line of credit is expected to be short-term and to charge interest rates above market rates to discourage misuse.<sup>8</sup> In September, 2002, the IMF also approved \$30 billion in emergency loans to Brazil battered by the financial crisis in Argentina. The announcement pushed various developing market currencies higher as investors welcomed both the vote of confidence in Brazil and the broader implications of the loan announcement for emerging market assets. Now as the global financial crisis has spread since late 2008, net capital inflows into emerging markets, which were \$929 billion in 2007, are expected to fall to a meager \$165 billion in 2009. Again, IMF is channeling a massive amount of capital to those

<sup>7</sup>International Monetary Fund Homepage, <http://www.imf.org/>, accessed July 11, 2009.

<sup>8</sup>Suk H. Kim and Mahfuzul Haque, "The Asian Financial Crisis of 1997: Causes and Policy Response," *Multinational Business Review*, 10 (Spring 2002), pp. 37–44; and Ramon Moreno, "Dealing with Currency Crises," *FRBSF Economic Letter*, Number 99-11, April 2, 1999.



countries to stem any precipitous collapse not only of their economies but also of the global trading regime itself.<sup>9</sup> These loans signal that there is still a commitment by international organizations to countries with major financial problems.<sup>10</sup>

Another creation of the Bretton Woods Agreement was the International Bank for Reconstruction and Development, known as the **World Bank**. Although the International Monetary Fund was created to aid countries in financing their balance of payment difficulties and maintaining a relatively stable currency, the World Bank was initially intended for the financing of post-war reconstruction and development and later for infrastructure building projects in the developing world. More recently, the World Bank has begun to participate actively with the IMF to resolve debt problems of the developing world, and it may also play a major role in bringing a market economy to the former members of the Eastern bloc. Each year the World Bank lends between US\$15–20 billion to developing country governments to support projects for economic development and poverty reduction. The World Bank is the largest external fund provider for education and HIV/AIDS programs, strongly supports debt relief, and is responding to the voices of the poor people. The organization greatly supports developing country governments to build schools and health centers, provide water and electricity, fight disease, and protect the environment.<sup>11</sup>

## The International Bank for Reconstruction and Development



Various foreign currencies and gold coins, nuggets, and bars as means to measure and store economic value.

Comstock Inc.

Since the 1970s all major nations have had floating currencies. An IMF meeting in Jamaica in 1976 reached consensus on amendments to the IMF Articles of Agreement that accepted floating rates as the basis for the international monetary system. The amended agreement recognized that real rate stability can only be achieved through stability in underlying economic and financial conditions. Exchange rate stability cannot be imposed by adoption of pegged exchange rates and official intervention in the foreign exchange markets.

There are two kinds of currency floats, and these are referred to as free or managed or as clean or dirty. The **free (clean) float** is the closest approximation to perfect competition, because there is no government intervention and because billions of units

## Fixed versus Floating Exchange Rates

<sup>9</sup>“Supersizing the Fund,” *Economist*, February 5, 2009; also see “2008–2009 Global Financial Crisis” at <http://wtfaculty.wtamu.edu/~sanwar.bus/otherlinks.htm#GlobalFinCrisis>, an excellent website maintained by Professor Syed Anwar of West Texas A&M University.

<sup>10</sup>“Special Summary of Stories on IMF \$30B Package for Brazil,” *Dow Jones Newswire*, August 8, 2002; “IMF Improves Terms on Emergency Aid,” *Finance & Development* (42), March 2005, p. 3.

<sup>11</sup>The World Bank, <http://www.worldbank.org/>, accessed December 20, 2005.

of currency are being traded by buyers and sellers. Buyers and sellers may change sides on short notice as information, rumors, or moods change, or as their clients' needs differ.

A **managed (dirty) float** allows for a limited amount of government intervention to soften sudden swings in the value of a currency. If a nation's currency enters into a rapid ascent or decline, that nation's central bank may wish to sell or buy that currency on the open market in a countervailing movement to offset the prevailing market tendency. This is for the purpose of maintaining an orderly, less-volatile foreign exchange market.

In March 1973, the major currencies began to float in the foreign exchange markets. The advocates for floating exchange regime argued that it would end balance of payments disequilibria because the value of each currency would float up or down to a point where supply equaled demand. It has not worked that way, at least in part due to the reluctance of governments to permit extreme changes in the value of their currencies. Governments have intervened in the currency markets to moderate or prevent value changes. In reality, however, the supposed benefits of floating exchange rates have not been borne to date. For example: Floating exchange rates were supposed to facilitate balance of payments adjustments. However, not only have imbalances not disappeared, they have become worse, as attested to by the recent Asian and Latin American financial crises.

1. Currency speculation was expected to be curtailed. But speculation has since been greater than ever. Similarly, short-term speculations worsened the Asian and Latin financial crisis.
2. Market forces, left to their own devices, were expected to determine the correct foreign exchange rate balance. But imbalances have become greater than ever, as have fluctuations in rates.
3. Autonomy in economic and monetary policy was hoped to be preserved, allowing each country free choice of its monetary policy and rate of inflation. But this has also not materialized.

As a result, international marketers have had to cope with the ever-fluctuating exchange rates (see **Exhibit 3.1**). Refer back to the enormous change in Toyota's operating profits as a result of a small change in the yen/dollar exchange rate illustrated in the opening paragraph of this chapter. Even a small fluctuation in exchange rates cannot be ignored, since it has an enormous impact on a company's operating profit.

## Currency Blocs

Although currencies of most countries float in value against one another, those of many developing countries are pegged (or fixed) to one of the major currencies or to a basket of major currencies such as the U.S. dollar, Special Drawing Rights, or some specially chosen currency mix. In general, developing countries that depend on their trading relationships with a major country, such as the United States, for economic growth tend to use the currency of the principal country.

For example, Chinese currency, *renminbi* (yuan), had been pegged to the U.S. dollar for a decade at 8.28 yuan to the dollar. Based on its growing trade surplus with the United States as well as its sustained real GDP growth in the past twenty years of 9.5 percent, China has been accused of pursuing a cheap-yuan policy and has been pressured to revalue its currency. In the past, in order to prevent the yuan from rising against the dollar, the Chinese central bank had to buy huge amounts of U.S. Treasury securities. The Chinese government believed that the fixed exchange rate would provide stability to the Chinese economy as it relied so much on trade with the United States. However, as the dollar continued to fall against other key currencies, the Chinese central bank decided on July 21, 2005 to abandon the yuan's peg to the dollar in favor of a link to a basket of several currencies, including the euro and the yen, and revalued the yuan by 2.1 percent against the dollar. On September 23, 2005, the Chinese central bank further decided to let the yuan float against the major currencies by up to 3 percent a day against the euro, yen and other non-dollar currencies, compared with 1.5 percent previously. Daily movements against the dollar, meanwhile, remained

**EXHIBIT 3-1****FOREIGN EXCHANGE RATE FLUCTUATIONS OVER THE PAST 30 YEARS (FOREIGN CURRENCY UNITS/U.S. DOLLAR)**

Year	<i>Deutsche Mark</i>	<i>French Franc</i>	<i>Japanese Yen</i>	<i>Swiss Franc</i>	<i>British Pound</i>
1980	1.96	4.55	203	1.76	0.42
—	—	—	—	—	—
1985	2.46	7.56	201	2.08	0.69
—	—	—	—	—	—
1990	1.49	5.13	134	1.30	0.52
1991	1.52	5.18	125	1.36	0.53
1992	1.61	5.51	125	1.46	0.66
1993	1.73	5.90	112	1.48	0.68
1994	1.55	5.35	100	1.31	0.64
1995	1.43	4.90	103	1.15	0.65
1996	1.50	5.12	94	1.24	0.64
1997	1.73	5.84	121	1.45	0.64
1998	1.82	6.10	139	1.53	0.60
1999		0.94 euro*	108	1.69	0.66
2000		1.08	108	1.69	0.66
2001		1.12	122	1.69	0.69
2002		1.06	125	1.55	0.67
2003		0.88	116	1.35	0.61
2004		0.80	108	1.24	0.55
2005		0.80	116	1.24	0.55
2006		0.79	113	1.24	0.54
2007		0.68	111	1.13	0.50
2008		0.72	91	1.07	0.62
2009**		0.72	92	1.09	0.62

Source: International Monetary Fund, *Balance of Payments Statistics Yearbook* (Washington, D.C.: U.S. Government Printing Office); and “World Value of the Dollar,” *Wall Street Journal*, March 17, 2009.

\*The euro was introduced in 1999 and completely replaced the currencies of member countries in 2002.

\*\*Exchange rate as of July 10, 2009.

limited to only 0.3 percent.<sup>12</sup> On May 16, 2007, however, China again took steps to let its currency trade more freely against the dollar and to cool its sizzling economy and its soaring trade surplus<sup>13</sup>. The yuan is now allowed to fluctuate against the dollar by 0.5 percent a day, up from 0.3 percent. The renminbi exchange rate rose from 8.28 yuan/\$ in July 2005 to 6.84 yuan/\$ in February 2009, a jump of 21 percent in three years.

Today, the global economy is increasingly dominated by three major currency blocs. The U.S. dollar, the EU's euro, and the Japanese yen each represent their “sphere of influence” on the currencies of other countries in the respective regions (i.e., North and South America, Europe, and East Asia, respectively).<sup>14</sup> After its launch, the euro immediately became the world's second leading international currency. The U.S. dollar is still likely to remain the dominant international currency for the time being. However, the current financial crisis seems to indicate that companies based in countries with more stable currencies than the U.S. dollar, such as Japan, have seriously started to move away from the U.S. dollar as the international transaction currency.<sup>15</sup>

Due to the large size of the euro-area economy, the stability attached to the euro, and the ongoing integration of national financial markets in Europe into broad, deep and liquid Pan-European financial markets, the euro is gradually becoming an international currency.<sup>16</sup> Although the U.S. dollar has lost some of its role as the

<sup>12</sup>“Yuan Step at a Time,” *Economist*, January 22, 2005, p. 74; and “Patching the Basket,” *Economist*, October 1, 2005, p. 71.

<sup>13</sup>“China Eases Controls to Allow Yuan Float Freely against Dollar,” *SeekingAlpha.com*, August 30, 2007.

<sup>14</sup>Michael H. Moffett, Arthur I. Stonehill, and David K. Eiteman, *Fundamentals of Multinational Finance*, 2nd ed., Reading, Mass.: Addison-Wesley, 2006.

<sup>15</sup>“Japan Firms Rethink Using Dollar as Settlement Currency,” NikkeiNet Interactive, www.nni.nikkei.co.jp, October 9, 2008.

<sup>16</sup>“The Passing of the Buck?” *Economist*, December 4, 2004, pp. 71–73.



international transaction currency, it remains a currency of choice that many Latin American companies use for operating purposes. The Japanese yen has increasingly become a regional transaction currency in Asia. In other words, U.S. companies will find it easier to do business with companies in Latin America as business planning and transactions are increasingly conducted in dollar denominations. On the other hand, those U.S. companies will increasingly have to accept yen-denominated business transactions in Asia and euro-denominated transactions in Europe, thus being susceptible to exchange rate fluctuations. Considering increased trade volumes with Asian and European countries as well as with Latin American countries, it has become all the more important for U.S. marketing executives to understand the dynamic forces that affect exchange rates and predict the exchange rate fluctuations.

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## ◆ ◆ ◆ ◆ ◆ ◆ ◆ ◆ FOREIGN EXCHANGE AND FOREIGN EXCHANGE RATES

Foreign exchange, as the term implies, refers to the exchange of one country's money for that of another country. When international transactions occur, foreign exchange is the monetary mechanism allowing the transfer of funds from one nation to another. In this section, we explore what factors influence the exchange rates over time and how the exchange rates are determined.

### Purchasing Power Parity

One of the most fundamental determinants of the exchange rate is **purchasing power parity (PPP)**, whereby the exchange rate between the currencies of two countries makes the purchasing power of both currencies equal. In other words, the value of a currency is determined by what it can buy.

The following formula represents the relationship between inflation rates and the exchange rate, say, in the United States and Europe's eurozone:

$$R_t = R_0 * \frac{(1 + \text{Infl}_{\text{euro}})}{(1 + \text{Infl}_{\text{US}})}$$

where

$R$  = the exchange rate quoted in euro/\$,  
 $\text{Infl}$  = inflation rate,  
 $t$  = time period.

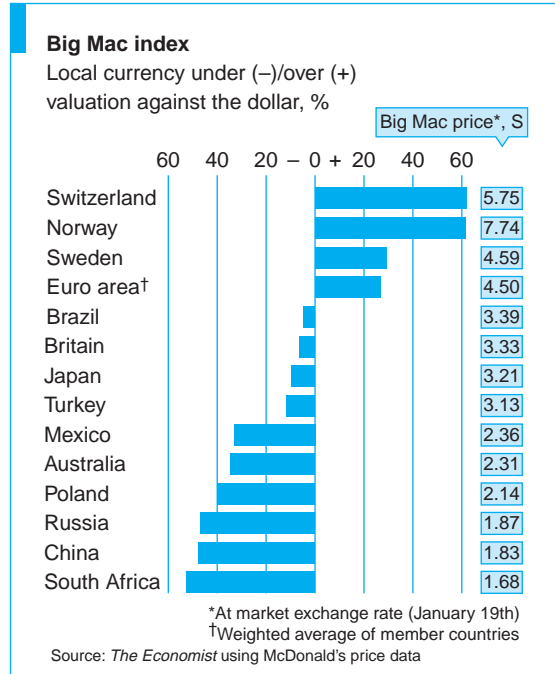
For example, if the inflation rate in the eurozone were 2 percent a year and U.S. inflation were 5 percent a year, the value of the dollar would be expected to decline by the difference of 3 percent, so that the real prices of goods in the two countries would remain fairly similar. If the current exchange rate ( $R_0$ ) is 0.675 euro to the dollar (€0.675/\$), then

$$R_t = 0.675 * \frac{(1 + .02)}{(1 + .05)} = \text{€}0.656/\$.$$

In other words, the dollar is expected to depreciate from €0.675/\$ to €0.656/\$ in a year. The U.S. dollar will be able to buy slightly more less euro. Or, stated in reverse, the euro will be able to buy slightly more U.S. dollars.

