2 As globalisation continues, the tearing down of trade barriers has provided some companies opportunities for growth while it has been harmful for others. Accustomed to dominant positions in protected markets, the influx of foreign competition often poses a threat to the survival of local companies.
Source: Harvard Business Review

(a) Explain the benefits that a firm enjoys when it grows in size. [10]

(b) Evaluate the various strategies a firm can adopt to respond to the challenges posed by globalisation. [15]

(a)

Intro:

- Clarify what "size" means to a firm / define : The idea of greater quantity of production or market share must be expressed
- Firm's objective: Benefits to a firm must be expressed in the idea of achieving profit maximisation
- Direction statement: Benefits a firm enjoys comes in the form of cost savings from exploiting EOS or from revenue advantages that a firm may gain from being large.

TS1: Firms can enjoy cost savings when they grow large through exploiting economies of scale.

E1: One source of EOS that firms can enjoy comes from marketing EOS.

- ➢ When firms are larger, they can enjoy lower average costs from purchasing inputs in bulk.
- ➢ Larger firms are likely to make up a larger proportion of a supplier's revenue stream and thus are more important customers than a smaller firm.
- ➢ These larger firms will then have stronger negotiating power than smaller firms and can negotiate for discounts for bulk purchases of inputs.
- ➢ The lower price that large firms pay for inputs will allow them to have a lower average cost of production

E2: Another source of EOS that firms can enjoy comes from financial EOS

- ➢ Larger firms are often considered more credit-worthy than smaller firms and are able to enjoy lower interest rates on loans.
- ➢ Larger firms will often have more physical assets that they are able to offer as collateral in negotiating for a loan.
- ➢ Larger firms also earn greater amounts of revenue and have more stable revenue streams and thus are considered to be more likely to be able to repay the loan.
- ➢ Since large firms are considered more credit-worthy, banks are willing to offer lower interest rates for loans to large firms since the risk of defaulting on the loan is lower
- ➢ Large firms are thus able to borrow at cheaper rates whether to purchase capital goods, inputs or even to finance expansion.
- ➢ The lower costs of repaying loans allow for larger firms to have lower average costs.

TS2: Firms can enjoy revenue advantages when they grow sufficiently large. This can be from domination of the market OR from diversification into multiple markets.

E1: When firms grow in size, this might involve the firm expanding into different markets. This can be expanding into different product markets or geographical markets.

- ➢ This allows the firm's revenue stream to be more stable in the face of changes.
- ➢ If demand in a particular country / demand for a particular good falls, it can be mitigated by changes in the demand from other countries / for other goods

E2: Firms that have large size can have greater market power and thus use that to maximize their revenue.

- ➢ Firms that grow larger and take up a larger part of the market can better establish barriers to entry in the form of limit pricing / predatory pricing
- ➢ When a firm has sufficient market power, they are able to influence the market price through increasing or decreasing their output
- ➢ Large firms can then use limit pricing / predatory pricing to prevent the entry of other firms into the market
- ➢ This prevents competitors for entering the market and taking away demand from the incumbent large firm thus ensuring that the revenue earned will continue to be high in the long run
- ➢ Large firms that earn supernormal profits can also use these profits to invest in research & development to do product innovation thus differentiating their product
- ➢ This makes other companies goods poorer substitutes, thus the XED of their good would be more inelastic.
- ➢ This makes the demand for their good more stable in the face of competitor's pricing strategies and the revenue more consistent.

Level	Marks	Description
L3	**8-10**	• **An answer that explores both costs AND revenue advantages of being a large firm** • **An answer that explains two sources of EOS OR provides a very detailed answer on one source of EOS** • **AND** • **An answer that explains one or more source of revenue advantage with economic theory** • **Total of 3 key ideas**
L2	**5-7**	• **One sided answer than only considers cost advantages OR revenue advantages without exploring the other** • **An answer that briefly explains the advantage without any economic theory or application to the context of a firm's decisions** • **OR two-sided answer lacking in detail / rigour**
L1	**1-4**	• **Answer is generally descriptive with little or no economic analysis** • **Does not identify/explain any source of EOS** • **Vaguely understands the aim of achieving profits but does not consider profits as revenue/costs**

(b)

Intro:

- Clarify and expand on definition of globalization
- Identify main challenges of globalization: greater competition for consumers / greater competition for limited FOP
- Direction statement: There are many strategies a firm can undertake to cope with the challenges of globalization.

