



# GLOBAL BUSINESS

FOURTH EDITION

peng



# GLOBAL BUSINESS

Fourth Edition

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*To Agnes, Grace, and James*



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# Preface

The first three editions of *Global Business* aspired to set a new standard for international business (IB) textbooks. They have been widely used in Australia, Austria, Brazil, Britain, Canada, China, Denmark, Egypt, France, Hong Kong, India, Indonesia, Ireland, Israel, Lithuania, Macau, Malaysia, Mexico, the Netherlands, Netherlands Antilles, New Zealand, Puerto Rico, Russia, Slovenia, South Africa, South Korea, Spain, Sweden, Switzerland, Taiwan, Thailand, and the United States. Based on the enthusiastic support from more than 30 countries, the first three editions achieved unprecedented success. Available in Chinese and Spanish, *Global Business* has also launched a European adaptation (with Klaus Meyer) and an Indian adaptation (with Deepak Srivastava). In short, *Global Business* is global.

The fourth edition endeavors to achieve even more. It continues the market-winning framework centered on one big question and two core perspectives, and has been thoroughly updated to capture the rapidly moving recent research and events. Written for undergraduate and MBA students around the world, the fourth edition will continue to make IB teaching and learning (1) more engaging, (2) more comprehensive, (3) more fun, and (4) more relevant.

## More Engaging

As an innovation in IB textbooks, a unified framework integrates all chapters. Given the wide range of topics in IB, most textbooks present the discipline in a fashion that “Today is Tuesday, it must be Luxembourg.” Very rarely do authors address: “Why Luxembourg today?” More important, why IB? What is the big question in IB? Our unified framework suggests that the discipline can be united by one big question and two core perspectives. The big question is: What determines the success and failure of firms around the globe? To address this question, *Global Business* introduces two core perspectives—(1) the institution-based view and (2) the resource-based view—in all

chapters.<sup>1</sup> It is this relentless focus on our big question and core perspectives that enables this book to engage a variety of topics in an integrated fashion. This provides unparalleled continuity in the learning process.

*Global Business* further engages readers through an *evidence-based* approach. I have endeavored to draw on the latest research, as opposed to the latest fads. As an active researcher myself, I have developed the unified framework not because it just popped up in my head when I wrote the book. Rather, this is an extension of my own research that consistently takes on the big question and leverages the two core perspectives.<sup>2</sup>

Another vehicle to engage students is debates. Most textbooks present knowledge “as is” and ignore debates. But, obviously, our field has no shortage of debates. It is the responsibility of textbook authors to engage students by introducing cutting-edge debates. Thus, I have written a beefy “Debates and Extensions” section for *every* chapter.

## More Comprehensive

*Global Business* offers the most comprehensive and innovative coverage of IB topics available on the market. Unique chapters not found in other IB textbooks are: Chapter 9 (entrepreneurship and small firms’ internationalization), Chapter 11 (global competitive dynamics), and Chapter 16 (corporate finance and governance).

The most comprehensive topical coverage is made possible by drawing on the latest and most comprehensive range of the research literature. I have accelerated my own

<sup>1</sup> On the integration of these two perspectives, see K. Meyer, S. Estrin, S. Bhaumik, & M. W. Peng, 2009, Institutions, resources, and entry strategies in emerging economies, *Strategic Management Journal*, 30(1): 61–80; D. Zoogah, M. W. Peng, & H. Woldu, 2015, Institutions, resources, and organizational effectiveness in Africa, *Academy of Management Perspectives*, 29(1): 7–31.

<sup>2</sup> For the big question, see M. W. Peng, 2004, Identifying the big question in international business research, *Journal of International Business Studies*, 35(2): 99–108. For the institution-based view, see M. W. Peng, D. Wang, and Y. Jiang, 2008, An institution-based view of international business strategy: A focus on emerging economies, *Journal of International Business Studies*, 39(5): 920–936. For the resource-based view, see M. W. Peng, 2001, The resource-based view and international business, *Journal of Management*, 27(6): 803–829.

research, publishing a total of 30 articles after I finished the third edition.<sup>3</sup> Some of these recent articles appear in top-tier outlets in IB, such as the *Academy of Management Journal* (2012), *Journal of International Business Studies* (2014 and 2016), *Journal of Management Studies* (2012, 2013, and 2015), *Journal of World Business* (2012, 2014, and 2015), and *Strategic Management Journal* (2013, 2015, and 2016). Writing *Global Business* has also enabled me to broaden the scope of my research, publishing recently in top-tier journals in operations (*Journal of Operations Management*), ethics (*Journal of Business Ethics*), entrepreneurship (*Journal of Business Venturing* and *Entrepreneurship Theory and Practice*), and human resources (*International Journal of Human Resource Management*). In addition to my own work, I have also drawn on the latest research of numerous colleagues. The end result is the unparalleled, most comprehensive set of evidence-based insights on the IB market. While citing every article is not possible, I am confident that I have left no major streams of research untouched. Feel free to check the Name Index to verify this claim. (Unfortunately, a number of older references have to be deleted to make room for more recent research.)

Finally, the fourth edition of *Global Business* continues to have a global set of cases contributed by scholars around the world—an innovation on the IB market. Virtually all other IB textbooks have cases written by book authors. In comparison, this book has been blessed by a global community of case contributors who are based in Australia, Austria, Canada, China, Mexico, and the United States. Many are experts who are located in or are from the countries in which the cases take place. For example, we now have a Mexico case penned by two Mexico-based authors (see Integrative Case on Farmacias Similares), and a China case written by a China-based author (see Integrative Case on Ostnor). This edition also features a Russia case contributed by the world's top two leading experts on Russian management (see Integrative Case on Wikimart).

## More Fun

If you fear this book must be boring because it draws so heavily on latest research, you are wrong. I have used a clear, engaging, conversational style to tell the “story.” Relative to rival books, my chapters are shorter and more lively. Some earlier users commented that reading *Global Business* is like reading a “good magazine.” A large number of interesting anecdotes have been woven

<sup>3</sup> All my articles are listed at [www.mikepeng.com](http://www.mikepeng.com) and [www.utdallas.edu/~mikepeng](http://www.utdallas.edu/~mikepeng). Go to “Journal Articles.”

into the text. Non-traditional (“outside-the-box”) examples range from ancient Chinese military writings to mutually assured destruction (MAD) strategy during the Cold War, from LEGO toys to Tolstoy’s *Anna Karenina*. Check out the following fun-filled features that spice up the book:

- The rebirth of the East India Company (Chapter 1 Opening Case)
- Testing the Dell theory of peace in East Asia (Emerging Markets 2.2)
- LEGO’s secrets (Chapter 4 Opening Case)
- ANA: Refreshing the parts other airlines cannot reach (In Focus 4.1)
- Why are US exports so competitive? (Chapter 5 Closing Case)
- One multinational versus many national companies (In Focus 6.1)
- Sriracha spices up American food (Chapter 9 Opening Case)
- Mickey goes to Shanghai (Chapter 10 Closing Case)
- Patent wars and shark attacks (Chapter 11 Opening Case)
- Is a diamond (cartel) forever? (In Focus 11.1)
- Can mergers of equals work? (In Focus 12.2)
- Marketing Aflac in the United States and Japan (Chapter 14 Opening Case)
- Dallas versus Delhi (Chapter 15 Closing Case)
- High drama at Hewlett-Packard (HP) (Chapter 16 Opening Case)
- Professor Michael Jensen as an outside director (In Focus 16.2)
- Global warming and Arctic boom (In Focus 17.1)

Finally, the PengAtlas allows you to conduct IB research using informative maps and other geographic tools to enhance your learning. In addition, a series of new videos enhance the multi-media, fun aspects of learning (see below).

## More Relevant

So what? Most textbooks leave students to figure out the crucial “so what?” question for themselves. In contrast, I conclude every chapter with an action-packed section titled “Management Savvy.” Each section has at least one table (or slide) to summarize key learning points from a *practical* standpoint. No other IB book is so savvy and so relevant.

As a theme, ethics cuts through the book, with at least one “Ethical Dilemma” feature and a series of Critical

Discussion Questions on ethics in each chapter. Finally, many chapters offer *career* advice for students. For example, Chapter 4 develops a resource-based view of the individual—that is, about you, the student. The upshot? You want to make yourself into an “untouchable,” someone who adds valuable, rare, and hard-to-imitate capabilities indispensable to an organization. In other words, you want to make sure your job cannot be outsourced.

## What’s New in the Fourth Edition?

In addition to the completely updated content, the fourth edition has (1) created a new video package, (2) dedicated more space to emerging economies, (3) enhanced the quantity and variety of cases, and (4) drawn directly on the author’s consulting experience.

First, a new video package has been created that is tightly coupled with the content of the Opening and Closing Cases for *every* chapter. Instructors can ask students to watch such videos before class and answer questions online, or to watch videos as a way to open or close class sessions. In short, students can “watch TV” and gain knowledge.

Second, this edition builds on *Global Business*’ previous strengths by more prominently highlighting emerging economies. At least one Emerging Markets feature is launched in every chapter. Many of the Integrative Cases deal with emerging economies, such as Brazil, China, Cuba, Mexico, Russia, Slovakia, Thailand, and Turkey. Numerous in-chapter features (Opening/Closing Cases, In Focus, and Emerging Markets) deal with emerging economies other than those mentioned previously, such as the Czech Republic, Greenland, Guinea, India, Kenya, Liberia, Nigeria, Poland, Senegal, Sierra Leone, South Africa, Taiwan, Tanzania, and the United Arab Emirates.

Third, in response to students’ and instructors’ enthusiasm about the wide-ranging and globally relevant cases in previous editions, the fourth edition has further enhanced the quantity and variety of cases. The variety has also been enhanced not only in terms of the geographic diversity noted above, but also in terms of the mix of longer cases and shorter cases. In addition, I have pushed myself to more actively participate in case writing. Finally, users of the online MindTap version of the product will have access to Media Cases that pair the Opening and Closing chapter cases with news articles from sources such as the *New York Times*, *The Economist*,

and other leading publications, as well as videos from sources such as the BBC and CBS and access to additional information from *Business Insights*. More information on the MindTap product is discussed later in this Preface.

Finally, I have directly drawn on my recent consulting experience to inject new insights. Chapter 1 Closing Case (“Two Scenarios of the Global Economy in 2050”) is adapted from a major consulting engagement I completed for the UK Government Office for Science as part of its two-year Future of Manufacturing project. Integrative Case 2.2 (“Twelve Recommendations to Enhance UK Export Competitiveness”) is a direct excerpt from the final report submitted (coauthored with Klaus Meyer). Table 3.4 (“Texas Instruments Guidelines on Gifts in China,” which is in the public domain) is shared with me by a consulting client at TI. Overall, I am confident that students can directly benefit from such new insights gained from my consulting engagements with multinationals and governments.

## MindTap

Online resources are transforming many aspects of everyday life and learning is not immune to the impact of technology. Rather than simply take the book pages of *Global Business* and place them on a screen to be accessed via a PC, tablet, or smartphone, we have reset the content and have adapted it to fully utilize the potential that the medium allows. Students can highlight passages, take notes in the MindTap content, and compile their notes for review in the EverNotes app. We have embedded assessments for each chapter as well as provide Flash Cards for all of the key terms that provide feedback to students and provide guidance so that they can address gaps in the course requirements. Faculty can use the results from the quizzes as well as using the Media Cases for assignments (see above) and utilize the assigned student work outside the classroom to benefit from a “flipped learning” approach that can result in more favorable outcomes and more rewarding experiences for students and faculty. Additional apps such as ConnectYard allow faculty to integrate social media capabilities into their course and are especially useful in online and hybrid course delivery.

As part of the MindTap product, we are not limited to the page length limitation of a physical book. Students certainly don’t enjoy carrying 1,000-page volumes, and are also frustrated when material included in the book is not assigned by the instructor. Since we are not limited by length online, faculty will also have



access to numerous additional cases that they can select and add to their course. We have also included additional homework assessments and unique pre- and postcourse Global Literacy assessments that can be used to demonstrate student awareness of global business knowledge. We want to thank Anne Magi of the University of Illinois at Chicago for her work on the homework and Global Literacy assessments.

Finally, users of MindTap will also have access to *Business Insights: Global* from Gale, which provides a rich online research tool.

## Support Materials

A full set of support materials is available for students and adopting instructors:

- Product Support Website
- Instructor's Manual
- Test Bank
- PowerPoint Slides
- MindTap (see above)
- Peng DVD

## Acknowledgments

As *Global Business* celebrates the launch of its fourth edition, I first want to thank all the customers—instructors and students around the world who have made the book's success possible. A special thank you goes to Klaus Meyer (China Europe International Business School, China) and Deepak Srivastava (Nirma University, India), who respectively spearheaded the adaptation of the European, Middle Eastern, and African (EMEA) edition and the Indian edition. In China, a big thanks goes to Liu Yi (Shanghai Jiao Tong University), Xie En and Wang Longwei (Xi'an Jiaotong University), and Yi Jingtao (Renmin University of China). In Mexico, my heart-felt appreciation goes to two groups of colleagues: (1) professional translators Ma. del Pilar Carril Villarreal and Magda Elizabeth Treviño Rosales and (2) faculty colleagues who engaged in some technical revisions Claudia P. Gutiérrez Rojas (Tecnológico de Monterrey, Campus Estado de México), Mercedes Muñoz (Tecnológico de Monterrey, Campus Santa Fe y Estado de México), and Enrique Benjamín Franklin Fincowski (Facultad de Contaduría y Administración, Universidad Nacional Autónoma de México). They loved the book so much that they were willing to endure the pain of translating it into Chinese and Spanish. My

kudos to these colleagues who have made *Global Business* more global.

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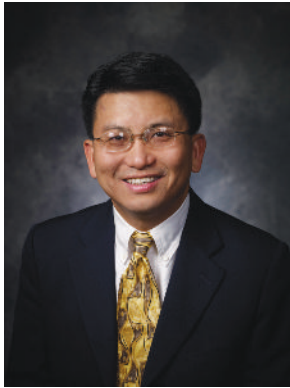
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# About the Author



courtesy of Mike Peng

**Mike W. Peng** is the Jindal Chair of Global Business Strategy at the Jindal School of Management, University of Texas at Dallas. He is also a National Science Foundation (NSF) CAREER Award winner and a Fellow of the Academy of International Business (AIB). At UT Dallas, he has been the

number-one contributor to the list of 45 top journals tracked by *Financial Times*, which consistently ranks UT Dallas as a top 20 school in research worldwide.