In fact, the *Economist* publishes a PPP study every year based on McDonald's Big Mac hamburger, sold all over the world. It is known as the Big Mac Index to show whether currencies are at their "correct" exchange rate. Look at the recent Big Mac Index to see how actual exchange rates "deviate" from the Big Mac Index (see **Exhibit 3.2**). The average price for a Big Mac is \$3.54 in the United States in 2009. For example, the cheapest burger in the chart is in South Africa, at 47 percent of the U.S. price, or \$1.68. This implies that the South African rand is 53 percent undervalued

**EXHIBIT 3-2**  
THE BIG MAC INDEX



Source: "Big Mac Index," *Economist*, July 26, 2009.

relative to the U.S. dollar, based on the Big Mac dollar-PPP. On the same basis, the euro is 27 percent overvalued, the Swedish krona a whopping 98 percent overvalued, and the yen 9 percent undervalued. We can observe that, in general, major European currencies are overvalued relative the U.S. dollar, while Asia-Pacific currencies are undervalued. Theoretically, over the long run, exchange rates tend to go toward the direction of PPP index. If the dollar is overvalued relative to a foreign currency (i.e., the foreign currency is undervalued relative to the dollar), people using that foreign currency will find it more expensive to buy goods from the United States. Conversely, people living in the United States will find it cheaper to import goods from a country with an undervalued currency.

Actual exchange rates can be very different from the expected rates. Those deviations are not necessarily a random variation. As summarized in **Exhibit 3.3**, many inter-related factors influence the value of a floating currency. In particular, the nation's inflation rate relative to its trading partners, its balance of payments situation, and world political events are the three most fundamental factors.

Although accurately predicting the actual exchange rate fluctuations is not possible and it is not related directly to marketing executives' jobs, seasoned marketers can benefit from the knowledge. Exchange rate fluctuations have an enormous direct impact on the bottom line for the company—profitability.

When the fast-food operator Kentucky-Fried Chicken (KFC) opens new restaurants in Mexico, for example, it often imports some of the kitchen equipment, including fryers, roasters, stainless steel counters, and other items for its stores from U.S. suppliers.

In order to pay for these imports, the Mexican subsidiary of KFC must purchase U. S. dollars with Mexican pesos through its bank in Mexico City. This is necessary because Mexican pesos are not readily accepted currency in the United States. Most likely, KFC-Mexico will pay for the imported merchandise via a bank cashier's check from its

**Forecasting Exchange Rate Fluctuation**

**Coping with Exchange Rate Fluctuations**

**EXHIBIT 3-3****FACTORS INFLUENCING FOREIGN EXCHANGE RATES**

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## MACROECONOMIC FACTORS

1. **Relative Inflation:** A country suffering relatively higher inflation rates than other major trading partners will cause depreciation of its currency.
2. **Balance of Payments:** Improvement (deterioration) in the balance of payments for goods and services is an early sign of a currency appreciation (depreciation).
3. **Foreign Exchange Reserves:** A government may intervene in the foreign exchange markets to either push up or push down the value of its currency. The central bank can support (depreciate) the domestic currency by selling its foreign currency reserves to buy its own currency (selling its domestic currency to buy foreign currency).
4. **Economic Growth:** If the domestic economy is growing fast relative to major trading partners, the country's imports tend to rise faster than exports, resulting in deterioration of the trade balance and thus depreciation of its currency. However, if the domestic economic growth attracts a large amount of investment from abroad, it could offset the negative trade effect, thus potentially resulting in appreciation of the domestic currency.
5. **Government Spending:** An increase in government spending, particularly if financed through deficit spending, causes increased inflationary pressures on the economy. Inflation leads to domestic currency depreciation (as in 1).
6. **Money Supply Growth:** Many countries' central banks attempt to stave off recession by increasing money supply to lower domestic interest rates for increased consumption and investment. Increase in money supply usually leads to higher inflation rates and subsequently currency depreciation.
7. **Interest Rate Policy:** As in 6, the central bank may also control its discount rate (interest rate charged to banks) to raise domestic lending rates so as to control inflation. Higher interest rates discourage economic activity and tend to reduce inflation and also attract investment from abroad. Reduced inflation and increased investment from abroad both lead to currency appreciation.

## POLITICAL FACTORS

1. **Exchange Rate Control:** Some governments have an explicit control on the exchange rate. The official rate for domestic currency is artificially overvalued, thereby discouraging foreign companies from exporting to such a country. However, as long as there is a genuine domestic demand for imported products, the black market tends to appear for foreign currency. Black market exchange rates for a domestic currency tend to be much lower than the government-imposed artificial rate. Thus, a wide spread between the official exchange rate and the black market rate indicates potential pressures leading to domestic currency devaluation.
2. **Election Year or Leadership Change:** Expectations about imminent government policy change influence exchange rates. In general, pro-business government policy tends to lead to domestic currency appreciation as foreign companies are willing to accept that currency for business transactions.

## RANDOM FACTORS

Unexpected and/or unpredicted events in a country, such as assassination of political figures and sudden stock market crash, can cause its currency to depreciate for fear of uncertainty. Similarly, events such as sudden discovery of huge oil reserves and gold mines tend to push up the currency value.

*Source:* Developed from a discussion in Chapter 3 of David K. Eiteman, Arthur I. Stonehill, and Michael H. Moffett, *Multinational Business Finance*, 9th ed., New York: Addison-Wesley, 2001.

local bank in Mexico City, denominated in U.S. dollars. If the exchange rate on the date of purchase is 10.19 Mexican pesos per U.S. dollar and their debt is \$10,000 dollars, then KFC-Mexico must pay 101,900 pesos, plus a commission to the bank, for the dollars it sends to the U.S. supplier. The bank in Mexico acquires the dollars on the open foreign exchange market or through other banks for the purpose of satisfying the foreign exchange needs of its customers.

This is the case when currency is freely convertible with minimal government foreign exchange controls, as has been true in Mexico. However, this is not always the case. Governments have often limited the amount of domestic currency that can leave a country, in order to avoid capital flight and decapitalization. One example of this was South Africa in the 1980s, where it was illegal to buy foreign currency or take domestic currency out of the country without government approval. If a company in South Africa required foreign manufactured goods, it had to solicit authorization for the purchase of foreign exchange through the national treasury in order to make payment.

Even more rigid exchange controls existed in the former Soviet Union and other Eastern bloc countries prior to the fall of communism, where trade in foreign currency was a crime meriting harsh punishment. The problem with such tight exchange controls is that often they promote a black market in unauthorized trade in the controlled currency. In such cases, the official rate of exchange for a currency will tend to be overvalued, or in other words, possessing an officially stated value that does not reflect its true worth. The black market will more likely reflect its true worth on the street.

Another issue affecting foreign exchange concerns fluctuation in the rates of exchange, whereby currencies either appreciate or depreciate with respect to one another. Since the 1970s most of the world's currencies have been on a floating system, often fluctuating with wide variations. For example, in 1976, the Mexican peso traded at an exchange rate of 12.5 per dollar, but in 1993 it had fallen to 3,200 pesos per dollar.

This peso depreciation reflected much greater inflation in Mexico compared to the United States, and the fear of political/financial instability in Mexico prompted Mexican residents to buy dollars for security. In 1993, the Mexican government dropped three zeroes off the currency, creating a new peso (*nuevo peso*) worth 3.2 pesos per dollar. This rate climbed again with the depreciation that began in December 1994 to the 11 pesos per dollar range by 2004. Since then, the peso has begun to appreciate a little against the U.S. dollar as the dollar has weakened. As of June 2008, the exchange rate rose to 10.29 peso/\$. On the other hand, in the early 1980s, the Japanese yen traded at approximately 250 yen per dollar, but by 1996 had appreciated to 94 yen per dollar (before losing value slightly to approximately 108 yen per dollar in 2008). This long-term depreciation of the dollar against the yen reflected continuing U. S. trade deficits with Japan, as well as a higher level of inflation in the United States relative to Japan.

Many countries attempt to maintain a lower value for their currency in order to encourage exports. The reason for this is that if the dollar depreciates against the Japanese yen, for example, U.S.-manufactured goods should become cheaper to the Japanese consumers, who find that their supply of yen suddenly purchases a greater quantity of dollars; and Japanese and other foreign goods more expensive to Americans. The depreciation of the U.S. dollar should then help to reduce the United States' deficit with its trading partners by increasing exports and reducing imports, in the absence of other countervailing factors.

Directly related to the issue of floating currency is the concept of transaction gain or loss on the import or export of merchandise. Returning to the example of KFC-Mexico's import of \$10,000 in kitchen equipment, if that company ordered the equipment in January 2008 (when the exchange rate was 10 pesos per dollar) for payment in June 2009 (when the exchange rate had fallen to 11.5 pesos per dollar), they would incur a foreign exchange transaction loss. This happens because the company would have to buy dollars for payment in the month of June at a depreciated rate, thus paying more pesos for every dollar purchased. Only if they had the foresight (or good luck) to buy

the dollars in January 2008 at the more favorable rate could they avoid this foreign exchange loss. A more detailed illustration follows:

Cost of imported equipment in pesos at exchange rate in effect at order date (10 pesos per dollar)	100,000 pesos
Cost of imported equipment in pesos at exchange rate in effect at payment date (11.5 pesos per dollar)	115,000 pesos
Foreign exchange loss in pesos	15,000 pesos

Conversely, if the peso were to appreciate prior to the payment date, KFC-Mexico would have a transaction gain in foreign exchange.

### Spot versus Forward Foreign Exchange

If payment on a transaction is to be made immediately, the purchaser has no choice other than to buy foreign exchange on the **spot (or current) market**, for immediate delivery. However, if payment is to be made at some future date, as was the case in the KFC-Mexico example, the purchaser has the option of buying foreign exchange on the spot market or on the **forward market**, for delivery at some future date. The advantage of the forward market is that the buyer can lock in on an exchange rate and avoid the risk of currency fluctuations; this is called **currency hedging**, or protecting oneself against potential loss.<sup>17</sup>

The sound management of foreign exchange in an environment of volatile floating rates requires an astute corporate treasurer and effective coordination with the purchasing or marketing functions of the business.<sup>18</sup> If they see their national currency or the currency of one of their subsidiaries declining, they may purchase a stronger foreign currency as a reserve for future use. Often, if the corporation's money managers are savvy enough, significant income can be generated through foreign exchange transactions beyond that of normal company operations.<sup>19</sup> However, in recent years, many companies seem to be reducing hedging because exchange rate fluctuations have become so erratic and unpredictable. According to a survey conducted by the University of Pennsylvania's Wharton School and Canadian Imperial Bank of Commerce, only one-third of large U.S. companies engage in some kind of foreign-currency hedging.<sup>20</sup>

For example, Merck, a pharmaceutical giant, hedges some of its foreign cash flows using one- to five-year options to sell the currencies for dollars at fixed rates. Merck argues that it can protect adverse currency moves by exercising its options or enjoy favorable moves by not exercising them. But many well-established companies see no strong need to hedge for protection against currency risk. The reason is that fluctuations in the underlying business can spoil the hedge's effectiveness. For companies with a strong belief in hedging, the sustained rise in the dollar over the past several years proved a serious test. Coca-Cola hopes to limit the negative impact of unfavorable currency swings on earnings to 3 percent annually over the long term. However, Coca-Cola's profits from foreign sales were knocked off by 10 percent due to the stronger dollar in 1998, instead. Eastman Kodak used to use aggressive hedging strategy, but abandoned such practice recently as it realized that hedging was not necessary since the ups and downs of currencies would even out in the long run.<sup>21</sup>

<sup>17</sup>Alternatively, there is **operational hedging**, which is to shift production and procurement abroad to match revenues in foreign currency when exchange rate fluctuations are very difficult to predict (i.e., successful currency hedging is increasingly difficult). For example, by producing abroad all of the products a company sells in foreign markets, this company has created an "operational hedge" by shielding itself from fluctuating exchange rates. See, for example, Christos Pantzalis, Betty J. Simkins, Paul A. Laux, "Operational Hedges and the Foreign Exchange Exposure of U.S. Multinational Corporations," *Journal of International Business Studies*, 32 (4), 2001, pp. 793–812.

<sup>18</sup>Raj Aggarwal and Luc A. Soenen, "Managing Persistent Real Changes in Currency Values: The Role of Multinational Operating Strategies," *Columbia Journal of World Business* (Fall 1989), pp. 60–67.

<sup>19</sup>Stephen D. Makar and Stephen P. Huffman, "Foreign Currency Risk Management Practices in U.S. Multinationals," *Journal of Applied Business Research*, 13, Spring 1997, pp. 73–86.

<sup>20</sup>Peter Coy, De'Ann Weimer, and Amy Barrett, "Perils of the Hedge Highwire," *Business Week*, October 26, 1998, p. 74.

<sup>21</sup>Ibid.



However, it does not necessarily mean that currency hedging is less important to any company. Who should consider financial hedging more seriously? For an export-oriented economy, which is heavily dependent on the export of dollar-based products, such as Norway, currency hedging strategies remain vital.<sup>22</sup> While more young companies have started getting involved with international imports or exports, currency hedging has also become more accessible to them, thanks to a growing number of services offered by large banks as well as business-to-business Web sites. Currency hedging allows small business owners to greatly reduce or eliminate the uncertainties attached to any foreign currency transaction.

