Revision Guide to Year 2 Economics B

Themes 3 and 4 of Edexcel's Economics B

Nancy Wall

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Contents

Using this book

This revision guide covers Themes 3 and 4. Much of the content builds on work done in Themes 1 and 2. Do not rely on this book alone. Every chapter starts with the revision you need to do on aspects of Themes 1 and 2. Build on the work you did earlier. The theme glossaries include only the terminology that is relevant and new for that theme.

Revision guides are good for checking knowledge but do not help much with the important skills of application, analysis and evaluation. So you must practice these skills so you can show a deep understanding of the theory and provide real insights into the way the world actually works. Many questions will require you to draw on detail from a range of topics and themes.

It is quite difficult to do this while you are working on specific topics. But many of the questions you have to answer require a synoptic approach. This means that you must be able to draw on a wide range of theories and examples from across the course, using all the relevant details that relate to the question.

This gets easier towards the end of the course. In this book you will find many cross-references to particular pages where something relevant is to be found. You will also have become familiar with all aspects of the course. So it becomes possible to draw on many different concepts to create a balanced and meaningful answer.

In some places, this revision guide goes a little further than the textbooks, to show the connections between different ideas and current events. Revision guides can refer to ideas from all over the course – because you have at least some understanding of all topics covered. Think about how the many components of the subject fit together.

A word about evaluation. It means *making a judgment about something*. It might entail looking at advantages and disadvantages, or making a choice between alternatives and discussing the underlying reasons for each. Good evaluation requires a balanced conclusion, referring to factors that might contribute to a rational decision. Many of the issues you encounter are controversial, involving conflicting interests and different points of view. Often there is a range of different perspectives on any given issue. Drawing a balanced conclusion requires consideration of different points of view.

If you are comparing two possible policies, you could say:

Policy X would be likely to solve (this problem, whatever it is) but there could be disadvantages such as…

Critics of policy X would prefer policy Y, which would have the advantage of… but might cause complications because…

This is much better than just saying, *there is a trade-off…* Explain everything as thoroughly as you can.

What about Brexit. This creates a great deal of uncertainty for us all. The 2017 exams were written around the beginning of 2016, with the referendum still six months off. However you will still be able to pick up marks wherever recent events are relevant to the question, for example on the effects of exchange rate changes. The 2018 exams may have questions relating to Brexit, requiring analysis that does not figure in this book. So revise the events and opinions that have emerged since the end of 2016.

You are living in interesting times. I hope that your understanding of the subject will carry you through the years of uncertainty that are to come and help you to deal with whatever challenges you face.

3.1 Chapter 1
Globalisation

3.1.1 Growing economies

WATCH OUT!

Before you start to revise Theme 3, make sure that you have fully understood the content of Section 2.4 in Theme 2, The wider economic environment. This is covered in the Revision Guide to AS and A level Economics B, Themes 1 and 2, pages 84-93. It covers all of the basic aspects of globalisation and trade liberalisation. This book covers all this in more detail but you need to have revised the Year 1 content first. For example, see page 89 on developed, developing and emerging economies.

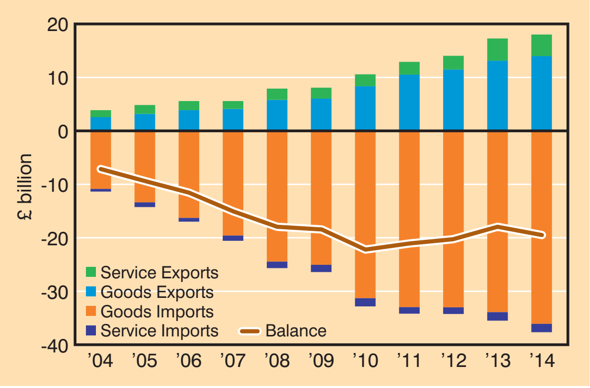
Extraordinary growth

Rapid economic growth

After World War II, the global economy began to grow.

- In the 1960s, the Asian Tigers took off – South Korea, Taiwan, Hong Kong and Singapore. They began to grow at a rate not previously seen before, anywhere.
- In 1980, the Chinese government decided to engage in international trade in the hope of increasing incomes.
- In 1989, the communist USSR collapsed and the new Russian government increased trade with the rest of the world.
- In the 1990s the Indian government reformed its policies to increase trade.
- By 2000, emerging economies everywhere were industrialising fast. People who had worked in the agricultural sector moved to the cities where jobs were available. In the manufacturing sector, labour productivity was rising fast.
- The BRIC countries, Brazil, China, India and Russia were trading more.
- Even during the financial crisis, the emerging economies mostly continued to grow after a short time. In 2010 both India and China had 10% economic growth. India's growth rate was 8% in 2016. China's slowed to 6.5%.
- Most of this economic growth was associated with rapid increases in the volume of trade. Figure 1 shows how significant trade between China and the UK has become.

Figure 1: UK exports, imports and trade balance with China, 2004 to 2014



Source: ONS

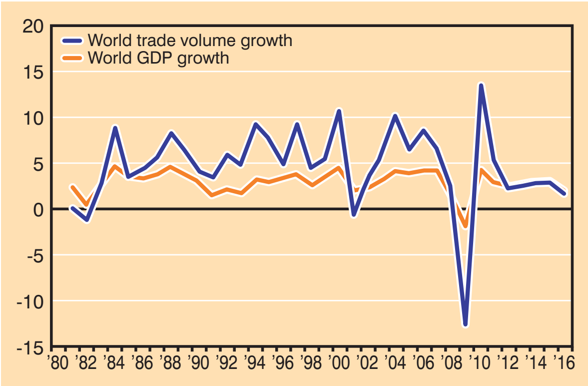
What happened next?

Slow growth in many developed economies after the financial crisis of 2008-9, especially in the Eurozone, reduced demand for emerging market exports for several years.

- In China, growth was based partly on high levels of investment, some of which was not very profitable. China needed to rebalance its economy and encourage more consumer spending.
- In India, growth now remains high and trade is buoyant.
- In 2014 both oil and commodity prices fell. GDP fell in Russia and in other oil exporting countries, especially in Nigeria and other African countries. Brazil found revenue from its big exports, agricultural and mineral commodity products, declining fast.
- Slow growth in many developed economies after the financial crisis of 2008-9, especially in the Eurozone, reduced demand for imports.

Slower growth

Figure 2: GDP and trade growth 1980-2016 (%)



Source: WTO

Watch...
...what happens to oil prices. Observe the effects on exporters and importers of oil.

For most economies, the rapid growth of trade was an important element in GDP growth. But between 2011 and 2016, trade and economic growth rose at a slower and almost identical rate. Figure 2 shows the change.

Uncertain times

Patterns of trade are changing. The reasons might include:

- In some countries, public opinion may shift towards protectionism even though this would reduce real incomes for many wage-earners.
- Brexit may alter trade patterns considerably.
- New technologies (e.g. robots or 3-D printing) may lead to less **offshoring**.
- Ageing populations may need more services and fewer manufactures.
- Political changes and wars may disrupt some trade.

Offshoring means moving part or all of the production process abroad. It could mean setting up a subsidiary company abroad or paying local contractors to manufacture the product or component.

Implications of economic growth for individuals and firms

Economic growth implies dynamism in both labour and product markets.

