

Most of modern global strategy focuses on minimizing differences between countries. Perhaps it's time to dust off approaches that exploit those differences as well.

# The Forgotten Strategy

by Pankaj Ghemawat



company, for which international business is usually much less profitable than domestic business, as the sidebar "A Poor Global Showing" reveals.

Why is globalization proving so hard to get right? The answer is related in part to how companies frame their globalization strategies. In many if not most cases, companies see globalization as a matter of taking a superior (by assumption) business model and extending it geographically, with necessary modifications, to maximize the firm's economies of scale. From this perspective, the key strategic challenge is simply to determine how much to adapt the business model—how much to standardize from country to country versus how much to localize to respond to local differences. Recently, as at Coke, many companies have moved toward more localization and less standardization. But no matter how they balance localization and standardization, all companies that view global strategy in this way focus on similarities across countries, and the potential for the scale economies that such commonalities unlock, as their primary source of added value. Differences from country to country, in contrast, are viewed as obstacles that need to be overcome.

Correctly choosing how much to adapt a business model is certainly important for extracting value from international operations. But to focus exclusively on the tension between global scale economies and local considerations is a mistake, for it blinds companies to the very real opportunities they could gain from exploiting differences. Indeed, in their rush to exploit the similarities across borders, multinationals have discounted the original global strategy: arbitrage, the strategy of difference.

Of course, we're all familiar with arbitrage in its traditional, and least-sustainable, form—the pure exploitation of price differentials. But the world is not so homogeneous as to have removed arbitrage from a company's strategic tool kit. In fact, many forms of arbitrage offer relatively sustainable sources of competitive advantage, and as some opportunities for arbitrage disappear, others spring up to take their place. I do not claim that arbitrage to exploit differences is any more a complete strategic solution than the optimal exploitation of scale economies. To the contrary: If they are to get their global strategies right in the long term, many companies will have to find ways to combine the two approaches, despite the very real tensions between them.

## The Strategy of Differences

Arbitrage gets little respect these days as a global strategy. This partly reflects the tendency of companies to equate size with a global presence, which naturally focuses the mind on scale economies rather than on the absolute economies that underlie arbitrage. But it also reflects the fact that arbitrage has been around for so long. Many of the industries in which arbitrage has historically been

applied—farming, mining, and textiles—are regarded as low-tech and mature. There is also the sense that well-run global enterprises have already reaped what competitive advantage they can from arbitraging such generic factors of production as capital or labor, which, as one leading management guru has put it, can now be sourced efficiently with the click of a mouse.

But arbitrage is about much more than cheap capital or labor (although these, as we will see, continue to be very important). Indeed, the scope for arbitrage is as wide as the differences that remain among countries, which continue to be broad and deep. Some of the empirical evidence for this can be found in my last HBR article, "Distance Still Matters: The Hard Reality of Global Expansion" (September 2001), where I presented a four-dimensional framework for measuring distance between countries. I argued that distance could be measured not only by geography but also by the extent of differences in culture, differences in the administrative and institutional context, and differences in economic attributes (which all together I call the CAGE framework).<sup>1</sup> Let us consider each type of arbitrage in turn to examine both the traditional and less obvious ways companies can apply arbitrage strategies to exploit differences.

**Cultural Arbitrage.** Arbitrage strategies have in fact long exploited differences in culture. For example, French culture (or, more specifically, its cachet abroad) has long underpinned the international success of French haute couture, cuisine, wines, and perfumes. But cultural arbitrage can also be applied to newer products and services. Consider, for example, the extraordinary international dominance of U.S.-based fast-food chains, which at the end of the 1990s accounted for 27 of the world's top 30 fast-food chains and for over 60% of worldwide fast-food sales. In their international operations, these chains exploit to varying extents the general global surge of American popular culture by serving up slices of Americana (at least as it's perceived locally) along with their food. Nor, certainly, is this advantage reserved for rich nations; many poor countries are important platforms for cultural arbitrage. Think of Haitian compas music and dance music from the Congo, which enjoy image advantages in their respective regions.