TS1: Globalisation poses a challenge to firms in the form of greater competition for consumers. This can reduce the demand / revenue / profits of the firm. Globalisation can also pose a challenge in affecting the costs of a firm.

E1: Globalization poses a challenge to firms in the form of greater competition for consumers. This can reduce the demand / revenue / profits of the firm.

- ➢ Continued globalisation involves the removal of trade barriers such as tariffs and quotas/restrictions on foreign imports of goods and services
- ➢ This allows for imports to become more price competitive / allows for greater competition between imported goods and domestic goods
- ➢ A firm that is in the domestic market will face a fall in demand due to the entrant of foreign company into the market
- ➢ This will be reflected as a fall in the demand faced by an individual firm as more foreign companies enter the domestic market
- ➢ Assuming the costs of the firm remain unchanged, the fall in revenue caused by a drop in demand would lead to lower profits earned
- ➢ If the profits fall into subnormal profits, this can cause the firms to shut down in the long-run

E2: Globalisation can also pose a challenge in affecting the costs of a firm.

- ➢ The removal of barriers to trade can also result in the increase in the demand for exports of a country
- ➢ The increase in demand for goods and services would lead to greater derived demand for factors of production such as labour
- ➢ This greater demand for factors of production leads to a shortage and subsequently leads to higher price of FOP. The increase in FOP price leads to an increase in per unit costs of production ceteris paribus.
- ➢ For firms that are not involved in the export sector and do not enjoy an increase in demand, the increase in costs would lead to a fall in the profits of the firm.

TS2: Firms can respond to the challenges of globalisation by expanding in size.

- ➢ In the face of globalisation, the firms can respond to the challenges by expanding. This can either be done through expanding their production, merging with other firms and entering foreign markets.
- ➢ If the firm is able to take advantage of the lower barriers to trade by entering foreign markets, they are able to enjoy access to a larger market thus increasing the demand for their goods.
- ➢ When there is greater demand, the firm can be justified in expanding to a larger scale of production thus allowing them to exploit greater EOS and lowering the average costs.

Evaluation:

- The feasibility of such a strategy depends on the presence of EOS in the particular market as well as relative costs of production of the firms.
- Not all markets have significant EOS for firms to exploit by increasing scale of production.
- Some products that are highly personalised and require personal attention do not have significant technical EOS to be exploited because it is difficult to mass produce.
- This is thus more feasible for firms in markets where the production process is easily automated and scaled-up.
- Furthermore, the ability of a firm to expand into foreign markets depends on the differences in production costs that may result from differences in factor endowments.
- A firm that is producing a labour-intensive product is unlikely to be able to expand into a market such as China because the abundant labour in China would make the production of that same product much cheaper for Chinese firms.
- As such, the feasibility of entering a foreign market depends on the costs of production relative to the costs of the firms in the foreign market.

TS3: Firms can respond to the challenges of globalization undertaking innovation and product differentiation.

- Firms can respond to greater competition from foreign imports by engaging in greater investment in innovation and R&D.
- <u>This can take on the form of product innovation where the firm invests money into developing improvements in their production process.</u>
- An example could be the investing into developing better machinery that can use less fuel to run and thus produce more output for the same amount of fuel.
- This can increase the productivity of their production, meaning that they are able to produce more output for the same amount of inputs.
- This results in a fall in per unit costs of production.
- This can mitigate any increase in costs of production caused by greater competition for limited factors of production.
- This can allow firms to lower the prices they charge in order to compete with foreign imports.
- <u>Firms can also undertake product innovation where they invest into developing improvements on the quality of their product.</u>
- This can take on the form of producing goods with better designs, more features or made out of more durable materials.
- This will increase the desirability of the goods thus changing consumers' tastes and preferences.
- Beyond increasing the demand for their good, this will also result in product differentiation where consumers will view other products as poor substitutes for a firm's goods because of the difference in quality.
- This makes the XED of the firm's good more inelastic, making the fall in import prices have a smaller impact on the firm's revenue.

Evaluation:

- The feasibility of such a strategy depends on the firms' ability to engage in research and development.
- Research and development is often very costly, takes a long time to show results and may not always yield positive results for the money invested in it.