Market dynamism

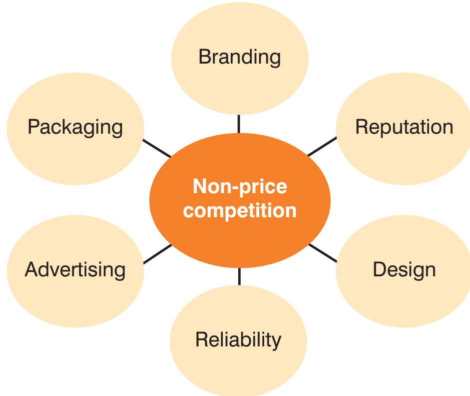
- Individuals will have widening ranges of job opportunities and if they are mobile, will be able to increase their incomes.
- The demand for people with scarce skills will be high. There will be a need for individuals and businesses to enhance their human capital. Training may be available, increasing productivity.
- People may migrate from agricultural areas to cities, or to other countries.
- **Patterns of employment** change as businesses find new markets, or fail to compete in their existing markets (i.e. when there is structural change).

- Economic growth may be associated with better health care, education and welfare systems but only if governments take action to achieve these objectives.

For businesses, the big questions is, **can they stay competitive**? Increased trade and interdependence usually makes markets more competitive, so businesses operating in global markets have to watch out.

Price and non-price competition

Businesses in developed economies may improve competitiveness by **offshoring** production to where labour costs are lower. Businesses that are facing competition from other developed economies may engage in non-price competition.



In emerging economies, offshoring by developed country businesses provides strong demand for manufacturers. A ready supply of cheap labour keeps them competitive. Over time, economic growth leads to rising incomes and higher labour costs. Some businesses will continue to thrive by investing and increasing productivity, and by widening the scope of their product range.

Globalisation does encourage mergers and takeovers. These can create scope for economies of scale and for access to new markets. Businesses that merge and then rationalise will shut down departments that duplicate work and cut costs.

Rationalisation

Rationalisation involves reorganising production to achieve efficiency and use fewer resources to get the same output. Merged companies usually rationalise by creating a single department for each function.

Dynamic businesses can adapt to market change wherever they are. Businesses that lack appropriate expertise may struggle. Mobile individuals with skills and flexible businesses will benefit most from economic growth.

Rising incomes

Global labour market

Many people are effectively working in a global labour market. This favours people with scarce skills but hurts those who have few skills and little bargaining power. Overall, economic growth resulting from globalisation has reduced poverty. An estimated 600 million Chinese people have been lifted out of poverty. Similar pictures appear in other emerging economies. Even the people who do not have good jobs have benefited because of the increased spending power that flows into an economy that is exporting successfully.

Globalisation and growth	Gainers	Losers
Developed economies	Employees working in firms that export successfully. People with scarce skills.	Employees who have few skills working in firms that cannot compete with imports and close down.
Emerging economies	People who move from farm work to manufacturing, especially if they benefit from training.	People without scarce skills who have little bargaining power and poor working conditions.

Real and nominal values

Nominal prices (for goods and services) and nominal values (for property or financial assets) are those that are actually in use at the present time, i.e. current prices. **Real values** are stated in **constant prices**, i.e. removing the effects of inflation.

If we want to know how much GDP has increased, it is no use looking at current values. We have to convert these to real values which tell us exactly how much more spending power we have compared to an earlier year. Similarly if we want to know how much better off we are in terms of our earnings, we need to look at real wages expressed in constant prices, not the nominal wage rate that goes into the bank.

Nominal value means value at current prices.

Current prices apply to data given at the price level in the year concerned.

Real values measure money values with the effect of inflation removed.

Constant prices are the prices that would have been in use if there had been no inflation.

Nominal values

Supposing we want to know how much the real price of butter has risen over the past five years. We might know that a tub of Anchor spreadable butter costs £1.75, and that five years ago it would have cost £1.50. What we really want to know is how much of the change is due to inflation. If we have index numbers for the relevant period we can work this out. The formula is:

$$\frac{\text{Nominal value x 100}}{\text{Price index}} = \text{real value}$$

Calculating: we can make five years ago the base year. If the price index that measures inflation stands at 110 now,

$$\frac{£1.75 \text{ x } 100}{110} = £1.59$$

This tells us that something other than inflation has made the price higher by 9p. Maybe the news that butter is not very bad for us increased demand and enabled Anchor to put the price up. The difference between the real and the nominal value of a tub of Anchor five years on is 16p.

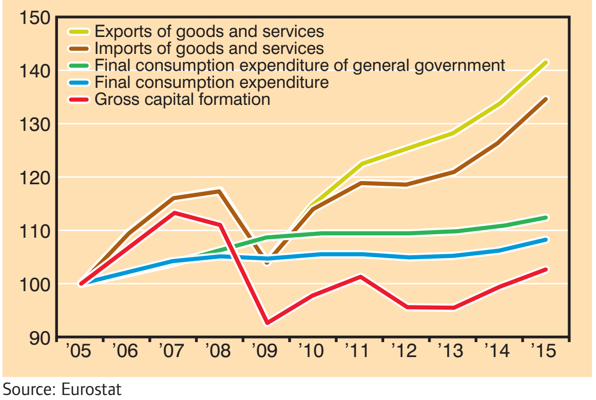
Similarly we can take nominal GDP and find out real GDP using the same formula and data from the price indices that measure inflation.

Index numbers

Take a long hard look at Figure 3. If you looked at this in numbers, the blue and red lines would add up to round about GDP without exports and imports. Exports and imports, the other elements in the circular flow of money, are way above the rest. How can this be?

Using index numbers

Figure 3: EU28, changes in consumption, trade and investment, 2005-15



Source: Eurostat

The simple answer is that this is not about numbers or GDP. It is about different rates of growth in different sectors of the EU economy. It tells us about the impact of the 2008-9 financial crisis. It tells us that:

- exports rose faster than imports.
- investment (gross fixed capital) in 2015 was only just above what it was in 2005.
- government spending on consumption (e.g. health, education and general administration) grew faster than total consumption.

- exports rose fast because the weakness of the southern economies in the Eurozone depressed the euro exchange rate, thus making Germany highly competitive and able to increase its export sales fast.
- austerity policies reduced consumption spending below what it would have been in normal circumstances.

Any time we want to make comparisons like this, we need index numbers to highlight the changes.

WATCH OUT!

Being able to interpret index numbers is very important. You can compare inflation rates or exports or investment, in different economies. Or you can compare different sectors in one specific economy. These are just examples.

Calculating index numbers can be done like this. The table shows GDP € billions at constant prices.

	2006	2015
EU28	€12,680	€13,500
Germany	€2,516	€2,791

Source: Eurostat

Calculating index numbers

The formula for calculating index numbers is:

$$\text{Index number} = \frac{\text{Current value}}{\text{Base year value}} \times 100$$

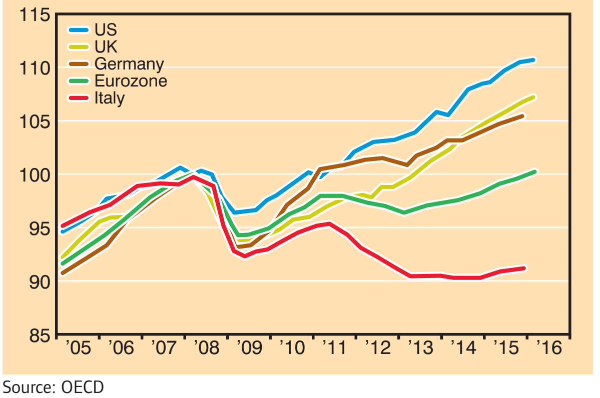
Using 2006 as the base year, (13,500 ÷ 12,680) x 100 = 106.5

This tells us that the EU28 GDP index was 106.5 in 2015, calculated from the base year, 100 in 2006. In other words, total economic growth in those nine years was 6.5%.