Claims that the scope for cultural arbitrage is decreasing over time are clearly not true for all countries and product categories. The persistent association of Brazil with football, carnival, beaches, and sex—which all resonate powerfully in the marketing of youth-oriented products and services—illustrates the unexploited potential of some countries in this regard, though in this case the potential is starting to be recognized. Witness Mol-

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son's recent launch in the Canadian market of A Marca Bavaria, a superpremium beer imported from its Brazilian subsidiary, which uses its association with Brazil's high-energy and sensual image to target primarily 19- to 24-year-old men. In fact, new opportunities for reinforcing cultural arbitrage are appearing all the time. For instance, the push by the European Union to restrict labels such as Parma ham and Cognac brandy to only those products that actually come from those places is a move to reinforce the natural advantages of particular geographic areas. What's more, as Finland's recently developed reputation for excellence in wireless technology shows, in certain product categories, such advantages can now be created much faster than before, in years rather than decades or centuries. Reduction in other dimensions of difference—tariffs or transport costs, for instance—can also increase the viability of cultural arbitrage.

**Administrative Arbitrage.** Legal, institutional, and political differences from country to country open up a host of strategic arbitrage opportunities. Tax differentials are an obvious example. Through the 1990s, to take one case, Rupert Murdoch's News Corporation paid income taxes at an average rate of less than 10%, rather than the statutory 30% to 36% of the three main countries in which it op-

erated: Britain, the United States, and Australia. By comparison, major competitors such as Disney were paying close to the official rates. These tax savings were critical to News Corporation's expansion into the United States, given the profit pressures on the company: net margins consistently less than 10% of sales in the second half of the 1990s and an asset-to-sales ratio that had ballooned to three to one. By placing its U.S. acquisitions into holding companies in the Cayman Islands, News Corporation could deduct interest payments on the debt used to finance the deals against the profits generated from its newspaper operations in Britain. Overall, the company has incorporated approximately 100 subsidiaries in havens with no or low corporate taxes and limited financial disclosure laws. The intangibility of its informational assets has helped in this regard. As one accounting authority puts it: "There's absolutely no reason why a piece of paper, which is the right to show something, couldn't sit anywhere. So it could be sitting in the Cayman Islands."

Few managers ever explicitly treat tax or other administrative arbitrages as a strategic tool, despite their potential. That's partly because executives are reluctant to draw attention to such arrangements for fear that they might be outlawed. For instance, many Chinese businesspeople

## A Poor Global Showing

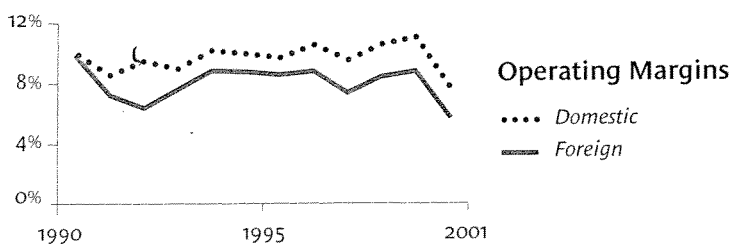
SINCE 1990, the foreign operations of large companies have consistently posted lower average returns on sales than their domestic operations. Nor do foreign revenues work as a hedge against slumping domestic results. As the graph below clearly shows, foreign and domestic margins generally move in the same direction. Based on data supplied by Michael Gestrin of the OECD, the graph compares the

foreign and domestic operating margins for 147 of the companies in the *Fortune* Global 500 for which such data were available for at least six years.

Of course, an international presence could theoretically add value even if international operations were persistently less profitable, in accounting terms, than domestic operations. Say, for instance, that significant fixed costs incurred at home can be avoided by

entering foreign markets. But other recent studies, based on market values rather than accounting data, also tend to indicate that, on average, an international presence impairs performance instead of improving it.

Such studies are certainly subject to many caveats (about data, inferences of causality, and so on). And in any case, they reflect average tendencies around which there is substantial—and predictable—variation. So one should not conclude from them that individual companies ought never expand beyond their home countries. A more sensible lesson to draw is that companies need to think harder about how globalization can add value instead of assuming that if they are profitable at home, they will surely be profitable abroad.



## Complex Aggregation Strategies

A NUMBER OF STRATEGISTS have proposed that rather than adapt its business model country by country, a company should organize its operating units along regional lines, business lines, or some combination of both. The idea is to avoid thinking in terms of a country-level trade-off between localization and standardization and instead build global networks that can share knowledge, find and train global managers, and create a truly global corporate culture.