Forward currency markets exist for the strongest currencies, including the EU's euro, the British pound, Canadian dollar, Japanese yen, Swiss franc, and U.S. dollar. The terms of purchase are usually for delivery of the foreign currency in either thirty, sixty, or ninety days from the date of purchase. These aforementioned currencies are often called hard currencies, because they are the world's strongest and represent the world's leading economies.

Traditionally weaker currencies, such as the Indian rupee or the Colombian peso, are rarely used in forward currency markets, because there is no worldwide demand for such a market; nearly all international transactions are expressed in terms of a hard currency. **Exhibit 3.4** illustrates the daily quotes for foreign exchange on the spot and forward markets. In the second column, the foreign currency is expressed in terms of how many dollars it takes to buy one unit of foreign currency. The third column indicates the inverse, or how many units of a foreign currency it would take to purchase one dollar. For example, on July 11, 2009, one Japanese yen was worth \$0.01082; or more conventionally, the value of the yen was expressed as 92.42 yen per dollar. Similarly, on the same day, one euro was worth \$1.3949; or conversely, one U.S. dollar could buy 0.7169.

The dramatic swings in the value of the dollar since the early 1980s have made it clear that foreign companies charge different prices in the United States than in other markets.<sup>23</sup> When the dollar appreciated against the Japanese yen and the German mark in the 1980s, Japanese cars were priced fairly low in the United States, justified by the cheaper yen, while German cars became far more expensive in the United States than in Europe. In the 1990s, when the dollar began depreciating against the yen and the mark, Japanese and German auto makers had to increase their dollar prices in the United States. Japanese auto makers did not raise their prices nearly as much as German competitors. Obviously, they “price to market.”<sup>24</sup> As a result, Japanese carmakers did not lose as much U.S. market share as did German car makers.

One of the success factors for many Japanese companies in the U.S. markets seems to be in the way they used dollar–yen exchange rates to their advantage, known as the **target exchange rate**. Japanese companies, in particular, are known to employ a very unfavorable target exchange rate (i.e., hypothetically appreciated yen environment) for their costing strategy to make sure they will not be adversely affected should the yen appreciate. Therefore, despite close to a twofold appreciation of the yen vis-à-vis the dollar from 240 yen/\$ in to 110 yen/\$ in a decade, the dollar prices of Japanese products have not increased nearly as much. The extent to which a foreign company changes dollar prices of its products in the U.S. market as a result of exchange rate fluctuations is called **exchange rate pass-through**. Although accurately estimating the average increase in dollar prices of Japanese products is almost impossible, our estimate suggests

## Exchange Rate Pass-Through

<sup>22</sup>Ranga Nathan and Nils E. Joachim Hoegh-Krohn, “Norwegian Institutional Investors: Currency Risk,” *Derivatives Quarterly*, 6 (Fall 1999), pp. 59–63.

<sup>23</sup>Terry Clark, Masaaki Kotabe, and Dan Rajaratnam “Exchange Rate Pass-Through and International Pricing Strategy: A Conceptual Framework and Research Propositions,” *Journal of International Business Studies*, 30 (Second Quarter 1999), pp. 249–68.

<sup>24</sup>“Pricing Paradox: Consumers Still Find Imported Bargains Despite Weak Dollar,” *Wall Street Journal* (October 7, 1992), p. A6.

**EXHIBIT 3-4****FOREIGN EXCHANGE RATES.**

Friday, July 10, 2009

U.S.-dollar foreign-exchange rates in late New York trading

	<i>IN US\$</i>	<i>PER US\$</i>		<i>IN US\$</i>	<i>PER US\$</i>
<b>Americas</b>			<b>Europe</b>		
Argentina peso	0.2631	3.8008	Czech Rep. koruna	0.05368	18.629
Brazil real	0.5005	1.9980	Denmark krone	0.1873	5.3390
Canada dollar	0.8587	1.1646	Euro area euro	1.3949	0.7169
1-mos forward	0.8588	1.1644	Hungary forint	0.00503	198.81
3-mos forward	0.8590	1.1641	Norway krone	0.1532	6.5274
6-mos forward	0.8593	1.1637	Poland zloty	0.3188	3.1368
Chile peso	0.001819	549.75	Romania leu	0.3307	3.0239
Colombia peso	0.0004754	2103.49	Russia ruble	0.03059	32.690
Ecuador US dollar	1	1	Sweden krona	0.1260	7.9365
Mexico peso	0.0731	13.6724	Switzerland franc	0.9219	1.0847
Peru new sol	0.3306	3.0248	1-mos forward	0.9222	1.0844
Uruguay peso	0.04320	23.15	3-mos forward	0.9230	1.0834
Venezuela b. fuerte	0.46570111	2.1473	6-mos forward	0.9245	1.0817
<b>Asia-Pacific</b>			Turkey lira	0.6446	1.5513
Australian dollar	0.7787	1.2842	UK pound	1.6208	0.6170
China yuan	0.1464	6.8327	1-mos forward	1.6207	0.6170
Hong Kong dollar	0.1290	7.7504	3-mos forward	1.6205	0.6171
India rupee	0.02050	48.7805	6-mos forward	1.6203	0.6172
Indonesia rupiah	0.0000986	10142	<b>Middle East/Africa</b>		
Japan yen	0.01082	92.42	Bahrain dinar	2.6525	0.3770
1-mos forward	0.010824	92.39	Egypt pound	0.1790	5.5869
3-mos forward	0.010831	92.33	Israel shekel	0.2507	3.9888
6-mos forward	0.010845	92.21	Jordan dinar	1.4119	0.7083
Malaysia ringgit	0.2795	3.5778	Kenya shilling	0.01302	76.800
New Zealand dollar	0.6276	1.5934	Kuwait dinar	3.4751	0.2878
Pakistan rupee	0.01224	81.699	Lebanon pound	0.0006634	1507.39
Philippines peso	0.0207	48.216	Saudi Arabia riyal	0.2666	3.7509
Singapore dollar	0.6837	1.4626	South Africa rand	0.1216	8.2237
South Korea won	0.0007759	1288.83	UAE dirham	0.2723	3.6724
Taiwan dollar	0.03026	33.047	SDR*	1.5466	0.6466
Thailand baht	0.02935	34.072			
Vietnam dong	0.00006	17806			

\*Special Drawing Rights (SDR); from the International Monetary Fund; based on exchange rates for U.S., British and Japanese currencies.  
Source: *Wall Street Journal*, July 10, 2009.

about 30 percent price increase, or pass-through, over the same period. If this estimate is accurate, Japanese companies must have somehow absorbed more than 70 percent of the price increase. This cost absorption could result from smaller profit margins and cost reductions as well as effective use of the unfavorable target exchange rate for planning purposes. According to Morgan Stanley Japan Ltd.'s estimate in the 1990s,<sup>25</sup> Toyota could break even at an unheard of 52 yen to the dollar. In other words, as long as the Japanese currency does not appreciate all the way to 52 yen to the dollar, Toyota is expected to earn windfall operating profits.

The emergence of the Internet as a global purchasing tool also brings a whole new aspect to the concept of pass-through, particularly at the retail setting. Now that retailers can sell to the world through one web site, it is increasingly difficult for them to set different prices for each country. One can already see this with software purchased and downloaded over the Net. Consumers in England will not pay £120 for a software

<sup>25</sup>Valerie Reitman, "Toyota Names a Chief Likely to Shake Up Global Auto Business," *Wall Street Journal* (August 11, 1995), pp. A1, A5.

program that they know sells for \$100 in the United States. Online commerce will limit price flexibility in foreign markets.

This pass-through issue will be elaborated on in Chapter 12.

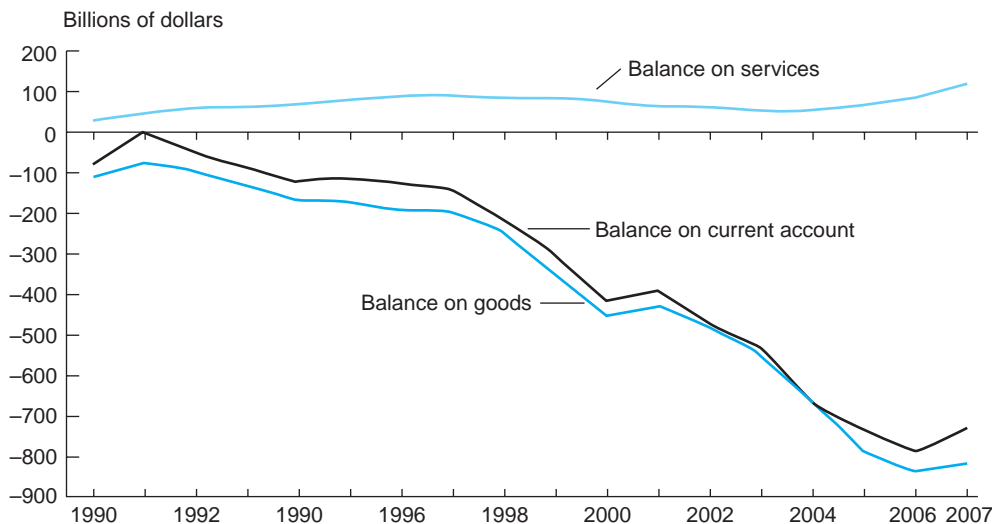
## BALANCE OF PAYMENTS

The balance of payments of a nation summarizes all the transactions that have taken place between its residents and the residents of other countries over a specified time period, usually a month, quarter, or year. The transactions contain three categories: current account, capital account and official reserves. There is also an extra category for statistical discrepancy. **Exhibit 3-5** shows the balance of payments for the United States 1990–2007.

The balance of payments record is made on the basis of rules of credits (transaction that result in an inflow of money) and debits (i.e., transactions that result in an outflow of money), similar to those in business accounting. Exports, like sales, are outflows of goods, and are entered as credits to merchandise trade. Imports, or inflows of goods, are represented by debits to the same account. These exports and imports are most likely offset by an opposite entry to the capital account, reflecting the receipt of cash or the outflow of cash for payment.

When a German tourist visits the United States and spends money on meals and lodging, it is a credit to the U.S. trade in services balance reflecting the U.S. rendering of a service to a foreign resident. On the other hand, this transaction would represent a debit to the trade in services account of Germany, reflecting the receipt of a service from a U.S. resident (or company) by a resident of Germany. If the foreign resident's payment is made in cash, the credit to trade in services is offset by a debit (inflow) to short-term capital. On the other hand, if a foreign resident purchases land in the United States, paying cash, this is represented on the United States balance of payments as a debit to short-term capital (representing the inflow of payment for the land) and a credit to long-term capital (representing the outflow of ownership of real estate).

**EXHIBIT 3-5**  
U.S. BALANCE OF PAYMENTS, 1990–2007



Sources: constructed from *Statistical Abstract of the United States 2009*, Washington, DC: U.S. Census Bureau, 2009.

This is based on the principle of double-entry accounting, so theoretically every debit must be offset by a credit to some other account within the balance of payments statement. In other words, the balance of payments statement must always balance, because total debits must equal total credits. A deficit (debit balance) in one account will then be offset by a surplus (credit balance) in another account. If the statement does not balance, an entry must be made as statistical discrepancy. But in reality, there is no national accountant making accounting entries for every international transaction. In the United States, the Department of Commerce, which prepares the balance of payments statement, must gather information from a variety of sources, including banks and other business entities concerning the inflow and outflow of goods, services, gifts, and capital items.

The **balance of payments on goods** (also known as **trade balance**) shows trade in currently produced goods. Trade balance is the most frequently used indicator of the health of a country's international trade position. The **balance of payments on services** shows trade in currently transacted services. The **balance of payments in current account** (**current account balance**, for short) shows trade in currently produced goods and services, as well as unilateral transfers including private gifts and foreign aid. The goods or merchandise account deals with tangibles such as autos, grain, machinery, or equipment that can be seen and felt, as well as exported and imported. The services account deals with intangibles that are sold or bought internationally. Examples include dividends or interest on foreign investments, royalties on trademarks or patents abroad, food or lodging (travel expenses), and transportation. Unilateral transfers are transactions with no quid pro quo; some of these transfers are made by private individuals and institutions and some by government. These gifts are sometimes for charitable, missionary, or educational purposes, and other times they consist of funds wired home by migrant workers to their families in their country of origin. The largest unilateral transfers are aid, either in money or in the form of goods and services, from developed to developing countries.

Although not shown in Exhibit 3-5, the mirror image of the balance of payments in current account (goods, services, and unilateral transfers), as a result of double entry accounting, is the capital account. The balance of payments in capital account (**capital account**) summarizes financial transactions and is divided into two sections, short- and long-term capital accounts. Long-term capital includes any financial asset maturing in a period exceeding one year, including equities. Subaccounts under long-term capital are direct investment and portfolio investment.

**Direct investments** are those investments in enterprises or properties that are effectively controlled by residents of another country. Whenever 10 percent or more of the voting shares in a U.S. company are held by foreign investors, the company is classified as a U.S. affiliate of a foreign company and therefore a foreign direct investment.<sup>26</sup> Similarly, if U.S. investors hold 10 percent or more of the voting shares of a foreign company, the entity is considered a foreign affiliate of a U.S. company.

**Portfolio investment** includes all long-term investments that do not give the investors effective control over the investment. Such transactions typically involve the purchase of stocks or bonds of foreign investors for investment. These shares are normally bought for investment, not control, purposes.

Short-term capital includes only those items maturing in less than one year, including cash. The official reserves account registers the movement of funds to or from central banks.

A key point to remember here is that the deficit or surplus is calculated based not on the aggregate of all transactions in the balance of payments, but on the net balance for certain selected categories.