Calculate the 2015 GDP index for Germany. It is quite a lot higher than the index for EU28 GDP. Suggest a possible reason for this.

Companies real GDP growth for 2008

Figure 4: GDP, 2008 = 100



Source: OECD

Figure 4 shows GDP for the US, the UK, Germany, the Eurozone, and Italy.

The base year is 2008 – the year of the financial crisis. It shows very clearly how the different economies fared after that. The outcome is much easier to grasp in index numbers than it would be in raw data.

3.1.2 Trade and growth

- The world changes rapidly. Between 1950 and 2008, world wide, incomes and output grew at an average of 4% per year but trade, exports and imports, grew on average at 6%.
- Much, much more of what we produce and consume is now either exported or imported.
- A significant reason for this is that it has become easier to trade internationally.

Trade liberalisation

In the past, many governments feared that imports might reduce demand for their own domestic products. So they used **tariffs** (import duties) and other trade barriers to make imports dearer and discourage people from buying them. Then governments saw that other countries' trade restrictions were discouraging sales of their own exports. If they all reduced trade barriers together prices would fall, there would be more economic growth and spending power would increase. Free trade opens up new markets.

Trade negotiations between governments reduced trade barriers considerably. This gave businesses everywhere a chance to develop their products for international markets and expand output. This is **trade liberalisation**.

> **Tariffs** are taxes on imported goods. They make the price higher, so that the imports are less competitive. They protect domestic producers.
>
> **Trade liberalisation** means reducing barriers to trade so that economies can move gradually closer to free trade, which means no trade barriers at all.

How trade barriers were reduced

Trade agreements

The past 60 years or so have seen exceptional growth in international trade. Total trade in 2000 was 22-times the level of 1950. Trade agreements that were conducted under the auspices of the WTO reduced many trade barriers.

WTO

The WTO (World Trade Organisation – formed 1995)

- The stated aim of the WTO is to oversee and regulate the international trading environment.
- It has 164 members, accounting for over 97% of world trade. Around 30 others are negotiating membership.
- The main objective is to help trade flow smoothly, promote free trade and encourage economic growth by reducing trade barriers.
- The WTO is a forum for trade negotiations, facilitating trade agreements.
- It also helps developing nations with technical matters and training programmes.
- It provides a dispute resolution mechanism for member countries with trade disagreements.

What it does not do

- It is not a global policeman.
- It cannot 'force' countries to co-operate.

The WTO has its critics

- The WTO has been accused of favouring the richer countries at the expense of the developing ones.
- Some doubt that free trade and liberalisation are the best solutions for developing nations.

Specialisation

Identify products with a competitive advantage → Specialise in this area → Use increased export revenue to buy cheap imports

- It is clear that if all economies specialise in products in which they have a competitive advantage, and export as much as they can, and increase imports from other economies that have a competitive advantage in other products, trade will help to increase total output. When trade is easy, specialisation creates significant benefits.

Trade and growth

- Specialisation leads to enhanced economic growth; GDP and personal incomes increase.
- The link between trade and growth overall is well established. Higher exports increase GDP. (They are an injection into the circular flow of money.)

Examples
India has a competitive advantage in IT services because it has well trained IT specialists who accept relatively modest incomes. So it benefits from exporting these services. The UK has a competitive advantage in the provision of higher education, because of its long traditions and breadth of research experience. It benefits from the large number of foreign students who are, in effect, buying invisible (i.e. service) exports. (Visa restrictions have cut the number of Indian students coming to UK universities from 60,000 to 12,000 per year. Export revenue from this source is falling.)

Specialisation means producing more of the goods and services that have a competitive advantage. The advantage can be enhanced by economies of scale.

Competitive advantage

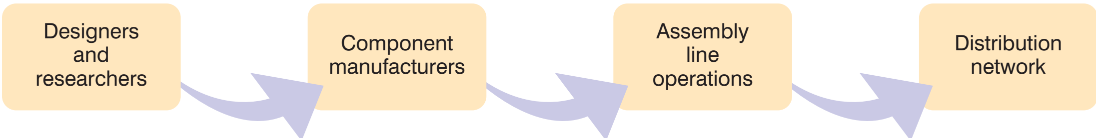
- Specialisation is linked to the division of labour.
- Individuals specialise and become more competent in their work.
- Fewer employees are needed.
- The availability of finance for investment allows businesses to use the best technologies available.
- The productivity of both capital and labour increases.
- Over time, production costs are reduced and competitive advantages emerge.

Trade liberalisation and economic growth

- Trade liberalisation makes it much easier for businesses everywhere to export. Finding new markets creates opportunities to specialise and to benefit from economies of scale.
- Many businesses (and individuals) benefit if they are adaptable and accustomed to functioning in a dynamic economy, especially if they are able to operate very efficiently.
- When trade is growing, businesses with a competitive advantage can expand quite quickly.
- Some businesses find it difficult to adapt to global demand; they may shrink or be taken over or simply close down.
- These processes are associated with structural change.

Supply chains

Trade liberalisation encourages new and different supply chains to develop. A **supply chain** is a sequence of processes, some of which may be outsourced to other businesses. These businesses, often called B2B (business-to-business) providers, each contribute to the finished product. They are chosen because they are the most efficient suppliers, having a competitive advantage in whatever process they supply. A supply chain in the car industry might look like this:



Nowadays the car manufacturer will probably outsource all or much of the component production, all of the distribution and a whole range of ancillary functions like accountancy, IT, catering, cleaning and so on. Some of this will be offshored. The assembly lines may be offshored, though probably not outsourced, to locations close to the market. (Think of Nissan, Honda and Toyota in the UK.)

Outsourcing

Outsourcing and offshoring have helped to cut costs and given many emerging economies faster economic growth. Each industry has followed its own pattern – Apple offshores all of its assembly processes to Asian countries, contributing to economic growth wherever its markets are, and creating jobs around the assembly plant.

Outsourcing means buying in goods or services from other businesses, either close at hand or abroad.

Supply chain management

Supply chain management means organising the sequence of processes that leads to the sale of the final product. The supply chain may have many different suppliers, often located in different countries. Managers must locate the supplier with the greatest competitive advantage so that costs are minimised.

Complex supply chains rely on trade liberalisation to keep trade barriers at low levels.

- They create opportunities for new businesses to grow; by minimising the resource costs of production they open up new markets and spread their expansion across many locations.
- Careful **supply chain management** can make it easier for businesses to adapt flexibly to dynamic markets that keep on changing.

This pattern of global growth is changing. Slower economic growth in China and lower oil prices have already slowed the growth of international trade. Protectionism, Brexit and economic uncertainty may bring more change.

FDI and the link to growth

Growth in incomes and wealth increases spending and investment. As trade barriers are reduced, FDI flows increase as businesses set up factories or other production or distribution facilities abroad.

FDI and growth

- Much FDI flows from one developed country to another but increasingly, FDI is flowing into emerging and developing economies.
- FDI may be associated with the offshoring of production to countries with lower input costs, or with production for foreign markets.
- China invests heavily both within and outside China. It has improved its own infrastructure. It is now financing investment projects all over the world. It is helping to fund Hinkley Point, the nuclear power station that is under construction in Somerset, UK.
- India is now powerful enough to acquire some of the world's leading companies. In the UK, by 2010 the Indian conglomerate Tata had spent $15 billion acquiring Jaguar Land Rover, Corus (the steel company) and Tetley.
- Almost all governments welcome FDI because it provides finance for investment and helps to create jobs.

