Global Strategy

Globalization

Globalization is a term you hear about with increasing frequency these days. It could be protesters in Seattle or Italy protesting "globalization" or some talking head on TV going on and on about globalization, the buzzword is clearly here to stay. What does it mean?

For the purposes of strategy, the word globalization actually refers to two simultaneous changes. The first, and what most of the protesters are upset about, is the **globalization of industries** - the idea that the world's economy is becoming much more integrated. This is the traditional "the world is getting smaller" argument that revolves around increased trade and commerce between nations. The second, and much less talked about but equally important idea is the **globalization of markets** – that consumer preferences are becoming more homogenous. Globalization of markets says that people increasingly want the same products around the world, i.e. we all want to wear blue jeans, drive BMW's, drink Coca-Cola, and eat at McDonalds.

<u>Globalization of Industries</u>. Rapid advances in communications, transportation, and the absence of wide spread high intensity world conflict have facilitated increased international trade flows and foreign direct investment (FDI). The globalization of industries refers to this increased integration of businesses across national borders. These technological advances coupled with the successful adoption of free trade policies by many of the world's leading nations has resulted in companies being able to disperse their operations internationally as well as compete in multiple countries. In industrialized countries this has served to increase competition in many different industries but has especially effected their manufacturing sectors. In less developed countries, this has resulted in industrial expansion, although often at a much lower wage levels and with fewer environmental safeguards than in industrialized countries. It is this latter aspect that seems to most inspire the opponents of globalization and is often publicized as sweatshop labor.

<u>Globalization of Markets</u>. In his influential book, *The Marketing Imagination*, Theodore Levitt makes the argument that demand preferences are becoming more homogenous across national borders. This is the globalization of markets. He cites the success of blue jeans, fast food, and color televisions. This trend also can impact the United States, witness the success of Mexican, Italian, and Chinese food. In fact, salsa recently passed ketchup as the number one condiment in the U.S. This aspect of globalization is not of much concern in the United States, but does concern many nations, such as France, that are very protective of their national culture, and offers considerable opportunities for international marketers.

Both of these aspects of globalization will have important implications for firm strategy. However, the first question is - Why should firms go international at all?

Why Global?

Firms engage in international activities for two primary reasons. Either they are transferring their competencies/resources in a search for new customers or they are attempting to gain some type of location economies.

International expansion can be viewed as simply a search for new customers. In this sense, all a firm is doing is attempting to extend its existing internal VRIO resources to a new market. For example, consider the success of the Japanese automakers in entering the United States auto market from the mid-1970s to 1990s with their high quality small cars. This type of expansion can aid the firm in developing new internal advantages such as economies of scale, e.g. you need more than your local market to reach the MES.[1] Singapore is a good example of this type of nation. Note that this is nothing really new or surprising. If you expand domestically, say from Texas to Virginia, this is sometimes referred to as geographic diversification, but it is exactly the same underlying concept.

Another reason to expand internationally is to gain some type of location economy. The most common of these is low wage rates. (But see Porter's Diamond below for a full range of potential location economies.) Wage rates in developing countries are dramatically lower than in industrialized countries. This has led to tremendous shifts in productive capacity, absent trade barriers, to less developed countries, e.g. China. This is starting to affect service industries as well. For example, computer programmers in India get paid only a small fraction of what U.S. based programmers are paid.

Both of the above issues are elegantly captured in John Dunning's famous OLI or eclectic paradigm that describes international activities by firms. O refers to organizational advantages, conceptually identical to firms attempting to extend their existing internal resources we described above. L refers to location advantages as described above. Where OLI advances the above is the idea of I, or internalization, the idea that sometimes firms will not only want to expand over seas but do so utilizing foreign direct investment. Foreign direct investment is simply the ownership of assets in a foreign country. If you bought a house in Brazil, you'd have foreign direct investment. Hence the I refers to *internalization*, why firms might want to conduct international operations internally. We'll return to this idea under entry mode below.

For now, the key is that firms expand overseas in order to exploit their core competencies (O advantages per Dunning) or to exploit some location economy (L under Dunning). That brings us to the next question…

Where Do You Go?

There are several ways to approach this question. One way is to simply use the five forces model and look for a nation where some of the threats, e.g. rivalry, are lower than they are domestically. Another way is to utilize Porter's Diamond. Porter's Diamond was developed in the late 1980's to explain why firms based in some nations did so well in certain industries. Trying to explain the Japanese successes of the 1980s was a prime motivation for its development. However, we can take the idea of the diamond and turn it around, rather than use it to explain nation state competitive advantage, you can use it to identify where international expansion may be beneficial for your firm.

Porter explained that firms based in certain countries had competitive advantages based on four dimensions:

[1] MES - Minimum Efficient Scale, see discussion of threat of entry.

a. **Factor Endowments** - These are the specific elements of production (inputs) needed by the firm, e.g. labor or oil, some countries have more or better of these than others.
b. **Supporting Industries** - These are the nature of industries that are available to support the focal industry, e.g. auto parts makers.
c. **Demand Conditions** - This is one of the most interesting dimensions because it relates to the nature of consumers in the home market. How demanding are the consumers? Two great stories, the Cavalier in Japan and the X-Box in Japan.
d. **Rivalry** - Recall that in the five forces model, rivalry is "bad" in that it tends to depress an industry's return. Here rivalry is exactly the same idea, the intensity of price competition between firms, but it is "good" in that the more rivalry there is a firm's home market the more efficient it will be when it goes to compete in other countries.