There are three particularly important balances to identify on the balance of payments statement of a country, including the balance of the merchandise trade

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<sup>26</sup>Department of Commerce, *U.S. Direct Investment Abroad* (Washington, D.C.: Bureau of Economic Analysis, 2008).

account, the current account (including merchandise trade, trade in services and unilateral transfers) and the basic balance (the current account and long term capital). Everyone knows about the U.S. deficit in merchandise trade, but what is less commonly known is that the U.S. regularly runs a surplus in trade in services. This surplus offsets a small part of the deficit in the merchandise account (see **Global Perspective 3-1**).

Many observers have commented that since the 1980s, the United States has been able to continue its import binge via the sale of long-term investments, including real estate and ownership in companies. This belief was heightened by the high-profile sale of such U.S. landmarks as the legendary Hollywood studio MGM to Sony of Japan in 2005 and Anheuser-Busch to InBev of Belgium in 2008. These foreign companies invested in U.S. capital assets, paying in cash that was then recycled in payment for merchandise imports by U.S. residents. The criticism was made that the U.S. was selling off capital assets for short-term merchandise imports like a wealthy heir who sells off the family jewels to finance a profligate lifestyle. Meanwhile, others viewed the increase in foreign investment in the United States as proof of the nation's vitality and long-term attractiveness to investors.

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## **G**LOBAL PERSPECTIVE 3-1



### **BALANCE OF PAYMENTS AND COMPETITIVENESS OF A NATION**

The Information Age characterizes the world we live in today, but some people do not seem to recognize it.

Each time the U.S. trade statistics are reported, we hear the dismal news of a trade deficit of \$707 billion in 2004. But when it comes to U.S. balance of payments, many people do not look beyond the “trade” statistics.

When we say trade statistics, we talk about exports and imports of goods. Trade of services is not included. When the United States incurred an \$819 billion trade deficit in goods in 2007, its trade deficit was partly—albeit weakly—offset by a \$119 billion trade surplus in services. Such services—the hallmark of the Information Age—include telecommunications, education, financial services, and a host of other intangibles.

These and other services did not only have just one good year. Around the world, service companies are expanding rapidly, ringing up sales at a fast pace. Indeed, worldwide, services accounted for about \$3 trillion in international trade in 2008.

Why, then, don't we notice this important development? It is primarily because many of us are still measuring our economic performance based on the facts of an earlier era, which meant apples, steel, sneakers and the like—tangible merchandise and nothing else. Many just do not realize a new day has

dawned—one in which advertising exports can mean as much as auto exports.

Take the Department of Commerce, which collects U.S. trade data. The department keeps track of more than 10,000 different kinds of tangible goods. But when it comes to services, the agency collects trade data for only a few service categories. Services excluded from Department of Commerce data, or addressed only partially, include such significant ones as public relations, management consulting, legal services, and many financial and information-related services. While accurate estimates are difficult, it is believed that exports of services would be 70 percent higher than reported in Department of Commerce trade data.

What is wrong with underplaying the importance of services? First, it misleads the public about the nation's true competitiveness. Second, it induces government officials to develop trade policy on mistaken premises. Third, and worst of all, the growth of services could be thwarted because many non-tariff barriers to trade in services—such as discriminatory licensing and certification rules, and bans of the use of internationally known company names—do not get as much policy attention as tariffs on goods and thus could harm U.S. service companies trying to sell various services abroad.

There is also a word of caution. The increased importance of services in the U.S. balance of payments does not necessarily mean that the United States can ignore manufacturing businesses. First, exports of services have been historically too small to offset the staggering deficits in goods. Second, if the United States loses mastery and control of manufacturing, the high-paying and thus important service jobs that are directly linked to manufacturing—such as product designing, engineering, accounting, financing and insurance, and transportation—may also wither away. Manufacturing and those services are tightly linked and may not be separable.

*Sources:* Based on Daniel J. Connors, Jr. and Douglas S. Heller, “The Good Word in Trade is ‘Services,’” *New York Times*, September 19, 1993, p. B1; Stephen S. Cohen and John Zysman, *Manufacturing Matters: The Myth of the Post-Industrial Economy*, New York: Basic Books, 1987; *World Trade Report 2007*, Geneva: World Trade Organization, 2007; and “U.S. International Trade in Goods and Services: Annual Revision for 2007,” *News*, U.S. Census Bureau, Bureau of Economic Analysis, June 10, 2008.



## The Internal and External Adjustments

According to the theory of international trade and balance of payments, a surplus or deficit in a country's basic balance should be self-correcting to some extent. This self-correction is accomplished through the internal and external market adjustments. The market adjustment mechanisms bring a nation's deficit or surplus within the basic balance back into equilibrium. This is a natural event where the economy of a nation corrects its prior excesses by moving back toward the middle.<sup>27</sup>

The **internal market adjustment** refers to the movement of prices and incomes in a country. The following is a hypothetical example of such an adjustment process in the case of a Current Account surplus country, such as Japan.

1. As Japan continues to export more than it imports resulting in a surplus in the Current Account, its internal money supply grows, the result of receiving payment from foreigners for their purchases of goods, services, and investments originating in Japan. The payments are made to Japanese residents and may be deposited in banks either in Japan or abroad, either in yen or foreign currency. But wherever and however payment is made, it becomes an asset of a Japanese resident.
2. As Japan's money supply increases, domestic residents of Japan spend more, because they have more money available to spend. Japan's money supply is increasing because foreigners are buying Japanese goods in greater quantities than Japanese are buying foreign goods.
3. As local residents in Japan spend more (i.e., have greater demand for products and services), domestic prices rise. In other words, inflation occurs.
4. As domestic prices increase, Japanese residents find that foreign goods are relatively cheaper.
5. Because the Japanese find foreign goods cheaper, they import more goods from abroad. This begins to reduce Japan's current account surplus and bring it back into balance.

The **external market adjustment** concerns exchange rates or a nation's currency and its value with respect to the currencies of other nations. The following is a hypothetical description of the application of the external adjustment to a surplus nation, in this case again, Japan:

Japan exports more than it imports, resulting in a surplus in its current account. So, foreigners must pay Japanese residents for the goods they purchase from Japan. Payment will likely be made in Japanese yen.

1. Because Japanese residents export more than they import, there is more demand for yen by foreigners than demand for dollars by Japanese residents. This excess in relative demand for yen causes it to appreciate in value with respect to other currencies. Remember, it appreciates because foreigners must pay Japanese suppliers for their goods and services.
2. The appreciated yen causes Japanese goods, services, and investments to be more expensive to foreign residents who convert prices quoted in yen to their local currencies.
3. All other things being equal, this should cause foreigners to buy fewer Japanese goods and thus shrink Japan's trade surplus.

However, other factors, such as a country's taste for foreign goods and general habits of consumption, must be taken into account, as well as the quality and reputation of a country's manufactured goods. Many other factors beyond domestic prices and foreign exchange values affect Japan's trade balance with the United States, and these have become a topic of serious discussion between the governments of these two nations.

<sup>27</sup>Mordechai E. Kreinin, *International Economics: A Policy Approach*, Mason, OH: Thomson South-Western, 2006, pp. 241–52.

## ECONOMIC AND FINANCIAL TURMOIL AROUND THE WORLD



Since the last few years of the twentieth century we have observed some unprecedented economic and financial crises in some parts of the world that have caused significant slowdowns in the growth of the world economy and international trade and investment. Excessive borrowing by companies, households or governments lie at the root of almost every economic crisis of the past two decades from East Asia to Russia and to South America, and from Japan to the United States. In this section, we highlight the Asian financial crisis of 1997–1998, the South American financial crisis of 2002 that spread out of Argentina to other parts of South America, and most recently the severe global recession triggered by the U.S. subprime mortgage loan crisis, to illustrate the global ripple effect of local and regional economic downturn.

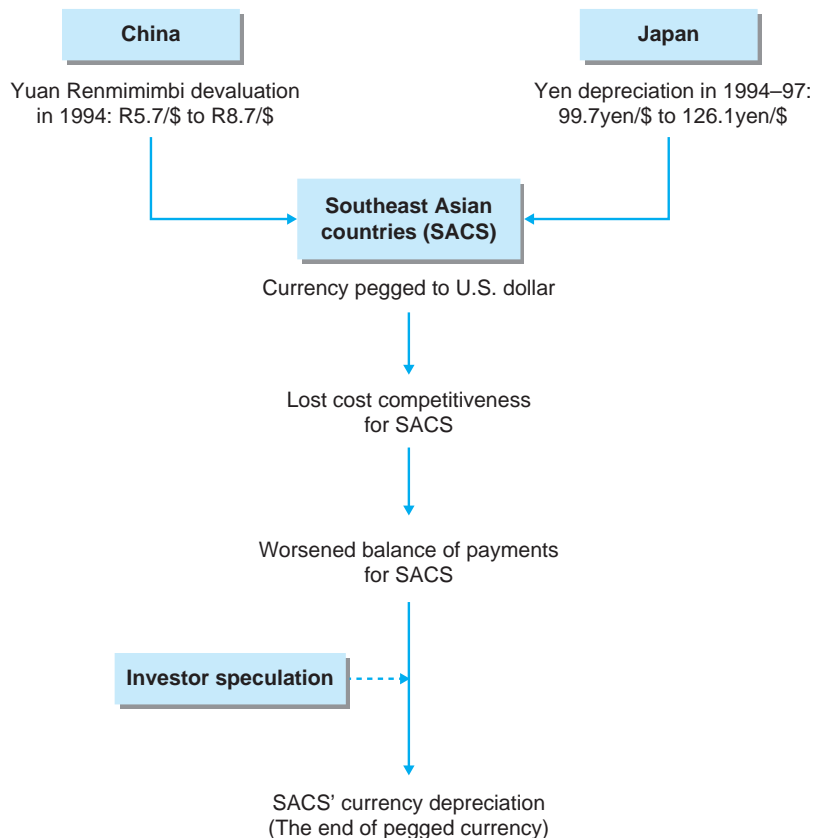
Chronologically speaking, China's devaluation of its currency, Yuan, from 5.7 yuan/\$ to 8.7 yuan/\$ in 1994, set the stage for an ongoing saga of the Asian financial crisis. The mechanism of how the Asian financial crisis occurred is summarized in **Exhibit 3-6**.

The currency devaluation made China's exports cheaper in Southeast Asia where most currencies were virtually pegged to the U.S. dollar. According to Lawrence Klein, a Nobel Laureate in economics, the Southeast Asian countries' strict tie to the U.S.

### Asian Financial Crisis and its Aftermath

#### EXHIBIT 3-6

#### MECHANISM OF THE ASIAN FINANCIAL CRISIS



dollar cost them between 10 and 20 percent of export loss spread over three or four years.<sup>28</sup>

Separately, Japan's post-bubble recession also caused its currency to depreciate from 99.7 yen/\$ in 1994 to 126.1 yen/\$ in 1997, resulting in two pronged problems for Southeast Asian countries. First, recession-stricken Japan reduced imports from its Asian neighbors; second, the depreciated yen helped Japanese companies increase their exports to the rest of Asia. Consequently, Southeast Asian countries' trade deficits with China and Japan increased abruptly in a relatively short period. Southeast Asian countries' trade deficits were paid for by their heavy borrowing from abroad, leaving their financial systems vulnerable and making it impossible to maintain their currency exchange rates vis-à-vis the U.S. dollar. The end result was the sudden currency depreciation by the end of 1997. For example, Thailand lost almost 60 percent of its baht's purchasing power in dollar terms in 1997. Malaysian ringgit lost some 40 percent of its value in the same period. Korean won was similarly hit toward the end of 1997 and depreciated 50 percent against the U.S. dollar in less than two months. The worst case was Indonesia whose rupiah lost a whopping 80 percent of its value in the last quarter of 1997. In a way, it would amount to a U.S. dollar bill becoming worth only 20 cents in three months!

The Asian financial crisis in the latter half of the 1990s had escalated into the biggest threat to global prosperity since the oil crisis of the 1970s. The region's once booming economies were fragile, liquidity problems hurt regional trade, and losses from Asian investments eroded profits for many Japanese companies. Similarly, among Western companies, quite a few U.S. companies that had large investments in Asia reported less than expected earnings. Others feared that the Asian crisis would wash ashore to the seemingly unrelated regions of the world, including the United States and Europe.<sup>29</sup> For example, the unsettling ups and downs of the Dow Jones Industrial Average reflected the precarious nature of U.S. investments in Asia. Economists blamed Asia for nipping the world's economic growth by one percentage point in 1998–1999.<sup>30</sup>

Now the Asian market has recovered from the crisis since the beginning of this century. The acceleration of Asia's economic growth since 2000 can be largely credited to the recovery of the Japanese economy.<sup>31</sup> In 2003, Asia's GDP grew at 3.5 percent, exceeding the average growth rate for the 1990s. Further, Asian developing countries' GDP growth continued to exceed 5 percent. Asia's merchandise trade growth was realized primarily by intra-regional trade, which rose by 20 percent to \$950 billion in 2003. Further, China's surging import demand and increased purchase of investment goods, semi-manufactured goods and machinery parts have sustained output and exports in many East Asian economies. Asia's developing economies had sustained robust growth boosted by domestic demand, regional trade, and a steady inflow of investment until 2008.

### The South American Financial Crisis and Its Aftermath

Starting from the end of 2001, we witnessed the largest debt default in Argentina. Unlike the Asian financial crisis, Argentina's problems took a long time to develop, giving enough signs to investors and analysts.<sup>32</sup> However, the trouble has turned out to be much worse than anyone would have imagined. By April 2002, Argentine currency had lost nearly 40 percent of its value since the government freed it from the dollar in December 2001. Unemployment rate reached about 25 percent and bank accounts

<sup>28</sup>“Panel Discussion One: An Overview of the Crisis,” *Journal of International Management*, Supplement, 4 (1), 1998, pp. 7S–17S.