3.1.3 Trading blocs

Free trade

A **trade bloc** can be a **free trade area**, a loose alliance of countries that want free trade between themselves. Or it can be a more tightly integrated **common market**. A **single market** has harmonised business regulations so that there is a 'level playing field', with all businesses competing on equal terms.

Trade blocs are groups of countries where barriers to trade are reduced or eliminated between the member states.

- The creation and growth of trade blocs has made it much easier to access member countries' markets without hindrance.
- Trade blocs encourage specialisation and open up new markets.
- The best known free trade area is NAFTA (North American Free Trade Area).
- The best known common market is the EU (European Union); it is also a single market.
- ASEAN (the Association of South East Asian Nations) has reduced trade barriers between members and aims to become a free trade area by 2020. It includes Indonesia, Malaysia, the Philippines, Singapore and Thailand. It is working on free trade agreements with other Asian economies.

Free trade areas are groups of countries that trade completely freely with each other, with no trade barriers, but each member country retains its own independent trade policies in relation to the rest of the world.

Common markets have completely free trade internally and a single unified trade policy covering all member countries' trade with the rest of the world. There is free movement of goods and services.

The single market

A **single market** involves free movement of people and capital. Individuals in all member countries can work in any other member country. Businesses based within a common market can invest in any member country. The EU also has harmonised regulations and no border controls between member countries. This could in time make it almost like a single economy.

Trade creation and diversion in the EU

Trade blocs all encourage and increase trade amongst the member states; this is called **trade creation**. After the UK joined the EU, its exports to other member countries increased greatly. Trade blocs also create **trade diversion**. Member countries may trade more with each other and less with the outside world.

Trade creation occurs when there is an increase in the total amount of goods and services traded because of reduced trade restrictions within a trading bloc.

Trade diversion occurs when a trading bloc reduces imports from non-member countries, enabling businesses within member countries to increase sales inside the trading bloc.

Benefits and constraints of trading within a trading bloc e.g. the EU or NAFTA

Benefits

- Access to member country markets without trade restrictions means export levels increase.
- No tariffs on imports from bloc members; lower prices benefit business and consumers.
- Possibility of economies of scale.
- Spreading of risk.
- A trading bloc creates a larger market which attracts foreign direct investment (FDI).
- Greater competition within the trade bloc can increase incentives for firms to strive for efficiency, cutting costs and prices.

Constraints

For free trade areas:

- No protection for domestic industries competing with other bloc members.
- Stiffer competition for domestic producers.
- Reaching agreement with member states is a slow process.

For common markets:

- A common external tariff can increase costs of raw materials or supplies from outside the bloc.
- Harmonised regulations may not suit all businesses, especially those without ethical commitments.

Impact on firms of trading blocs

Competing within trade blocs like the EU

- Businesses that can increase exports within a trading bloc will always benefit.
- Businesses that compete with other producers in other member countries will face more competition.
- All businesses will have an incentive to adapt, by upgrading their products, investing, increasing productivity, cutting costs, increasing their competitive advantage and cutting prices.
- In the EU, competition law reduces anti-competitive practices.
- Some businesses may resist regulations that aim to improve working conditions.

Growing interdependence

The growth of trade and FDI has made all economies increasingly reliant on each other. Both businesses and governments are more likely to be affected by adverse events in the economies with which they trade.

Inter-dependence

Figure 2 (page 2) shows the impact of the 2008-9 financial crisis on the global economy, even though the problem began first in the USA and then in some EU economies. For example:

- China's slowing growth rate is affecting demand for exports from both developed and emerging economies.
- Lower commodity prices including oil prices can have a marked effect on the GDP of producer countries, which in many cases already have poverty problems.
- Changes in the macro-economy of one economy can affect its trading partners, e.g. a change in the rate of inflation.
- Brexit may cause disturbances in financial transactions.

Equally, positive trends in some economies can have a marked effect on export trends in other countries.

Think!
To what extent are the UK and its trading partners interdependent?

3.1.4 Trade policy and trade negotiations

There is a strong connection between trade liberalisation and economic growth. Yet nearly all governments put some measures in place to restrict or prevent trade liberalisation. This process is called **protectionism**; it involves slowing or preventing imports coming into their country. The most common forms of protectionism are tariffs, quotas and regulation. These are collectively known as trade barriers.

Protectionism

Protectionism refers to government policies that protect the domestic economy from imports that compete with domestic industries and reduce employment.

Trade barriers include any measure that slows or prevents free trade from taking place, e.g. tariffs, quotas and safety regulations.

Why create barriers to trade?

- To stop cheaper foreign imports from replacing domestic substitutes, leading to business closures and job losses.
- To protect 'infant' industries, small businesses that have started up recently and not yet had a chance to grow. If they are shielded from foreign competition they can grow big enough to reach maturity. This protects jobs and allows new industries to achieve economies of scale. Protecting infant industries may lead to their being able to export in the future, provided they are not protected indefinitely.

Infant industries

- The balance of trade is important. (This is the difference between the amount of imports and amount of exports.) Reducing imports helps to avoid a trade deficit.
- If jobs are lost this is a drain on the economy, there is a loss of tax revenue and an increase in benefits paid. It is also politically damaging.
- Tariffs raise some tax revenue which can help fund public expenditure; this can be particularly useful for emerging economies.
- Often protectionist measures are put into place as a means of retaliation against other countries' protectionist measures.

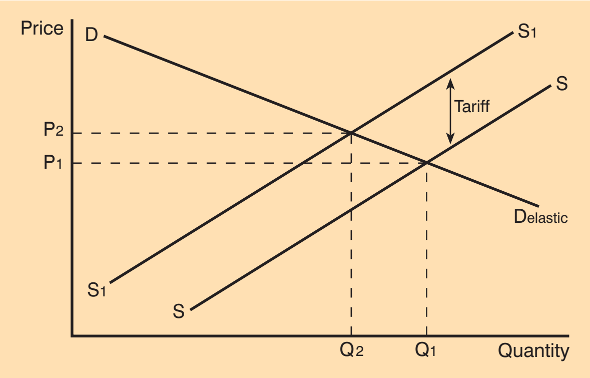
Tariffs

Tariffs are taxes placed on imported goods; this increases their price to customers.

- The supply curve shifts to the left. (The supply curve rises vertically by the amount of the tariff.)

Tariffs

Figure 5: Tariffs



- This causes the price to rise to P2. Quantity bought of the import will fall to Q2. Consumers will do without, or purchase a domestic substitute instead.
- The effectiveness of a tariff depends upon the price elasticity of demand for the import.
- If it is price inelastic the reduction in demand for the import may be limited. This will happen if domestic substitutes are inferior.

Price elasticity of demand

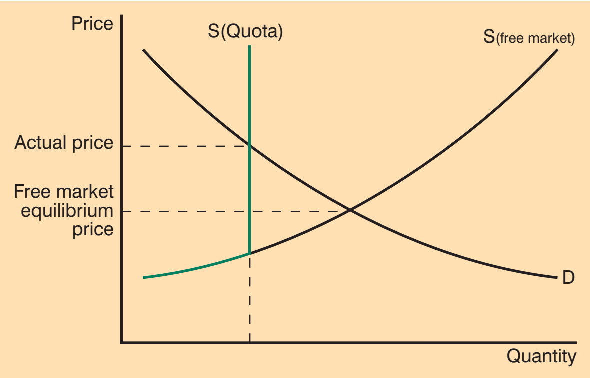
Tariffs are taxes placed on specific imported goods. They are sometimes called import or customs duties.