Professor Peng holds a bachelor's degree from Winona State University, Minnesota, and a PhD degree from the University of Washington, Seattle. He had previously served on the faculty at the Ohio State University, University of Hawaii, and Chinese University of Hong Kong. He has taught in five states in the United States (Hawaii, Ohio, Tennessee, Texas, and Washington), as well as in China, Hong Kong, and Vietnam. He has also held visiting or courtesy appointments in Australia, Britain, China, Denmark, Hong Kong, and the United States, and lectured around the world.

Professor Peng is one of the most-prolific and most-influential scholars in international business (IB). Both the United Nations and the World Bank have cited his work. During the decade 1996–2006, he was the top seven contributor to IB's number-one premier outlet: *Journal of International Business Studies*. In 2015, he received the *Journal of International Business Studies* Decade Award. A *Journal of Management* article found him to be among the top 65 most widely cited management scholars, and an *Academy of Management Perspectives* study reported that he is the fourth most-influential management scholar among professors who obtained their PhD since 1991. Overall, Professor Peng has published more than 120 articles in leading journals, more

than 30 pieces in nonrefereed outlets, and five books. Since the launch of *Global Business*' third edition, he has not only published in top IB journals, such as the *Academy of Management Journal*, *Journal of International Business Studies*, *Journal of World Business*, and *Strategic Management Journal*, but also in leading outlets in entrepreneurship (*Entrepreneurship Theory and Practice*), ethics (*Journal of Business Ethics*), and human resources (*International Journal of Human Resource Management*).

Used in more than 30 countries, Professor Peng's best-selling textbooks, *Global Business*, *Global Strategy*, and *GLOBAL*, are global market leaders that have been translated into Chinese, Portuguese, and Spanish. A European adaptation (with Klaus Meyer) and an Indian adaptation (with Deepak Srivastava) have been successfully launched.

Truly global in scope, Professor Peng's research has investigated firm strategies in Africa, Asia Pacific, Central and Eastern Europe, and North America. He is best known for his development of the institution-based view of strategy and his insights about the rise of emerging economies such as China in global business. With more than 18,000 Google citations and an H-index of 57, he is listed among *The World's Most Influential Scientific Minds* (compiled by Thomson Reuters based on citations covering 21 fields)—in the field of economics and business, he is one of the only 95 world-class scholars listed and the *only* IB textbook author listed.

Professor Peng is active in leadership positions. He has served on the editorial boards of the *AMJ*, *AMP*, *AMR*, *JIBS*, *JMS*, *JWB*, and *SMJ*; and guest-edited a special issue for the *JMS*. At AIB, he co-chaired the AIB/*JIBS* Frontiers Conference in San Diego (2006), guest-edited a *JIBS* special issue (2010), chaired the Emerging and Transition Economies track for the Nagoya conference (2011), and chaired the Richard Farmer Best Dissertation Award Committee for the Washington conference (2012). At the Strategic Management Society (SMS), he was elected to be the Global Strategy Interest Group Chair (2008). He also co-chaired the SMS Special



Conferences in Shanghai (2007) and in Sydney (2014). He served one term as Editor-in-Chief of the *Asia Pacific Journal of Management*. He managed the successful bid to enter the Social Sciences Citation Index (SSCI), which reported *APJM*'s first citation impact to be 3.4 and rated it as the top 18 among 140 management journals (by citation impact factor) for 2010. In recognition of his significant contributions, *APJM* has named its best paper award the Mike Peng Best Paper Award. Currently, he is a Senior Editor at the *Journal of World Business*.

Professor Peng is also an active consultant, trainer, and keynote speaker. He has provided on-the-job training to more than 400 professors. He has consulted and been a keynote speaker for multinational enterprises (such as AstraZeneca, Berlitz, Nationwide, SAFRAN, and Texas Instruments), nonprofit organizations (such as World Affairs Council of Dallas-Fort Worth), educational and funding organizations (such as Canada Research Chair, Harvard Kennedy School

of Government, National Science Foundation of the United States, and Natural Science Foundation of China), and national and international organizations (such as the UK Government Office for Science, US-China Business Council, US Navy, and World Bank).

Professor Peng has received numerous honors, including an NSF CAREER Grant (\$423,000), a US Small Business Administration Best Paper Award, a *JIBS* Decade Award, a (lifetime) Distinguished Scholar Award from the Southwestern Academy of Management, a (lifetime) Scholarly Contribution Award from the International Association for Chinese Management Research (IACMR), and a Best Paper Award named after him. He has been quoted by *The Economist*, *Newsweek*, *Dallas Morning News*, *Smart Business Dallas*, *Atlanta Journal-Constitution*, *The Exporter Magazine*, *The World Journal*, *Business Times* (Singapore), *CEO-CIO* (Beijing), *Sing Tao Daily* (Vancouver), and *Brasil Econômico* (São Paulo), as well as on the Voice of America.



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# PART 1

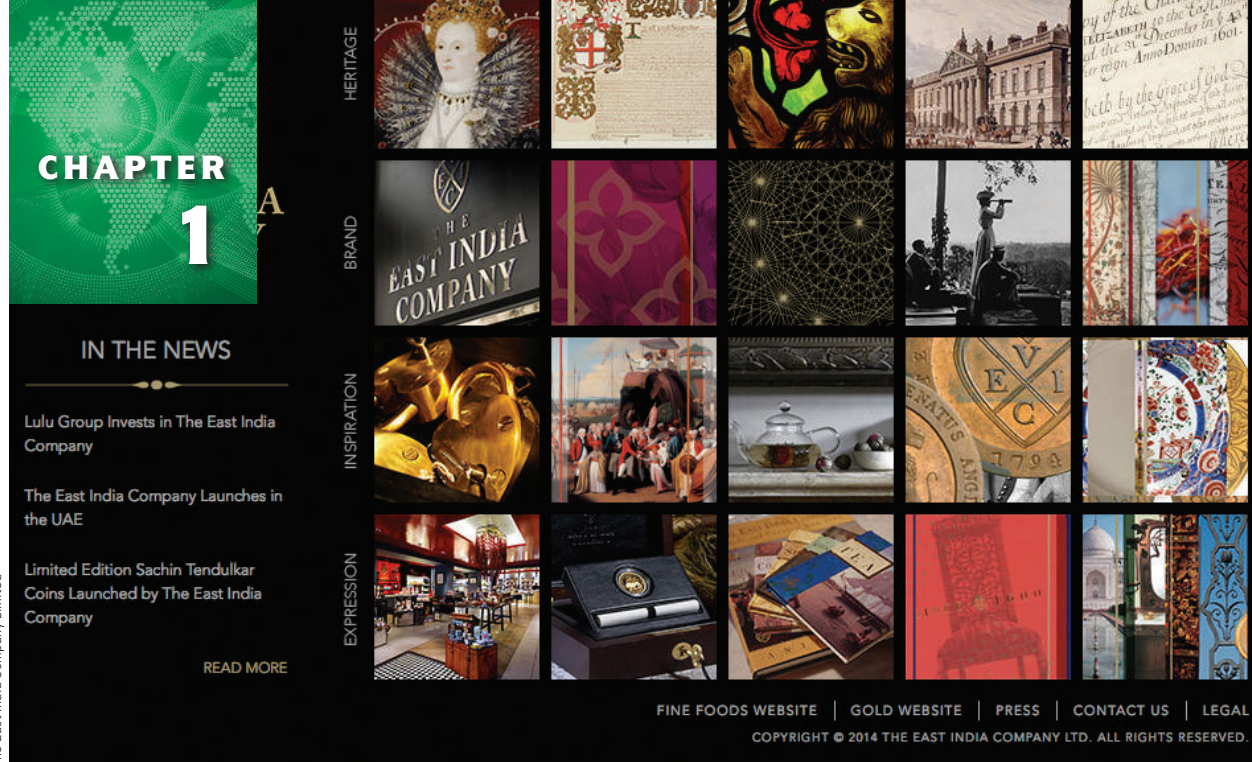
# Laying Foundations

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## Chapters

- 1 Globalizing Business
- 2 Understanding Formal Institutions: Politics, Laws, and Economics
- 3 Emphasizing Informal Institutions: Cultures, Ethics, and Norms
- 4 Leveraging Resources and Capabilities





## Learning Objectives

After studying this chapter, you should be able to

- explain the concepts of international business and global business, with a focus on emerging economies.
- give three reasons why it is important to study global business.
- articulate one fundamental question and two core perspectives in the study of global business.
- identify three ways of understanding what globalization is.
- state the size of the global economy and its broad trends, and understand your likely bias in the globalization debate.

# Globalizing Business

## OPENING CASE

### EMERGING MARKETS: The Rebirth of the East India Company

Before picking up this book, the majority of readers are likely to have already heard of the East India Company. Yes, we are talking about *the* East India Company, the colonial trading company that created British India, founded Hong Kong and Singapore, and introduced tea, coffee, and chocolate to Britain and large parts of the world. Wait a minute—as you scratch your head over your rusty memory from history books—wasn't the company dead? Yes, it was dead—or, technically, dissolved or nationalized in 1874 by the British government. But, no, it was not dead.

After a hiatus of more than 130 years, the East India Company was reborn and relaunched in 2005 by a visionary and entrepreneurial Indian businessman, Sanjiv Mehta. With permissions granted by the UK Treasury for an undisclosed sum of money, Mumbai-born Mehta became the sole owner, chairman, and CEO of the *new* East India Company, with the rights to use the name and original trademarks. His goals were to unlock and strengthen the potential value of the world's first multinational and the world's first global brand. In 2010, with much fanfare, the East India Company launched its first luxury fine foods store in the prestigious Mayfair district of London. In 2014, the East India Company set up a new boutique inside London's most prestigious department store, Harrods—a format called “store in store.” The initial products included

premium coffees and teas, artisan sweet and savory biscuits, an exquisite range of chocolates, and gourmet salts and sugars. While the old company obviously never had a website, the new one proudly announced on its website:

We see our role as bringing together the best the world has to offer; to create unique goods that help people to explore and experience what's out there. Products that help people see their world in a different and better light. Products that have the power to amaze and astonish . . . The East India Company made a wide range of elusive, exclusive, and exotic ingredients familiar, affordable, and available to the world; ingredients which today form part of our daily and national cuisines. Today we continue to develop and market unique and innovative products that breathe life into the history of the Company. We trade foods crafted by artisans and specialists from around the world, with carefully sourced ingredients, unique recipes, and distinguished provenances.

Just like the old East India Company, the new company is a “born global” enterprise, which immediately declared its intention to expand globally upon its launch. By 2014, it had expanded throughout Europe (Austria, Finland, France, Germany, the Netherlands, Norway, and Spain), Asia Pacific (Australia, China,

Hong Kong, Japan, Malaysia, and South Korea), and the Middle East (Kuwait and Qatar). Its online store can deliver anywhere worldwide. Overall, in the first five years since 2005, the East India Company spent US\$15 million to develop its new business. In 2011, the Mahindra Group, one of India's most respected business houses, acquired a minority stake in the East India Company. After receiving capital injection from Mahindra, the East India Company announced that it would invest US\$100 million in the next five years to grow the iconic brand.

What had made the (old) East India Company such a household name? Obviously, the products it traded had to deliver value to be appreciated by customers around the world. At its peak, the company employed a third of the British labor force, controlled half of the world's trade, issued its own coins, managed an army of 200,000, and ruled 90 million Indians. Its organizational capabilities were awesome. Equally important were its political abilities to leverage and control the rules of the game around the world, ranging from managing politicians back home in the UK to manipulating political intrigues in

India. Granted a royal charter by Queen Elizabeth I in 1600, the old East India Company certainly benefitted from formal backing of the state. Informally, the brand still resonates with the 2.5 billion people in the British Commonwealth, especially Indians. Mehta was tremendously moved by the more than 14,000 e-mails from Indians all over the world wishing him well when he announced the acquisition. In his own words: "I have not created the brand, history has created it. I am just the curator of it."

Blending continuity and change, the saga of the East India Company continues. Mehta said he believed the East India Company was the Google of its time. But one reporter suggested, "Google is in fact the East India Company of its modern era. Let's see if Google is still around and having the same impact in 400 years' time."

Sources: Based on (1) *Arabian Business*, 2014, The empire strikes back, October 4, [www.arabianbusiness.com](http://www.arabianbusiness.com); (2) East India Company, 2014, EIC today, [www.theeastindiacompany.com](http://www.theeastindiacompany.com); (3) East India Company, 2014, History, [www.theeastindiacompany.com](http://www.theeastindiacompany.com); (4) East India Company, 2014, Press, [www.theeastindiacompany.com](http://www.theeastindiacompany.com); (5) East India Company, 2014, History of fine foods, [www.eicfinefoods.com](http://www.eicfinefoods.com); (6) *Economist*, 2011, The Company that ruled the waves, December 17; (7) *Economist*, 2014, Hidden gems, April 12.

How do firms such as the old and the new East India Company compete around the world? How do they deal with the various rules of the game? What capabilities do they have? How do they enter new markets? What determines their success and failure? This book will address these and other important questions.

### Learning Objective

Explain the concepts of international business and global business, with a focus on emerging economies.

### International business (IB)

(1) A business (firm) that engages in international (cross-border) economic activities, and/or (2) the action of doing business abroad.

### Multinational enterprise (MNE)

A firm that engages in foreign direct investment.

### Foreign direct investment (FDI)

Investment in, controlling, and managing value-added activities in other countries.

## 1-1 What Is Global Business?

### 1-1a Defining International Business and Global Business

Traditionally, **international business (IB)** is defined as a business (firm) that engages in international (cross-border) economic activities. It can also refer to the action of doing business abroad. The previous generation of IB textbooks almost always takes the foreign entrant's perspective. Consequently, such books deal with issues such as how to enter foreign markets and how to select alliance partners. The most frequently discussed foreign entrant is the **multinational enterprise (MNE)**, defined as a firm that engages in **foreign direct investment (FDI)** by directly investing in, controlling, and managing value-added activities in other countries.<sup>1</sup> Of course, MNEs and their cross-border activities are important. But they only cover one aspect of IB—the foreign side. Students educated by these books often come away with the impression that the other aspect of IB—namely, domestic firms—does not exist. Obviously, this is not true. Domestic firms do not just sit around in the face of foreign entrants. They often actively compete and/or collaborate with foreign entrants in their markets.