<sup>29</sup>“Europeans, Despite Big Stakes Involved, Follow U.S. Lead in Asia Financial Crisis,” *Wall Street Journal*, January 16, 1998: A11.

<sup>30</sup>This section builds on Masaaki Kotabe, “The Four Faces of the Asian Financial Crisis: How to Cope with the Southeast Asia Problem, the Japan Problem, the Korea Problem, and the China Problem,” *Journal of International Management*, 4 (1), 1998, 1S–6S.

<sup>31</sup>“The Sun Also Rises,” *Economist*, October 8, 2005, pp. 3–6.

<sup>32</sup>Martin Crutsinger, “Shock Waves From Argentina Crisis Could Yet Reach U.S. Economy,” *AP Newswire* (April 28, 2002).

remained frozen. Several presidents failed to slow down the recession. The economy contracted by 1 percent in 2001, and a whopping 8 percent in 2002.<sup>33</sup> In December 2001, the government stopped payment on much of its \$141 billion in foreign debt—the biggest government default in history. Thousands of commercial establishments were closed in a week.

The first reason behind the crisis lies in its own monetary system. For a decade, Argentine government fixed peso at one U.S. dollar, which overvalued the currency and caused a lack of competitiveness when other currencies depreciated. Three months after peso was freed from the dollar, the rate became 3 pesos to the dollar, with a depreciation of 67 percent.<sup>34</sup> The second reason is its unbelievable government debt. Argentina has years of chronic government deficit spending. The debt sent the interest rate up and caused so many businesses to close. As more companies were closed and more people were laid off, the government's tax income have shrunk and increased the debt burden. Finally, as IMF refused to make an advance payment on a previously agreed loan to allow Argentina to make its next debt payment, the economy became paralyzed. The Argentina crisis inevitably hurt its neighbors, such as Brazil, South America's largest economy that conducts nearly one-third of its trade with Argentina. The Mexican peso had weakened 5 percent within two months since the end of March 2002. The Brazilian real had retreated 6.4 percent over the same period, and several other regional currencies had also slid while their counterparts from Asia and Europe were in their 12-month high. After the Argentine crisis, both international bank loans and capital inflows in Latin America declined. International financial flows to Latin America have declined substantially since the crisis in Argentina,<sup>35</sup>

The property boom in the United States since early 1990s and the availability of easy mortgage loans through the Federal Reserve's loose monetary policy helped pump up the property bubble, much like what had happened in Japan a decade earlier. In the process, a huge amount of easy mortgage loans had been offered to the subprime mortgage market, that is, those customers who could otherwise not afford to purchase houses. Easy money and loose regulations allowed banks to securitize the expected cash flows from a pool of underlying assets such as home mortgages and sell those securities on the open market. Not only domestic but also foreign—particularly, European and Japanese—banks and securities companies purchased them. Then an onslaught of defaults in the subprime mortgage market in the United States in recent years has snowballed into a global credit crisis, causing the collapse of the securities market around the world.<sup>36</sup> The current global recession is the worst of its kind since the Great Depression of 1929–1932.

As the credit market has dried up, businesses that rely on consumer credit have suffered dearly. For example, when the credit crisis became evident by the end of 2009, the December sales of cars and light trucks in the United States fell by 36 percent compared with a year ago; in France, car sales were down by 16 percent despite government incentives designed to prop up the market; in Spain, car sales were off by almost 50 percent; and in Japan, by 22 percent.<sup>37</sup> Car sales have since continued to decline. Toyota, now the world's largest and most profitable automaker, reduced domestic production by 40 percent in January 2009 as its exports dropped almost 60 percent from a year earlier.<sup>38</sup> You can see the severity of the current global recession as such a precipitous sales decline is extraordinary by any means.

## The U.S. Subprime Mortgage Loan Crisis and the Subsequent Global Financial Crisis

<sup>33</sup>Terry L. McCoy, "Argentine Meltdown Threatens to Derail Latin Reforms," *The Orlando Sentinel*, (April 22, 2002), p. A15.

<sup>34</sup>Ian Campbell, "As IMF Fiddles, Argentina Burns," *United Press International* (March 28, 2002).

<sup>35</sup>Patricia Alvarez-Plata and Mechthild Schrooten, "Latin America after the Argentine Crisis: Diminishing Financial Market Integration," *Economic Bulletin*, 40, December 2003, pp. 431–36.

<sup>36</sup>"Ruptured Credit," *Economist*, May 15, 2008.

<sup>37</sup>"The Big Chill," *Economist*, January 15, 2009.

<sup>38</sup>"Toyota, Nissan Japan Output Drop As Exports Sink," *NikkeiInteractive.net*, <http://www.nni.nikkei.co.jp/>, February 25, 2009.

## Financial Crises in Perspective

There is some commonality across the recent financial problems facing Asian and South American countries and in how they could affect businesses and consumers in the region. The Asian financial crisis has to be placed in a proper perspective that the “economic miracles” of the East and Southeast Asian countries have already shifted the pendulum of international trade from cross-Atlantic to cross-Pacific in the last decade. Companies from the United States and Japan, in particular, have been helping shape the nature of the cross-Pacific bilateral and multilateral trade and investment. Today, as a result, North America’s trade with these five Asian countries alone exceeds its trade with the European Community by upwards of 20 percent. The trend is irreversible. Although the recent stock market turmoil and the subsequent depreciation of the foreign exchange rates of many Asian countries may have set back their economic progress temporarily, the fundamental economic forces are likely to remain intact.

Now we are in the midst of a severe global recession. Again and again, the unbridled asset appreciation, whether it is stock prices or property value, and the availability of easy credit appear to lead to an eventual collapse of a financial system. The United States is no exception. As we discussed in Chapter 2, the fundamental source of “easy” money in the United States is the persistent current-account deficits in the United States, matched by surpluses in emerging markets, notably China. In other words, the United States has been living beyond its economic means by borrowing money from foreign creditors. It is a stark reminder to the rest of the world that no country could sustain its livelihood for good on borrowed money.<sup>39</sup>

In order for countries to sustain their strong economic performance, the importance of several necessary conditions needs to be stressed. Those include: strong financial institutions—commercial and investment banks, stock exchanges; transparency in the way the institutions do business; financial reporting systems that are consistent with free markets where capital and good flow competitively; and supply of a managerial pool to shepherd these economies through very difficult transitional periods. While the Asian countries remain strong and attractive with respect to their “economic” fundamentals, the recent events have demonstrated that institutional environment of the countries needs reforms (See **Global Perspective 3-2** for a new lurking problem in emerging economies).

## Responses to the Regional Financial Crises

For illustrative purposes, let us use the Asian financial crisis of 1997–1998 and explain how domestic and foreign companies coped with the sudden recessionary environment brought about by the crisis. Such implications apply to any regional and global financial crisis.

Reeling from the initial shock of the financial crisis, marketing executives have begun to cope with the realities of marketing their products in a completely changed world—from the world that was once believed to keep growing with ever increasing prosperity to a world that has decimated the burgeoning middle class by snapping more than 50 percent of the consumers’ spending power. Marketers are facing two dire consequences of the crisis: namely, declining markets and increased competition from existing competitors. Their major task is to figure out how to keep current customers and gain new ones and maintain profitability in the long run.

Although Asia’s current recession caused by its financial crisis is a serious one, other countries or regions have also experienced economic slumps over the years. Recession is usually defined as an economic situation in which the country’s GDP has shrunk for two consecutive quarters. Based on this definition, the United States has experienced 29 recessions since 1894, approximately once every four to five years. First, we examine how consumers react to an economic slump. Second, we show different ways in which competing companies cope with the recession and the changed consumer needs.

<sup>39</sup>“When a Flow becomes a Flood,” *Economist*, January 22, 2009.





## GLOBAL PERSPECTIVE 3-2

### RISING INFLATION IN EMERGING ECONOMIES

Inflation has risen far more over the past few years. Taken as a whole, the average world inflation rate had grown to 5.5 percent in 2008, the highest since 1999. With the relatively low inflation rates of 3.9 percent in the United States and 3.3 percent in the euro area, this high world average resulted from the soaring inflation in emerging economies.

As of May 2008, China's official rate of consumer-price inflation had risen from 3 percent a year ago to 8.5 percent, a 12-year high. Russia's inflation rate had increased from 8 percent to over 14 percent. Indonesian inflation was already 9 percent and likely to reach 12 percent soon as the government raised the price of subsidized fuel by 25–30 percent. India's wholesale price inflation rate was also at a four-year high of 7.8 percent. In the Middle East, most Gulf oil producers were also witnessing double-digit inflation rates.

Although inflation in Latin America remained relatively low, Brazil's rate still rose to 5 percent in 2008 from less than 3 percent in early 2007. Chile's had changed from 2.5 percent to 8.3 percent. In Argentina where the officially published inflation rate was recorded as 8.9 percent, economists estimated that its true figure was 23 percent, up from 14.3 percent in

Sources: *Economist*, May 24, 2008, p.17; and "An Old Enemy Rears its Head," *Economist*, May 24, 2008, pp. 91–93.

2007. When it comes to Venezuela, where the national money went through a currency change of taking three zeros to the new Bolivar Fuerte on January 1, 2008, the inflation rate may even have reached as high as 29.3 percent, making this country the most alarming one.

This rising inflation in emerging economies should be mainly ascribed to the surge in the prices of food and oil. For example, in China food prices had risen by 22 percent in 2007, whereas non-food prices had gone up by only 1.8 percent. But a real dangerous reason, although only partly explaining the recent jump in prices, is the loose monetary conditions in emerging economies. The initial shock to food prices may have come from the supply side, but the strength of income and money growth helps to validate higher prices.

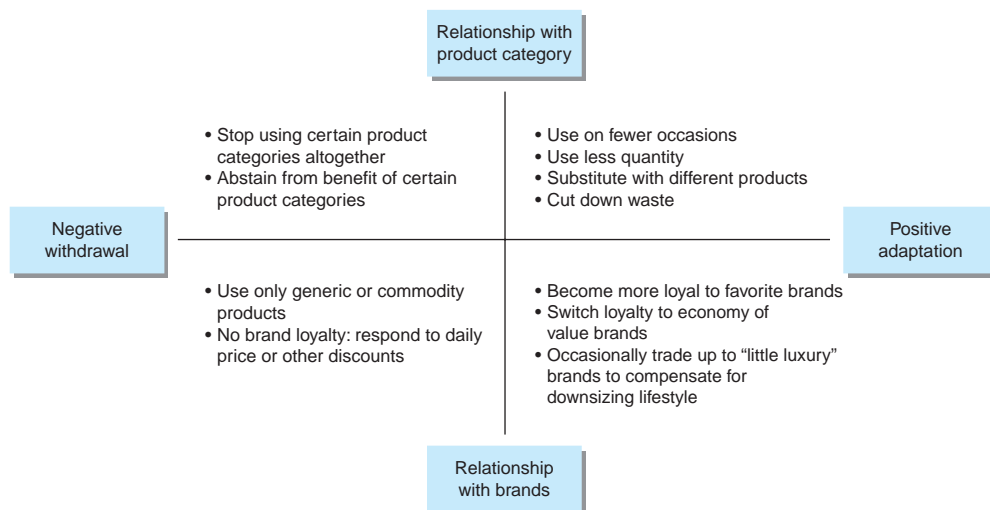
Unfortunately, many policymakers in emerging economies view the rise in inflation as a short-term supply shock and consequently see little need to raise interest rates. In order to keep prices from rising further, they are instead using price controls and subsidies. Money supplies are growing almost three times as fast as in the developed world. Many central banks are still not fully independent. As inflationary expectations are not properly contained, the risk of a wage-price spiral could trigger another huge inflation as we had experienced in the 1970s. And this is what the globe is really worried about.

**Consumer Response to the Recession.** As we all know from our own personal experiences, we tend to become more selective in choosing products and stay away from impulse buying in a recessionary period. In other words, consumers begin to spend their money more wisely and emphasize value for the money. We may consume less of some products but we may even consume more of certain other products. General changes in the consumption pattern in an economic downturn are summarized in **Exhibit 3-7**.

Although a recession alters the mood of a country, it does not necessarily affect consumption of all products in the same way. If you now travel to any major city in Asia, such as Kuala Lumpur in Malaysia, you will hardly notice any change in shopping behavior at first glance. Finding a parking spot at One Utama, a large shopping mall on the outskirts of Kuala Lumpur, is as difficult now as it was a year ago. Young Malaysian couples shop for groceries and kitchenware, while moviegoers flock to a cinema multiplex showing Columbia Pictures' *Spider-Man*. The coffee houses such as Starbucks are successful as ever, teeming with trendy customers, and high-tech aficionados are trying out the latest iPhones. In sharp contrast, if you visit the huge upscale Meladas Casa Mobili store, you will see few middle-class families buying its exquisite Italian furniture there. Indeed, the most susceptible to a recessionary downturn usually are big ticket items, such as cars, home furnishings, large appliances, and travel. Those relatively unaffected are alcohol, tobacco, small appliances, packaged goods, and computer items.<sup>40</sup>

<sup>40</sup>James Chadwick, "Communicating through Tough Times in Asia," *Economic Bulletin*, August 1998, pp. 25–29.

### EXHIBIT 3-7 CHANGES IN THE CONSUMPTION PATTERN DURING A RECESSION



Source: Adapted from James Chadwick, "Communicating through Tough Times," *Economic Bulletin*, August 1998, p. 27.