The most famous practitioner of this approach was ABB's Percy Barnevik, who broke up the bureaucracy and geographic fiefdoms he had inherited in the power and automation-technology company created by the merger of Asea of Sweden and Brown, Boveri of Switzerland. He flattened the organization and fragmented its businesses into small, local operating companies that reported to both a country manager and a business-area manager—a matrix, or dual basis of aggregation. This approach helped ABB digest acquisitions and reorganize and refocus operating units on new opportunities. The business-country matrix itself wasn't new, but ABB was one of the few companies that seemed to be able to make it work, through groundbreaking management information systems and many other linking mechanisms, both formal and informal.

Yet, as ABB was to demonstrate, complex aggregation schemes are hugely expensive and hard to manage. The challenge is magnified by the fact that there aren't just two potential dimensions for aggregation, countries and product lines, but many others as well: function, competence, client industry, key accounts, and on and on. Indeed, in 1993, Barnevik himself added a regional overlay to the matrix by grouping countries into three regions. Five years later, his successor as CEO, Göran Lindahl, removed this overlay because it was too costly.

Under Lindahl, ABB moved toward a more traditional global structure, organized by products, and also developed a global account-management structure to serve key accounts across borders. But pres-

ures on the company continued to mount as a result of a slowdown in demand in the wake of the Asian financial crisis, which caused prices to plunge and efficiency requirements to escalate. These conditions complicated ABB's already intricate efforts to market systems that integrated products from different business areas or for which the key customers were global or regional, not local. There were also other problems intertwined with the autonomy of the local companies.

In 2001, new CEO Jörgen Centerman replaced the matrix with a structure that combined front-end operations in a different way than it grouped its back-end functions. Specifically, ABB created four main customer-oriented units, defined by the industries (rather than the countries) that the customers were in, which were supposed to enhance the company's ability to create value for its global and regional customers in particular. Then it also created two back-end technological units, Power Technologies and Automation Technologies, which (assuming that appropriate linking mechanisms could be created) were supposed to aggregate technology development across the businesses in each of ABB's two main areas of technological competence.

Centerman, however, was forced out in 2002, amid pressures associated with the sluggishness of this new organization and asbestos-related liabilities picked up in the acquisition (under Barnevik) of the U.S. company Combustion Engineering. His successor, Jürgen Dormann, dismantled the front-end/back-end organization, which was deemed unworkable, sold off portions of the front end, and regrouped the remaining businesses into two divisions—Power Systems and Automation—thereby returning the company to just one primary basis of aggregation, products. But losses grew from \$691 million in 2001 to \$787 million in 2002, and questions persisted in mid-2003 about whether a turnaround was really at hand.

Perhaps the broader moral from the ABB story is that attempting to organize a global business without first understanding what one is hoping to achieve through cross-border activities—in particular whether one is trying to exploit similarities or differences—is a bit like putting the proverbial cart before the horse. Indeed, to limit the strategic discussion to structure and process is to presuppose that there is only one best global strategy. The discussion in this article should convince you that this is not the case.

channel investment funds through foreign third parties and then back into China to secure better legal protection, tax concessions, or otherwise favorable treatment. In fact, about half the foreign direct investment flowing into China is estimated to have originated in China. Similar considerations explain why Mauritius is one of the top two sources of FDI flowing into India.

In some cases, administrative arbitrageurs are actually breaking the law. By some estimates, more than half the regular filter cigarettes smoked in India are smuggled in. Given the taxes and tariffs evaded, they can be sold for 30% to 50% less than cigarettes legally produced and sold there. Major international tobacco companies have been widely accused in the press of conniving in such activities to boost profits and market penetration. And if India has high tariffs, "there is," as the CEO of a candy manufacturer pointed out, "always Dubai" (a major entrepôt and smuggling hub). Clearly, legislation and law enforcement face a huge challenge.

Most forms of administrative arbitrage involve working with or around given rules. In some cases, though, companies can leverage political power to try to change the rules. In 1994, for example, four big Swedish corporations—ABB, Volvo, Ericsson, and Stora—threatened to send overseas as much as \$6.6 billion in investments to pressure the Swedish government into limiting corporate tax rates. Similarly, companies can use powerful home governments to pressure foreign governments into granting favorable treatment. Enron, for example, enlisted the help of the Clinton State Department, which obligingly threatened to cut off development assistance to Mozambique, one of the poorest countries in the world, if it granted a gas deal to a South African competitor instead of to an Enron-led consortium. Unattractive though they are, stories like this suggest that the potential for using government influence to create administrative arbitrage opportunities remains high.