- Research and development involves high amounts of expenditure, thus firms that are small and earn little or no supernormal profit are unlikely to have the funds to engage in such a strategy.
- At the same time, research and development taking a long time to show results could mean that the firm may have to suffer through many periods of subnormal profits. If the firm does not have sufficient funds to endure these losses, the firm may end up shutting down before the strategy yields any impact.
- Finally, not all research and development projects can yield improvements or the extent of the improvements may not be significant. This can end up increasing the total costs of the firm without a large enough increase in the revenue of the firm thus worsening the profits of the firm.

TS4: Firms can respond to the challenges of globalization by reducing costs via outsourcing OR sourcing for cheaper FOP from foreign sources.

- Globalization does not only increase the flow of finished goods and services but also increases the flow and mobility of factors of production such as raw materials and labour.
- One way firms can then address the challenges of globalization is by purchasing FOP from other countries that have those FOP in greater abundance and thus lower price.
- An example would be hiring of foreign labour from developing nations that have abundance of people and thus people are willing to work for lower wages.
- This allows the firms to cut costs and subsequently price competitiveness and profits.
- Another aspect of globalization is in the improvements of transport and communications technology.
- This gives firms the option to outsource certain parts of their production process to be done in other countries.
- The increased speed and lower costs of transportation allows for firms to produce different parts of their goods in different countries before finally assembling them into one finished product.
- The improvements in communication technology also make it easier for firms to coordinate between different branches in different countries.
- This allows for the rise of multi-national corporations that make it possible for firms to best exploit different prices of factors of production to produce goods at lower costs.

Evaluation

- Just like with the strategy on research and development, the ability to outsource requires a lot of expenditure and initial investment on the part of the firm to set up the networks and partnerships to make it feasible. This again makes it a difficult strategy for small firms with limited profits to use.
- At the same time, globalization may not always be applied equally across all countries and all goods. The lowering of the trade barriers may only be for specific goods and services. Barriers to foreign investment and barriers to mobility of FOP such as immigration laws may still pose problems for firms attempting such a strategy.
- Hence, the available resources of a firm and the way the government chooses to implement trade policies can greatly affect the feasibility of such a strategy.

Conclusion

In conclusion, globalization poses a challenge in terms of falling revenue from competition from imported goods and services as well as increasing costs from greater competition for the limited factors of production. At the same time, it presents certain opportunities such as the ability to enter into foreign markets and the access to greater pools of resources via outsourcing. However, these strategies all require significant expenditure on the part of the firm and thus do not favour small firms that have limited supernormal profits. Furthermore, globalization is not a homogeneous process and can occur unequally across countries and different markets. Thus the specific policies and the way a government chooses to allow the country's economy to become more globalized will drastically affect the degree of challenge that globalization poses and the feasibility of certain strategies.

Level	Marks	Description
L3	**8-10**	- **An answer that explains the challenges of globalisation with regards to revenue / costs** - **An answer that offers multiple strategies that are clearly linked to reducing costs or increasing the revenue of the firm** - **Answers provided effectively use economic reasoning to explain how costs fall or revenue increase** - **Explanation of strategy is applied appropriate to the context of globalisation**
L2	**5-7**	- **An answer that explains the challenges of globalisation with regards to revenue / costs** - **An answer that offers a strategy that is clearly linked to reducing costs or increasing the revenue of the firm** - **Answer is limited to only one strategy well-explained OR touches on two strategies but the explanations of the strategy lack detail / rigour**
L1	**1-4**	- **A generally descriptive answer lacking in economic analysis** - **Describes the challenges of globalisation without any reference to revenue or costs** - **Suggests actions that firms can take but fail to properly link those strategies to revenue or costs clearly** - **An answer that does not explore any strategies but ONLY challenges of globalization**

Level	Marks	Description
E3	**4-5**	- **Expresses a conclusion on how effective the strategies are** - **Uses appropriate economic theory** - **Expresses a criteria / condition on which the success of the strategies are dependent on**
E2	**2-3**	- **Expresses a conclusion on how effective the strategies are** - **Some attempt to justify the conclusion but the justification lacks any link to economic theory**
E1	**1**	- **Makes an unjustified conclusion on whether the strategies are likely to work**