FOREIGN MARKET ENTRY

Martin Grančay, PhD.

Today´s class

1. Why do countries trade?
2. Foreign market entry: export
3. Foreign market entry: contract
4. Foreign market entry: investment

Why do countries trade?

-6 basic reasons why international trade exists:

1. Differences in natural and climate conditions
2. Differences in technologies
3. Differences in factor endowment
4. Differences in demand (consumer preferences)
5. Existence of economies of scale

\+ Existence of protectionism in international trade

1./2. Absolute advantage

-differences in natural and climate conditions,
differences in technologies

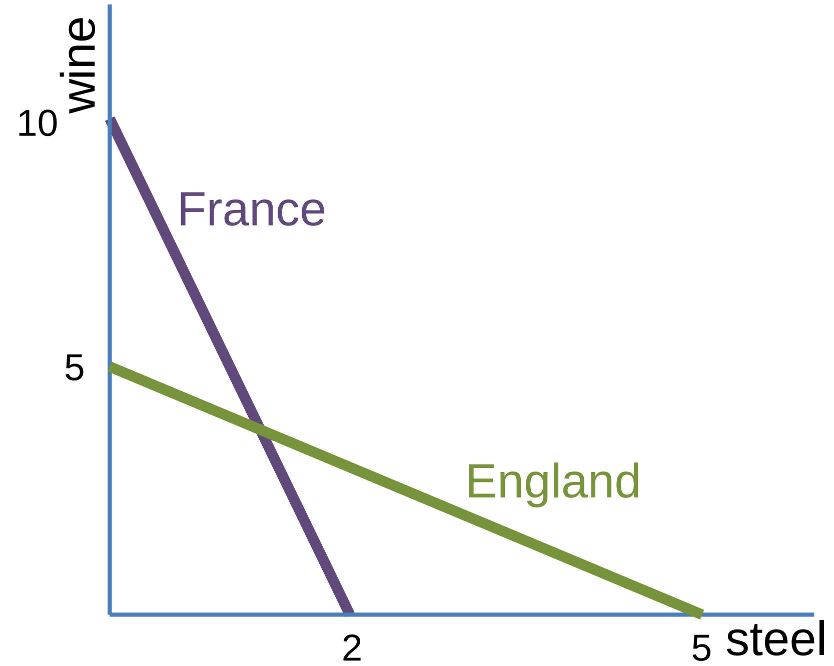
Countries should only produce goods that they have an absolute advantage in. A country is said to have an absolute advantage if it can produce a good at a lower cost than another.

Adam Smith, 1776

1./2. Absolute advantage

Let´s say that there are only two countries in Europe: England and France. These countries have an endowment with labor of 100 hours each.

	Absolute cost	
	Wine	Steel
England	20 h	20 h
France	10 h	50 h



How can Europe maximize its production?

1./2. Comparative advantage

-differences in natural and climate conditions, differences in technologies

What will happen in international trade if one country has an absolute advantage in the production of both goods and the other has an absolute disadvantage in the production of both goods?

The country will specialize in production and export of that good, which it can produce at comparatively lower cost than the other country, i.e. it produces the good with relatively lower cost.

David Ricardo, 1817

1./2. Comparative advantage

-England and Portugal produce wine and cloth:

	Absolute cost	
	Wine	Cloth
England	120 workers	100 workers
Portugal	80 workers	90 workers

„Though she [Portugal] could make the cloth with the labour of 90 men, she would import it from a country where it required the labour of 100 men to produce it, because it would be advantageous to her rather to employ her capital in the production of wine, for which she would obtain more cloth from England, than she could produce by diverting a portion of her capital from the cultivation of vines to the manufacture of cloth. Thus England would give the produce of the labour of 100 men, for the produce of the labour of 80.“

3. Factor endowment

-countries have different endowments with factors of production (some are relatively capital-abundant, some are labor-abundant...)

-production of different goods has different factor intensity (some goods are relatively capital-intensive, some are labor-intensive...)

Countries will have a comparative advantage in goods that are produced with the factor of production (land, labor or capital) that the country has an abundance of; and hence will export these goods.

Eli Heckscher and Bertil Ohlin, 1930s

3. Factor intensity

Industry	1960	2000
Chemicals	30 400	85 900
Electrical machinery	6 400	35 300
Metals	8 700	22 100
Food industries	12 200	36 800
Furniture	4 600	10 400
Leather	2 300	14 600
Paper	20 200	58 900
Gas, oil and coal	93 800	266 700
Textiles	8 400	27 300
Tobacco	9 000	100 100
Transportation equipment	10 500	21 300
AVERAGE	15 300	47 600

Note: Data for USA. USD of capital per worker.
Source: HUSTED – MELVIN. 2006. *International economics.*

3. Factor abundance

Country	2017
United Arab Emirates	758 894
Aruba	751 265
Brunei	719 546
Italy	672 536
Belgium	637 402
Ireland	621 695
Singapore	591 380
Qatar	586 975
Austria	579 330
Norway	561 052
Slovakia	289 934
Burundi	3 440

Note: Capital in USD available per worker.
Penn World Tables, own calculations 2020.