Sometimes, strong domestic firms have also gone overseas themselves. Overall, focusing on the foreign entrant side captures only one side of the coin at best.<sup>2</sup>

There are *two* key words in IB: international (I) and business (B).<sup>3</sup> However, many previous textbooks focus on the international aspect (the foreign entrant) to such an extent that the business part (which also includes domestic business) almost disappears. This is unfortunate, because IB is fundamentally about B (business) in addition to being I. To put it differently, the IB course in the undergraduate and MBA curricula at numerous business schools is probably the *only* one with the word “business” in its title. All other courses are labeled management, marketing, finance, and so on, representing one functional area but not the overall picture of business. Does it matter? Of course! It means that your IB course is an *integrative* course that can provide you with an overall business perspective (rather than a functional view) grounded in a global environment. Therefore, it makes sense that your textbook should give you both the I and B parts, not just the I part.

To cover both the I and the B parts, **global business** is defined in this book as business around the globe—thus, the title of this book is *Global Business* (not IB). In other words, global business includes both (1) international (cross-border) business activities covered by traditional IB books *and* (2) domestic business activities. Such deliberate blurring of the traditional boundaries separating international and domestic business is increasingly important today, because many previously domestic markets are now globalized.

Consider the competition in college textbooks, such as this *Global Business* book you are studying now. Not long ago, competition among college business textbook publishers was primarily on a nation-by-nation basis. The Big Three—Cengage Learning (our publisher, which is the biggest in the college business textbook market), Prentice Hall, and McGraw-Hill—primarily competed in the United States. A different set of publishers competed in other countries. As a result, most textbooks studied by British students would be authored by British professors and published by British publishers, most textbooks studied by Brazilian students would be authored by Brazilian professors and published by Brazilian publishers, and so on. Now Cengage Learning (under British and Canadian ownership), Pearson Prentice Hall (under British ownership), and McGraw-Hill (under US ownership) have significantly globalized their competition, thanks to the rising demand for high-quality business textbooks in English. Around the globe, they are competing against each other in many markets, publishing in multiple languages and versions. For instance, *Global Business* and its sister books, *Global Strategy*, *Global* (paperback), and *International Business* (an adaptation for the European market), are published by different subsidiaries in Chinese, Spanish, and Portuguese in addition to English, reaching customers in more than 30 countries. Despite such worldwide spread of competition, in each market—down to each school—textbook publishers have to compete locally. Since no professor teaches globally and all students study locally, this means *Global Business* has to win adoption every class, every semester. Overall, it becomes difficult to tell in this competition what is international and what is domestic. Thus, “global” seems to be a better word to capture the essence of this competition.

## 1-1b Global Business and Emerging Economies

*Global Business* also differs from other books on IB because most of them focus on competition in developed economies. Here, by contrast, we devote extensive space to competitive battles waged throughout **emerging economies**, a term that

### Global business

Business around the globe.

### Emerging economy

A term that has gradually replaced the term “developing country” since the 1990s.



**Emerging market**

A term that is often used interchangeably with “emerging economy.”

**Purchasing power parity (PPP)**

A conversion that determines the equivalent amount of goods and services that different currencies can purchase.

has gradually replaced the term “developing countries” since the 1990s. Another commonly used term is **emerging markets** (see PengAtlas Map 1). How important are emerging economies? Collectively, they command 48% of world trade, attract 60% of FDI inflows, and generate 40% FDI outflows. Overall, emerging economies contribute approximately 50% of the global gross domestic product (GDP).<sup>4</sup> In 1990, they accounted for less than one-third of a much smaller world GDP. Note that this percentage is adjusted for **purchasing power parity (PPP)**, which is an adjustment to reflect the differences in cost of living (see In Focus 1.1). Using official (nominal) exchange rates without adjusting for PPP, emerging economies contribute about 30% of the global GDP. Why is there such a huge difference

**IN FOCUS 1.1****SETTING THE TERMS STRAIGHT**

GDP, GNP, GNI, PPP—there is a bewildering variety of acronyms that are used to measure economic development. It is useful to set these terms straight before proceeding. **Gross domestic product (GDP)** is measured as the sum of value added by *resident* firms, households, and governments operating in an economy. For example, the value added by foreign-owned firms operating in Mexico would be counted as part of Mexico’s GDP. However, the earnings of *non-resident* sources that are sent back to Mexico (such as earnings of Mexicans who do not live and work in Mexico, and dividends received by Mexicans who own non-Mexican stocks) are not included in Mexico’s GDP. One measure that captures this is **gross national product (GNP)**. Recently, the World Bank and other international organizations have used a new term, **gross national income (GNI)**, to supersede GNP. Conceptually, there is no difference between GNI and GNP. What exactly is GNI/GNP? It comprises GDP plus income from non-resident sources abroad.

While GDP, GNP, and now GNI are often used as yardsticks of economic development, differences in cost of living make such a direct comparison less meaningful. A dollar of spending in Thailand can buy a lot more than in Japan. Therefore, conversion based on purchasing power parity (PPP) is often necessary. The PPP between two countries is the rate at which the currency of one country needs to be converted into that of a second country to ensure that a given amount of the first country’s currency will purchase the same volume of goods and services in the second country

(see Chapter 7 for details). According to the International Monetary Fund (IMF), the Swiss per capita GDP is US\$81,276 based on official (nominal) exchange rates—a *lot higher* than the official US per capita GDP of US\$53,001. However, everything is more expensive in Switzerland. A Big Mac costs US\$6.83 in Switzerland versus US\$4.80 in the United States. Thus, Switzerland’s per capita GDP based on PPP shrinks to US\$53,977—only slightly higher than the US per capita GDP based on PPP of US\$53,001 (the IMF uses the United States as a benchmark in PPP calculation, which does not change from the nominal number).

One of the most recent and probably most important debates concerns the size of the Chinese GDP. Calculations based on the nominal exchange rates would find China’s GDP to be 47% of the US GDP. But new calculations based on PPP released by the World Bank in 2014 reported China’s GDP to be 87% as large as the US GDP. Given that the Chinese economy grows a lot more quickly than the US economy, some experts believe that China may become the world’s largest economy by the time you read this book—as opposed to in the next decade or so (see the Closing Case). Overall, when you read statistics about GDP, GNP, and GNI, always pay attention to whether these numbers are based on official exchange rates or PPP, which can make a huge difference.

Sources: Based on (1) *Bloomberg Businessweek*, 2014, Recognizing China’s clout, May 12: 14; (2) *Economist*, 2014, Calculating European GDP, August 23: 68–69; (3) *Economist*, 2014, The dragon takes wing, May 3: 65; (3) *Economist*, 2014, The Big Mac index, July 26: 61; (4) International Monetary Fund, 2014, *Report for Selected Countries and Subjects (PPP Valuation of Country GDP)*, October, Washington, DC.



between the two measures? Because the cost of living (such as housing and haircuts) in emerging economies tends to be lower than that in developed economies. For instance, US\$1 spent in Mexico can buy a lot more than US\$1 spent in the United States.

Of many emerging economies, Brazil, Russia, India, and China—commonly referred to as **BRIC**—command more attention. With the addition of South Africa, BRIC becomes **BRICS**. As a group, BRICS countries have 40% of the world's population, cover a quarter of the world's land area, and contribute more than 25% of global GDP (on a PPP basis). In addition to BRICS, other interesting terms include BRICM (BRIC + Mexico), BRICET (BRIC + Eastern Europe and Turkey), and Next Eleven (N-11—consisting of Bangladesh, Egypt, Indonesia, Iran, Korea, Mexico, Nigeria, Pakistan, the Philippines, Turkey, and Vietnam).

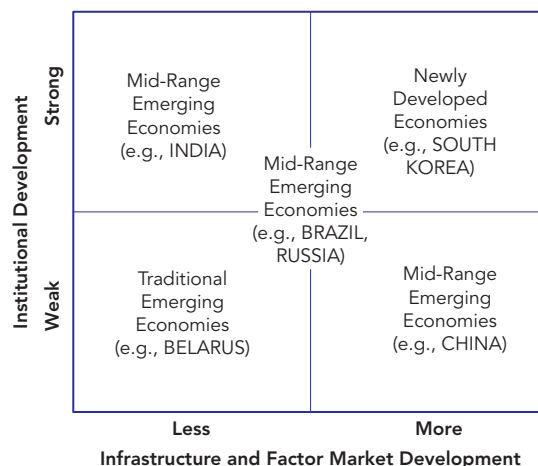
Does it make sense to group together as “emerging economies” so many countries with tremendous diversity in terms of history, geography, politics, and economics? As compared to developed economies, the label of “emerging economies,” rightly or wrongly, has emphasized the presumably homogenous nature of so many different countries. While this single label has been useful, more recent research has endeavored to enrich it. Specifically, the two dimensions illustrated in Figure 1.1 can help us differentiate various emerging economies.<sup>5</sup> Vertically, the development of market-supporting political, legal, and economic institutions has been noted as a crucial dimension of institutional transitions. Horizontally, the development of infrastructure and factor markets is also crucial.

Traditional (or stereotypical) emerging economies suffer from both the lack of institutional development and the lack of infrastructure and factor market development. Most emerging economies 20 years ago would have fit this description. Today, some emerging economies still have made relatively little progress along these two dimensions (such as Belarus and Zimbabwe).

However, much has changed. A great deal of institutional development and infrastructure and factor market development has taken place. Such wide-ranging development has resulted in the emergence of a class of *mid-range* emerging economies



**Figure 1.1 A Typology of Emerging Economies**



Source: Adapted from R. Hoskisson, M. Wright, I. Filatotchev, & M. W. Peng, 2013, Emerging multinationals from mid-range economies: The influence of institutions and factor markets (p. 1297), *Journal of Management Studies*, 50: 1295–1321.

#### Gross domestic product (GDP)

The sum of value added by resident firms, households, and governments operating in an economy.

#### Gross national product (GNP)

GDP plus income from non-resident sources abroad.

#### Gross national income (GNI)

GDP plus income from non-resident sources abroad. GNI is the term used by the World Bank and other international organizations to supersede the term GNP.

#### BRIC

Brazil, Russia, India, and China.

#### BRICS

Brazil, Russia, India, China, and South Africa.

that differ from both traditional emerging economies and developed economies. For example, the top-down approach to government found in China has facilitated infrastructure and factor market development. But China's political and market institutions tend to be underdeveloped relative to physical infrastructure. Alternatively, India has strong political institutions supporting market institutions. While Indian government policy reforms have facilitated better market institutions and associated economic development, world-class physical infrastructure is lacking. In the middle area of Figure 1.1, Brazil and Russia are examples, with democratic political institutions and some infrastructure and factor market development. Finally, some economies have clearly graduated from the “emerging” phase and become what we call “newly developed economies.” South Korea is such an exemplar country.

Overall, the **Great Transformation** of the global economy is embodied by the tremendous shift in economic weight and engines of growth toward emerging economies in general and BRIC(S) in particular.<sup>6</sup> Led by BRIC(S), emerging economies accomplished “the biggest economic transformation in modern economy,” according to the *Economist*.<sup>7</sup> In China, per capita income doubled in about ten years, an achievement that took Britain 150 years and the United States 50 years as they industrialized.<sup>8</sup> Throughout emerging economies, China is not alone. While groupings such as BRIC(S) and N-11 are always arbitrary, they serve a useful purpose—namely, highlighting the economic and demographic scale and trajectory that enable them to challenge developed economies in terms of weight and influence in the global economy.

Of course, the Great Transformation is not a linear story of endless and uniform high-speed growth. All BRIC(S) countries and most emerging economies have experienced some significant slowdown recently.<sup>9</sup> It is possible that they may not be able to repeat their extraordinary growth sprints of the decade between 1998 (the Asian economic crisis) and 2008 (the global financial crisis). For example, in 2007, Brazil accomplished an annual economic growth of 6%, Russia 8%, India 10%, and China 14%. In 2017, they would be lucky to achieve half of these enviable growth rates. However, it seems that emerging economies *as a group* are destined to grow both their absolute GDP and their percentage of world GDP relative to developed economies. The debate centers on how much and how quickly (or slowly) such growth will be in the future (see the Closing Case).

### Great Transformation

Transformation of the global economy that is embodied by the tremendous shift in economic weight and engines of growth toward emerging economies in general and BRIC(S) in particular.

### Triad

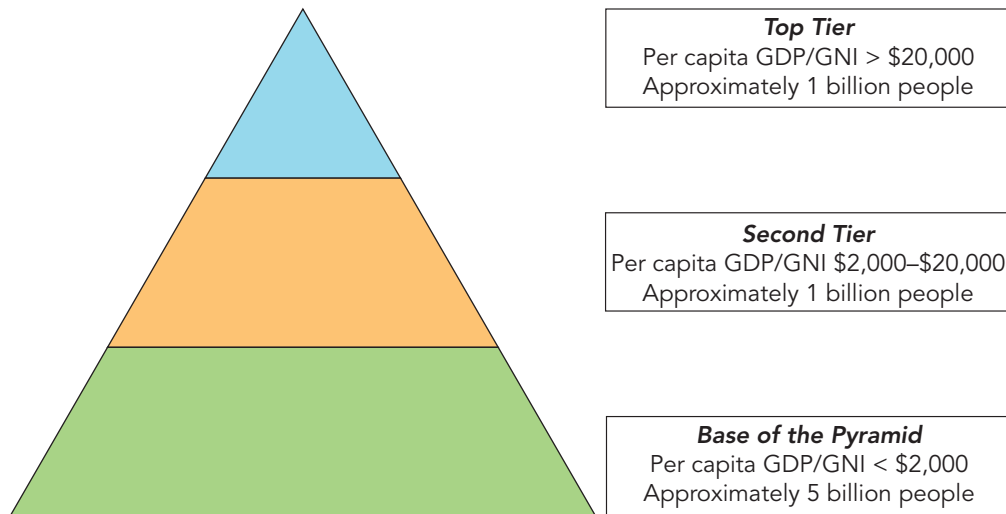
North America, Western Europe, and Japan.

### Base of the pyramid (BoP)

Economies where people make less than US\$2,000 per capita per year.