**Corporate Response to the Recession.** Different companies have reacted differently to the recession, based on their different corporate objectives. In general, there are short-term and long-term orientations in crisis management. Short-term orientation dictates that the corporate goal is to maximize year-to-year profit (or minimize loss), whereas long-term orientation tolerates some short-term loss for the benefit of future gains. Although any definitive value judgment should not be made of the two different orientations, short-term orientation tends to serve stockholders' speculative needs, while long-term orientation tends to cater to customer needs. A short-term oriented solution is to pull out of the market, at least temporarily as long as the markets remain in a recession. Long-term oriented solutions are to modify marketing strategies in various ways to address the consumer needs completely changed during the recession.

- **Pull-out.** Pulling out of the market is an easy way out, at least, financially in the short run. Immediately after Indonesia's rupiah depreciated by almost 80 percent in a couple of months, J.C. Penney and Wal-Mart had no second thought but simply left the Indonesian market. Similarly, Daihatsu, a small Japanese automobile manufacturer, decided to pull out of Thailand. While pull-out strategy may be the least painful option in the short run, it could cause some irreparable consequences in the long run, and particularly so in many Asian countries where long-term, trustworthy, and loyal relationships are a vital part of doing business and short-term financial sacrifices are revered as an honorable act. A better strategy would be to cut the planned production volume and maintain corporate presence on the market as General Motors did in Thailand.<sup>41</sup>
- **Emphasize a product's value.** Weary consumers become wiser consumers. In a prosperous time, middle-class consumers may have resorted to some impulse buying and conspicuous consumption. But during the current recession, they want to maintain their current lifestyle and standard of living. However, they want to feel vindicated that the product or service they purchase is worth the money they pay for. Marketers will have to develop a promotion that emphasizes the value contained in the product. For example, Procter&Gamble's new Pantene shampoo line, which

<sup>41</sup>"Asia's Sinking Middle Class," *Far Eastern Economic Review*, April 9, 1998, p. 12.

sells for \$2.20 to \$7.30, is one of the most expensive shampoos available in Hong Kong. Its advertising campaign promotes Pantene's extra moisturizers and other high-tech ingredients to tell clearly the benefits of Pantene over other less expensive brands.<sup>42</sup>

Another way to add value is to enhance the perceived quality image of a product. For example, in Thailand, an advertising campaign for a relatively cheap Clan MacGregor scotch whiskey made locally under license emphasizes the product value: "Even if you have to buy something cheap, you are getting something of real value." This is stated in reference to three times more expensive imported Johnnie Walker Black Label whiskey. This ad helps enhance Clan MacGregor's quality image in the minds of consumers.<sup>43</sup>

- **Change the product mix.** If a company has a wide array of product lines, it can shift the product mix by pushing relatively inexpensive product lines while de-emphasizing expensive lines. This strategy is suited to ride over a slump by generating sufficient cash flow not only to cover the fixed costs of business operations but also to maintain the corporate presence on the market. Particularly in Asia, the company's dedication to the market as perceived by local customers will win many favorable points in the long run. For example, Burberry's, a British fashion retailer, has replaced its expensive jackets in window displays with relatively inexpensive T-shirts, stressing that everyone still afford some luxury even in hard times.<sup>44</sup>
- **Repackage the goods.** As stated earlier, middle-class consumers want to maintain their lifestyle and quality of life as much as possible. It means that they will keep buying what they have been buying but consume less. Companies like Unilever are repackaging their products to suit consumers' declining purchasing power. Unilever has reduced the size of its Magnum-brand ice-cream packs and made it cheaper, offers giveaways on its Lux soaps (buy six, get one free), and marketing its detergents in smaller and cheaper refillable packs.<sup>45</sup>
- **Maintain stricter inventory.** Japanese companies have long taught us that their just-in-time inventory management practices not only reduce unnecessary inventory but also improve their product assortment by selling only what customers want at the moment. Even if companies are not practicing just-in-time inventory management, it would make a lot of sense to keep inventory low. Essentially, inventory is a tied-up capital of unsold merchandise that can be costly to the company. For example, the Kuala Lumpur store of Swedish furniture retailer, Ikea, has not restocked certain slow-selling items.<sup>46</sup>
- **Look outside the region for expansion opportunities.** Asia's recession is still a regional problem although there is some risk that it will bring down the rest of the world with it to cause a global economic crisis. Nevertheless, market opportunities can be found outside the recession-stricken part of Asia. This strategy is not only a part of geographical diversification to spread out the market risk but also an effective way to take advantage of cheaper Asian currencies which translate to lower prices in other foreign countries. For instance, Esprit, the Hong Kong based retailer, is now marketing very aggressively in Europe. Despite the Asian slump, its revenues increased 52 percent during fiscal 1998 with most of the gain coming from the European market.<sup>47</sup> Hewlett-Packard and Dell Computer, among others, which depend heavily on less-expensive components now made in Asia, have begun to trim the prices of their products.<sup>48</sup>

<sup>42</sup>"Multinationals Press On in Asia despite Perils of Unstable Economies," *Asian Wall Street Journal*, September 4-5, 1998, p. 12.

<sup>43</sup>"Asia's Sinking Middle Class," p. 12.

<sup>44</sup>"Asia's Sinking Middle Class," p. 13.

<sup>45</sup>"Asia's Sinking Middle Class," p. 12.

<sup>46</sup>"Asia's Sinking Middle Class," p. 13.

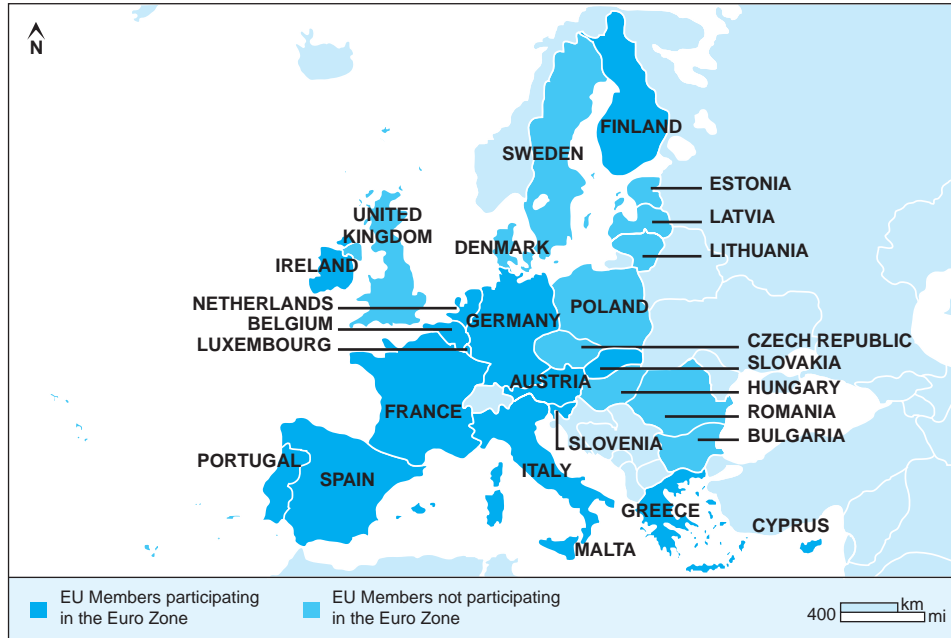
<sup>47</sup>"With Asia in collapse, Esprit pushes aggressively into Europe," *Asian Wall Street Journal*, January 4, 1999, p. 2.

<sup>48</sup>"Asia Crisis May Benefit U.S. Companies," *New York Times on the Web*, January 19, 1998, at [www.nytimes.com](http://www.nytimes.com).



**EXHIBIT 3-8**

16 EUROZONE COUNTRIES (AS OF JANUARY 1, 2009)



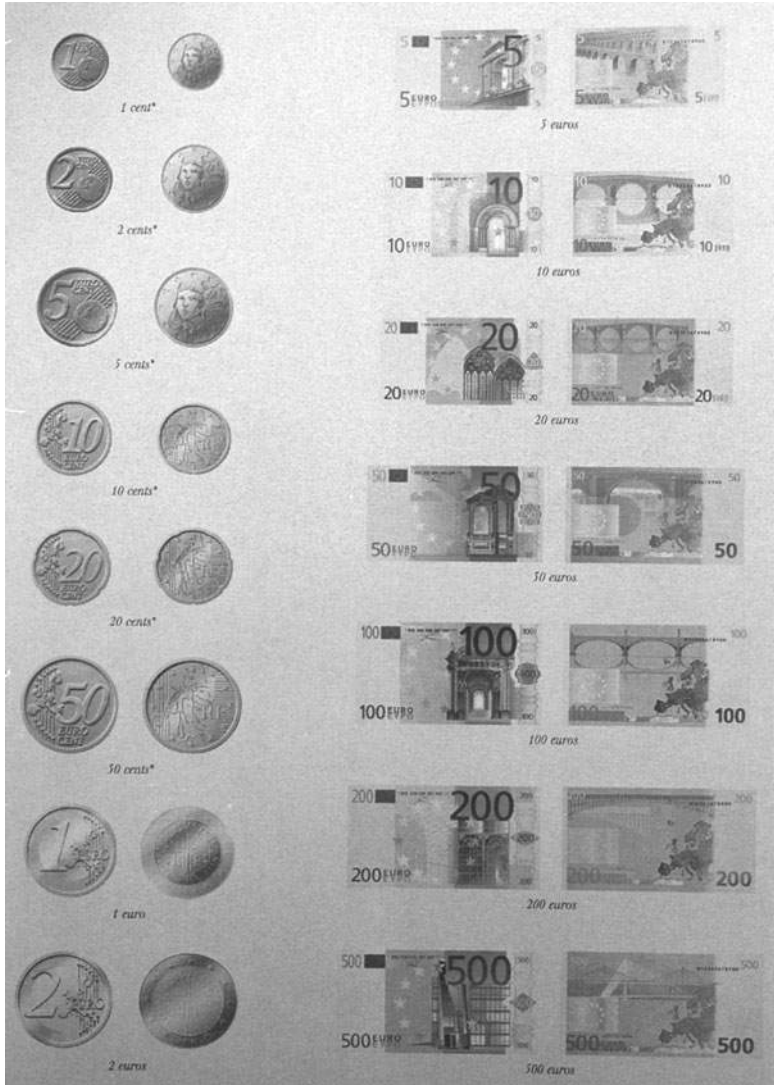
membership of sixteen countries as of January 1, 2009 (See **Exhibit 3-8**). The seeds for the euro had been laid almost exactly three decades ago. In 1969, Pierre Werner, a former prime minister of Luxembourg, was asked to chair a think tank on how European monetary union (EMU) could be achieved by 1980. The Werner report published in October 1970 outlined a three-phase plan that was very similar to the blueprint ultimately adopted in the Maastricht Treaty, signed on February 7, 1992. Just like the Maastricht treaty, the plan envisioned the replacement of local currencies by a single currency. However, EMU was put on hold following the monetary chaos created by the first oil crisis of 1973. The next step on the path to monetary union was the creation of the European monetary system (EMS) in the late 1970s. Except for the United Kingdom, all member states of the European Union joined the Exchange Rate Mechanism (ERM). The ERM determined bilateral currency exchange rates. Currencies of the then nine member states could still fluctuate but movements were limited to a margin of 2.25 percent. The EMS also led to the European currency unit (ecu)—in some sense the predecessor of the euro. Note that this newly bred currency never became a physical currency.

The foundations for monetary union were laid at the Madrid summit in 1989 when the EU member states undertook steps that would lead to free movement of capital. The Maastricht treaty signed shortly after spelled out the guidelines toward EMU. Monetary union was to be capped by the launch of a single currency by 1999. This treaty also set norms in terms of government deficits, government debt and inflation rate that applicants had to meet in order to qualify for EMU-membership. As stated earlier, there are now sixteen member countries in the Eurozone. Monetary policy for this group of countries is run by the European Central Bank headquartered in Frankfurt, Germany. Three of the developed EU member states, namely the United Kingdom (not surprisingly), Sweden, and Denmark, decided to opt out and sit on the fence. The new EU members may choose to adopt the euro in the future when they meet the EU's fiscal and monetary standards and the member states agreement. The Eurozone economies combined represent about a third of world's gross domestic product and 20 percent of



**EXHIBIT 3-9**

## THE EURO-BANK NOTES AND COINS



Source: Courtesy of Forestier Yves/Corbis Sygma

overall international trade, with a population of roughly 320 million people. Each of these countries has committed itself to adopt a single currency, the euro, designated by the € symbol. The euro bank notes and coins are shown in **Exhibit 3-9**.

On January 1, 2002, the euro notes and coins (see **Exhibit 3-10** for some spelling rules) began to replace the German mark, the Dutch guilder and scores of other currencies. By July 1, 2002, the local currencies ceased to exist. Those of you who traversed Europe before 2002 may remember the financial strains of exchanging one European currency for another one. Now this hassle became a thing of the past. The creation of the euro has been described as “the most far-reaching development in Europe since the fall of the Berlin Wall.”<sup>54</sup> According to the Economic and Monetary Union (EMU), it has already helped create a new culture of economic stability in Europe, to weather the recent slowdown in the world economy, and to avoid the kind of damaging intra-European exchange rate tension. With the euro in place, the citizens of euro area countries are now looking forward to the benefits of increased price

<sup>54</sup>“The Long and Arduous Ascent of Euro-Man,” *Financial Times*, December 15, 1998, p. 4.

**EXHIBIT 3-10****THE EURO—OFFICIAL SPELLING RULES**

One indication of the confusion surrounding the euro is the spelling of the word “euro.” Here are the “official” rules:

- **Question 1:** Upper-case or lower-case?

**Answer:** lower-case. In English but also in almost all other official EU languages, the spelling should always be lower-case, that is, euro and not Euro. One notable exception is Denmark—one of the four euro-out countries—where it is spelled Euro.

- **Question 2:** Plural: euros or euro?

