

Notes on Globalization and Strategy

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GLOBALIZATION IN THE CURRENT CRISIS

Reviving the Global Economy



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Does the current ongoing crisis herald an end to this process of globalization? Many have already proclaimed its death. Certainly, judging by the sharp collapse of trade in the last few months, this gloomy prophecy looks somewhat plausible. Yet, despite all the hyperbole, the data reveals that the current crisis is no deeper than the many crises the world has experienced over the last 100 years. The difference is that the current crisis has reached almost every corner of the world.

Since the end of World War II, the world's economies have been going through a process of increasing integration and globalization. Merchandise export share of production has more than doubled worldwide over the last 45 years, while the manufactured export share of production has almost quadrupled. Most countries — emerging nations, as well as developed ones — have seen a phenomenal rise in their exports' share of GDP.

Alongside this growth in trade, there has been a continual process of internationalization on the production side. Instead of concentrating production in a single country, the modern multinational firm uses production plants, operating either as subsidiaries or through joint-venture agreements in several countries. By doing so, firms can exploit the various advantages of a given location, such as its proximity to markets and access to relatively inexpensive natural resources and labor.

In the past, economic disruptions affected much smaller sections of the planet. Today, thanks to reduced barriers to trade, the accelerated growth of transport and communications, as well as the mushrooming of new technologies, the crisis has spread across the whole world at incredible speed.

The best illustration of the synchronized drop in global economic activity is the collapse of trade since the crisis erupted in late 2008. According to the International Monetary Fund (IMF), world trade volumes are expected to fall by 11 percent this year — the first time in a quarter of a century that global trade will decline.

Why has this collapse in international trade been so dramatic in terms of the sheer scale of its breadth and speed? As highlighted earlier, a significant feature of globalization today is the internationalization of production, through the vertical integration of manufactured products.

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A significant feature of globalization today is the internationalization of production, through the vertical integration of manufactured products. Currently, as much as 40 percent of manufactured products originate from supply chains that span different continents.

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Currently, as much as 40 percent of manufactured products originate from supply chains that span different continents.

With the development of vertical integration in manufacturing, consumers have benefited from better and cheaper goods, thanks to the efficient use of labor and resources in producer countries. Despite what the “made in” labels indicate, when a manufactured product reaches a consumer, it contains parts that have circled the earth many times at different stages of its production.

The gains achieved through this process are now revealing their dark side. As consumers in the U.S. scale back their demand for manufactured goods in uncertain times, the countries that supply the components of those goods find themselves with fewer orders to fill. As a result, they, in turn, stop importing other parts. Hence, the impact ripples throughout the supply chain. Therefore, given that much of today’s global trade is linked to production chains, the decline in one variable like private consumption in the U.S. can cause shockwaves all round, driving down trade in a more synchronized manner than it would in a less integrated world.

This, then, is the reason why the crisis has spread through markets around the globe with singular virulence. The U.S. economy is the principal generator of global aggregate demand, accounting for around one-fifth of global imports. Therefore, there is no way that the rest of the world can decouple from a U.S. recession. When the U.S. sneezes, the rest of the world catches the cold.

As external demand shrinks, countries are tempted to protect their export industries, by offering subsidies and raising both tariff and non-tariff barriers to entry. According to the World Bank, various governments have proposed or enacted 78 trade restrictive measures to protect domestic industries since the crisis began.

The risks of protectionism

In a vertically integrated world, these measures are likely to add more fuel to the engine of contraction. Any attempt to protect a coun-

try, which is part of an interlinked production system, by shutting out others ultimately risks hurting the very country its politicians are seeking to protect.

When governments choose to enact policies that affect other countries negatively, they are actually undermining their own chances of recovery. Politicians should be careful not to repeat the mistakes that President Herbert Hoover made just before leaving the White House in 1933. In the depths of the Great Depression, he legally sanctioned the innocent-sounding Buy America Act. It required the U.S. government to use American suppliers in all public contracts. Less notorious than the Smoot-Hawley Tariff Act, “Buy America” did huge damage. It proved a disaster for U.S. manufacturing exports and the global economy. Other governments followed suit, and it took decades to begin to reverse the closure of markets.