## 1-1c Base of the Pyramid and Reverse Innovation

The global economy can be viewed as a pyramid (Figure 1.2). The top consists of about one billion people with per capita annual income of US\$20,000 or higher. These are mostly people who live in the developed economies in the **Triad**, which consists of North America, Western Europe, and Japan. Another one billion people earning US\$2,000 to US\$20,000 per year make up the second tier. The vast majority of humanity—about five billion people—earn less than US\$2,000 per year and comprise the **base of the pyramid (BoP)**. Most MNEs focus on the top and second tiers and end up ignoring the BoP markets.<sup>10</sup> An increasing number of such low-income countries have shown a great deal of economic opportunities as income levels have risen. More Western MNEs, such as General Electric (GE), are investing aggressively in the BoP and leveraging their investment to tackle markets in both emerging and developed economies.

**Figure 1.2 The Global Economic Pyramid**

Sources: Adapted from (1) C. K. Prahalad & S. Hart, 2002, The fortune at the bottom of the pyramid, *Strategy+Business*, 26: 54–67; (2) S. Hart, 2005, *Capitalism at the Crossroads*, Philadelphia: Wharton School Publishing, 111.

One interesting recent development out of emerging economies is **reverse innovation**—an innovation that is adopted first in emerging economies and then diffused around the world.<sup>11</sup> Traditionally, innovations are generated by Triad-based multinationals, with the needs and wants of rich customers at the top of the pyramid in mind. When such multinationals entered lower-income economies, they tended to simplify the product features and lower prices. In other words, the innovation flow is *top-down*. However, as Deere & Company found out in India, its large-horsepower tractors designed for American farmers were a poor fit for the different needs and wants of Indian farmers. Despite Deere's efforts to simplify the product and reduce the price, the price was still too high in India. Instead, Mahindra & Mahindra brought its widely popular small-horsepower tractors that were developed in India to the United States and carved out a growing niche that eventually propelled it to be the world's *largest* tractor maker by units sold.<sup>12</sup> (Mahindra & Mahindra is now so committed to the United States that it sponsors bull-riding tournaments in Texas.) In response, Deere abandoned its US tractor designs and "went native" in India, by launching a local design team charged with developing something from scratch—with the needs and wants of farmers in India (or, more broadly, in emerging economies) in mind. The result was a 35-horsepower tractor that was competitive with Mahindra & Mahindra not only in India, but also in the United States and elsewhere. In both cases, the origin of new innovations is from the BoP. The flow of innovation is bottom-up—in other words, reverse innovation.

### Reverse innovation

An innovation that is adopted first in emerging economies and is then diffused around the world.



India Pictures RM/Dinodia Photos/Alamy Limited

Does this Mahindra & Mahindra tractor developed from a BoP market have potential elsewhere?

The reverse innovation movement suggests that emerging economies are no longer merely low-cost production locations or attractive new markets (hence the term “emerging markets”). They are also sources of new innovations that may not only grow out of BoP markets, but also have the potential to go uphill to penetrate into the top of the global economic pyramid. For example, a Chinese start-up, Xiaomi, has recently dethroned Samsung and Apple in the smart-phone market in both China and India, selling its smartphones for only US\$100 (see Emerging Markets 1.1). Relative to a feature-rich US\$600 Apple iPhone or a US\$500 Samsung Galaxy, a Xiaomi phone is merely good enough. It is 3G-capable and has a solid processor, a passable camera, and barely decent but expandable memory (8 GB), which can be expanded to 64 GB with cheap SD cards. But its performance is certainly more than 20% of an Apple or a Samsung. Thus, to customers in the BoP and beyond, Xiaomi’s reverse innovation delivers tremendous value relative to its price. In a *Harvard Business Review* article, Jeff Immelt, chairman and CEO of a leading practitioner of reverse innovation, GE, noted:

To be honest, the company is also embracing reverse innovation for defensive reasons. If GE doesn’t come up with innovations in poor countries and take them global, new competitors from the developing world—like Mindray, Suzlon, Goldwind, and Haier—will . . . GE has tremendous respect for traditional rivals like Siemens, Philips, and Rolls-Royce. But it knows how to compete with them; they will never destroy GE. By introducing products that create a new price-performance paradigm, however, the emerging giants very well could. Reverse innovation isn’t optional; it is oxygen.<sup>13</sup>

As advised by GE’s Immelt, today’s students—and tomorrow’s business leaders—will ignore the opportunities and challenges at the BoP at their own peril. This book will help ensure that *you* will not ignore these opportunities and challenges.

### Learning Objective

Give three reasons why it is important to study global business.

## 1-2 Why Study Global Business?

Global business (or IB) is one of the most exciting, most challenging, and most relevant subjects offered by business schools. Why study it? Table 1.1 outlines three compelling reasons.

First, you don’t want to be a loser. Mastering global business knowledge helps advance your employability and career in an increasingly competitive global economy. Take a look at the Opening Day Quiz in Table 1.2. Can you answer all the questions correctly? If not, you will definitely benefit from studying global business.

The answer to Question 1 is empirical—that is, based on data. You should guess first and then look at the label of your shirt yourself or ask a friend to help you. The key here is international trade. Do you wear a shirt made in your own country or another country? Why?

**Table 1.1** Why Study Global Business?

- Enhance your employability and advance your career in the global economy
- Better preparation for possible expatriate assignments abroad
- Stronger competence in interacting with foreign suppliers, partners, and competitors, and in working for foreign-owned employers in your own country

**Table 1.2** Opening Day Quiz**1. Which country made the shirt you are wearing?**

- (A) China (D) Romania  
 (B) Malaysia (E) US  
 (C) Mexico

**2. Which country made your mobile device?**

- (A) China (D) Taiwan  
 (B) Germany (E) US  
 (C) Singapore

**3. How many member countries does the G-20 have?**

- (A) 20 (D) 19  
 (B) 21 (E) 18  
 (C) 22

**4. Which city has the largest number of *Fortune* Global 500 company headquarters? (operational headquarters where top executives go to work, not place of registration)**

- (A) Beijing (D) New York  
 (B) Hong Kong (E) Tokyo  
 (C) London

**5. A 2,000-employee manufacturing plant is closing in a developed economy, and production is moving to an emerging economy. How many of the 2,000 jobs will the company keep?**

- (A) 0 (D) 20–30  
 (B) 5–10 (E) 30–50  
 (C) 10–20

In Question 2, smart students typically ask whether the mobile device (such as a smartphone or an iPad) means the motherboard or the components. My answer is: “I mean the whole device, all the production that went into making the machine.” Then some students respond: “But they could be made in different countries!” My point exactly. Specifically, the point here is to appreciate the complexity of a global value chain, with different countries making different components and handling different tasks. It is likely the tiny components inside your mobile device have crossed borders a dozen or more times. Such a value chain is typically managed by an MNE—such as Apple, Dell, Foxconn, HP, Lenovo, or Samsung. The capabilities necessary to organize a global supply chain hints at the importance of resources and capabilities—one of the two key themes of this book.

Question 3 is deceptively simple. Unfortunately, 100% of my own students—ranging from undergraduates to PhDs—*miss* it. Surprise! The [Group of 20 \(G-20\)](#) only has 19 member countries. The 20th member is the European Union (EU)—a regional bloc, not a single country. Ideally, why the G-20 is formed in such an interesting way will make you more curious about how the rules of the game are made around the world. In this case, why are 19 countries in, but numerous others out? What is special about the EU? Why are other regional blocs not included in the G-20? A focus on the rules of the game—more technically, institutions—is another key theme of the book.

Question 4 is interesting. Most of my own students pick New York, which has the *third*-largest number of headquarters of *Fortune* Global 500 companies (measured by sales). Beijing now has 52 *Fortune* Global 500 headquarters, followed by 41 in Tokyo, which until recently dethroned by Beijing had had the largest cluster of *Fortune*

**Group of 20 (G-20)**

The group of 19 major countries plus the EU whose leaders meet on a biannual basis to solve global economic problems.





© Sean Pavone/Shutterstock.com

Do you know Beijing now has the world's largest number of *Fortune* Global 500 headquarters?

Global 500 headquarters. In comparison, New York has 20 such headquarters (17 in New York City and three outside the city).<sup>14</sup> The rise of Beijing is indicative of the changing global economic winds, which have propelled China to become the world's second-largest economy in the years between the second and third editions of this book. To gain a better understanding of global economy, you need to pay more attention to companies based in Beijing (and in China and other emerging economies).

Question 5 will really frighten you. Some students typically clarify: "Do you mean the few security guards looking after the closed plant?" "Not necessarily," I point out. "The question is: How many jobs will be kept by the *company*?" Students eventually get it: even adding a few jobs as security

guards at the closed plant, the most optimistic estimates are that only 30 to 50 jobs may be kept. Yes, you guessed it: these jobs typically are high-level positions such as the CEO, CFO, CIO, factory director, and chief engineer. These managers will be sent by the MNE to start up operations in an emerging economy. You need to realize that in a 2,000-employee plant, even if you may be the 51st-highest-ranked employee, your fate may be the same as the 2,000th employee. You really need to work hard and work smart to position yourself as one of the top 50 (preferably one of the top 30). Doing well in this class and mastering global business knowledge may help make that happen.

In addition to the first reason to equip you with relevant knowledge, the second compelling reason why you should study global business is related to Question 5. Because many ambitious students aspire to join the top ranks of large firms, expertise in global business is often a prerequisite. Today, it is increasingly difficult, if not impossible, to find top managers at large firms without significant global competence. Of course, eventually, hands-on experience, not merely knowledge acquired from this course, will be required. However, mastery of the knowledge of, and demonstration of interest in, global business during your education will set you apart as a more ideal candidate to be selected as an **expatriate manager ("expat")**—a manager who works abroad—to gain such an experience (see Chapter 15 for details).

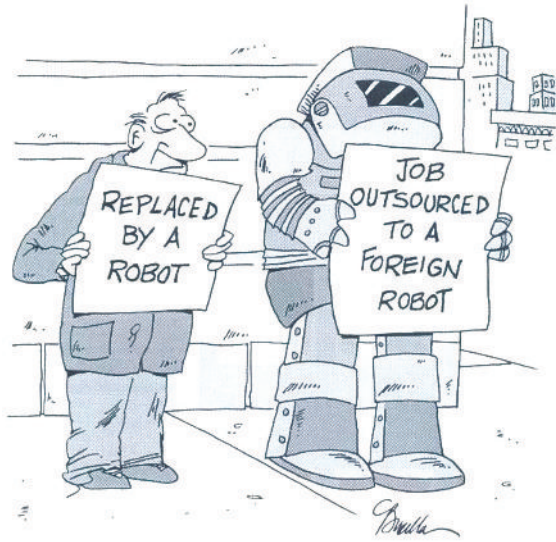
Thanks to globalization, low-level jobs not only command lower salaries, but are also more vulnerable.<sup>15</sup> However, high-level jobs, especially those held by expats, are both financially rewarding and relatively secure. Expats often command a significant **international premium** in compensation—a significant pay raise when working overseas. In US firms, an expat's total compensation package is approximately US\$250,000 to US\$300,000 (including perks and benefits; not all is take-home pay). When they return to the United States after a tour of duty (usually two to three years), a firm that does not provide attractive career opportunities to experienced expats often finds them to be lured away by competitor firms. Competitor firms also want to globalize their business, and tapping into the expertise and experience of these former expats makes such expansion more likely to succeed. And yes, to hire away these internationally experienced managers, competitor firms have to pay an even larger premium. This indeed is a virtuous cycle. This hypothetical example is designed to motivate you to study hard so that, someday, you may become one of these sought-after globetrotting managers. But even if you

#### Expatriate manager (expat)

A manager who works abroad.

#### International premium

A significant pay raise when working overseas.

**Figure 1.3** Jobs Outsourced

Source: *Harvard Business Review*, April 2012: 34.

don't want to be an expat, you really don't want to join the army of the unemployed due to factory closings and business failures (see Figure 1.3).

Lastly, even if you do not aspire to compete for the top job at a large company and instead work at a small firm or are self-employed, you may find yourself dealing with foreign-owned suppliers and buyers, competing with foreign-invested firms in your home market, or perhaps even selling and investing overseas. Alternatively, you may find yourself working for a foreign-owned firm, your domestic employer acquired by a foreign player, or your unit ordered to shut down for global consolidation. Understanding how global business decisions are made may facilitate your own career in such firms. If there is a strategic rationale to downsize your unit, you want to be prepared and start polishing your résumé right away. In other words, it is your career that is at stake. Don't be the last in the know!

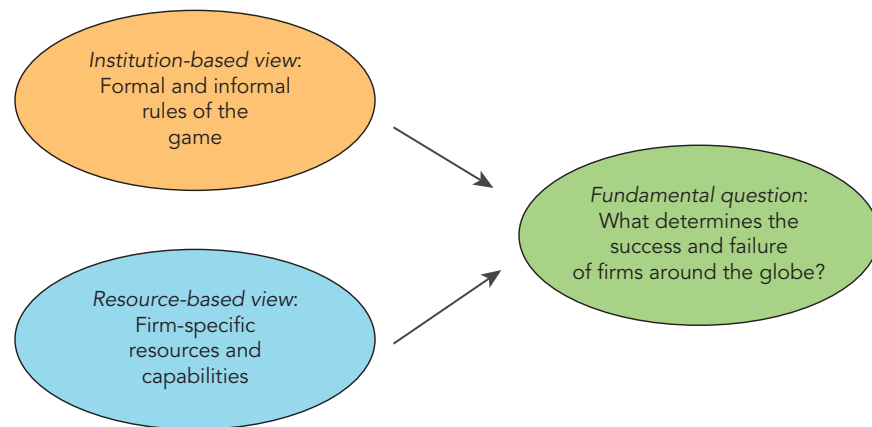
### 1-3 A Unified Framework

Global business is a vast subject area. It is one of the few courses that will make you appreciate why your university requires you to take a number of seemingly unrelated courses in general education. We will draw on major social sciences, such as economics, geography, history, political science, psychology, and sociology. We will also draw on a number of business disciplines, such as strategy, finance, and marketing. The study of global business is, thus, quite interdisciplinary. It is easy to lose sight of the “forest” while scrutinizing various “trees” or even “branches.” The subject is not difficult, and most students find it to be fun. The number-one student complaint (based on previous student feedback) is that there is an overwhelming amount of information. Honestly, this is also *my* number-one complaint as your author. You may have to read and learn this material, but I have to bring it all together in a way that makes sense and in a (relatively) compact book that does not go on and on and on for 990 pages.