Quotas are physical limits on the level of specific imports in any one year.

Quotas

A quota sets a maximum quantity of a specific product that can be allowed into the country in one year.

Figure 6: Quotas



- Quotas make the supply curve vertical at the quota limit. (Supply becomes perfectly inelastic.)
- Reduced supply raises the price and causes quantity demanded to fall.
- The effectiveness of this will depend on the price elasticity of demand for the import.

Other forms of protectionism

- Subsidies can help domestic industries to lower their prices and remain competitive against imports (and be more successful as exports). Governments may think this is too expensive to be of value. In the EU subsidies are strictly limited.
- Keeping the exchange rate low makes imports more expensive (and exports more competitive). China has been accused of keeping its exchange rate too low.
- Imposing regulations such as safety standards can exclude some imports. These are usually used to exclude unsafe products, protecting consumers. Some countries have used them just to avoid stiff competition from particular imports.

Government policies

Costs of protection

- All protectionist measures cause a welfare loss. If consumers have to pay more for the imports they buy, then they have less to spend on other things. This reduces their real income and has a negative effect on other domestic spending.
- Protection reduces competition, which can lead to inefficiency and higher prices being charged for products manufactured domestically.
- It reduces incomes in exporting countries.

- It can provoke retaliation – making it difficult to increase the level of exports.
- Some infant industries are allowed to continue producing rather inefficiently for a long time, charging high prices to domestic consumers.

WTO rules

The disadvantages of protectionism are big enough to make most governments want to liberalise trade. Over the past few decades, trade restrictions have been greatly reduced, and that is one reason why the globalisation process has helped so many countries to grow their economies. Most countries are, or want to be, members of WTO, which means making a commitment to keep most tariffs and other trade restrictions quite low, or eliminating them completely.

> **Trade barriers** help individual industries that cannot compete with imports. But because they cause prices to rise, everyone has to pay more for the imports they need. How much depends on price elasticity of demand.

How protection constrains businesses

On the whole, most businesses favour trade liberalisation policies because protectionism will make it harder for them to tap into new markets. However, a few industries that have faced strong competition from imports have at times put pressure on governments to increase protection.

> **Examples**
> The **steel industry** in the USA regularly tries to persuade the US government to put tariffs and quotas on steel imports. These do not usually last for very long and they usually apply to certain special types of steel.
>
> The **Common Agricultural Policy** of the EU involves a system of tariffs and subsidies that ensures that farm products sell at the same price within the EU, wherever they come from. This protects EU farmers' incomes. It means that everyone in the EU pays more for their food than they would if they were buying it at world prices. (NB the government has said it will retain protection for UK farmers after Brexit.)

Many businesses oppose tariffs

The majority of businesses want to keep trade barriers low. They value the ease with which they can sell within the EU and want to avoid trade wars which might reduce their export sales. Often very specialised businesses need foreign markets in order to reap economies of scale – the home market just isn't big enough to allow this. Exporters of scotch whisky want to sell all over the world – the UK market is not nearly big enough for all of them to survive. They could be greatly damaged by customer countries' tariffs. Most countries have some good domestic substitutes.

> **Show how…**
> …whisky distillers would be affected by a US tariff on scotch. Use an appropriate diagram and explain the effect on the Scottish economy.

International trade negotiations – the role of the G20

The Group of Twenty was set up in 2008 when the Financial Crisis was gathering pace and threatened to destabilise the entire world economy. It includes heads of government and their central bank governors. The worry was that many countries might introduce trade barriers but in fact all governments tried to avoid this.

- All continents are represented; the biggest developed and emerging economies are involved, together with representatives from groups of smaller countries.
- Initially they met twice yearly, now once yearly.
- Financial and economic stability is a primary concern. When possible the G20 tries to ensure that individual governments' policy decisions are compatible with each other.
- Members discuss policy issues including those relating to the international organisations (IMF, WTO, World Bank).

International institutions

Trade negotiations

Most governments want to reduce trade barriers if trade agreements can be negotiated. The **WTO** facilitates these.

- Over a long period, WTO negotiations greatly reduced trade barriers. In 1994, 123 countries agreed to significant reductions in tariffs and very limited use of quotas in relation to almost all manufactured products.
- Subsequent negotiations on services and agricultural products have been attempted but not succeeded.
- The WTO provides a dispute resolution mechanism that helps trading partners to resolve differences.

IMF

The **IMF** exists to promote monetary and economic stability in the global economy.

- It advises governments on economic policy.
- It provides money for governments that are struggling with trade deficits that threaten to cause very fast falls in their exchange rates.

The **World Bank** helps the poorest countries to develop economically.

- It provides policy advice.
- It offers grants and loans, e.g. for infrastructure development, improving agricultural techniques and health and education facilities.

All of these organisations – as well as the United Nations and its satellite organisations – encourage governments to communicate effectively with one another.

Bilateral trading agreements

Bilateral trade

Bilateral trade involves agreement between just two economies. These have increased in number since 2000. More importantly, regional negotiations have become very significant. These include: the TPP (Trans-Pacific Partnership) and the TTIP, (the Transatlantic Trade and Investment Partnership) which could be important in liberalising trade further. However, there are concerns about dispute resolution mechanisms. President Trump may veto them anyway.

Bilateral agreements make trade regulations very complex because they will not all cover the same issues in the same way. However, only the two governments have to agree, so they can be implemented more quickly than multilateral agreements. They may turn out to be important in the Brexit process.

Think!
What evidence is there that protectionism is increasing? Give examples and explain their likely impact.

3.1.5 The impact of exchange rate changes

When exchange rates change, there are significant effects on levels of competitiveness, so any change other than small day-to-day fluctuations will affect the pattern of trade.

WATCH OUT!

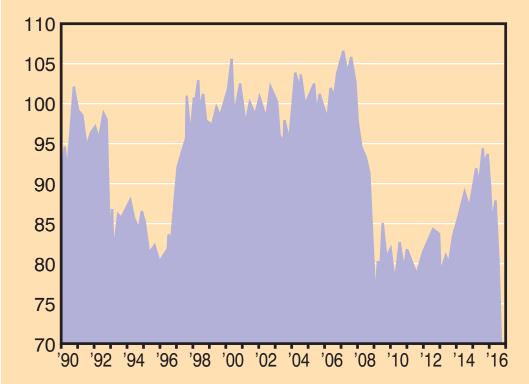
Make sure you have revised appreciation and depreciation, their impact on people and businesses, and the balance of payments. (See Revision Guide Theme 1, page 12 and Theme 2, pages 92-3.)

After the EU referendum in the UK, the exchange rate fell. Figure 7 overleaf shows how the exchange rate fluctuated between 1990 and 2016.

- Look at Figure 7 and the depreciation that took place at the time of the financial crisis, 2008-9.
- Figure 8 shows what happened in 2016. The high and low bars show the extent of the fluctuations during the month.

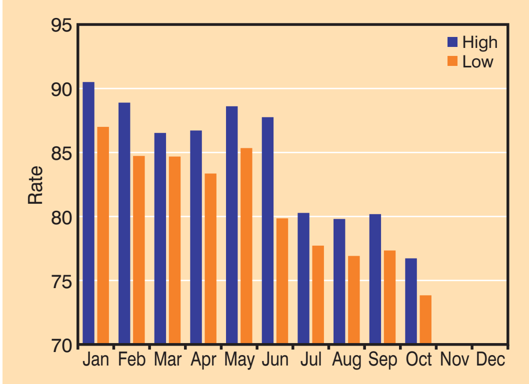
Fluctuating exchange rates

Figure 7: UK effective exchange rate, 1990-2016



Source: Highcharts.com

Figure 8: UK effective exchange rate, highs and lows, 2016, 2005 = 100



Source: Bank of England

Think!
How did depreciation affect business? Circumstances in 2008 were quite different from 2016. Explain the differences from the viewpoint of two different businesses.