In a world where manufacturing is vertically integrated, protectionism would damage any chances of a synchronized recovery based on the growth in international trade.

Bearing in mind the dangers of withdrawing behind borders, what then are the options for action within a situation, which as history shows, will surely pass? This issue explores three potential ways of harnessing the new environment. Reviewing strategies to maximize your company’s potential while looking ahead is one. Another is exploiting the new dynamic for companies that outsource services offshore. Finally, we look at strategic alliances as a feasible option to flourish in times of uncertainty. There is, through all this, one shining beacon of certainty: today’s crisis is tomorrow’s history.



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Beyond the Downturn

Enough wallowing in the macroeconomic gloom of this global crisis. What strategies should businesses employ during this downturn given that it too shall pass? Here, in a nutshell, are five fundamental recommendations for maximizing your company's potential.

Reemphasize Profits (and Cash)

Companies are emerging from a period in which there was a focus on the top line as opposed to the bottom line. They may have been able to get away with less-than-intelligent deals against a background of low interest rates and rising asset prices. But now that this situation has been reversed, earning an adequate return on capital employed has become a priority and liquidity a powerful competitive weapon—if you have any left.

In assessing your liquidity position, remember what is perhaps the single biggest lesson of the last year: instead of suppressing uncertainty by, for instance, guessing how long until recovery and then fixating on that guess, allow for several possible futures. This means more than simply allowing for short, medium and long lags until recovery. In terms of when your industry or your company is likely to recover, you may want to allow for cycles by building lean years as well as fat ones into long-term planning. Or try to model the effects of various kinds of shocks before they actually occur.

Raise the Bar on Employees

We seem to have slipped very fast from assertions by companies that their people are their greatest assets in the knowledge economy to a situation in which companies need to be reminded that people are assets too. As with any long-term asset, decisions about what to do need to be based on a deep look into the future rather than on knee-jerk reactions to current conditions. That deep look is necessarily industry- and company-specific and can, in some cases, imply headcount additions, e.g., for a solvent financial services organization that still has the ability and the appetite to target rapid growth. And even when the drive for greater

profitability dictates headcount reductions are indicated, it is better to treat the exercise as one of raising the bar on the kinds of people employed rather than on reducing numbers to conform to desired targets. The difference is subtle—but potentially material. It steers managers away from uniform across-the-board reductions in headcounts or in benefits, untargeted employee buyout plans and blanket cancellation of training and development programs of the sort that far too many companies continue to engage in, lessons from previous recessions notwithstanding.

The other people-related point worth making is that given the ambiguities and anxieties that a recession induces, it is a time for more rather than less communication about what the company plans to do. Of course, such communication is eased by actually having a plan that goes beyond holding one's breath and waiting for the end of the recession, i.e., having a strategy for responding rather than just one tool, cutbacks.

Restructure businesses

Recessions are the obvious times to restructure businesses because, as Warren Buffett put it, only when the tide goes out do you see who has been swimming naked—a point that applies within companies as well as across them. Note that such restructuring subsumes not just employee-related decisions, but all the other assets that businesses deploy and the activities that they perform with them.

The means to do this vary depending on company history. For example, companies that have grown in the last few years through acquisition will have to redouble their efforts to integrate their operations – or find an alternative route to rationalize them. In the case of multinational



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companies, downturns are obvious times to restructure the chronically unprofitable operations in their global portfolios—a lever whose importance is indicated by a study suggesting that half of large companies have significant geographic units that earn negative returns. Companies that have diversified widely along a horizontal rather than geographic dimension may need to focus on improving operations in their core businesses. Whatever the specific challenges or opportunities may be, they all require focused hands-on management and sheer hard work.

Review your Strategy

A strategic vision of how the business is going to compete going forward is required to provide some overall direction for efforts to increase profitability or streamline the business portfolio. This point is worth stressing because the pressure on the operational side during crises often means that strategic thinking takes a back seat – even though this is precisely when a strategic rethink is most likely to be useful. Given the markedly changed environment, most businesses need to at least think through such a rethink.