To make your learning more focused, more manageable, and (hopefully) more fun, in this section—and throughout the book—we will develop a unified

#### Learning Objective

Articulate one fundamental question and two core perspectives in the study of global business.

**Figure 1.4 A Unified Framework for Global Business**

framework (shown in Figure 1.4). This will provide great continuity to facilitate your learning. Specifically, we will discipline ourselves by focusing only on one most fundamental question and two core perspectives. A fundamental question acts to define a field and to orient the attention of students, practitioners, and scholars in a certain direction. Our “big question” is: *What determines the success and failure of firms around the globe?*<sup>16</sup> To answer this question, we will introduce only two core perspectives throughout this book: (1) an institution-based view and (2) a resource-based view.<sup>17</sup> The remainder of this section outlines this framework.

### 1-3a One Fundamental Question

What is it that we do in global business? Why is it so important that practically all students in business schools around the world are either required or recommended to take this course? While there are certainly many questions to raise, a relentless interest in what determines the success and failure of firms around the globe serves to focus the energy of our field. Global business is fundamentally about not limiting yourself to your home country. It is about treating the global economy as your potential playground (or battlefield). Some firms may be successful domestically but fail miserably overseas. Other firms successfully translate their strengths from their home markets to other countries. If you were expected to lead your firm’s efforts to enter a particular foreign market, wouldn’t you want to find out what drives the success and failure of other firms in that market?

Overall, the focus on firm performance around the globe defines the field of global business (or IB) more than anything else. Numerous other questions all relate in one way or another to this most fundamental question. Therefore, all chapters in this book will be centered on this consistent theme: What determines the success and failure of firms around the globe?

### 1-3b First Core Perspective: An Institution-Based View<sup>18</sup>

An institution-based view suggests that the success and failure of firms are enabled and constrained by institutions. By institutions, we mean the rules of the game. Doing business around the globe requires intimate knowledge about both formal rules (such as laws) and informal rules (such as values) that govern competition in



various countries. Firms that do not do their homework and thus remain ignorant of the rules of the game in a certain country are not likely to emerge as winners.

Formal institutions include laws, regulations, and rules. For example, Hong Kong's laws are well known for treating all entrants, whether from neighboring mainland China (whose firms are still technically regarded as "non-domestic") or far-away Chile, the same as they treat indigenous Hong Kong firms. Such equal treatment enhances the potential odds for foreign firms' success. Thus, it is not surprising that Hong Kong attracts numerous outside firms. Other rules of the game discriminate against foreign firms and undermine their chances for success. India's recent attraction as a site for FDI was only possible after its regulations changed from confrontational to accommodating. Prior to 1991, India's rules severely discriminated against foreign firms. For example, in the 1970s, the Indian government demanded that Coca-Cola either hand over the recipe for its secret syrup, which it does not even share with the US government, or get out of India. Painfully, Coca-Cola chose to leave India. Its return to India since the 1990s speaks volumes about how much the rules of the game have changed in India.

Informal institutions include cultures, ethics, and norms. They also play an important part in shaping the success and failure of firms around the globe (see the Opening Case). For example, individualistic societies, particularly the English-speaking countries, such as Australia, Britain, and the United States, tend to have a relatively higher level of entrepreneurship, as reflected in the number of business start-ups. Why? Because the act of founding a new firm is a widely accepted practice in individualistic societies. Conversely, collectivistic societies, such as Japan, often have a hard time fostering entrepreneurship. Most people there refuse to stick their neck out to found new businesses, because it is contrary to the norm.

Overall, an institution-based view suggests that institutions shed a great deal of light on what drives firm performance around the globe. Next, we turn to our second core perspective.

### 1-3c Second Core Perspective: A Resource-Based View<sup>19</sup>

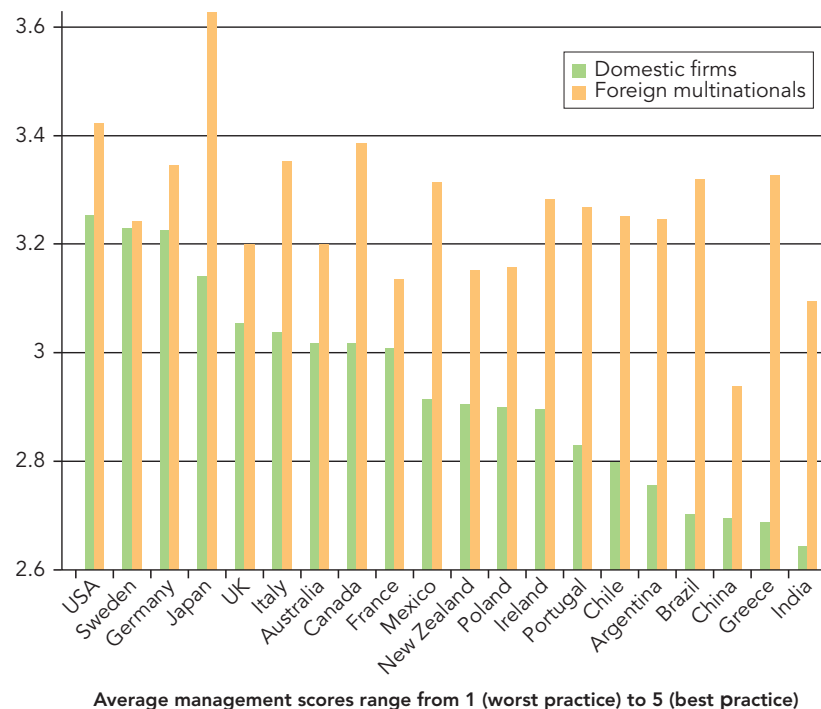
The institution-based view suggests that the success and failure of firms around the globe are largely determined by their environments. This is certainly correct. Because of their institutions (or specifically, institutional imperfections), India did not attract much FDI prior to 1991 and Japan does not nurture a lot of internationally competitive start-ups. However, insightful as this perspective is, there is a major drawback. If we push this view to its logical extreme, then firm performance around the globe would be *entirely* determined by environments. The validity of this extreme version is certainly questionable.

The resource-based view helps overcome this drawback. While the institution-based view primarily deals with the *external* environment, the resource-based view focuses on a firm's *internal* resources and capabilities. It starts with a simple observation: In harsh, unattractive environments, most firms either suffer or exit. However, against all odds, a few superstars thrive in these environments. For instance, despite the former Soviet Union's obvious hostility toward the United States during the Cold War, PepsiCo began successfully operating in the former Soviet Union in the 1970s (!). In another example, airlines often lose money. But a small number of players, such as Southwest in the United States, Ryanair in Ireland, Hainan in China, and IndiGo in India, have been raking in profits year after year. In the fiercely competitive fashion industry, Zara has been defying gravity. How can these

firms succeed in such challenging environments? What is special about them? A short answer is that PepsiCo, Southwest, Ryanair, Hainan, IndiGo, and Zara must have certain valuable and unique *firm-specific* resources and capabilities that are not shared by competitors in the same environments.

Doing business outside one's home country is challenging. Foreign firms have to overcome a **liability of foreignness**, which is the *inherent* disadvantage that foreign firms experience in host countries because of their non-native status.<sup>20</sup> Just think about all the differences in regulations, languages, cultures, and norms. Think about the odds against Mahindra & Mahindra when it tried to eat some of John Deere's lunch in the American heartland. Against such significant odds, the primary weapons that foreign firms such as Mahindra & Mahindra employ are *overwhelming* resources and capabilities that can offset their liability of foreignness (Figure 1.5). Today, many of us take it for granted that the best-selling car in the United States rotates between the Toyota Camry and the Honda Civic, that Coca-Cola is the best-selling soft drink in Mexico, and that Microsoft Word is the world's number-one word processing software. We really shouldn't. Why? Because it is *not* natural for these foreign firms to dominate nonnative markets. These firms must possess some very rare and powerful firm-specific resources and capabilities that drive these remarkable success stories. This is a key theme of the resource-based view, which focuses on how winning firms acquire and develop such unique and enviable resources and capabilities, and how competitor firms imitate and then innovate in an effort to outcompete the winning firms.

**Figure 1.5** In Every Country, Multinationals Possess Better Management Capabilities Than Do Local Firms



### Liability of foreignness

The inherent disadvantage that foreign firms experience in host countries because of their non-native status.

Source: Adapted from N. Bloom, C. Genakos, R. Sadun, & J. Van Reenen, 2012, Management practices across firms and countries (p. 23), *Academy of Management Perspectives*, February: 12–33. Sample of 7,262 manufacturing and 661 retail firms, of which 5,441 are purely domestic and 2,482 are foreign multinationals. Domestic multinationals (such as the domestic subsidiaries of Toyota in Japan) are excluded.

### 1-3d A Consistent Theme

Given our focus on the fundamental question of what determines the success and failure of firms around the globe, we will develop a unified framework by organizing the material in *every* chapter according to the two core perspectives, namely, the institution-based and resource-based views (see Emerging Markets 1.1). With our unified framework—an innovation in IB textbooks—we will not only explore the global business “trees,” but also see the global business “forest.”



## EMERGING MARKETS 1.1

### Fighting In and Out of the Chinese Smartphone Industry



Commanding one-third of worldwide sales, China is now the largest smartphone market in the world. Not surprisingly, global leaders Samsung and Apple (in that order) sell a lot in China, which absorbs approximately 20% of their output. What is interesting is that six of the top eight vendors are Chinese firms, and that neither Samsung nor Apple is the volume leader. Competing intensely among themselves, the “Gang of Six” consists of computer king Lenovo, telecom equipment giants Huawei and ZTE, consumer electronics firms TCL and Coolpad, and red-hot start-up Xiaomi.

Which firm is the market leader by volume in China? Surprise: it is Xiaomi (pronounced “shee-owl-mee,” meaning “Little Rice”). In the second quarter of 2014, Xiaomi, which only sells online, dethroned Samsung to be the market champion by volume, with a 14% market share. Xiaomi’s secrets? From a resource-based view, plenty. Fast prototyping, with very short “launch-test-improve” cycles. Offering special software not available in other Android devices. Undercutting rivals with rock-bottom prices—US\$100 for most Xiaomi models vis-à-vis Samsung’s high-end Galaxy smartphones that retail for US\$500. Imitating leading brands—Xiaomi’s founder, Lei Jun, is famous for wearing Steve Jobs-style black T-shirts and jeans when showing off new models on stage. Overall, Xiaomi grew 240% in the second quarter of 2014, compared with the second quarter of 2013. Its

extraordinary performance propelled it to become the fifth-largest smartphone player in the world—behind Samsung, Apple, Huawei, and Lenovo (in that order).

Chinese smartphone makers are naturally salivating about global markets. Xiaomi only sells 3% of its smartphones outside of China, Lenovo 16%, and Huawei 41%. They are likely to drive smartphones’ commoditization—a process of competition through which unique products that command high prices and high margins are no longer able to do so, thus becoming commodities. Just as in China, Xiaomi at US\$98 apiece has rapidly become the market leader in India. But here is a catch from an institution-based view. As they increasingly venture outside China, similarities in design between Chinese brands and global leaders—and potential intellectual property (IP) infringement inside the devices—are likely to incur the wrath of Apple and Samsung. IP disputes, of course, are nothing unusual among smartphone giants. Apple and Samsung themselves fought nasty court battles for years. Xiaomi and other Chinese smartphone makers have armed themselves with Google executives and Silicon Valley lawyers seasoned at navigating the perilous waters between war and peace in IP. While the last page of Chinese smartphone makers’ story is not likely to be written any time soon, their performance will ultimately be driven by a combination of their technological and marketing capabilities and their institutional and legal savvy.

Sources: Based on (1) *Bloomberg Businessweek*, 2014, Samsung’s China problems come to India, October 27: 44–45; (2) *Economist*, 2014, Smartening up their act, October 25; (3) *Forbes*, 2014, China’s Xiaomi becomes world’s 5th largest smartphone maker, July 31; (4) T. Hout & D. Michael, 2014, A Chinese approach to management, *Harvard Business Review*, September; (5) *South China Morning Post*, 2014, Chinese companies drive commoditization of smartphone market, August 18; (6) *Wall Street Journal*, 2014, Xiaomi overtakes Samsung in China smartphone market, August 4; (7) P. Williamson & E. Yin, 2014, Accelerated innovation, *MIT Sloan Management Review*, summer.

**Learning Objective**

Identify three ways of understanding what globalization is.

## 1-4 What Is Globalization?

**Globalization**, generally speaking, is the close integration of countries and peoples of the world. This abstract five-syllable word is now frequently heard and debated. Those who approve of globalization count its contributions to include greater economic growth, higher standards of living, increased technology sharing, and more extensive cultural integration. Critics argue that globalization undermines wages in rich countries, exploits workers in poor countries, grants MNEs too much power, destroys the environment, and promotes inequality. So, what exactly is globalization? This section outlines three views on globalization, recommends the pendulum view, and introduces the idea of semiglobalization.

### 1-4a Three Views on Globalization

Depending on what sources you read, globalization could be

- a new force sweeping through the world in recent times
- a long-run historical evolution since the dawn of human history
- a pendulum that swings from one extreme to another from time to time

An understanding of these views helps put into perspective the debate about globalization. First, opponents of globalization suggest that it is a new phenomenon beginning in the late 20th century, driven by recent technological innovations and a Western ideology focused on exploiting and dominating the world through MNEs. The arguments against globalization focus on environmental stress, social injustice, and sweatshop labor, but present few clear alternatives to the present economic order. Nevertheless, anti-globalization advocates and protesters often argue that globalization needs to be slowed down if not stopped.<sup>21</sup>

A second view contends that globalization has always been part and parcel of human history. Historians debate whether globalization started 2,000 or 8,000 years ago. The earliest traces of MNEs have been discovered in Assyrian, Phoenician, and Roman times.<sup>22</sup> International competition from low-cost countries is nothing new. In the first century A.D., the Roman emperor Tiberius was so concerned about the massive quantity of low-cost Chinese silk imports that he imposed the world's first known import quota of textiles.<sup>23</sup> Today's most successful MNEs do not come close to wielding the historical clout of some MNEs, such as the (old) East India Company during colonial times (see the Opening Case). In a nutshell, globalization is nothing new and will probably always exist.