While Porter's Diamond is great at predicting which nations' firms will do well in an industry, I'd like to encourage you to use it for something else as well. Porter's Diamond can also be a guide to a firm for where it can expand internationally successfully. You want to expand where Porter's Diamond suggests you'll have an advantage over *local* rivals, e.g. local firms currently face lower rivalry than you do. The classic example of this is the Japanese success in the U.S. auto market. In the 1970s the Japanese had labor cost advantages (gone today but important at the time), strong networks of suppliers (which helped them solve their economies of scale disadvantage versus the U.S. firms), very demanding consumers, and with eight major companies (Toyota, Nissan, Honda, Fuji Heavy Industries, Suzuki, Mazda, Isuzu, and Daihatsu) selling cars in Japan's smaller automobile market, much higher rivalry.

Another way to approach the global decision is to examine how well your VRIO advantages will transfer to the foreign market. A good way to do this is to revisit your macro environmental analysis and conduct it for the foreign country. For example, if your existing key VRIO is patented technology and the other nation's political legal system does not include strong intellectual property protection, you may not do well. So our existing frameworks can serve well in examining this important question. There is no reason why external analysis frameworks, VRIO, and Porter's Diamond cannot all be used together.

How Do You Get There?

Once you decide to go overseas you have some options on how to do so. The most common way is simply **exporting**, sending your goods or services to another country. This is the form of international business we are all most familiar with seeing "Made in _____" on many products. When technology is involved **licensing** is a natural choice. You sell a license to a foreign firm to use your technology (recall technology is simply a way work is accomplished). Frequently, more technology is involved than a simple license can convey, so you want to transfer an entire way of doing business. Under these circumstances a franchise may be used. A **franchise** is simply a business plan, and they are quite common domestically. For example, McDonalds will sell you a way to compete in the fast food business, so will Taco Bell.

There are also two additional options that embody direct firm ownership, or foreign direct investment as described above. The first is a **joint venture** where a firm sets up a new organization in conjunction with another, usually local, firm. A joint venture is the most easily identified form of a strategic alliance (see below), and is common globally because a firm is seeking to exploit some of its advantages, e.g. economies of scale, but gain the assistance of a local firm's advantages as well in order to facilitate market entry. The New United Motors Manufacturing Initiative (NUMMI) between General Motors and Toyota is a great example of this type of activity. Toyota knew how to build high quality small cars inexpensively while GM had surplus production capacity and knowledge about selling in the U.S. market so they formed a joint venture. If a firm doesn't want to set up a joint venture it can always go it alone, using a **wholly owned subsidiary**. This is in fact what Toyota did later with its production plants in Tennessee.

Why do firms engage in FDI? This brings us back to Dunning's "I" which stands for internalization. Firms basically engage in FDI to avoid the potential for hold up, or opportunistic behavior that they could be exposed to if they used an alternate entry method. For example, rather than having a joint venture Toyota could have simply licensed its designs of the Corolla to GM rather than form NUMMI. However, then GM could have easily competed against Toyota by building "Corolla's" everywhere. So firms engage in FDI when they have some resource or capability they fear may be easily imitated or copied if they don't protect it by owning it. This is very similar to situations surrounding specific assets.

<u>Trade Barriers</u>. **Trade barriers** are simply barriers to the cross border flow of goods and services. They can be broken down into two broad categories. The simplest is tariffs, or taxes on cross border commerce, often referred to as customs duties. Most countries have some sort of taxes on imports into their country of some type. Sometimes these tariffs can have important consequences for firms. For example, the U.S. tariff on cars is 2.5% while it is 25% for light trucks. Light trucks includes SUVs and minivans. Perhaps it is therefore no surprise that the U.S. automakers make most of their money on SUVs and light trucks! At least tariffs are easy to see, non-tariff barriers are much more dangerous and common in industrialized nations today. A **non-tariff barrier** is a regulation that serves to restrain trade, even if it has a legitimate purpose. A recent example is opening all express mail packages to check for pornography (in China & earlier in Japan) that come from abroad. This hurt U.S. express mail firms such as Federal Express. Note that while tariffs on exports are prohibited by the U.S. constitution, many other nations make use of taxes on their exports as well.

Strategic Alliances. Rather than undertake all the risks alone of operation overseas a firm may want to consider a strategic alliance or joint venture. A **strategic alliance** is an ongoing cooperative arrangement between two or more competitors or potential competitors. A joint venture is simply a very definite structure for a strategic alliance where two companies come together to form a separate third entity. The definition of strategic alliances is not very stable, many scholars disagree and the term is thrown around quite a bit, and most joint ventures are generally assumed to be strategic alliances even if they are not between "competitors."