**Geographic Arbitrage.** Considering all that has been written about the alleged death of distance, it is hardly surprising that few strategy gurus take geographic arbitrage very seriously. It is true that transportation and communication costs have dropped sharply in the last few decades. But the drop does not necessarily translate into a decrease in the scope of geographic arbitrage strategies. Consider the case of air transportation, the cost of which has declined more than 90% in real terms since 1930, more sharply than older modes of transportation. In the process, new opportunities for geographic arbitrage have been created. For example, in the Netherlands' Aalsmeer international flower market, more than 20 million flowers and

2 million plants are auctioned off every day; blooms flown in from India are sold to customers in the United States or Europe on the day they arrive.

Although communication costs have dropped more sharply than transportation costs, there are cases in the telecom sector where returns earned by focusing on residual distance have been higher than those gained by building or exploiting global connectivity. Cable & Wireless, a far-flung and once high-flying telecom company headquartered in London, has two main areas of business, organized into a regional unit and a global one. Analysts assess the market value of the global unit, in which \$10 billion has been invested since 1999, at about zero because competitors also invested in much the same kind of long-haul overcapacity and global connectivity. The valuable part of the company is its regional unit, which consists of subsidiaries providing a full range of telecommunication services to consumer and business customers in 33 small countries around the world—mainly islands, whose communication links with the outside world C&W still dominates.

The geographic arbitrageurs that *have* lost some ground in recent decades are the great general trading companies of the past, which traditionally took advantage of large international variations in prices for a broad

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array of products by getting them from market A to market B (and in the process somewhat eroding those price differentials). Lower transportation costs and greater connectivity have made it much easier for manufacturers and retailers to exploit these opportunities themselves. Yet the savviest trading companies have found ways to stay in business. For instance, instead of simply engaging in trading, Hong Kong-based Li & Fung derives most of its revenue from

a more sophisticated kind of geographic arbitrage, setting up and managing multinational supply chains for clients through its offices in more than 30 countries.

**Economic Arbitrage.** In a sense, all arbitrage strategies that add value are economic. But I use the term here to refer to exploitation of specific economic factors that don't derive directly from a country's culture, geography, or administrative context. These factors include differences in the costs of labor and capital, as well as variations in more industry-specific inputs such as knowledge or the availability of complementary products, technologies, or infrastructures.

The best-known type of economic arbitrage is the exploitation of cheap labor, which is common in labor-intensive, capital-light industries like clothing. But high-tech, capital-intensive companies can use the strategy just as well. Consider the case of Embraer, the Brazilian firm

that, among other types of aircraft, designs and assembles regional jets. Many factors contribute to Embraer's success, including managerial and technical excellence, but labor arbitrage has clearly played a critical role. Witness Embraer's employment costs, which came to \$26,000 per employee in 2002, versus an estimated \$63,000 in the regional jet business of its chief rival, Montreal-based Bombardier. If Embraer had had Bombardier's employment cost structure, its operating margin would have fallen from 21% of revenues to 7%, and its net income would have turned negative. Unsurprisingly, Embraer has focused its operations on final assembly, which is the most labor-intensive part of the production process, and has outsourced other operating activities to its supplier partners.

Labor arbitrage can be applied to R&D as well as to ongoing operations, as Embraer also demonstrates. The company is currently preparing for the certification and initial delivery of a 70-seater, the first model in a new, larger family of regional jets. When it was announced in 1999, the plane was projected to cost \$850 million to develop. It would have cost \$100 million more, the company estimated, had the 10 million engineering man-hours involved in developing the new family come from Canada.

One might argue that labor arbitrage is an unsustainable strategy in knowledge industries because labor costs quickly rise to match demand. But the experience of East Asian economies suggests that even if one assumes labor costs will converge in the long run (or that costs will eventually reflect productivity levels), the period between now and then can extend into decades. Indeed, the top Indian software services firms have consistently posted returns on capital employed in the range of 50% to 75% and have grown at 30% to 40% a year over the past decade. And the prospects are for continued profitable growth, in part because the reduction in large companies' technology budgets makes labor cost advantages more important.