A third view suggests that globalization is the “closer integration of the countries and peoples of the world which has been brought about by the enormous reduction of the costs of transportation and communication, and the breaking down of artificial barriers to the flows of goods, services, capital, knowledge, and (to a lesser extent) people across borders.”<sup>24</sup> Globalization is neither recent nor one-directional. It is, more accurately, a process similar to the bi-directional swing of a pendulum.

#### Globalization

The close integration of countries and peoples of the world.

### 1-4b The Pendulum View on Globalization

The pendulum view probably makes the most sense because it can help us understand the ups and downs of globalization. The current era of globalization



originated in the aftermath of World War II, when major Western countries committed to global trade and investment. However, between the 1950s and the 1970s, this view was not widely shared. Communist countries, such as China and the Soviet Union, sought to develop self-sufficiency. Many noncommunist developing countries, such as Brazil, India, and Mexico, focused on fostering and protecting domestic industries. But refusing to participate in global trade and investment ended up breeding uncompetitive industries. In contrast, four developing economies in Asia—Hong Kong, Singapore, South Korea, and Taiwan—earned their stripes as the “Four Tigers” by participating in the global economy. They became the *only* economies once recognized as less developed (low-income) by the World Bank to have subsequently achieved developed (high-income) status.

Inspired by the Four Tigers, more countries and regions—such as China in the late 1970s, Latin America in the mid-1980s, Central and Eastern Europe in the late 1980s, and India in the 1990s—realized that joining the global economy was a must. As these countries started to emerge as new players in the global economy, they became collectively known as “emerging economies.” As a result, globalization rapidly accelerated.

However, globalization, like a pendulum, is unable to keep going in one direction. Rapid globalization in the 1990s and the 2000s saw some significant backlash. First, the rapid growth of globalization led to the historically inaccurate view that globalization is new. Second, it created fear among many people in developed economies that they would lose jobs. Emerging economies not only seem to attract many low-end jobs away from developed economies, but they also increasingly appear to threaten some high-end jobs. Finally, some factions in emerging economies complained against the onslaught of MNEs, alleging that they destroy local companies as well as local cultures, values, and environments.

The December 1999 anti-globalization protests in Seattle and the September 2001 terrorist attacks in New York and Washington were undoubtedly some of the most visible and most extreme acts of anti-globalization forces at work. As a result, international travel was curtailed, and global trade and investment flows slowed in the early 2000s. Then in the mid-2000s, however, worldwide GDP, cross-border trade, and per capita GDP all soared to historically high levels. It was during that period that “BRIC” became a buzzword (discussed earlier).

Unfortunately, the party suddenly ended in 2008. The 2008–2009 global economic crisis was unlike anything the world had seen since the Great Depression (1929–1933). The crisis showed, for better or worse, how interconnected the global economy has become. Deteriorating housing markets in the United States, fueled by unsustainable subprime lending practices, led to massive government bailouts of failed firms. The crisis quickly spread around the world, forcing numerous governments to bail out their own troubled banks. Global output, trade, and investment plummeted, while unemployment skyrocketed. The 2008–2009 crisis became known as the Great Recession. Many people blamed globalization for the Great Recession.

After unprecedented government intervention in developed economies, confidence was growing that the global economy had turned the corner and that the recession was ending.<sup>25</sup> However, starting in 2010, the Greek debt crisis and

then the broader PIGS debt crisis erupted. (“PIGS” refers to Portugal, Ireland or Italy, Greece, and Spain). The already-slow recovery in Europe thus became slower, and unemployment hovered at very high levels (see Chapter 8).

The Great Recession reminds all firms and managers of the importance of **risk management**—the identification and assessment of risks and the preparation to minimize the impact of high-risk, unfortunate events.<sup>26</sup> As a technique to prepare and plan for multiple scenarios (either high risk or low risk), **scenario planning** is now used extensively around the world.<sup>27</sup> The recovery has seen more protectionist measures, since the stimulus packages and job-creation schemes of various governments often emphasize “buy national” (such as “buy American”) and “hire locals.” In short, the pendulum is swinging back. The Closing Case shows a pendulum consisting of two polar scenarios—continued globalization and de-globalization—with a view toward 2050.

Like the proverbial elephant, globalization is seen by everyone, yet rarely comprehended. The sudden ferocity of the 2008–2009 crisis surprised everybody—ranging from central bankers to academic experts. Remember, all of us felt sorry when we read the story of a bunch of blind men trying to figure out the shape and form of the elephant. We really shouldn’t have. Although we are not blind, our task is more challenging than the blind men who study a standing animal. Our beast—globalization—does not stand still and often rapidly moves, back and forth (!). Yet, we try to live with it, avoid being crushed by it, and even attempt to profit from it. Overall, relative to the other two views, the view of globalization as a bi-directional pendulum is more balanced and more realistic. In other words, globalization has both rosy and dark sides, and these change over time.

### 1-4c Semiglobalization

Despite the debate over it, globalization is not complete. Do we really live in a globalized world? Are selling and investing abroad just as easy as at home? Obviously not. Most measures of market integration, such as trade and FDI, have recently scaled new heights, but still fall far short of pointing to a single, globally integrated market. In other words, what we have may be labeled **semiglobalization**, which is more complex than extremes of total isolation and total globalization. Semiglobalization suggests that barriers to market integration at borders are high, but not high enough to insulate countries from each other completely.<sup>28</sup>

Semiglobalization calls for more than one way of doing business around the globe. Total isolation on a nation-state basis would suggest localization—a strategy of treating each country as a unique market. So an MNE marketing products to 100 countries will need to come up with 100 versions of local cars or drinks. This approach is clearly too costly. Total globalization, on the other hand, would lead to standardization—a strategy of treating the entire world as one market. The MNE in our previous example can just market one version of “world car” or “world drink.” But the world obviously is not that simple. Between total isolation and total globalization, semiglobalization has no single correct strategy, resulting in a wide variety of experimentations (see Emerging Markets 1.2). Overall, (semi)globalization is neither to be opposed as a menace nor to be celebrated as a panacea; it is to be *engaged*.

#### Risk management

The identification and assessment of risks and the preparation to minimize the impact of high-risk, unfortunate events.

#### Scenario planning

A technique to prepare and plan for multiple scenarios (either high- or low-risk).

#### Semiglobalization

A perspective that suggests that barriers to market integration at borders are high, but not high enough to insulate countries from each other completely.



## EMERGING MARKETS 1.2

### Coca-Cola's Deep Dive in Africa



Founded in 1892, Coca-Cola first entered Africa in 1929. While Africa had always been viewed as a “backwater,” it has recently emerged as a major growth market commanding strategic attention. Of the US\$27 billion that Coca-Cola would invest in emerging economies between 2010 and 2020, US\$12 billion will be used to beef up the plants and distribution facilities in Africa. Why does Coca-Cola show such a strong interest in a “deep dive” in Africa? Both the push and pull effects are at work.

The push comes from the necessity to find new sources of growth for this mature firm, which has promised investors of 7% to 9% earnings growth. In 1998, its stock reached a high-water mark at US\$88. But it dropped to US\$37 in 2003. Since 2004, the share price has rallied again, rising from US\$43 to a new peak of US\$90 in November 2014 (adjusted for a 2:1 share split in 2012). Can Coca-Cola's stock reach higher?

Its home markets are unlikely to help. Between 2006 and 2011, US sales declined for five consecutive years. Further, health advocates accused Coca-Cola of contributing to an epidemic of obesity in the United States and proposed to tax soft drinks to pay for health care. While Coca-Cola defeated the tax initiative, it is fair to say that the room for growth at home is limited. In Europe and Japan, sales are similarly flat. Elsewhere, in China, strong local rivals have made it tough for Coca-Cola to break out. Its acquisition of a leading local fruit juice firm was blocked by the government, which did not seem to bless Coca-Cola's further growth. In India, Pepsi is so popular that “Pepsi” has become the Hindi shorthand for all bottled soft drinks (including Coke!). In Latin America, sales are encouraging, but growth may be limited. Mexicans, on average, are already guzzling 665 servings of Coca-Cola products every year, the highest in the world. There is only so much sugary water one can drink every day.

In contrast, Coca-Cola is pulled by Africa, where it has a commanding 29% market share versus Pepsi's 15%. With 65,000 employees and 160 plants, Coca-Cola is Africa's largest private-sector employer. Yet, annual per capita consumption of Coca-Cola products is only 39 servings in Kenya. For the continent as a whole, disposable income is growing. In 2014, 100 million Africans earned at least US\$5,000 per person. While Africa indeed has some of the poorest countries in the world, 12 African countries (with a combined population of 100 million) have a GDP per capita that is greater than China's. Coca-Cola is hoping to capitalize on Africa's improved political stability and physical infrastructure. Countries not fighting civil wars make Coke's operations less disruptive, and new roads penetrating the jungle can obviously elevate sales.

Coca-Cola is already in all African countries. The challenge now, according to chairman and CEO Muhtar Kent, will be to *deep dive* into “every town, every village, every township.” This will not be easy. War, poverty, and poor infrastructure make it extremely difficult to distribute and market products in hard-to-access regions. Undaunted, Coca-Cola is in a street-by-street campaign to increase awareness and consumption of its products. The crowds and the poor roads dictate that some of the deliveries have to be done manually on pushcarts or trolleys. Throughout the continent, Coca-Cola has set up 3,000 Manual Distribution Centers. Taking a page from its playbook in Latin America, especially Mexico, Coca-Cola has aggressively courted small corner stores. Coca-Cola and its bottlers offer small corner store owners delivery, credit, and direct coaching—ranging from the tip not to ice down the Cokes until the midday rush to save electricity, to helping on how to buy a house after vendors make enough money.

In Africa, US-style accusations of Coca-Cola's alleged contribution to the obesity problem are

unlikely. After all, the primary concern in many communities is too few available calories of any kind. However, this does not mean Africa is Coca-Cola's marketing Shangri-La, free from any criticisms. It has to defend itself from critics who accuse it of depleting fresh water, encouraging expensive and environmentally harmful refrigeration, and hurting

local competitors who hawk beverages. In response, Coca-Cola often points out the benefits it has brought. In addition to the 65,000 jobs it has directly created, one million local jobs are indirectly created by its vast system of distribution, which moves beverages from bottling plants deep into the slums and the bush a few crates at a time.

Sources: Based on (1) M. Blanding, 2010, *The Coke Machine*, New York: Avery; (2) *Bloomberg Businessweek*, 2010, Coke's last round, November 1: 54–61; (3) *Bloomberg Businessweek*, 2010, For India's consumers, Pepsi is the real thing, September 20: 26–27; (4) *Bloomberg Businessweek*, 2011, Can Coke surpass its record high of \$88 a share? June 6: 49–50; (5) D. Zoogah, M. W. Peng, & H. Woldu, 2015, Institutions, resources, and organizational effectiveness in Africa, *Academy of Management Perspectives*, 29(1): 7–31.

### Learning Objective

State the size of the global economy and its broad trends, and understand your likely bias in the globalization debate.

## 1-5 Global Business and Globalization at a Crossroads

Twenty-first-century business leaders face enormous challenges. This book helps overcome these challenges. As a backdrop for the remainder of this book, this section makes two points. First, a basic understanding of the global economy is necessary. Second, it is important to critically examine your own personal views and biases regarding globalization.

### 1-5a A Glance at the Global Economy

The global economy in 2013 was an approximately US\$75 trillion economy (total global GDP calculated at official, nominal exchange rates—US\$100 trillion on PPP basis).<sup>29</sup> While there is no need to memorize a lot of statistics, it is useful to remember this US\$75 trillion (or US\$100 trillion) figure to put things in perspective.

One frequent observation in the globalization debate is the enormous size of MNEs. Take a look at the largest MNE within one sizeable country: Volkswagen's worldwide sales would represent 10% of German GDP, Samsung's sales 17% of South Korean GDP, and BP's sales 26% of British GDP.<sup>30</sup> Table 1.3 shows the most recent top ten firms. The top three largest MNEs—measured by sales—happened to be headquartered in North America, Europe, and Asia. If the largest MNE, Wal-Mart, were an independent country, it would be the 27th largest economy—its sales are smaller than Belgium's GDP but larger than Venezuela's. The sales of the largest EU-based MNE, Royal Dutch Shell, were larger than the GDP of each of the following EU member countries: Austria, Denmark, Finland, Portugal, and Ireland. The sales of the largest Asia-based MNE, SINOPEC, were larger than the GDP of each of the following Asian economies: Thailand, Malaysia, Hong Kong, Singapore, and the Philippines. Today, more than 82,000 MNEs manage at least 810,000 subsidiaries overseas.<sup>31</sup> Total annual sales for the largest 500 MNEs exceed US\$31 trillion (about one-third of global output).<sup>32</sup>

Table 1.4 documents the change in the makeup of the 500 largest MNEs. While MNEs from the Triad (North America, Europe, and Japan) dominate the list, their share has been shrinking—thanks to the Great Transformation (discussed earlier). Among MNEs from emerging economies, those from BRIC contribute 118 firms to the *Fortune* Global 500 list. In particular, MNEs from China have come on strong.<sup>33</sup>



**Table 1.3** Top Ten Largest Firms in the World (Measured by Sales in US\$)

|    | Corporate name                       | Home country | Revenues      |
|----|--------------------------------------|--------------|---------------|
| 1  | Wal-Mart Stores                      | USA          | \$476 billion |
| 2  | Royal Dutch Shell                    | Netherlands  | \$460 billion |
| 3  | SINOPEC Group                        | China        | \$457 billion |
| 4  | China National Petroleum Corporation | China        | \$432 billion |
| 5  | ExxonMobil                           | USA          | \$408 billion |
| 6  | BP                                   | UK           | \$396 billion |
| 7  | State Grid                           | China        | \$333 billion |
| 8  | Volkswagen                           | Germany      | \$261 billion |
| 9  | Toyota Motor                         | Japan        | \$256 billion |
| 10 | Glencore                             | Switzerland  | \$233 billion |

Source: Adapted from *Fortune*, 2014, Global 500, July 21: F–1. Data refer to 2013.