Again, the direction that any changes should take can only be considered in the context of each company. For example, strategic innovation involving transformation of a business model that had worked for more than a century was the optimal response for De Beers when faced with a glut of diamonds in the 1990s. Other companies may not have to respond as radically to a recession, but it is worth looking more broadly about ways of coping with cycles, or ideally, of exploiting them.

Remember the future

Unless your strategic review shows that the best option is to close down the business, the relevant time horizon for strategic decision making is typically likely to stretch out well into the future. While the financial risk of investing during a downturn may be high, the competitive risk of not investing may be higher. The behaviour of many companies during previous downturns has tended to err on the side of caution. Data from the US shows that investment has tended to decline two to four times as fast as output. It is hard to defend such large cutbacks in the name of maximizing value, which is perhaps why Keynes attributed this behaviour to “animal spirits”. Herd behaviour, indeed, reinforces such tendencies. Companies in the US have been known in previous recessions to finance investment from internal cash flow even when external funds were available. This has had the effect of halting or delaying investment during downturns as cash flow dries up or moves into the red.

Conclusion: beyond the downturn

Broadly speaking, investing to create and sustain competitive advantage is one of the best measures for dealing with a downturn, provided the advantage can be achieved cost effectively. Whilst the unbridled optimism of the past may be outmoded in the wake of this brutal global downturn, it is equally important to guard against overreacting by giving into extreme pessimism. Knee jerk reactions are a common theme in our collective history. However, a downturn is not an excuse to forget about the future. There will be one, after all.



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Offshoring Comes of Age

This crisis brings with it a new dynamic for those companies that outsource services offshore or for those considering such strategies. Companies may be more defensive than before in their approach to strategy making. Yet they continue to implement and even accelerate their existing strategies.

The findings from a recent Offshoring Research Network (ORN) survey, (taken in the second and third weeks of November 2008), of nearly 100 companies based in the U.S. and Europe, highlight the key aspects of this new maturity.

Lower costs: immediate operational payback a priority

Cost savings, particularly labor costs, with rising pressure on margins coupled with declining top-line growth, emerge as the essential strategic driver for expanding or initiating projects offshore. In the short term, a renewed urgency to release cash flow is unsurprising. While discretionary projects are being cut down or postponed, most companies are not yet considering relocating business units to new lower cost countries because of the high upfront costs involved.

Higher efficiency: increasingly important

Accompanying this low cost focus is a notable drive to improve efficiency. Getting more from existing projects is a significant trend that looks likely to continue longer term. Companies tend to adopt a two-pronged approach. The first is a critical look at their business processes. Leading practice organizations are looking at optimizing shared services and globally sourcing for activities such as finance and accounting. On the buy side, companies are also pressuring providers to offer better terms and a faster speed of delivery.

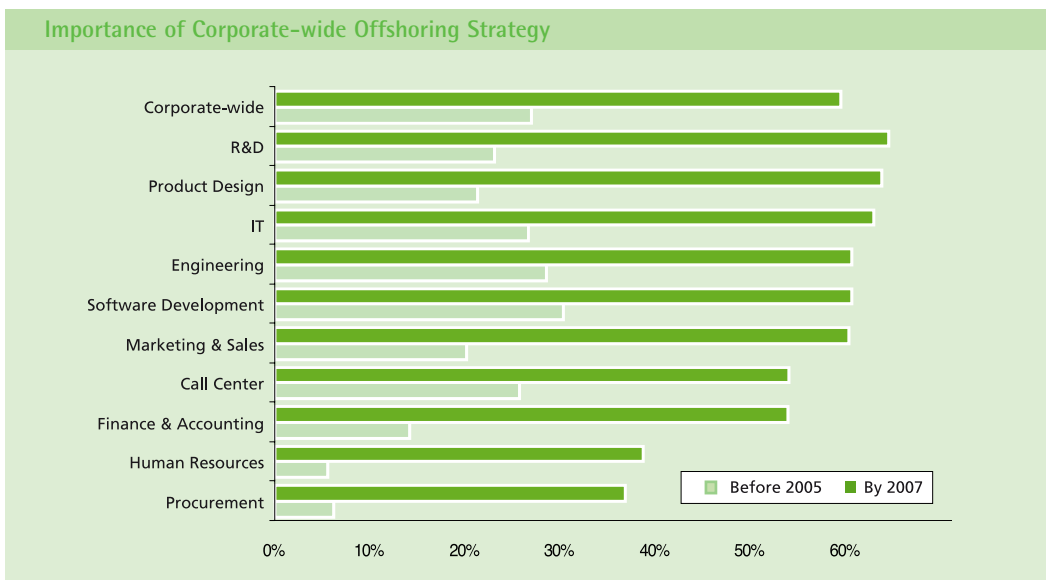
A second way is by raising their internal management capabilities to better coordinate a complex and dispersed web of offshore projects.