The current account and the balance of payments

Visible and invisible exports and imports

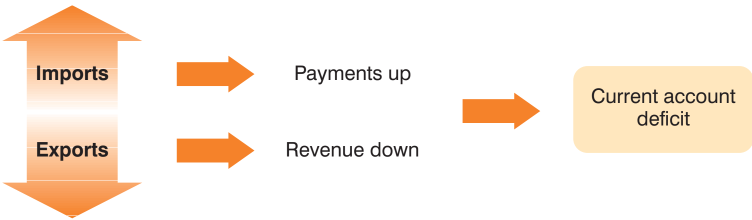
The balance of payments records all transactions between the UK and other countries.

- The **current account** records all payments for imports and exports, whether visible or invisible (services), plus inflows and outflows of income from investments.
- The capital account and financial account covers all FDI and all financial transactions e.g. when people abroad are buying UK financial products and UK residents are buying financial products from elsewhere.
- Depreciation makes exports more competitive and can lead to a current account surplus when exports are selling well. The reverse happens when there is appreciation.

The **current account of the balance of payments** provides information on trading activities and income from abroad. If export revenues are less than import payments there will be a trade deficit. If we import less than we export there will be a trade surplus.

Economic growth

If the economy is growing, (e.g. when there is a boom developing) there may be increasing demand for imports. Aggregate demand will be strong and exporters may be able to sell most of their output in the home market; they have little incentive to seek out new markets abroad. This may lead to lower exports and a current account deficit.



Depreciation

A current account deficit can be balanced by FDI or financial transactions (the capital account). But if together the outflow exceeds the inflow then the exchange rate will be pushed downwards; there will be depreciation.

- This will make exporting more profitable and provide an incentive to exporters.
- Imports will be dearer and buyers will look for locally produced substitutes which will be cheaper.

If the economy is slowing down or if output is declining, as in recession conditions, the reverse will happen.

Appreciation

Incomes are falling → Fewer imports demanded → Businesses try to sell more abroad → A current account surplus develops → The exchange rate appreciates

All these changes will be subject to time lags. The actual changes will depend on the price elasticity of demand for the products involved. Quite often demand for exports will be quite elastic – many substitutes are available. Demand for imports will be inelastic if few substitutes are available in the domestic market.

Businesses that use forward markets to buy the currency they will need in the future at a fixed price will be protected from exchange rate risks until they have used up all the currency bought at previous exchange rates.

Employment and unemployment

- Export growth creates jobs. Import growth reduces demand for domestically produced goods and services and reduces employment opportunities.
- In an open economy that facilitates trade, consumers get many opportunities to buy from producers that have a strong competitive advantage, and therefore lower prices. They then have more money to spend on other things e.g. local eateries and tourist attractions. These will need to employ more people.
- Businesses also have chances to buy inputs from the cheapest sources. This cuts production costs and prices, increases competitiveness and demand for their products, and employment.
- Businesses that cannot compete may make some employees redundant, close down or be taken over. Takeovers lead to rationalisation, which also creates redundancies.
- Competitive businesses recruit more employees while the uncompetitive create redundancies.
- To keep employment opportunities, it is necessary for businesses to strive for efficiency.

Structural change

- This is **structural change** – an important feature of a dynamic and growing economy. It hurts unskilled people who have difficulty finding jobs and also anyone with an obsolete skill. (Welders have been replaced with robots.)
- Changes in exchange rates alter levels of competitiveness and shift patterns of demand, so affecting employment.

> **Structural change** occurs when demand is increasing for some products while falling for others. It can be caused by global business developments that make imports cheaper, and by opportunities for businesses to branch out into new export markets.

The rate of inflation

Inflation refers to rising prices, leading to loss of competitiveness.

Imports look cheaper than rival domestic products.

Raising interest rates may help to control inflation.

→

If not, the exchange rate will fall.

There will be depreciation as demand for exports falls and demand for the cheaper imports rises.

→

Depreciation will restore export competitiveness but raise import prices.

This may raise the inflation rate, especially if demand for some imports is price inelastic.

FDI flows – the short and the long run

- FDI is shown in the capital and financial account of the balance of payments. It creates a demand for the currency of the destination economy. This will push up its exchange rate in the short run.
- If the FDI is being invested in facilities to produce goods for export, in the long run the exchange rate of the host country may rise further when the exports start to flow.
- Appreciation may make many producers less competitive.
- **But...** FDI has potential to increase employment and incomes in the destination economy. This may encourage individuals to spend more on consumer goods, some of which will be imported. Higher imports will tend to push the exchange rate down. This may take time.

Time lags

All exchange rate changes have both short and long term effects. An economy that has lost competitiveness will be helped by depreciation but there will be **time lags**.

- Rising import prices will occur quite quickly – mostly around 4-6 months after a sharp fall in the exchange rate.
- Exports will rise slowly. Most buyers will have already ordered their requirements for at least six months.
- The full benefits of enhanced export competitiveness will take around 18 months or more to emerge.

Time lags are a factor in many economic changes. Businesses plan ahead; they may place orders for their component inputs or products months before they need them. People take time to discover the new opportunities offered by exchange rate changes. (Many government policies take a long time to be implemented and to show their effects.)

The Eurozone

The Eurozone has benefited both businesses and individuals: a single currency does away with the need to make payments in a foreign currency. It reduces the cost of financial transactions between individual countries and saves time and trouble. It makes trade easier within the Eurozone and also for all the economies that trade with the Eurozone.

Competitiveness

Eurozone members have a fixed exchange rate for all their trade with each other. If any one member country becomes less competitive than the rest (e.g. because of inflation), its export sales will fall. It cannot improve its competitiveness with the rest of the Eurozone by depreciating. Its trade deficit with the rest of the Eurozone will increase over time. The only solutions are:

- Businesses that export cut costs which may mean cutting pay.
- Governments can implement contractionary economic policies e.g. raising either tax rates, interest rates or both.

Both strategies will tend to reduce incomes. Less competitive member countries do not have the flexibility of depreciation to fall back on.

The Eurozone has benefited both businesses and individuals

3.2 Chapter 2
Economic factors in business expansion

Terms to revise: product life cycle (Revision Guide Theme 2, pages 63-4), capacity utilisation (RG Theme 2, page 78), economies of scale (RG Theme 2, pages 57-9).

3.2.1 Conditions that prompt trade

There are many reasons why a business might want to start trading internationally. These include both factors that 'push' businesses out of domestic markets and factors that 'pull' them towards international ones. Often it is a combination of both. Most businesses want to expand and increase profitability. Moving into international markets is often the best way to do this.

Push factors

Market saturation

For many businesses the first stimulus to start marketing abroad comes when it becomes steadily more difficult to increase sales in the domestic market. There will be few new customers left to target with their products or services. Sales will come either from existing customers replacing old or worn out products, or by attracting customers away from a rival's product. This situation is called **market saturation**.

> **Market saturation** occurs when it becomes impossible to expand sales further in that particular market. If the product is a durable good, e.g. a washing machine, it may still be possible to sell replacement machines.

Competition

Competition can be fearsome, coming from both domestic suppliers and imports.