At first sight, capital cost differentials would seem to offer slimmer pickings than labor cost differences; they are measured in single percentage points rather than multiples of ten or 20. But considering that most companies (at least in the United States) earn returns within two to three percentage points of their cost of capital, such differences are consequential, especially in capital-intensive industries. Thus, Cemex, the international cement company headquartered in Mexico, has striven to reduce the effects of "Mexico risk" on its finances not just by listing the company on the New York Stock Exchange. More uniquely among Mexican companies, Cemex has also folded the ownership of all its non-Mexican assets into its operations in Spain (where interest costs are lower and

are tax deductible) and has formed investment partnerships with entities such as the insurer AIG and the private equity arm of the Government of Singapore Investment Corporation. These moves have reportedly helped reduce Cemex's capital costs by several hundred basis points and has solidified its position as the world's most profitable international cement manufacturer (as well as the largest trader).

The subtlest forms of economic arbitrage involve the exploitation of knowledge differentials.<sup>2</sup> Forget, for a moment, the tangible aspects of Cemex's international operations and focus on its internationally recruited knowledge workers. The company seeks out graduates of leading business and other professional schools around the world and creates career paths for them that involve sending them abroad and immersing them in foreign cultures. (CEO Lorenzo Zambrano himself has an MBA from Stanford.) The company also makes

heavy use of foreign (mostly U.S.) management and technical consultants and benchmarks its performance against best-in-class foreign companies (like Federal Express in logistics). Some analysts see these international influences as key ingredients in Cemex's heavy emphasis on information technology, as well as in its decision to remain focused on the cement industry and expand geographically rather than diversify into other industries—the model followed by most other Mexican conglomerates. Whatever the truth of the claim, there is no doubt that the diverse experiences of Cemex's international workforce has broadened the company's horizons.

## Reconciling Difference and Similarity

One would think companies that try to exploit differences would not find it easy to exploit similarities as well. And indeed, a large body of research on the horizontal versus the vertical multinational enterprise has shown that there are fundamental tensions between pursuing scale economies and playing the spreads. (See the table "Conflicting Challenges.") The data indicate that there is some merit to classifying companies according to the primary way they add value through their international operations over long periods of time. But that either/or characterization of globalization strategies is very broad. Finer grained analysis of case studies—particularly of companies that have in various ways been global innovators—suggests that it is possible to combine the two approaches to some extent.

For a start, it's possible to apply different strategies to different elements of a business. Cemex pursued a finan

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cial strategy of arbitraging capital cost differences even as it implemented a standardized operational strategy. It set up complete, uniform production-to-distribution chains in most of its major markets, reinforced by cross-border scale economies in such areas as trading, logistics, information technology, and innovation (in the broadest sense of the term). Mixing and matching was possible in this case because, to a large extent, Cemex can choose how to raise capital independently from the way it chooses to compete in product markets.

Some companies have gone further. Consider the case of GE Medical Systems (GEMS), the division that Jeffrey Immelt built up between 1997 and 2000 before he was tapped to take over from Jack Welch as CEO. Immelt pushed for acquisitions to build up scale because, for the leading global competitors, an R&D-to-sales ratio of at least 8% represented a significant source of scale economies. But he also implemented a production strategy that

was intended to arbitrage cost differences by concentrating manufacturing operations – and, ultimately, other activities – wherever in the world they could be carried out most cost effectively. By 2001, GEMS obtained 15% of its direct material purchases from, and had located 40% of its own manufacturing activities in, low-cost countries.

Like Cemex, GEMS was able to pursue both approaches because it could organize its operations into relatively autonomous bundles of activities (like product development) in which economies of scale and standardization were essential and those (like procurement and manufacturing) where arbitrage economies were being pursued. What's more, it was able to coordinate its widely dispersed operations by applying centrally developed learning templates. In particular, Immelt applied the "pitcher-catcher concept," developed elsewhere in GE, in which for each move, a pitching team at a high-cost existing plant works with a catching team at a low-cost new

## Conflicting Challenges

The challenges facing companies pursuing economies of scale through adaptation or aggregation are fundamentally different from those that companies face when pursuing absolute economies through arbitrage.