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Spinning-off captive: could it be a trend?

There have recently been a series of high-profile deals in the news, involving companies selling off their captive operations to service providers, such as Citigroup's sell-off deal to Tata Consultancy Services. Although most companies are under pressure to increase their capital base and lower costs, the trend of spinning off captives to release capital is unlikely to become as popular an option as its low cost, high efficiency counterparts. The spin-off option takes a significant amount of time and effort to negotiate. Moreover, service providers are unlikely to have the requisite level of capital to acquire a critical mass of captives.

A more likely phenomenon is the rate of consolidation amongst service providers who face mounting pressure to cut costs and increase efficiency through economies of scale. However, as cash flow declines across the board, acquisitions within the industry are more likely than not to slow down.

A corporate-wide offshoring strategy

In the new environment, the coupling of lower costs with higher efficiency means that service providers can no longer count on price alone as a differentiator. Companies require swift payback and a consistent high quality service. These cost and efficiency pressures have highlighted the need for a corporate wide offshoring strategy for those providing services and a global strategy for those who source them. The net result is better quality for all concerned. In addition, companies that have adopted corporate wide offshoring strategies show significantly more cost savings across all functions. Thanks in part to the struggling economy, offshoring at last, has become serious business.

Strategic Alliances: an option to survive in uncertain times

Environmental uncertainty usually comes about for reasons outside a company's control. It is particularly hard to predict and usually only resolves itself over time. The prevailing uncertainty and corresponding lack of credit is likely to lead to an increase in the rate of strategic alliances (SAs) between companies.



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Strategic alliances are particularly suited to current times: their possible advantages are highlighted as follows. In this case the umbrella term SA is taken to include both purely contractual alliances and joint-venture agreements.

Reducing costs by gaining economies of scale

In sectors where fixed costs are high, alliances could be a way for companies to cope with falling volumes, while staying competitive at the same time.

Gaining access to new markets in the same industry, in new ones or in foreign countries

The challenges of entering new markets have increased, in terms of the time and cost involved in building up a knowledge base and securing clients. An SA may provide a way of securing more distribution networks in the same industry. It may also give a company a more cost and time effective entry route to potentially more profitable new markets overseas.



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Gaining access to or developing new technologies

When a company has to make an important technological leap, but cannot dedicate enough time to this, an alliance could provide the necessary support. Alliance could also help companies minimize the investment outlay at a time of scarce resources.

Blocking the Competition

Increasingly, in these competitive times, an alliance with a particular partner may be sealed to prevent a competitor from fortifying his market position through an alliance with the same partner.

Compliance with government requirements

Alliances that are formed with this objective continue to be relevant in some instances, even if to a lesser extent than others on this list.

Developing new skills

In a highly competitive environment, the demands on the company may be greater than its capacity to meet them in terms of management and processes. The presence of a robust partner can help the company narrow this skills and experience gap.

Developing new brands/extending own brands

Alliances are effective for brand building as they provide marketing synergies in terms of know-how and resources. At the same time, they are a way of automatically filling any complementary gaps in brand portfolios.

