

2 Many firms have been aggressively expanding overseas. This expansion not only involves selling products in new markets, but also includes offshoring their production. Such expansion has not been welcomed by domestic firms in these overseas markets.

(a) Explain why domestic firms might fear such expansion by foreign firms. [10]

(b) Discuss the view that the best strategy for domestic firms to respond to increased competition from foreign firms is to cultivate brand loyalty. [15]

### Suggested Answer for Part a

#### Question analysis

<b>Approach</b>	<b>Command Word</b>	Explain why – Provide reasons
	<b>Question Type</b>	Consequences
	<b>End Point</b>	Problems of expansion firms by foreign firms on domestic firms
<b>Content and Context</b>	<b>Content</b>	<ul style="list-style-type: none"> <li>Impact on revenue of domestic firms</li> <li>Impact on costs of domestic firms</li> </ul>
	<b>Context</b>	Not provided – to provide own examples

#### Introduction

As mentioned in the preamble, many firms have been expanding overseas and this has caused tremendous issues for domestic firms. These either involve a fall in revenue or an increase in costs of production, which has negatively affected the profits of domestic firms.

#### Fall in profits due to fall in total revenue

1. With the expansion of foreign firms into domestic markets, this has resulted in a fall in demand for the goods and services produced by domestic firms. For example, the entry of Taobao (via both Lazada as well as the Taobao platform) into the Singapore market for electronics has resulted in many consumers who previously purchased from domestic firms such as Courts, to **switch towards purchasing from these foreign substitutes**. The fall in demand has led to a fall in total revenue for domestic firms, resulting in a fall in profits.
2. Many of these foreign competitors are also producing at a much larger scale as they cater a bigger market in their own countries. Thus, many of the foreign competitors are able to enjoy economics of scale which cannot be enjoyed by relatively domestic firms in countries such as Singapore. The ability to produce at a lower average cost than their domestic rivals has allowed these **foreign firms to better engage in price competition** due to their cost advantage to chase out these domestic rivals from the market. This can be done by setting a price below the average cost of the domestic firm but yet higher than the average cost of the foreign firm, allowing the foreign firm to continue making supernormal profits. For example, the initial entry of Chinese bike sharing companies, such as Ofo and Mobike, has driven domestic firms such as Obike to such down, as they are unable to compete with the prices offered by Ofo and Mobike.

3. The entry of foreign firms also increases the number of substitutes available to domestic consumers. Thus, the **demand for a domestic firm's goods/services will become more price elastic**. This means that should that be an increase in cost, for example due to increase in rent or labour costs, the domestic firm will be **less able to pass on the cost increase** by raising prices as this will result in a more than proportionate fall in quantity demanded, and a fall in total revenue.

### Fall in profits due to increase in costs of production

1. As stated in the preamble, foreign firms have also been offshoring their production overseas. For example, Apple has offshore production of some components of iPhones to countries such as China and Taiwan. Such actions by foreign firms will drive up the demand for factors of production, such as land and labour, in these countries, and results in an **increase in costs of production in the form of higher wages and rent**. This has reduced the profits that can be earned by domestic firms, who may not even be selling the same goods and services as these foreign firms, but uses the same factors of production.
2. For domestic firms who are in direct competition with these foreign firms, the fall in demand as explained earlier, will result in a fall in the scale of production. This will **reduce the ability of domestic firms to exploit internal economies of scale** and results in an increase in average cost of production. Thus, profits will fall.

In conclusion, domestic firms fear expansion by foreign firms as they are likely to bring about a fall in revenue as well as increased costs.

### Level descriptors

Level	Out of 10 marks	Descriptors
<b>Level 3</b>	8-10	Displays full slew of skills across AO1, AO2 and AO3: <ul style="list-style-type: none"> <li>• Thorough knowledge displayed by explaining how expansion by foreign firms affects a domestic firm's revenue and costs</li> <li>• Clear and coherent analysis, grounded by economic concepts, frameworks and principles</li> <li>• Good use of relevant examples</li> <li>• Considers at least 3 ways in which revenue and costs are affected.</li> </ul>
<b>Level 2</b>	5-7	Displays AO1 and AO2 skills: <ul style="list-style-type: none"> <li>• Answers are relevant to question but undeveloped explanation of impact on costs and revenue</li> <li>• Answers that only consider either revenue or cost</li> <li>• Must consider at least 2 ways in which revenue and cost are affects</li> <li>• Limited use of examples; pure theoretical answer</li> </ul>
<b>Level 1</b>	1-4	Uneven display of AO1 and AO2 skills: <ul style="list-style-type: none"> <li>• Smattering of points</li> <li>• Many conceptual errors</li> <li>• Fails to address question requirement (For example considers increase in revenue or fall in costs)</li> </ul>

- (b) Discuss the view that the best strategy for domestic firms to respond to increased competition from foreign firms is to cultivate brand loyalty. [15]

Question analysis

<b>Approach</b>	<b>Command Word</b>	Discuss the view: balanced answer + EV
	<b>Question Type</b>	Strategies
	<b>End Point</b>	Whether cultivating brand loyalty is the best way to respond to increased competition
<b>Content and Context</b>	<b>Content</b>	<b><u>Thesis</u></b> <ul style="list-style-type: none"> <li>How cultivating brand loyalty reduces the problem of increased competition from foreign firms</li> </ul> <b><u>Anti-thesis</u></b> <ul style="list-style-type: none"> <li>Limitations of cultivating brand loyalty</li> <li>How other strategies can also be used to respond to increased competition from foreign firms</li> </ul>
	<b>Context</b>	Not provided – to provide own examples

### Suggested Answer for Part b

In view of the expansion by foreign firms as explained above, domestic firms can respond by building brand loyalty or by other means.