**Table 1.4** Recent Changes in the *Fortune* Global 500

|                            | 2005 | 2010 | 2014 |
|----------------------------|------|------|------|
| <b>Developed economies</b> |      |      |      |
| United States              | 170  | 133  | 128  |
| European Union             | 165  | 149  | 128  |
| Japan                      | 70   | 68   | 57   |
| Switzerland                | 12   | 15   | 13   |
| Canada                     | 14   | 11   | 10   |
| Australia                  | 8    | 8    | 8    |
| <b>Emerging economies</b>  |      |      |      |
| China                      | 20   | 61   | 95   |
| India                      | 6    | 8    | 8    |
| Brazil                     | 4    | 7    | 7    |
| Russia                     | 5    | 7    | 8    |
| BRIC                       | 35   | 83   | 118  |

Sources: Adapted from various *Fortune* issues. The most recent *Fortune* Global 500 list (for 2014) was published in *Fortune*, July 21, 2014.

Beijing is now headquarters to 52 *Fortune* Global 500 firms, more than New York's 20—remember Question 4 in Opening Day Quiz. Clearly, Western rivals cannot afford to ignore these emerging multinationals, and students studying this book need to pay attention to these emerging multinationals.<sup>34</sup>

## 1-5b The Globalization Debate and You

As a future business leader, you are not a detached reader. The globalization debate directly affects *your* future.<sup>35</sup> Therefore, it is imperative that you participate



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### Why do protestors like these object to globalization?

globalization. However, many other members of the society do not necessarily share the same views. Unfortunately, many of the elite fail to understand the limits of their beliefs and mistakenly assume that the rest of the world thinks like them. To the extent that powerful economic and political institutions are largely controlled by the elite in almost every country, it is not surprising that some anti-globalization groups, feeling powerless, end up resorting to unconventional tactics, such as mass protests, to make their point.

Many of the opponents of globalization are **nongovernmental organizations (NGOs)**, such as environmentalists, human rights activists, and consumer groups. Ignoring them will be a grave failure when doing business around the globe. Instead of viewing NGOs as opponents, many firms view them as partners. NGOs do raise a valid point when they insist that firms, especially MNEs, should have a broader concern for the various stakeholders affected by the actions of MNEs around the world. At present, this view is increasingly moving from the peripheral to the mainstream (see Chapters 3 and 17).

It is certainly interesting, and perhaps alarming, to note that as would-be business leaders who will shape the global economy in the future, current business school students already exhibit values and beliefs in favor of globalization similar to those held by executives, policy makers, and scholars and different from those held by the general public. Shown in Table 1.5, US business students have significantly more positive (almost one-sided) views toward globalization than does the general public. My lectures around the world suggest that most business students—regardless of their nationality—seem to share such positive views on globalization. This is not surprising. Both self-selection to study business and socialization within the curriculum, in which free trade is widely regarded as positive, may lead to certain attitudes in favor of globalization. Consequently, business students tend to focus more on the economic gains of globalization and to be less concerned with its darker sides.

Current and would-be business leaders must be aware of their own biases embodied in such one-sided views toward globalization. Since business schools aspire to train future business leaders by indoctrinating students with the dominant values

in the globalization debate instead of letting other people make decisions on globalization that will significantly affect your career, your consumption, and your country. It is important to know your own biases when joining the debate. By the very act of taking an IB course and reading this book, you probably already have some pro-globalization biases, compared to non-business majors elsewhere on campus and the general public in your country.

You are not alone. In the last several decades, most executives, policy makers, and scholars in both developed and emerging economies, who are generally held to be the elite in these societies, are biased toward acknowledging the benefits of glo-

### **Nongovernmental organization (NGO)**

An organization that is not affiliated with governments.

**Table 1.5** Views on Globalization: General Public versus Business Students

| Percentage answering “good” for the question:<br>Overall, do you think globalization is <i>good</i> or <i>bad</i> for | General public <sup>1</sup><br>(N = 1,024) | Business students <sup>2</sup><br>(N = 494) |
|---|--|---|
| US consumers like you   | 68%  | 96%   |
| US companies  | 63%  | 77%   |
| The US economy  | 64%  | 88%   |
| Strengthening poor countries’ economies   | 75%  | 82%   |

Sources: Based on (1) A. Bernstein, 2000, Backlash against globalization, *BusinessWeek*, April 24: 43; (2) M. W. Peng & H. Shin, 2008, How do future business leaders view globalization? *Thunderbird International Business Review*, 50 (3): 175–182. All differences are statistically significant.

that managers hold, business schools may have largely succeeded in this mission. However, to the extent that current managers (and professors) have some strategic blind spots, these findings are potentially alarming. They reveal that business students already share these blind spots. Despite possible self-selection in choosing to major in business, there is no denying that student values are shaped, at least in part, by the educational experience that business schools provide. Knowing such limitations, business school professors and students need to work especially hard to break out of this mental straitjacket.

In order to combat the widespread tendency to have one-sided, rosy views, a significant portion of this book is devoted to the numerous debates that surround globalization.<sup>36</sup> Debates are systematically introduced in *every* chapter to provoke more critical thinking—a hallmark for high-level university training. Virtually all textbooks uncritically present knowledge “as is” and ignore the fact that the field is alive with numerous debates. No doubt, debates drive practice and research forward. Therefore, it is imperative that you be exposed to cutting-edge debates and encouraged to form your own views. In addition, business ethics are emphasized throughout the book. A featured Ethical Dilemma can be found in every chapter. Two whole chapters are devoted to ethics, norms, and cultures (Chapter 3) and corporate social responsibility (Chapter 17).

## 1-6 Organization of the Content

This book has four parts. Part I is *foundations*. Following this chapter, Chapters 2, 3, and 4 address the two leading perspectives—namely, institution-based and resource-based views. Part II covers *tools*, focusing on trade (Chapter 5), foreign investment (Chapter 6), foreign exchange (Chapter 7), and global and regional integration (Chapter 8). Part III sheds light on *strategy*. We start with the internationalization of small, entrepreneurial firms (Chapter 9), followed by ways to enter foreign markets (Chapter 10), to manage competitive dynamics (Chapter 11), to make alliances and acquisitions work (Chapter 12), and to strategize, structure, and learn (Chapter 13). Finally, Part IV builds *excellence in different functional areas*: marketing and supply chain (Chapter 14), human resource management (Chapter 15), finance and corporate governance (Chapter 16), and corporate social responsibility (Chapter 17).

## CHAPTER SUMMARY/LEARNING OBJECTIVES

### 1-1 Explain the concepts of international business and global business, with a focus on emerging economies.

- IB is typically defined as (1) a business (firm) that engages in international (cross-border) economic activities, and/or (2) the action of doing business abroad.
- Global business is defined in this book as business around the globe.
- This book has gone beyond competition in developed economies by devoting extensive space to competitive battles waged in emerging economies and the base of the global economic pyramid.
- An interesting recent development out of emerging economies is reverse innovation.

### 1-2 Give three reasons why it is important to study global business.

- Enhance your employability and advance your career in the global economy by equipping yourself with global business knowledge.
- Better preparation for possible expatriate assignments abroad.
- Stronger competence in interacting with foreign suppliers, partners, and competitors, and in working for foreign-owned employers in your own country.

### 1-3 Articulate one fundamental question and two core perspectives in the study of global business.

- IB's most fundamental question is: What determines the success and failure of firms around the globe?
- The two core perspectives are (1) the institution-based view and (2) the resource-based view.
- We develop a unified framework by organizing materials in *every* chapter according to the two perspectives guided by the fundamental question.

### 1-4 Identify three ways of understanding what globalization is.

- Some view globalization as a recent phenomenon, and others believe that it has been a one-directional evolution since the dawn of human history.
- We suggest that globalization is best viewed as a process similar to the bi-directional swing of a pendulum.

### 1-5 State the size of the global economy and its broad trends, and understand your likely bias in the globalization debate.

- MNEs, especially large ones from developed economies, are sizable economic entities.
- Current and would-be business leaders need to be aware of their own hidden pro-globalization bias.

## KEY TERMS

|                              |                                    |                                 |
|------------------------------|------------------------------------|---------------------------------|
| Base of the pyramid (BoP), 8 | Emerging market, 6                 | Global business, 5              |
| BRIC, 7                      | Expatriate manager (expat), 12     | Globalization, 18               |
| BRICS, 7                     | Foreign direct investment (FDI), 4 | Great Transformation, 8         |
| Emerging economy, 5          |                                    | Gross domestic product (GDP), 6 |



|                                 |                                   |                                  |
|---------------------------------|-----------------------------------|----------------------------------|
| Gross national income (GNI), 6  | International premium, 12         | Purchasing power parity (PPP), 6 |
| Gross national product (GNP), 6 | Liability of foreignness, 16      | Reverse innovation, 9            |
| Group of 20 (G-20), 11          | Multinational enterprise (MNE), 4 | Risk management, 20              |
| International business (IB), 4  | Nongovernmental organization      | Scenario planning, 20            |
|                                 | (NGO), 24                         | Semiglobalization, 20            |
|                                 |                                   | Triad, 8                         |

## REVIEW QUESTIONS

1. What is the traditional definition of IB? How is global business defined in this book?
2. Compare PengAtlas Maps 2.1 (Top Merchandise Importers and Exporters), 2.2 (Top Service Importers and Exporters), and 2.3 (FDI Inflows and Outflows) and note that the United States is number one in all categories except one. What is it? Many people feel that is a big problem—do you? In your opinion, what—if anything—should be done about that?
3. Compare PengAtlas Maps 2.1 (Top Merchandise Importers and Exporters), 2.2 (Top Service Importers and Exporters), and 2.3 (FDI Inflows and Outflows) once again and note the BRIC countries that are referenced in this chapter. Which of the BRIC countries is most often among the categories in those maps? Do you think that the long-term trend will be for that country to continue to become more important and perhaps surpass the United States, or do you think that it may decline, and one of the other BRIC countries will become more important? Why?
4. **ON CULTURE:** Not all people in your country support globalization, and some feel that globalization is an economic threat. However, to what extent could it be they may also feel that it is a threat to their culture?
5. Discuss the importance of emerging economies in the global economy. Use current news.
6. What is your interest in studying global business? How do you think it may help you succeed in the future?
7. If you were to work as an expatriate manager, where would you like to go? Why?
8. How would you describe an institution-based view of global business?
9. How would you describe a resource-based view of global business?
10. After comparing the three views of globalization, which seems the most sensible to you and why?
11. What is semiglobalization? What factors contribute to it?
12. Do those who protest against globalization make any valid point(s) that all people, whether for or against globalization, should consider?
13. You may view yourself as objective and neutral regarding globalization, but do you sense any bias that you may have, one way or the other? What bias most likely exists on the part of other students taking this course?



14. Given the size of the global economy and the size of some of the large corporations, do you think it is possible to carve out a niche that you can exploit as a small businessperson? Or do you feel that the most practical way to participate in the global economy is to do so as an employee or manager in a global corporation?

### CRITICAL DISCUSSION QUESTIONS

1. A classmate says: “Global business is relevant for top executives, such as CEOs, in large companies. I am just a lowly student who will struggle to gain an entry-level job, probably in a small domestic company. Why should I care about it?” How do you convince her that global business is something to care about?
2. *ON CULTURE*: Thomas Friedman, in his book *The World is Flat* (2005), suggests that the world is flattening—meaning that it is increasingly interconnected by new technology, such as the Internet. On the other hand, this presents significant challenges for developed economies, whose employees may feel threatened by competition from low-cost countries. How does this flattening world affect you?
3. *ON ETHICS*: What are some of the darker sides (in other words, costs) associated with globalization? How can business leaders make sure that the benefits of their various actions outweigh their costs?
4. *ON ETHICS*: Some argue that aggressively investing in emerging economies is not only economically beneficial but also highly ethical, because it could lift many people out of poverty. However, others caution that in the absence of decent profits, rushing to emerging economies is reckless. What do you think?

### BUSINESS INSIGHTS GLOBAL

### GLOBAL ACTION

1. Chemical companies are among the largest firms worldwide. Two approaches to evaluating their operations are by capital spending and by research and development (R&D) spending. Access a resource that provides this information about top global chemical producers. Then compare the top five capital-spending and R&D-spending chemical companies. Are any companies found on both lists? What insights does this information provide?
2. One important aspect of globalization is the fundamental stability of the global economic order currently in place. Thus, FDI intentions can be influenced by its perceived sustainability to some degree. Identify the three most important issues related to global economic stability over the next 20 years.

## CLOSING CASE

## EMERGING MARKETS: Two Scenarios of the Global Economy in 2050

In the perilous exercise of predicting the future of the global economy, two scenarios have emerged with a view toward 2050. Known as “continued globalization,” the first scenario is the rosy one that has been widely known. Spearheaded by Goldman Sachs, whose chairman of its Asset Management Division, Jim O’Neil, coined the term “BRIC” more than a decade ago, this scenario suggests that—in descending order—China, the United States, India, Brazil, and Russia will become the largest economies by 2050 (Figure 1.6). BRIC countries together may overtake the US by 2015 and the G-7 by 2032, and China may individually dethrone the US by 2026. In PPP terms, BRIC’s share of global GDP, which rose from 18% in 2001 to 25% currently, may reach 40% by 2050. In addition, by 2050, the N-11 as a group may become significantly larger than the US and almost twice the size of the Euro area.

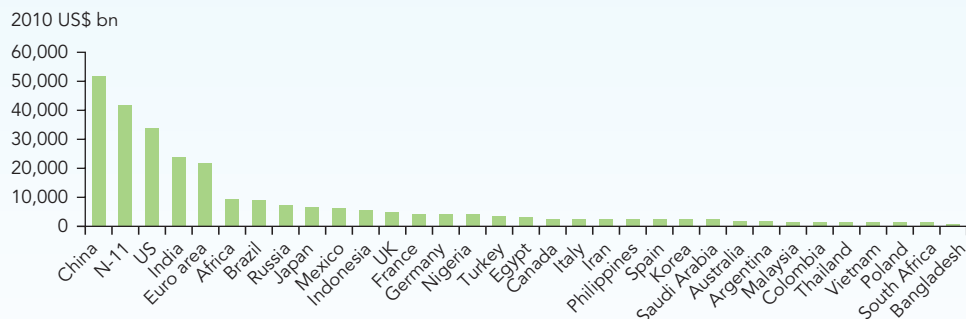
Broadening our thinking beyond a focus on acronyms such as BRIC and N-11, one interesting way is to identify the *larger* emerging markets (defined as exceeding 1% of global GDP by 2050). Nine of the N-11 may exceed the 1% of global GDP threshold by 2050. In addition, a number of other relatively *smaller* emerging markets (defined as not exceeding 1% of

global GDP by 2050) will exhibit strong growth dynamism and potential (Figure 1.7). The upshot? While BRIC growth rates will slow down, emerging economies *as a group*—consisting of BRIC, N-11, and other “larger” and “smaller” emerging markets—will continue to drive global growth.