- In a saturated market, businesses compete vigorously to increase sales at the expense of rivals. Competition may be based on price or non-price factors.
- Competing businesses will be watching each other all the time, looking for ways to differentiate their products and get a larger market share. Innovative product design, reliability, reputation and clever marketing will be constantly stiffening the competition. Providing value for money will be a key factor.
- This can be an expensive process as it may require constant innovation and/or intensive marketing to increase market share.

Competing on price

- Imported products will often be able to compete on price. Foreign suppliers may have lower labour costs (e.g. in clothing manufacturing). For some products, this will give them a potentially strong competitive advantage.
- International markets can be a welcome addition to the domestic market, as they contain many potential new customers; the scope for expansion and increased profits can be enormous.

Pull factors

Access to new markets in **emerging economies** creates huge potential for increased sales and profits and major growth opportunities for many businesses. The profit motive is often paramount, especially for large businesses, i.e. those public companies that are answerable to a significant body of shareholders. There is a strong attraction to expanding into new markets to satisfy this motive.

> **Emerging economies** are characterised by rapid economic growth. They have seen big increases in manufacturing output and standards of living are rising. Some would still be described as poor countries (e.g. India) but others (e.g. Mexico) are well on the way to becoming developed countries with modern economies. The group includes China as well as many smaller countries like Chile and Thailand.

Economies of scale

- Trading internationally will usually mean that the size of the business will increase.
- This means a greater chance of achieving economies of scale (a reduction in average cost brought about by increasing the scale of production).
- Increasing economies of scale can lead to a competitive advantage: lower costs may make lower prices possible and open up mass markets.
- Sometimes economies of scale are so significant that the most efficient level of output is greater than the level of demand for the product in any but the largest economies.

Risk spreading

Diversifying to avoid risk

- Diversified markets reduce risk: if sales fall in one market, they may still rise or remain stable in another. This is an economy of scale which can be achieved by selling a range of products or a single product in a range of different markets. Trading internationally gives a business greater stability: a problem or downturn in one country can be compensated for by growth in another.
- The wider the risk is spread, the safer the business.

Product life cycle

Push factors

- Saturated domestic market
- Fierce competition in domestic market
- Competition from imports
- The product is in the mature or decline stage of product life cycle

Pull factors

- Potential for increased sales and profits
- Economies of scale
- Risk spreading
- Global sourcing
- Increasing trade liberalisation
- Expanding trade blocs

Possibility of offshoring and outsourcing

- Outsourcing means buying inputs from an independent supplier, rather than producing them in-house. The objective is to exploit possible cost savings. The independent may be more efficient, better able to cut costs.
- Offshoring refers to the process of locating production abroad, usually to benefit from lower wage rates. The purpose of offshoring is usually to cut labour costs but it can also be to produce close to a target market.

Examples

Dyson manufactures in Malaysia. Nike products all come from manufacturers in East Asia. JCB has set up its own factories in India. Peugeot-Citroen, Ford, Volkswagen and Hyundai all manufacture cars in Slovakia, which has a population of 5 million and a tiny market for cars but plenty of cheap skilled labour. If you go to virtualemployee.com you can see how business-to-business (B2B) services might be obtained cheaply.

Think!

In all but one of the above examples, the business is looking for cheaper labour. Which one is different and why?

Extending product life cycles by selling in multiple markets

The product life cycle helps to explain how businesses might respond to market saturation. An extension strategy is aimed at extending the life of a product either by making small changes in it, finding new uses for it, or finding new markets.

Extension strategies

- A saturated market is one that is in the maturity stage of the cycle. Sales eventually reach a plateau and cannot be increased significantly.
- The usual solution for a business in this situation is to develop an extension strategy to prolong the maturity stage by bringing out a new or improved version.
- The next stage is decline, when no matter what the business does, sales and profits begin to fall.
- Moving into new international markets and exporting can be seen as an extension strategy.
- Equally, in a foreign market, the product can be placed earlier in the cycle, perhaps in the introduction or growth stages.
- Market research may be needed to ensure that the product will succeed in the new market.

Example
This has happened in the cigarette industry. In the UK consumption is in the decline stage; public awareness of the health dangers has led to falling numbers of smokers. Cigarette companies now target consumers in emerging economies where demand is growing. (Note – there are ethical issues here.)

Raising capacity utilisation

- Businesses that have **under-utilised capacity** may make better use of their resources by expanding into new markets.
- Finding new export markets creates more demand for the product.
- Output can expand up to capacity limits without incurring increased capital costs.
- Existing capital production costs (fixed costs) are spread across a larger quantity of output.
- This applies to all businesses with fixed costs – to car factories as much as to small hotels that could interest foreign tourists.

Covering fixed costs

Under-utilised capacity occurs when the business has premises or equipment that could be used to increase output. It also applies where there are enough employees to produce more than they are currently selling.

In competitive markets, some businesses cannot expand sales without cutting prices because of insufficient demand. But if they can find a market overseas, capacity utilisation increases. This helps to reduce average costs, improving competitiveness and profitability.

3.2.2 Assessing the potential of different economies

When a business starts to trade internationally, it will not decide which economy to target at random. Very careful investigation is needed to assess the potential of one location in comparison with other possible alternatives. Much will depend upon the nature of the business and the product or service that it provides.

Broadly speaking there are two main reasons why a company starts to operate in another country.

- To distribute and sell its products or services, perhaps to reduce risks by diversifying into new markets.

The decision is often complex as there will usually be trade-offs between different factors. A country that has an ideal consumer profile may have a high level of bureaucracy, making it hard to set up a new business there.

- To set up production facilities.

Skills

The cheapest labour is not necessarily the best if specific skills are required. Businesses must weigh up all relevant trade-offs before choosing the best location. Some businesses may go for inorganic growth by buying up appropriate businesses abroad.

Organic or inorganic growth

Alternatively a business may set up its own factories or offices or retail outlets, growing organically wherever it feels confident of being able to create a market or cut costs. Or they may arrange a joint venture (see page 30).

Factors influencing expansion into a market

Levels and growth of disposable income

- Economic growth in the economy as a whole suggests that incomes are rising. If demand for the product is income elastic it is reasonable to expect that demand may increase.
- However, it is also important to know which potential customers are likely to have growing incomes. If only the economic elite are enjoying income growth, demand for luxuries may increase but mass produced items may be out of reach for most people.

Market research

- When a business wants to produce close to its market, it needs to become very familiar with that market. Observation of current spending trends and the existing products that are selling well is essential. Extensive market research will be needed unless the launch is designed to start on a small scale, testing the water.

Ease of doing business

The **Ease of Doing Business Index** was created by the World Bank. It looks at a range of factors that make a business easier to start and run, including:

Starting up

- time, cost and minimum capital required to open a new business.
- dealing with permits and regulations.
- ease with which employees may be hired and fired.
- tax payable as a share of gross profit.
- cost and time needed to export and import.

The higher the ranking the easier it is to do business. Regulations are better, simpler and easier to comply with and there is strong protection for business property rights.

Ease of doing business

Easiest to do business in 2016		Least easy to do business in 2016	
1	New Zealand	185	Chad
2	Singapore	186	South Sudan
3	Denmark	187	Central African Republic
4	Hong Kong	188	Libya
5	South Korea	189	Eritrea

Source: World Bank

The UK was ranked 7th and the USA 8th. Brazil was ranked 123rd, Russia 40th, India 130th, China 78th and South Africa 74th. Businesses can prosper in emerging economies even when they face problems there, but those countries that have tried to make business conditions easier have seen real benefits and those really near the bottom of the ranking do face serious difficulties.