**Answer:** euro. This rule sounds puzzling but that is the official plural form in English (and also in Dutch and Italian, for example). Some of the Community languages (e.g., French, Spanish) add an “s.”

Source: The European Union’s Server at <http://www.europa.eu.int>

transparency, more intense competition in the market place and greater financial integration in Europe.<sup>55</sup> Although some of the benefits of the euro to firms and consumers are clear, many policy questions are still left unanswered.

Now, in order to protect all the member states, EU has made agreements to maintain the economic stability within the Eurozone and avoid any financial crisis. For example, under the Europe’s Stability and Growth pact, the EU’s executive body would recommend that public warnings be issued to any country that fell foul of European deficit control agreements. Some countries such as France complains that there was too much stress on budget stability and not enough on growth, thus seeking to loosen the constraints imposed on national budgets.<sup>56</sup>

Will the euro be the final stage leading to a “United States of Europe”? What opportunities does the euro create for firms operating in the Eurozone? What are the possible threats? Answers to these and many other euro-related questions are murky at best (See **Global Perspective 3-3**).

What is clear is that the switch to the euro has a wide-ranging impact on companies doing business in the Eurozone. There have been gains but also plenty of pain. Massive investments in computer infrastructure and logistical expenses have been needed to put in place the changeover. For example, Allianz, the German insurance group, spent \$124 million in euro-related data processing and devoted the equivalent of 342 years’ worth of extra manpower into its euro-changeover enterprise. DaimlerChrysler pumped \$120 million in its euro-conversion projects.<sup>57</sup> A consensus estimate was that switching to the euro would have cost companies around \$65 billion.<sup>58</sup> On top of these upfront investments, there was also the cost of lost revenues from price harmonization within the Eurozone. Apart from these immediate bottom-line effects, EMU also has a strategic impact on companies’ operations. For marketers, the key challenges include:

- **Price Transparency.** Before the introduction of the euro, drug prices varied as much as 250 percent within Europe, and German cars in Italy cost up to 30 percent less than in their home market.<sup>59</sup> Conventional wisdom says that prices will slide down to the same level throughout the Eurozone. The reason for that is that the single currency makes markets more transparent for consumers and corporate purchase departments. Now that retailers in different Eurozone member states display their prices in euro, price differentials have become clear to the consumer. Customers can then easily compare prices of goods across countries.<sup>60</sup> Savvy shoppers will bargain-hunt

### Ramifications of the Euro for Marketers

<sup>55</sup>“Three and a Half Years on the Benefits of the Single Currency are Evident,” The European Commission, Brussels, June 19, 2002.

<sup>56</sup>“France Challenges EU Deficit Pact,” *CNN News*, <http://www.cnn.com/>, June 18, 2002.

<sup>57</sup>“The Euro. Are You Ready?” *Business Week*, December 14, 1998, p. 35.

<sup>58</sup>“The Euro. Are You Ready?” p. 35.

<sup>59</sup>“When the Walls Come Down,” *Economist*, July 5, 1997, p. 69.

<sup>60</sup>John Paul Quinn, “The Euro: See-Through Pricing Arrives,” *Electrical Wholesaling*, April 2002, pp. 22–24.



## GLOBAL PERSPECTIVE 3-3

### THE EURO PROBLEM

In 2005, many countries in European Union were grumbling about the euro, complaining that euro had weakened the financial advantages that firms previously had in stable economies. The euro area's three largest economies, France, Germany, and Italy were struggling with how to stimulate economic growth. Germany, for example, was battling with unfriendly growth rates and double-digit unemployment; Italy entered its second recession in two years in the first quarter of 2005; France voiced their complains with the rejection of the European constitution. According to a government minister in Italy, the euro should be blamed for Italy's poor economic performance and he even advocated reintroducing the lira.

Three years later, new economic figures showed that the first quarter in 2008 was surprisingly strong for the Eurozone. The GDP in the Eurozone rose at an annual rate of 2.8 percent, far stronger than in either the United States or Britain. Solidity in the north made up for fragility in the south. Spain's growth was only 1.2 percent, making this its weakest quarter for over a decade. But Germany's economy grew by 6 percent, as construction firms took advantage of warm weather. France managed a solid 2.4 percent. Yet this could be a high-water mark for the Eurozone economy. A bellwether survey of German firms by Ifo in Munich, showed confidence dropping in April 2008 to its lowest in more than two years. French business confidence, which had briefly improved, wilted as well; and Italian firms have sunk further into gloom. The monthly survey of euro-area purchasing managers showed manufacturing industry in April 2008 growing at its slowest pace since August 2005.

Sources: "Three and a Half Years on the Benefits of the Single Currency are Evident," The European Commission, Brussels, June 19, 2002; "Can This Union Be Saved?" *Economist*, Global Agenda, June 3, 2005; "Too Good to Last," *Economist*, May 17, 2008, pp. 63–64.

So what's wrong with the euro, which was once believed to create "the most far-reaching development in Europe since the fall of the Berlin wall"? Can the united currency be unified across the EU? Ideally, currency zones should be solid and homogenous enough to exhibit little regional variation in business cycles. One potential problem for the one-size-fits-all monetary policy would be make some countries in the region lingering in recession, while others experience rapid growth. This is exactly what happened in the EU region with a few countries, such as Ireland growing so fast while its large economies, like Germany and Italy, stagnating.

In Europe, the lack of adjustment mechanism from the European Central Bank to mitigate imbalances across different regions pushes the EU into a situation of survival, instead of creating a new culture of economic stability in Europe. Wide differences in social insurance and retirement programs across the region, as well as the language and cultural barriers, do not seem to easily drive convergence of the labor market. Furthermore, policy makers have recently unsuccessful to force fiscal policies into rough alignment and strong public resistance has made government unwilling, or unable, to implement some structural reforms.

When growth in the euro area is weak and business confidence is declining, what are the disadvantages of the euro to be in a weak position for its member countries? How would less productive economies cope with competition in the euro area when devaluation was no longer an option? Would a single interest rate for different economies cause problems? And finally, unlike the United States, which has central controls on national budget, how could Europe survive with a single currency without effective controls on national budgets?

cross-border or search the Internet for the best deal. Significant price gaps will also open up arbitrage opportunities leading to parallel imports from low-priced to high-priced markets. Ultimately, manufacturers are forced to make their prices more uniform. While the logic of this argument sounds strong, there is some skepticism about whether the greater transparency achieved via the euro will really push prices downwards. For one thing, one could argue that anyone capable of browsing the Internet or handling a pocket calculator already enjoys the benefits of full price transparency. Hence, whether a single currency will enlighten shoppers a great deal is debatable. For many goods and services, cross-border transaction costs (e.g., shipping bulky goods), cost differentials (e.g., labor, energy), standard differences (e.g., televisions in France) and different tax regimes will still justify significant price gaps. Shrewd companies can also find ways to "localize" their products by offering different features or product configurations. One important point to remember is that transparency is two-way. For many firms, not only will the cost of their end product become more comparable but also the cost of supplies sourced from within the Eurozone.<sup>61</sup> In fact, in a 1997 survey of 2,100 companies within the European

<sup>61</sup>"US Sop Giants' Million-\$ Chances to Score," *Financial Times*, December 16, 1998, p. 4.

Union, 65 percent of the respondents viewed “greater price transparency” as one of the key areas of cost saving (ranked second behind “reduction of exchange risks or costs”).<sup>62</sup> Pricing implications of the euro will be discussed further in Chapter 12.

- **Intensified Competitive Pressure.** Many analysts predict that competitive pressure will intensify in scores of industries following the launch of the euro. Pressure to lower prices has increased. Most likely, the single currency spurs the pace of cross-border competition. But then again, intensified competition should be seen as the outcome of an ongoing process of which the euro is one single step. The euro plays a role but it is surely not the sole driver that accelerates rivalry within the European Union. To prepare their defenses, several companies have taken measures to lower their costs. This desire to cut costs has also spurred a wave of mergers and acquisitions to build up economies of scale. The Dutch supermarket chain Ahold, for example, is scouting opportunities in Britain, France, Germany, and Italy. By building up muscle, Ahold will be able to negotiate better prices with its suppliers.
- **Streamlined Supply Chains.** Another consequence of the euro is that companies will attempt to further streamline their supply channels. When prices are quoted in euro, singling out the most efficient supplier becomes far easier. Cutting back the number of suppliers is one trend. Numerous firms also plan to build up partnerships with their suppliers. Xerox, for instance, is cutting its supplier base by a factor of 10.<sup>63</sup>
- **New Opportunities for Small and Medium-Sized Companies.** The euro is most likely also a boon for small and medium-sized enterprises (SMEs). So far, many SMEs have limited their operations to their home markets. One motivation for being provincial has often been the huge costs and hassle of dealing with currency fluctuations. According to one study, currency volatility has deterred almost a third of German SMEs from doing business abroad.<sup>64</sup>
- **Adaptation of Internal Organizational Structures.** The euro also provides multinational companies (MNCs) an incentive to rethink their organizational structure. In the past, firms maintained operations in each country to match supply and demand within each country often at the expense of scale economies. Given that currency volatility, one of the factors behind such setups, significantly lessens with the introduction of the euro, many MNCs doing business on the continent are trimming their internal operations.<sup>65</sup> For instance, Michelin, the French tire maker, closed down 90 percent of its 200 European distribution sites. The pharmaceutical concern Novartis streamlined its European production and eliminated overlapping operations.<sup>66</sup> In the long run, firms like Michelin and Novartis will enjoy tremendous benefits of economies of scale. Once again, the euro should be viewed here as a catalyst stimulating a trend that has been ongoing for a number of years rather than a trigger.
- **EU Regulations Crossing National Boundaries.** As the EU matures and the member governments expand its authority, Europeans have found that the EU has increasingly become a force for social regulation that crosses ethnic and national boundaries. Its officials are regulating what people can eat, how they can travel, even how they incinerate their trash. Many cases have been filed for national violations of EU farming, fishing, educational, fiscal, consumer, transportation, taxation, and environmental policies. Countries stand accused of failing to enact laws that conform to EU policies, or of failing to enforce such laws.<sup>67</sup> Companies have been struggling through EU’s complex regulatory process. As a result, various industry associations are now trying to clarify exactly where EU-wide rules end and member state laws begin. For

<sup>62</sup> [www.euro.fee.be/Newsletter](http://www.euro.fee.be/Newsletter)

<sup>63</sup> “Business Performance Will Need Sharper Edge,” *Financial Times*, November 5, 1998, p. VIII; and John K. Ryans, “Global Marketing in the New Millennium,” *Marketing Management*, 8 (Winter 1999), pp. 44–47.

<sup>64</sup> “When the Walls Come Down,” *Economist*, July 5, 1997, p. 70.

<sup>65</sup> “Faster Forward,” *Economist*, November 28, 1998, p. 84.

<sup>66</sup> “The euro,” *Business Week*, April 27, 1998, p. 38.

<sup>67</sup> Jeffrey Smith, “EU Rules Leave a Bad Taste in Italians’ Mouths,” *Washington Post*, August 7, 2000, p. A01.



example, a workshop organized by international food and nutrition policy consultancy, European Advisory Services (EAS), in February 2008, aimed to guide companies toward developing multi-country strategies and successfully introducing food supplements and functional ingredients into the European market.<sup>68</sup>

<sup>68</sup>“EAS Clarifies EU and National Boundaries for Companies Launching Food Supplements,” WNII, [whatnewiningredients.com](http://whatnewiningredients.com), February 14, 2008.

<sup>69</sup>Masaaki Kotabe and Ricardo Leal, *Market Revolution in Latin America: Beyond Mexico*, New York: Elsevier Science, 2001.

## SUMMARY

The international financial environment is constantly changing as a result of income growth, balance of payments position, inflation, exchange rate fluctuations, and unpredictable political events in various countries. The International Monetary Fund and World Bank also assist in the economic development of many countries, particularly those of developing countries, and promote stable economic growth in many parts of the world. In most cases, the change in a country's balance of payments position is an immediate precursor to its currency rate fluctuation and subsequent instability in the international financial market.

Thanks to the huge domestic economy and the international transaction currency role of the U.S. dollar, many U.S. companies have been shielded from the changes in the international financial market during much of the postwar era. However, as the U.S. economy depends increasingly on international trade and investment for its livelihood, few companies can ignore the changes.

Having been more dependent on foreign business, many European and Japanese companies have honed their international financial expertise as a matter of survival, particularly since the early 1970s. Accordingly, European countries and Japan have been better able to cope with foreign exchange rate fluctuations than the United States.

International marketers should be aware of the immediate consequences of exchange rate fluctuations on pricing. As increased cost pressure is imminent in an era of global competition, cost competitiveness has become an extremely important strategic issue to many companies. Astute companies have even employed an adverse target exchange rate for cost accounting and pricing purposes. Although accurate prediction is not possible, international marketers should be able to “guesstimate” the direction of exchange rate movements in major currencies. Some tools are available.

The Asian and South American financial crises, and the recent unprecedented global recession triggered by the U.S.

subprime mortgage loan crisis as well as the introduction of the euro in the European Union are highlighted. We do not mean to imply that other issues, such as the collapse of the Russian economy, the recession in the United States and the EU, and global warming, are not equally important and do not have many business implications. We are sure that you are convinced of the importance of keeping constantly abreast of events around you to understand and cope with the ever-changing nature of international business.

We expect that companies from various Asian countries will become ever-leaner and more astute competitors in many different ways. South America is also expected to recover.<sup>69</sup> U.S. and other foreign companies doing business in Asia and South America should not pull out of the Asian markets simply because it is very difficult to do business there. Doing so will likely damage corporate reputation and customer trust. U.S. and other foreign companies should have longer-term orientation in dealing with Asian and Latin American consumers and competitors by developing strategies that emphasize value and reducing operational costs thereby reducing susceptibility to occasional financial upheavals.