Reducing risks and gaining additional financial resources

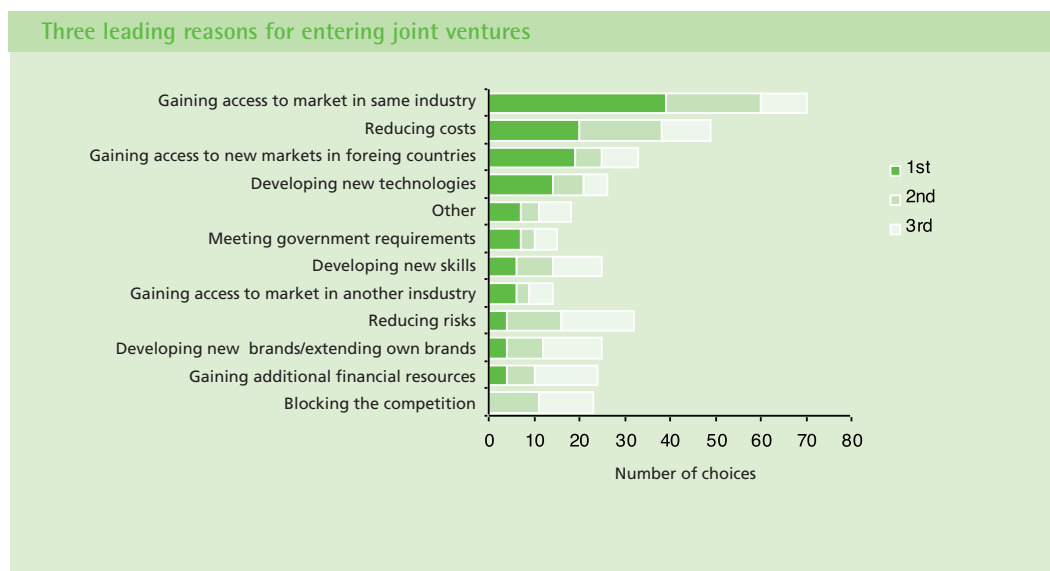
Some projects can involve a high level of investment which could threaten a company's financial health, which may be more vulnerable in the current climate. Having an alliance would cushion some of that risk.

In this climate of uncertainty, alliances are a more feasible alternative to, say, mergers or acquisitions. SAs may provide companies with a means to maintain flexibility while opening up more options for the future. Indeed, an alliance can be thought of as a real option to expand in the face of future market developments. It grants the company the option of future expansion and growth should the environmental uncertainty resolve itself favorably, while limiting the downside risks associated with investing in a volatile environment.

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Source: KPMG/IESE joint venture survey 2008

THE CENTER REPORTS

Globalization Newsletter Goes Completely Digital



It's been four years since the first issue of our monthly *Notes on Globalization and Strategy* newsletter went to press. Since then, this bulletin has kept the IESE community abreast of the latest issues and trends of globalization, such as the growing internationalization of business strategies.

Our aim is to keep up this work, but to do so in a more simple and sustainable way. Therefore, we have decided to cancel the paper format of the newsletter. The online version offers many advantages: it allows you to view our document with the simple click of a mouse; to change the language of the text from English to Spanish, and to navigate the different sections of each issue with utmost ease.

As a member of IESE's Alumni Association, you will continue to receive each quarterly issue of the Globalization Newsletter at your email address. Moreover, you will be able to consult our newsletters whenever you want by visiting www.iese.edu/globalcenter. Many thanks, as always, for your faith and support!

In Appreciation of Prof. Eduardo Ballarín



On behalf of everyone at the Center, we would like to express our great appreciation for the work and dedication of Prof. Eduardo Ballarín, who passed away in April.

Eduardo was professor of Strategic Management and Holder of the Nissan Chair of Corporate Strategy and International Business. He earned his DBA from Harvard Business School and wrote numerous books on strategy and control systems. He was a member of the Harvard-IESE Committee and founding member of the Strategic Management Society.

Prof. Ballarín founded the International Center for Competitiveness, a research center closely linked with the Institute for Strategy and Competitiveness (ISC), led by Michael Porter of Harvard University. During his academic career, he became a well-known expert in the area of international competitiveness, and was a consultant for various prominent firms. His contributions to the Center for Globalization and Strategy were crucial for the center's establishment and growth, and he will be missed tremendously by all of us.

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