Think!
Why might some businesses invest in India in spite of the bureaucracy associated with doing business there? You could take a look at JCB's website and look for content on India.

Infrastructure

Infrastructure includes all transport and communication facilities as well as the basic services such as energy and water supplies. Examples include telephone systems and ports as well as roads, power stations, and drains.

Transport and communication

- Economic growth requires infrastructure. Trade requires transport, to bring in inputs and to deliver finished products. It is also needed to bring employees to the workplace.
- There must be communication lines between buyers and sellers. Basic utilities must be adequate for the proposed developments.
- Businesses that want to develop trading relationships will be less likely to locate where infrastructure is lacking.
- Weak or unreliable infrastructure increases costs of production.

Political stability

Political unrest

Businesses need a stable political situation; civil unrest and wars especially are not conducive to successful enterprise. They may still be prepared to invest but only if the expected returns are very high, compensating for the risks.

- Countries that have a history of political unrest tend not to attract businesses, unless they really do need to be there, e.g. oil companies.
- Corruption can also be a problem and is endemic in many developing countries. For ethically motivated companies this is a problem.
- Both political instability and corruption are hindering the development of certain countries, including some in Africa.

Corruption

Least corrupt countries 2015		Most corrupt countries 2015	
1	Denmark	166	South Sudan
2	Finland	167	Sudan
3	Sweden	168	Afghanistan
4	New Zealand	169	North Korea
5	The Netherlands	170	Somalia

Source: Transparency International – the global coalition against corruption

Transparency International ranks the UK 10th and the USA, 16th. Brazil was ranked 76th, Russia 119th, India 76th, China 83rd and South Africa 61st. This shows that economic growth can take place even in corrupt economies. But some businesses will be deterred from locating there.

Exchange rates

Uncertainty

- Exchange rates are flexible and vary over time. This can be a source of great uncertainty.
- Selling exports in a foreign market that has an undervalued exchange rate can be a problem because of the cheaper domestic competition.
- China has often been accused of keeping the value of the Yuan artificially low to boost its exports and to make it harder for foreign imports to penetrate its domestic market. So selling to the Chinese market may entail producing there too.
- Locating production in an economy with a relatively low exchange rate may both cut costs and open up markets.
- However, businesses need to watch inflation rates as well. Wage rates in China have risen and this will affect the competitiveness of goods produced in China.

Factors influencing the location of production sites: costs of production

Businesses seeking low-cost locations are not concerned about whether their products will sell in local markets. They simply want to offshore in order to reduce labour costs.

Low pay or well skilled?

There can be a trade-off between the need for cheap labour and labour with the right technical skills. For routine assembly processes, unskilled labour may be adequate so pay is the key factor. In other cases, businesses look for a location where there are skilled people, willing to work for relatively low pay.

Skills and availability of the labour force

Labour can be a crucial factor in deciding where to produce. Its availability, cost and qualities can all have an influence. The skills and education level of the potential labour force may be important. Experience with new technologies may be needed. India has a reputation for skilled IT workers who also speak English.

- Wage costs can be critical in maintaining competitiveness. China's spectacular growth owes much to its low cost labour force. That may be changing now that some Chinese employees are negotiating higher pay. Some employers may move production to Bangladesh or Vietnam, where wages are lower.
- The workforce may need training; this will add to costs.
- The ease with which labour can be hired and fired is important. If it is easy to make employees redundant, the business will be able to adapt quickly to market change.
- Labour markets tend to be less heavily regulated in developing economies.

Example
Dyson chose to manufacture in Malaysia because there it could recruit well educated people who were comfortable with new technologies yet still willing to work for less pay than UK employees do.

Infrastructure

- For a business, it is vital to be able to access supplies, distribute goods and services and communicate with stakeholders.
- Weak infrastructure holds up economic development:
  – it slows down the transport system and raises costs.
  – it makes communications more uncertain and difficult.
  – it makes it harder to maintain supply chains and modern production techniques such as JIT.
  – it prevents efficient distribution of goods and services.

B&Q switched its main port and distribution centre from Southampton to Hull to avoid the chronic traffic congestion in the South of England.

- Even in developed economies poor infrastructure can be a real problem for businesses. In the UK, B&Q switched its main port and distribution centre from Southampton to Hull to avoid what is known as 'Southern Discomfort', the chronic traffic congestion in the South of England.

Location in trade bloc

Shifting patterns of trade

Many UK businesses rely on their export markets in the EU. Similarly in North America, NAFTA has created new trade patterns that have cut costs considerably. It is common for businesses to locate production facilities inside the trade bloc where they can access a large market without trade barriers. (Think of the Japanese car manufactures in the UK; they have been promised compensation for losing their EU market as a result of Brexit.)

Government incentives

Business taxes

- Some governments go out of their way to encourage potential sources of FDI.
- They may reduce their business tax rates in the hope that this will attract FDI. This has in the past worked well for Ireland and Luxembourg.
- 'Tax inversion' upsets governments that lose revenue when businesses move their HQs elsewhere.
- When it was first engaging in international trade, China created 'Special Economic Zones' for foreign businesses where they did not have to pay taxes and there were no trade barriers.

Ease of doing business

Businesses that are offshoring production processes to locations with lower labour costs need to consider the ease of doing business just as much as the businesses that are looking to produce and sell in overseas markets. For those businesses that are setting up distribution facilities and sales outlets for their exports, ease of business will be a rather less significant factor because their needs are less complex. See pages 20-21 for detail on ease of doing business.

Political stability

- Ideally, business hopes to locate where the rule of law is reliable. This reduces some business risks.

Rule of law

- If some of the law enforcement agencies are corrupt, the system may fail to protect foreign investors' interests.
- A functioning legal system helps businesses to enforce contracts and payments.
- Some businesses want to locate in places where their intellectual property rights are respected.

That said, many businesses survive in locations where these conditions are not always met. They would still probably be cautious about locations where war and civil unrest are threatening.

Natural resources

- For some businesses, expansion overseas is all about finding new sources of resources that they can exploit.
- Mining and oil companies go to where the resources are and then export them to where there is a demand for them.

Commodities

- The inexorable rise of China and other emerging economies has increased the demand for raw materials and commodities generally. When their prices rise businesses have a big incentive to seek out new sources.
- China itself has become one of the leading players in commodity markets, seeking out raw material sources everywhere.
- Businesses that need the raw materials for inputs mostly do not need to be near their source because most commodities can be transported quite cheaply. It may be more important to be near to markets for the finished product.

Commodities are raw or semi-manufactured products (intermediate goods) that are traded in bulk and are not recognisably originating from any particular business. Examples include iron ore, cotton, wheat and oil.

Likely return on investment

Ultimately the business must choose the location that will be most profitable in the long run, i.e. the one that gives it the best rate of return on its investment. Forecasting this may be very difficult.

In the early years of China's development process, many businesses located there simply because they thought that there would be profits to be made in the long run. They ignored all the pitfalls entailed in weak infrastructure and political restrictions. Some succeeded in the long run and were glad that they had taken risks early on, e.g. Apple. Others withdrew after years of poor returns.

Example
In 2013, after 9 years of disappointing results, Tesco abruptly withdrew from the Chinese market. It had created a joint venture with China's biggest retailer, which took over its 131 stores. Tesco kept just 20% of the equity. Most investment analysts approved the move.

While emerging markets are often very promising for investors, there are big potential risks. Bad luck, or insufficient care devoted to planning the enterprise, can lead to substantial losses.