4. Consumer preferences

The more similar the demand structures of countries, the higher the potential for their mutual trade.

When do countries have similar demand structures?
When they are similarly rich.

Countries with similar values of GDP per capita have similar consumer preferences. Therefore, there is overlapping demand = potential for development of mutual trade.

Staffan Linder, 1961

4. Consumer preferences

-e.g. automobile industry:

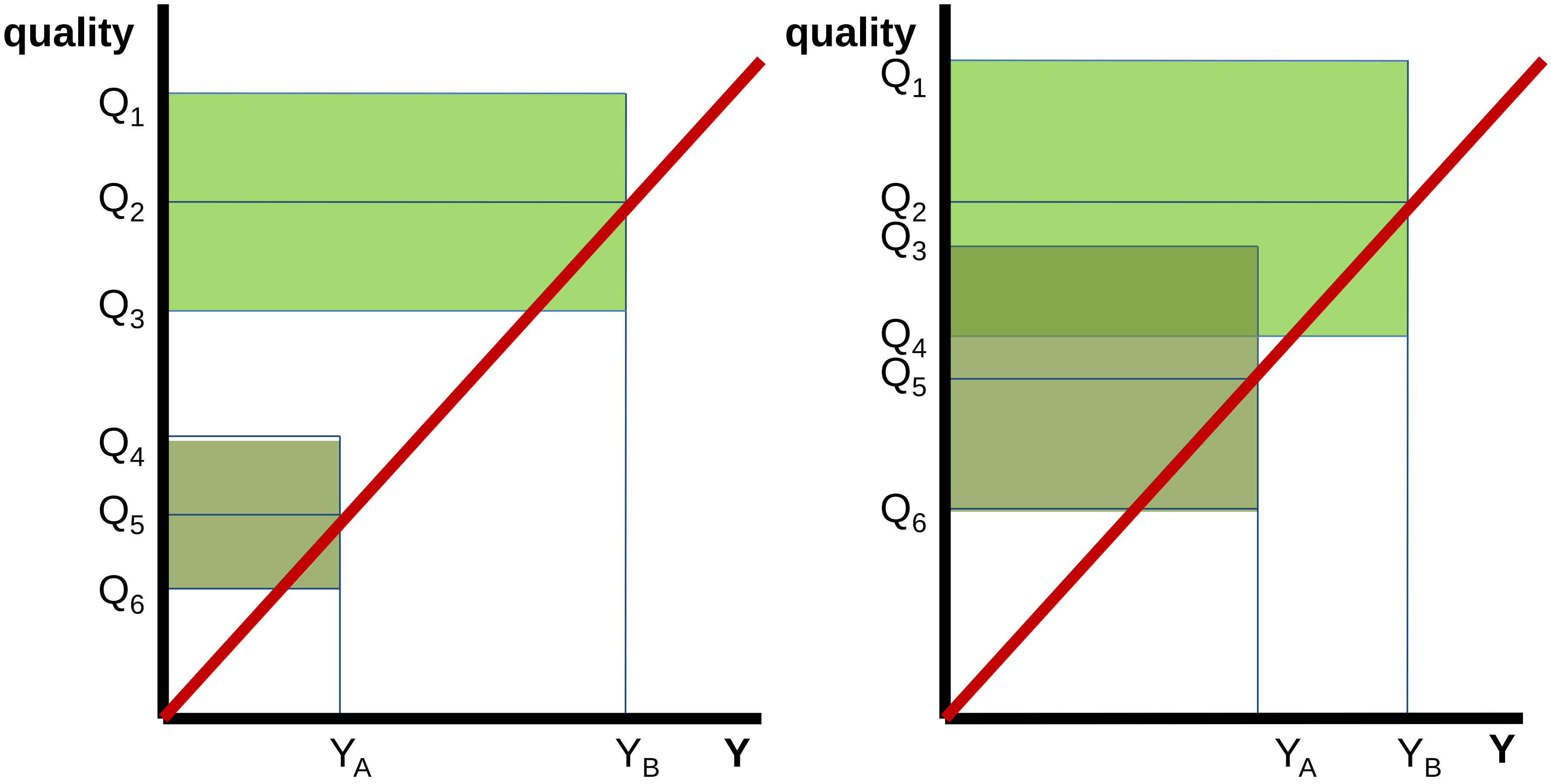
Exports from SK:

Audi, Citroen, Kia, Peugeot, Porsche, SEAT, Škoda, VW

Imports to SK:

Audi, BMW, Chevrolet, Citroen, Ford, Honda, Hyundai, Kia, Lexus, Mazda, Mercedes, Mitsubishi, Nissan, Peugeot, Porsche, Renault, SEAT, Subaru, Suzuki, Škoda, Toyota, Volvo, VW
...