Alliances, especially cross border or global alliances are increasingly common. They are needed for several reasons. One reason is to help companies get around non-tariff barriers. Occasionally they are legally required. For example, until 2004 China required that all FDI be done via a joint venture. All the reasons for domestic alliances tied to corporate strategy (sharing resources, transferring competencies, and creating specific assets) also apply.

Unfortunately, alliances have several problems, including moral hazard (people act opportunistically) and adverse selection (partners are only available because they are not very good). International alliances add some additional complications including national technology transfer, the hollowing out of domestic companies, and threats to your competencies. The threat of technology transfer is largely a concern of the Defense Department and now that the cold war has ended there is less concern about technology that can be used both for civilian and military purposes, with the exception of nuclear technology. Similarly, there was tremendous concern in the 1980s that U.S. firms would become “hollow” shells with little manufacturing ability. This of course has also come to pass though today we celebrate it as outsourcing! The last concern though is legitimate, firms do copy one another and steps should be taken to safe guard your firm’s primary competencies. This is probably the biggest challenge for the implementation of alliances. Firms seek to “wall off” their technology, utilize contractual safeguards, demand swaps of technology and finally seek significant commitments, both financial and otherwise, from their partners as part of the alliance relationship. Choosing a “good” alliance partner who shares your organizations goals, vision and is a fair player is obviously helpful as well. Of course it is much easier said than done!

Global Strategy[2]

All of this brings us finally to important issues of global strategy. This is primarily an issue for global firms with considerable FDI. Recall that globalization puts two competing pressures on the global firm. The globalization of industries leads to pressures of cost reduction. More firms competing means more potential for price competition. Simultaneously, the chance that markets are becoming more homogenous suggests an *inverse* pressure on needs to locally customize products. These conflicting pressures influence how firms should seek to structure their international operations. Early efforts to deal with this issue led to a Matrix form of organization, you’d have both a product boss and a country boss. This usually didn’t work out too well, so an alternative framework was developed.

The basic idea is that the firm has to pick which pressure it will focus on accommodating. If it is concerned about pressures for cost reduction (driven by the globalization of industries) it will adopt what is called the **Centralized Hub** strategy/structure. This structure centralizes decision making and control in a strong headquarters that can then work relentlessly to drive costs down. If the firm is concerned by the need for local responsiveness (because in its case the globalization of markets is NOT occurring), then it will adopt what’s called a **Multi-domestic** strategy/structure. This structure decentralizes decision making in strong country based units allowing them to meet the needs of local customers without a lot of interference from a corporate headquarters.

Table 1: Global Structures

Pressures for Local Responsiveness	Pressures for Cost Reduction: High	Pressures for Cost Reduction: Low
High	Transnational	Multi-domestic
Low	Centralized Hub	Coordinated Federation

[2] NOTE: For global strategy alone, we will treat strategy and structure as synonyms. The global structure you use IS your global strategy or vice versa.

Two other less common strategies/structures shown in Table 1 are **Coordinated Federation** and **Transnational**. With a coordinated federation strategy a central headquarters maintains some control but generally allows its national units to do limited customization. Almost all U.S. fast food firms that operate internationally utilize a coordinated federation strategy.

The transnational strategy is a little more complex. While popular in theory, it is very hard to implement. Firms attempting to implement such a strategy need to: a. Build and legitimize diverse internal viewpoints; b. Have its assets distributed internationally but be interdependent; and c. Therefore it needs, robust and flexible internal integrative processes. These things are VERY hard to do. While it is a strong theory there are few successful examples of firms that have implemented this strategy. In fact, the only firm that almost everyone agreed had implemented this strategy, ABB, has given it up and moved towards a centralized hub structure.

Risks of International Activities

International activities, at least when conducted by U.S. firms, usually expose the organization to increased risks. Entire courses are devoted to the interpersonal managerial challenges that arise from getting work done though others from different nations. The earlier macro-environment framework can apply with each force embodying some element of risk but two of these risks deserve special mention.

Political risk is a major concern. The U.S. is a very stable democracy and change is relatively gradual within it. However, this stands in stark contrast to the political risk abroad which can include dramatic shifts in political power (dictators and military take-overs) as well as the outright seizure (appropriation) or forced sale (nationalization) of firm assets.

Economic risks are also more dramatic abroad. Currency fluctuations can serve to easily destroy firm profits from international ventures. Currency shifts of over 20% per year are routine, even among well established industrialized nations, e.g. U.S. dollar to Euro. Shifts between currencies of developed and less developed countries are frequently even more dramatic. These shifts are often larger than the gross margins of firms, meaning that all profits and even entire investments can be quickly wiped out. While financial instruments exist to offset this risk, their use is frequently expensive and as a result many firms do not hedge this exposure.

Conclusion

Global strategy is becoming increasingly important with a lot of exciting developments. Currently the world is in a big opening up trend, with world trade growing rapidly and FDI growing even faster. The U.S. is leading the way by being a huge consumer of all the world's output. This has led the U.S. to become the world's biggest importer (with a huge current account deficit) and largest debtor as well. I think you can expect important developments in this area as your careers unfold.