|  | <b>Adaptation or Aggregation</b>  | <b>Arbitrage</b>   |
|--|---|--|
| <b>Competitive Advantage</b><br>Why globalize at all?                    | To achieve scale and scope economies through standardization  | To reap absolute economies through specialization  |
| <b>Configuration</b><br>Why locate in foreign countries?                 | To minimize the effects of distance by concentrating on foreign countries that are similar to one's home base       | To exploit distance by operating in a more diverse set of countries  |
| <b>Coordination</b><br>How should international operations be organized? | By business; to achieve economies of scale across borders by placing a greater emphasis on horizontal relationships | By function; to achieve absolute economies by placing a greater emphasis on vertical relationships (efficiently matching supply and demand across borders, for instance) |
| <b>Control Systems</b><br>What are the strategic dangers?                | Excessive standardization, on the one hand; variety, complexity, or both, on the other                              | Narrowing differences between countries  |
| <b>Corporate Diplomacy</b><br>What public issues need to be addressed?   | The appearance of, and backlash against, cultural or other forms of domination (especially by U.S. companies)       | The exploitation or bypassing of suppliers, channels, or intermediaries  |

## A Brief History of Globalization and Arbitrage

PROBABLY THE SINGLE MOST OVERLOOKED FACT in the history of globalization and strategy is that, for a number of centuries, firms' international economic activities were motivated entirely by considerations of arbitrage. The great trading companies of the seventeenth and eighteenth centuries arbitrated across extreme differences in cost and availability created by geography. Spices, to take just one example, could be grown in the East Indies but not in Northern Europe, where they originally cost several hundred times as much.

Arbitrage was also the strategy of the global whaling fleets of the late eighteenth century (which, with their floating factory ships, can be said to have originated offshore manufacturing). It was also behind the

location, and the move is not considered complete until the performance of the catching team meets or exceeds that of the pitching team. As a result, GEMS (and GE) seems to have managed to move production to low-cost countries faster than European competitors such as Philips and Siemens while also benefiting from greater scale economies.


But even the best management can get only so far in melding the two strategies. Acer, one of the world's largest computer manufacturers, supplies a cautionary tale of what can happen when companies go too far. Acer entered early into the contract manufacturing of personal computers, operating in low-wage Taiwan, and made good money with that arbitrage play. But in the early 1990s, it began to push Acer as a global brand, particularly in developed markets. This two-track approach turned out to be problematic. The branded business grew to significant volumes but continued to generate losses because the competitive environment was particularly tough for a late mover. Meanwhile, customers for Acer's contract-manufacturing arm worried that their business secrets would spill over to its competing line of business. They also feared that Acer could cross-subsidize its own brand with profits from its contract-manufacturing operations and so undercut their prices. In 2000, the strategy blew up when IBM canceled a major order, reducing its share of Acer's total contract-manufacturing revenues from 53% in the first quarter of 2000 to only 26% in the second quarter of 2001.

Acer responded by making some hard choices. Contract manufacturing has remained focused on customers in de-

veloped countries—and will gradually be spun off into a separate company. Meanwhile, sales of its own branded products have been focused on the East Asia region, particularly Greater China, where the contract customers cannot sell at a low enough price to compete. With this move, the company has acknowledged that the logic of exploiting similarities often calls for targeting countries similar to a company's home base, whereas the logic of arbitrage involves exploiting one or more of the differences inherent in distance.

The pursuit of scale, rather than of absolute, economies is quite new. Replicating successful business models in new locations didn't begin until the end of the nineteenth century. Since then, however, it has become the dominant strategy, which is why the *net* effect of most types of distance between countries is to reduce the economic activity between them.

veloped countries—and will gradually be spun off into a separate company. Meanwhile, sales of its own branded products have been focused on the East Asia region, particularly Greater China, where the contract customers cannot sell at a low enough price to compete. With this move, the company has acknowledged that the logic of exploiting similarities often calls for targeting countries similar to a company's home base, whereas the logic of arbitrage involves exploiting one or more of the differences inherent in distance.

The future of the globalization process is by no means obvious. Markets may integrate further once economic conditions improve. But some argue that the process could actually shift into reverse, toward even greater economic isolation, if the experience between the two World Wars is any precedent. Whatever the ultimate direction, though, the differences that make arbitrage valuable as well as the similarities that create scale economies will remain with us for the foreseeable future. That spells opportunity for those companies that have the imagination to see the full range of possibilities. 

1. For an even more extensive, market-based review of the evidence, see my article, "Semiglobalization and International Business Strategy," *Journal of International Business Studies*, June 2003.

2. Arbitrage aficionados are also fond of talking about "dynamic arbitrage," in which a broader global presence can enable companies to exploit exchange rate changes and other volatile financial fluctuations more quickly and efficiently. But the general benefits from such efforts, beyond pure portfolio insurance effects, remain in doubt.

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