4. Consumer preferences



5. Economies of scale

-when producing a bigger quantity of the same product, the unit costs are lower = economies of scale

-the size of domestic market is limited – firms wanting to reach even higher economies of scale will start to export

Paul Krugman, 1980s

Foreign market entry modes

-main questions before selection of a mode:

What quantity do we want to sell abroad?
How many countries do we want to enter?
What type of countries do we want to enter?

-main factors of decision on foreign entry:

analysis of foreign markets
- -does the market have a potential?
- -is it accessible?
- -how big are the risks?

analysis of competition
analysis of own capacities (SWOT)

-foreign market entry modes:

Export | Contract
Investment

Foreign market entry modes

- Export
  - Indirect
  - Direct
    - Agent
    - Distributor
    - Foreign sales office
    - Own distribution network
- Contact
  - Contract manufacturing
  - Licence
  - Franchize
- Investment
  - Foreign subsidiary
  - Joint venture
  - Direct investment

Indirect export

	Pros	Cons
Indirect export	Low cost. Low staff requirements. Low financial risk. Zero marketing cost. Foreign market entry difficulties are coped with by the intermediary. The easiest mode. Relatively easy and fast increase in the number of markets.	High dependency on local intermediary. Low profitability. No learning – zero experience with foreign market entry and zero knowledge about the foreign market. The intermediary can find a new supplier. The intermediary can start its own production.

Direct export

	Pros	Cons
Foreign agent	Low cost. Medium financial risk. The agent is responsible for clearing the entry barriers.	Low profitability. High dependency on foreign agent. No learning.
Foreign distributor	Low staff requirements. Low marketing cost.	The distributor can find a new supplier. High transport cost. Possible trade barriers.
Foreign sales office	Presence on the market. Direct contact with customers. Flexibility to react to market changes.	Relatively high dealership cost. High transport cost. Possible trade barriers.
Own distribution network	Presence on the market. Direct contact with customers. Full control of sales. Relatively high profitability.	High initial cost. High cost to maintain the network. Time-consuming.

Contracts

	Pros	Cons
Contract manufacturing	Low capital intensity. Low risk.	Relatively low profitability. Low learning. Often weak negotiation position with the manufacturer.
License	Low initial cost. Low financial risk. Stable revenue. Strong presence on foreign market – brand, logo. Licensee knows the market. Low staffing requirements.	Possibility of know-how theft. Possible problem of low product quality. Risk of disloyalty. Relatively low license fees.
Franchise	Low initial cost. Possibility of a fast expansion on the market, including on many (and large) markets.	Cost of controlling. Profit sharing issues. High requirements on the partner. Risk of disloyalty, low quality...

Investment

	Pros	Cons
Foreign subsidiary	Full control.	Relatively complicated registration procedures.
Joint venture	Synergy– combination of knowledge and skills of the exporter and the local partner. Risk sharing.	High initial cost. High risk. Relatively complicated registration procedures (solved by partner). Potential conflict of interest between exporter and partner.
Foreign direct investment	Full control. Potential for highest profit.	High initial cost. High risk. Relatively complicated registration procedures.

Selecting the mode

Exporter's situation \ Entry modes		Indirect export	Direct export	Licensing and/or franchising	Joint venture subsidiary	Wholly-owned subsidiary
Strategic intent	Immediate profit	✓✓✓	✓✓✓	✓✓	✓	✓
	Learn the market			✓	✓✓	✓✓✓
Need for control	High				✓✓	✓✓✓
	Low	✓✓✓	✓✓	✓		
Company resource	International expertise		✓		✓✓✓	✓✓✓
	Strong financial position				✓✓	✓✓✓
Product	Easy to adopt		✓✓	✓✓	✓	✓✓
	Difficult to adopt				✓✓✓	✓✓✓
Transport	Easy to transport	✓✓		✓✓	✓✓	✓✓
	Difficult to transport		✓✓	✓✓	✓✓✓	✓✓✓
Local government	Favourable regulatory environment		✓	✓	✓✓	✓✓✓
	Unfavourable regulatory environment	✓✓✓	✓			
Geography	Long distance between markets			✓✓	✓✓	✓✓
	Short distance between markets	✓✓	✓✓✓			
Culture	Large cultural distance	✓✓	✓	✓✓	✓✓✓	✓
	Small cultural distance	✓✓✓	✓✓✓		✓	✓✓✓

Source: adopted from (Cullen, Parboteeah, 2010, p. 296).

Thank you for your attention all semester long ;)

STU FCHPT