On the other hand, the European Union (EU) is going through a different kind of economic and political metamorphosis. The EU's new common currency, the euro, has begun to change the way companies do business in Europe. Price comparison across European countries has become easier than ever before. The ease of doing business across countries will permit small and medium-sized companies to go “international” in the region. Competitive pressure is bound to increase. European companies can also enjoy broader economies of scale and scope, making themselves more competitive in and outside the EU. Again, U.S. and other foreign companies should not take for granted the changing face of the EU market and competition originating from it.

## KEY TERMS

Balance of Payments  
Bretton Woods Conference  
Currency bloc  
Currency hedging  
Current account balance  
Direct investment  
Euro

Euro Area (Eurozone)  
Exchange rate pass-through  
External market adjustment  
Fixed exchange rate  
Forward market  
Free float  
Internal market adjustment

International Monetary Fund (IMF)  
Managed float  
Operational Hedging  
Portfolio investment  
Purchasing power parity (PPP)

Special Drawing Rights (SDRs)  
Spot market  
Target exchange rate  
Trade balance  
World Bank



## REVIEW QUESTIONS

How did the U.S. dollar become the international transaction currency in the post–World War II era?

1. Which international currency or currencies are likely to assume increasingly a role as the international transaction currency in international trade? Why?
2. Why is a fixed exchange rate regime that promotes the stability of the currency value inherently unstable?
3. Discuss the primary roles of the International Monetary Fund and World Bank.
4. What is the managed float?
5. How does a currency bloc help a multinational company's global operations?
6. Using the purchasing power parity argument, estimate whether the U.S. dollar is overvalued or undervalued relative to the German deutsche mark, the French franc, and the Japanese yen.
7. Describe in your own words how knowledge of the spot and forward exchange rate market helps international marketers.
8. Why is the exchange rate pass-through usually less than perfect (i.e., less than 100 percent)?
9. Define the four types of balance of payments measures.
10. Describe the sequence of events that took place to cause the Asian financial crisis in the late 1990s.
11. What are the advantages and disadvantages of having euro as a common currency in the European Union?

## DISCUSSION QUESTIONS

The Big Mac Index of the *Economist* has been introduced as a guide in the popular press to whether currencies are at their “correct” exchange rate. Although the merits of this index have been mentioned, this index has various defects. Identify and explain the defects associated with this index.

1. Fujitsu, a Japanese computer manufacturer, was recently quoted as taking various steps to prevent wild foreign exchange fluctuations from affecting the company's business. One step being taken is the balancing of export and import contracts. In 2001, the company entered into \$3.4 billion of export contracts and \$3.2 billion of import contracts. For the year 2002, these figures were expected to be balanced. Explain how this measure would help the firm. What are the advantages and disadvantages of this measure? Are there any alternate courses of action that would give the same end results?
2. In a referendum in September 2000, Denmark citizens voted to reject membership of Europe's single currency euro. The result was pretty close, with 53.1 percent of voters rejected the membership and 46.9 percent favoring adoption. Many feared that rejection would deepen divisions within the European Union and Denmark would be left out of the integration and cooperation; others believe that a single currency would erode Danish sovereignty. Do you believe that rejection of membership will create a “two-speed” Europe?
3. In July 2005, China dropped its decade-long currency peg to the U.S. dollar, an instead re-pegged to a basket of currencies. China reevaluated yuan to make the currency effectively 2.1 percent stronger against the U.S. dollar. On May 16, 2007, China again took steps to let its currency trade more freely against the dollar and to cool its sizzling economy and contain its soaring trade surplus with the United States. The yuan was allowed to fluctuate further against the dollar by 0.5 percent a day, up from 0.3 percent. Under the new currency system, China has not yet surrendered control of the currency. It has moved away from a fixed exchange rate but not all the way to a flexible or free-floating one. American manufacturers and

labor unions hope yuan's reevaluation will help U.S. factory sales and jobs by making U.S. goods more affordable abroad. For China, the currency move will make Chinese exports a little more expensive abroad. Many Asian countries have been trying to compete with China's low-cost manufacturing, and after China's yuan reevaluation, Malaysia announced it would drop its peg to the U.S. dollar as well. In the short run, the change in China's currency management system could be almost unnoticeable. In the longer run, however, the impact on trade and on the world financial system could be huge. Based on what you learned from this chapter, what would be the impacts on the world's economy, if China and other Asian countries truly allowed their currencies to float, or, instead, keep holding them within narrow bands against the dollar?

As presented in **Global Perspective 3-3**, many countries in European Union are complaining that the euro has weakened the financial advantages that firms previously had in stable economies. The euro area's three largest economies, France, Germany, and Italy are now struggling with how to stimulate economic growth. Germany, for example, is battling with unfriendly growth rates and double-digit unemployment; Italy entered its second recession in two years in the first quarter of 2005; France expressed their complaints through their rejection of the European constitution. According to a government minister in Italy, the euro should be blamed for Italy's poor economic performance and he even advocated reintroducing the lira. So the question is, can the united currency be unified across the EU? Ideally, currency zones should be solid and homogenous enough to exhibit little regional variation in business cycles. However, the current one-size-fits-all monetary policy would possibly make some countries in the region lingering in recession, while others experience rapid growth. Witnessing the rapid growth of a few countries, such as Ireland while other large economies like Germany and Italy, stagnate, should EU make any changes to its currency system? Or what needs to be done to adjust the EU problem?

## SHORT CASES

 CASE 3-1


## SAMSUNG'S SURVIVAL OF THE ASIAN FINANCIAL CRISIS

The Asian financial crisis severely affected the Korean economy, reflecting on its currency and balance of payments situation. Several Korean companies went bankrupt in its aftermath, the epicenter of which was the year 1997. Others such as Daewoo and Hyundai are still struggling to hang on almost eight years after the crisis. Among those that survived is the successful South Korean *chaebol* (conglomerate) Samsung with revenues of over \$50 billion and over 60 related and unrelated divisions under its umbrella. Samsung is known all over the world for its flat screen liquid display panels and superior memory chips as well as for finished products like cell phones and other consumer electronics. The company's electronics division Samsung Electronics is now one of the largest technology companies in Asia competing head on with older Japanese electronics firms such as Sony and Panasonic for global market share.

Samsung rose to global fame in the late 1980s and early 1990s when it introduced its DRAM (dynamic random access memory) chips in the West and developments in chip technology soon led it to present its 1 megabit chip, the first in the world and a technological breakthrough at the time. Samsung went on to later introduce upgrades on its chips in the years that led up to the crisis of 1997 and even though it was successful in chip manufacturing, it was losing out to its competitors in consumer electronics and white goods. When the Asian financial crisis hit, many companies shut down shop but Samsung steeled itself and persevered among falling prices for chips and its other products. In order to boost profitability, the company laid-off around 30 percent of its workforce after the crisis but continued to invest in innovation to bring it out of the red. So, how did Samsung make a turnaround? Well, it turned to the huge North American and Western European markets, known for their penchant for technologically advanced products and greater purchasing power among consumers compared with Asian consumers.

Samsung had to work hard to gain market share in these markets. In the years after the crisis, it set up subsidiaries in Western countries. One of its main targets was the large U.S. market. The company realized that to succeed in the U.S. and

the global arena, key factors would include better design to be able to charge premium prices and therefore generate increased revenues. The company set out and did just that. It focused on research in digital technology, design, and utility and brought in designers from the best design schools in the Western hemisphere. Their designers were sent all over the world to draw inspiration for electronics architecture. Thus, Samsung sought to differentiate itself from its global rivals through superior design. Its efforts paid off. By the year 2005, Samsung had captured the higher end TV market in the U.S. market and its brand was the best selling in such items in the country. It also is the largest maker of DRAMs and LCD monitors. Every year, the company increases its design staff and budget. Its design staff evaluates consumer tastes and advises engineers on products. According to a ranking of the IDEA Biggest Award Winners between 2003 and 2007, Samsung ranked the first with a total number of 15, much higher than Apple and Hewlett-Packard (HP) with 11, respectively.

In a way, the Asian financial crisis proved to be an indirect blessing for the company. Due to the crisis, the Korean government stepped in to revive the industry and that enabled firms like Samsung to take the necessary measures to get back to profitability such as laying off workers, which in Korea is a contentious issue due to the highly unionized workers. Also, it pushed the company to look beyond at larger markets. Somewhere in the midst of all the chaos that surrounded companies during and after the Asian financial crisis, the company made a big decision, to transform itself from a me-too producer of electronics to one of the most innovative companies and leading brands in the world. In 2005, it is known for its "cool" products. Between 1998 and 2006, the company raised its R&D expenditures to around \$6 billion, which constitutes 9.5 percent of its sales value. Today, the company that could have easily sunk in the crisis has brand equity worth more than \$15 billion and its market capitalization is greater than that of Sony and other Japanese electronics leaders that have been around much longer than Samsung has.

## DISCUSSION QUESTIONS

1. What did Samsung do differently from other firms that also faced the Asian financial crisis?
2. What should Samsung do to continue to bring in profits in the future?
3. What can global firms do to reduce vulnerability to financial crises?

Sources: Seung-Ho Kwon; Dong-Khee Ree; Chung-Sok Sub. "Globalization Strategies of South Korean Electronics Companies after the 1997 Asian Financial Crisis," *Asia Pacific Business Review*, 10 (Spring/Summer 2004), pp. 422–40; "The Lessons for Sony at Samsung," *Business Week*, October 10, 2005 pp. 37–38; "Winners Over The Past Five Years," *BusinessWeek.com*, July 30, 2007; and Samsung, <http://www.samsung.com/>.



## MANUFACTURING LOCATION: THE UNITED STATES OR CHINA

In this era of globalization, American factories and supplier networks in many industries have withered, with a large migration to developing countries, especially to China. In electronics, for instance, a lot of component manufacturers have moved to China in the past decade. The furniture industry has undergone a similar transformation. The same also goes for lighting fixtures, household appliances, and more. One reason accounting for the migration is what American managers call the China Price, the once-formidable 40 percent to 50 percent cost advantage enjoyed by Chinese manufacturers—and demanded by customers.

However, today the global industrial landscape appears to be starting a realignment, as the dollar has plunged by 30 percent against major world currencies since 2002 and the cost of fuel has surged. The euro's breathtaking appreciation against the dollar has spurred European manufacturers of cars, steel, aircraft, and more to shift production to the United States. Meanwhile, the soaring cost of fuel is making it pricier to send goods across the Pacific. In the case of China, the dollar dropped from 8.3 yuan/\$ in 2002 to 6.8 yuan/\$ in June 2008. Wages in China are rising 10 percent to 15 percent a year. And shipping rates are driven up by spiking oil prices—the cost of sending a 40-foot container from Shanghai to San Diego has soared by 150 percent, to \$5,500, since 2000. If oil hits \$200 a barrel, that could reach \$10,000. Will the surging shipping costs drive the United States to bring jobs in manufacture back from China?

If global shipping costs continue to rise, some businesses could eventually move their factories back to the United States, but that process will take years. In the short term, China is still irreplaceable. One reason for China being able to keep its edge in the face of soaring costs is its rising productivity, a factor widely overlooked by the world. For the past decade, U.S. manufacturing productivity growth has averaged 4.8 percent, which is doubtlessly impressive for an industrialized nation, and bodes well for U.S. industry when the economy recovers. But on the other side of the Pacific, productivity at medium and large Chinese manufacturers—the backbone of country's export boom—has averaged nearly 19 percent over the same period. In circuit-board industry, for instance, a decade ago the U.S. accounted for one-third of global circuit-board output. Today that is down to 10 percent, with China manufacturing 80 percent. According to Douglas Bartlett, chairman of Bartlett Manufacturing, a U.S. manufacturer of high-end circuit boards used in defense and medical

systems, Chinese boards are still 40 percent to 50 percent cheaper than the ones Bartlett makes in the United States, in part because Chinese producers have superior technology.

Another reason lies in that China's price edge against the United States will remain for a long time in spite of the soaring yuan, if not for a decade as contended by some analysts. While the United States has become a "midprice" alternative to Western Europe thanks to the plunge in the dollar, its cost structure in relation to China has changed only marginally. Take industrial compressors, which are used to power equipment such as office air-conditioning systems, for example. Three years ago it cost 38 percent less to make a 1.5-ton compressor in a factory in China than in a U.S. plant. The big driver was Chinese wages and benefits, which were 65 percent below those in the United States. Today, after accounting for rising labor costs in China, the strengthening yuan, and higher shipping rates, Chinese-made compressors are still about 30 percent less expensive.

Actually, expecting the United States to recapture industries that have already gone to China may not be realistic. In other words, the bulk of goods made in China—clothing, toys, small appliances, and the like—probably will not be coming back, because they require abundant cheap labor. If anything, their manufacture will go to other lower-wage nations in Asia or Latin America. And in industries from machinery to motorcycles, China's productivity gains have nearly offset rising wages and fuel prices.

But in areas where the United States is at the forefront of innovation—renewable energy, nano materials, solid-state lighting—the United States may have as good a chance as anyone of being a strong player. The new cost equation likely will influence U.S. companies' decisions about where to locate production in the future. The challenge will be to persuade reluctant venture capitalists and corporations to invest again in modern U.S. manufacturing facilities.

### DISCUSSION QUESTIONS

1. According to this case, U.S. companies will not bring back jobs from China in industries whose products are currently made in China but can be a strong player in areas where the United States is at the forefront of innovation. Do you agree with the opinion? Why or why not?
2. Besides shipping costs, are there any other possible advantages for U.S. firms to manufacture inside the country or any other possible disadvantages for them to manufacture in China? If yes, what are they? If not, why not?

Source: "Can the U.S. Bring Jobs Back from China?", *BusinessWeek.com*, June 19, 2008.

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