### Thesis: Building brand loyalty can help domestic firms respond to increased competition from foreign firms

#### How building brand loyalty works:

Domestic firms can build brand loyalty through generating actual or perceived differences. For example, domestic firms can engage in advertising campaigns to market the superior quality of its products to those produced by foreign firms. For example, domestic Singapore banks such as DBS, OCBC and UOB still maintain a strong brand loyalty among local consumers as their historical performance have been more stable, as compared to foreign banks which have generally taken a greater blow during the 2008 Global Financial Crisis. **Developing a strong brand loyalty will reduce the degree of substitutability and cross price-elasticity of demand (XED)** the domestic firms' products with respect to the foreign substitutes.

First, this will mean a **smaller fall in demand** due to the entry of foreign firms, as consumers are less likely to switch their consumption patterns due to the strong brand loyalty.

Second, reducing the XED value will also make the domestic firm less susceptible to the foreign firm's pricing strategy, since a fall in price of the foreign firm's products will only result in a **less than proportionate fall in demand**. Thus, profits will only be reduced to a smaller extent.

### Anti-Thesis (1): Building brand loyalty has its limitation in helping domestic firms respond to increased competition from foreign firms

- Building brand loyalty takes time.** In today's globalised world, the entry of foreign firms into different markets is happening rapidly. It is almost impossible for any domestic firms to have sufficient time to build brand loyalty, especially for newer

domestic firms. Even though building brand loyalty can help to address the issue, it often takes too long to be effective.

2. **Building brand loyalty involves costs.** Marketing and advertising involves large costs, especially when competing against the marketing and appeal of global giant firms. Thus, engaging in efforts to build brand loyalty may result in a greater fall in profits.
3. **Building brand loyalty does not address the increase in costs of production that comes about from increased foreign competition.** As explained in part (a), the entry of new firms can bring about an increase in costs of production as they are competing for the same FOPs.

### **Anti-Thesis (2): Other strategies may be better in helping domestic firms respond to increased competition from foreign firms**

1. **Mergers with other domestic firms.** For domestic firms operating in smaller consumer markets such as Singapore, they are unlikely to be able to enjoy the same level of EOS as larger foreign competitors. Thus, one possible strategy to address this issue is for the smaller domestic firms to **merge so that they are able to enjoy cost savings from the ability to enjoy economies of scale**. This will enable these domestic firms to better engage in price competition with these foreign firms.
2. **Expansion overseas.** Another way to respond to the entry of foreign firms is for domestic firms to expand overseas instead. This is especially so if the domestic firms see that prolonged competition (both price and non-price) with foreign firms will result in large costs being incurred and profits being negatively affected. Thus, expansion overseas will allow domestic firms to **generate revenue that could mitigate the loss of revenue from the entry of foreign firms**. For example, as the financial sector gets more saturated in Singapore, domestic banks have started to expand overseas, especially in fast developing countries such as China and Vietnam.
3. **Limit Pricing.** For domestic firms in bigger countries, such as US and China, with a large consumer market, they are likely to be able to enjoy EOS to a greater extent. For these firms, they are able to **set limit pricing (pricing below the profit maximizing price) in order to deter foreign firms** from entering the domestic market. Such actions might send the signal to foreign firms that domestic firms are willing to reduce price and endure subnormal profits in the short run if these foreign firms enter the market.

### **Evaluation**

- Which strategy is the best will depend on the market in question. For example, in markets where the domestic firms is already well established, building on its brand to develop consumer brand loyalty is a viable strategy since the marginal costs of doing so is relatively low.
- However, in markets where the domestic firms are either relatively small and not well established, it is unlikely that developing brand loyalty will help a firm to deal with increasing foreign competition in the short run. In these cases, mergers of these domestic firms will likely be a more effective strategy. Such mergers will also allow the domestic firms to possibly expand overseas.

### Level descriptors

Level	Out of 10 marks	Descriptors
<b>Level 3</b>	8-10	Displays full slew of skills across AO1, AO2 and AO3: <ul style="list-style-type: none"> <li>Balanced answer on whether developing brand loyalty is the best strategy</li> <li>Considers at least one other strategy</li> <li>Clear and coherent analysis, grounded by economic concepts, frameworks and principles</li> <li>Good use of examples</li> </ul>
<b>Level 2</b>	5-7	Displays AO1 and AO2 skills: <ul style="list-style-type: none"> <li>Balanced but under developed answer</li> <li>There is clarification of question and application of economic concepts, frameworks and principles to relevant contexts</li> <li>Limited use of examples</li> </ul> Answers that don't consider other strategies
<b>Level 1</b>	1-4	Uneven display of AO1 and AO2 skills: <ul style="list-style-type: none"> <li>Does not address the question (one sided answer)</li> <li>Smattering of points or conceptual errors</li> </ul>

Levels	Out of 5 marks	Descriptors
<b>E3</b>	4-5	Well-reasoned judgements/decisions <ul style="list-style-type: none"> <li>Critically evaluates policy choices</li> <li>Synthesises economic arguments to arrive at well-reasoned judgements and decisions</li> </ul>
<b>E2</b>	2-3	Largely unexplained judgements <ul style="list-style-type: none"> <li>Some attempt at evaluation or a summative conclusion</li> <li>Relevant to the question but does not substantiate the judgement</li> <li>Evaluation may not be a logical progression from the prior analysis</li> </ul>
<b>E1</b>	1	An unsupported judgement <ul style="list-style-type: none"> <li>Mere evaluative statements or judgements that are neither supported nor relevant to the specific context of the question</li> </ul>