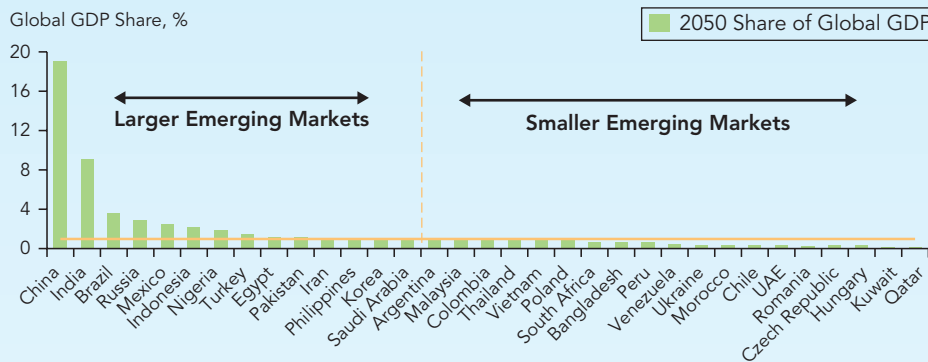
Goldman Sachs’s predictions have been largely supported by other influential forecasting studies. For example, Organization for Economic Cooperation and Development (OECD) predicted that by 2060, China, India, and the US will become the top three economies. The combined GDP of China and India will be larger than that of the entire OECD area (Figure 1.8). In 2011, China and India accounted for less than one-half of GDP of the seven major (G-7) OECD economies. By 2060, the combined GDP of China and India may be 1.5 times larger than the G-7. India’s GDP will be a bit larger than the US’s, and China’s a lot larger.

Despite such dramatic changes, one interesting constant is the relative rankings of income per capita. Goldman Sachs predicted that by 2050, the G-7 countries will still be the richest, led by the US, Canada, and the UK (Figure 1.9). Ranked eighth globally (US\$63,486—all dollar figures in this paragraph refer to 2010 US dollars), Russia may top the

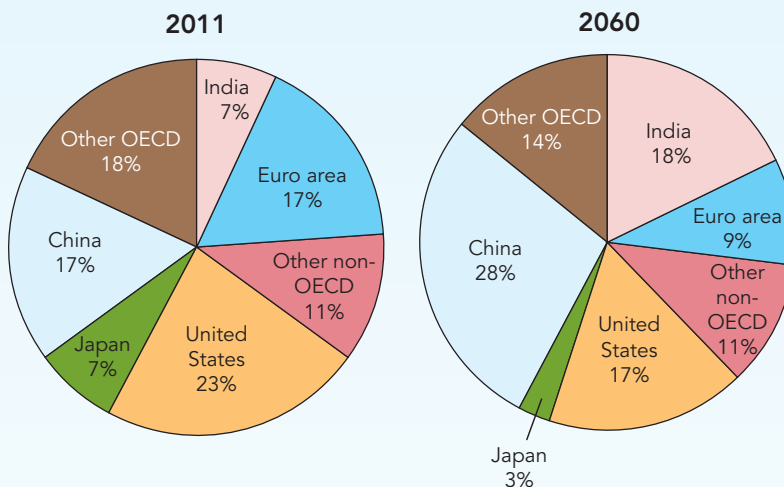
**Figure 1.6** BRIC and the US Will Become the Largest Economies by 2050



Source: Goldman Sachs, 2012, An update on the long-term outlook for the BRICs and beyond (p. 3), *Monthly Insights from the Office of the Chairman, Goldman Sachs Asset Management*, January. “N-11” refers to the Next Eleven identified by Goldman Sachs: Bangladesh, Egypt, Indonesia, Iran, Korea, Mexico, Nigeria, Pakistan, the Philippines, Turkey, and Vietnam.

**Figure 1.7** Larger (> 1% Global GDP) and Smaller (< 1% Global GDP) Emerging Markets by 2050

Source: Adapted from Goldman Sachs, 2012, An update on the long-term outlook for the BRICs and beyond (p. 3), *Monthly Insights from the Office of the Chairman, Goldman Sachs Asset Management*, January. In the original publication, “larger emerging markets” are labeled “growth markets,” and “smaller emerging markets” are labeled “emerging markets.” To avoid confusion, we label all of them “emerging markets,” which are differentiated by size. The orange line is 1% global GDP.

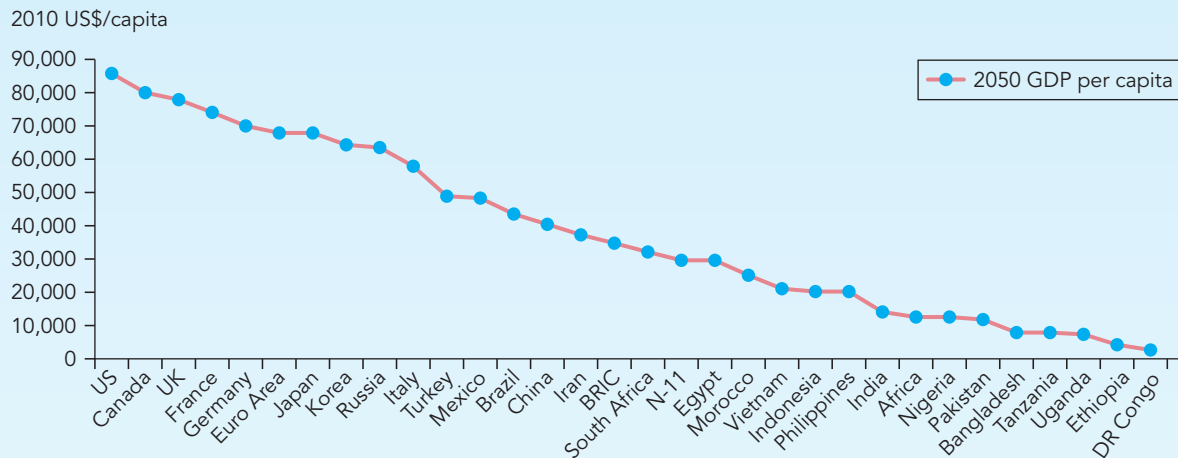
**Figure 1.8** The Percentages of Global GDP, 2011 and 2060

Source: OECD, 2012, Looking to 2060: A global vision of long-term growth (p. 8), *Economics Department Policy Note 5*, November. Note: The comparisons are based on 2005 purchasing power parity (PPP).

BRIC group, with income per capita approaching that of Korea. By 2050, per capita income in China (US\$40,614) and India (US\$14,766) will continue to lag behind developed economies—at, respectively, 47% and 17% of the US level (US\$85,791). These predictions were supported by OECD, which noted that by 2060, Chinese and Indian per capita income would only reach 59% and 27% of the US level, respectively.

Underpinning this scenario of “continued globalization” are three assumptions: (1) emerging economies as a group will maintain strong (albeit gradually reduced) growth; (2) geopolitical events and natural disasters (such as climate changes) will not create significant disruption; and (3) regional, international, and supranational institutions continue to function reasonably. This scenario envisions a path of growth that is perhaps more volatile than that of the past 20 years, but ultimately leads to considerably higher levels of economic integration and much higher levels of incomes in countries nowadays known as emerging economies.

The second scenario can be labeled “de-globalization.” It is characterized by (1) prolonged recession, high unemployment, droughts, climate shocks, disrupted food supply, and conflicts over energy (such as “water wars”) on the one hand; and (2) public unrest, protectionist policies, and the unraveling of certain institutions that we take for granted (such as the EU) on the other hand. As protectionism rises, global economic integration suffers.

**Figure 1.9** The Rankings of Per Capita Income Remain Relatively Unchanged by 2050

Source: Goldman Sachs, 2012, An update on the long-term outlook for the BRICs and beyond (p. 4), *Monthly Insights from the Office of the Chairman, Goldman Sachs Asset Management*, January. See footnote to Figure 1.6 for N-11.

The upshot? Weak economic growth around the world. While global de-integration would harm economies worldwide, regional de-integration would harm countries of Europe, especially those outside a likely residual core of the EU. Unable to keep growing sustainably, BRIC may become “broken bricks” and may fail to reach their much-hyped potential. For example, in the 1950s and 1960s, Russian economic growth was also very impressive, fueling Soviet geopolitical ambitions that eventually turned out to be unsupportable. In the late 1960s, Burma (now Myanmar), the Philippines, and Sri Lanka were widely anticipated to become the next Asian Tigers, only to falter badly. Over the long course of history, it is rare to sustain strong growth in a large number of countries over more than a decade. It is true that the first decade of the 21st century—prior to the Great Depression—witnessed some spectacular growth in BRIC and many other emerging economies. A key question concerns how unique the current times are. Historically, “failure to sustain growth has been the general rule,” according to a pessimistic expert.

In both scenarios, one common prediction is that global competition will heat up. Competition under

the “de-globalization” scenario would be especially intense since the total size of the “pie” will not be growing sufficiently (if not negatively). At the same time, firms would operate in partially protected markets, which result in additional costs for market penetration. Competition under the “continued globalization” scenario would also be intense, but in different ways. The hope is that a rising “tide” may be able to lift “all boats.”

#### CASE DISCUSSION QUESTIONS

1. Which of the two scenarios is more plausible for the global economy in 2050? Why? How does that affect *you* as a consumer, as a professional, and as a citizen of your country?
2. From a resource-based view, what should firms do to better prepare for the two scenarios?
3. **ON ETHICS:** From an institution-based view, what should firms do to better prepare for the two scenarios? (HINT: For example, if they believe in “continued globalization,” they may be more interested in lobbying for reduced trade barriers. But if they believe in “de-globalization,” they may lobby for higher trade barriers.)

Sources: Based on (1) Foresight Horizon Scanning Centre, 2009, *World Trade: Possible Futures*, London: UK Government Office for Science; (2) Goldman Sachs, 2012, An update on the long-term outlook for the BRICs and beyond, *Monthly Insights from the Office of the Chairman, Goldman Sachs Asset Management*, January; (3) OECD, 2012, Looking to 2060: A global vision of long-term growth, *Economics Department Policy Note 5*, November; (4) M. W. Peng & K. Meyer, 2013, Winning the future markets for UK manufacturing output, *Future of Manufacturing Project Evidence Paper 25*, London: UK Government Office for Science; (5) R. Sharma, 2012, Broken BRICS: Why the rest stopped growing, *Foreign Affairs*, November: 2–7.



## NOTES

[**Journal acronyms**] **AMJ**—*Academy of Management Journal*; **AMP**—*Academy of Management Perspectives*; **AMR**—*Academy of Management Review*; **APJM**—*Asia Pacific Journal of Management*; **BW**—*BusinessWeek* (before 2010) or *Bloomberg Businessweek* (since 2010); **GSJ**—*Global Strategy Journal*; **HBR**—*Harvard Business Review*; **ISQ**—*International Studies Quarterly*; **JIBS**—*Journal of International Business Studies*; **JIM**—*Journal of International Management*; **JM**—*Journal of Management*; **JMS**—*Journal of Management Studies*; **JWB**—*Journal of World Business*; **MBR**—*Multinational Business Review*; **MIR**—*Management International Review*; **SMJ**—*Strategic Management Journal*

1 This definition of the MNE can be found in R. Caves, 1996, *Multinational Enterprise and Economic Analysis*, 2nd ed. (p. 1), New York: Cambridge University Press; J. Dunning, 1993, *Multinational Enterprises and the Global Economy* (p. 30), Reading, MA: Addison-Wesley. Other terms are multinational corporation (MNC) and transnational corporation (TNC), which are often used interchangeably with MNE. To avoid confusion, in this book, we will use only MNE.

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## CHAPTER 2



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### Learning Objectives

After studying this chapter, you should be able to

- explain the concept of institutions and their key role in reducing uncertainty.
- articulate the two core propositions underpinning an institution-based view of global business.
- identify the basic differences between democracy and totalitarianism.
- outline the differences among civil law, common law, and theocratic law.
- understand the importance of property rights and intellectual property rights.
- appreciate the differences among market economy, command economy, and mixed economy.
- participate in two leading debates concerning politics, laws, and economics.
- draw implications for action.

# Understanding Formal Institutions: Politics, Laws, and Economics

## OPENING CASE

### EMERGING MARKETS: The Peril and Promise of Russia



Russia is not the Soviet Union. But what is it? Despite the extraordinary transitions moving from a centrally planned economy to a market economy and from a totalitarian regime to a democracy, most of the news we read (in the West) on Russia is negative. Corruption is widespread (Russia ranks 146th out of 180 countries, according to Transparency International). In 2004, Russia was downgraded from “Partly Free” to “Not Free”—on a 1 to 3 scale of “Free,” “Partly Free,” and “Not Free”—by Freedom House, a leading nongovernmental organization (NGO) promoting democracy. In 2012, Vladimir Putin was reelected as president (after he served as president for two terms between 2000 and 2008, and as prime minister between 2008 and 2012). The election was largely symbolic, as all viable candidates were not allowed to run against him. In 2014, Russia successfully staged the winter Olympics in Sochi. Then Russia quickly showed its aggressive side, swallowing Crimea and destabilizing Ukraine. Even before the geopolitical events in 2014, some commentators bearish on Russia had suggested kicking Russia out of the BRIC group, given its alleged lack of dynamism, and to focus more business attention on China, India, and Brazil. After Russia became deeply involved in the mess of Ukrainian politics, the United States, the European Union, Norway, Australia, Canada, and Japan imposed a series of sanctions to “punish” and “isolate” Russia.

Is Russia really that bad? The answer is: Of course not! Russia is simply being Russia. While Russia’s gross domestic product (GDP) is smaller than that of China and Brazil, it is larger than that of India. Russia’s per capita GDP, approximately US\$16,000 (at purchasing power parity), is one-third higher than that of Brazil, three times that of China, and five times that of India. Russia has the second-largest automobile market in Europe (behind Germany), and it has more college graduates (as a percentage of population) than any other country. Simply put, Russia is too big and too rich to ignore. None of the high-tech giants (such as Cisco, HP, and Intel) and industrial and consumer goods firms (such as Carrefour, Danone, IKEA, Nestlé, PepsiCo, and Unilever) has announced plans to quit Russia. Russia’s economic growth may not be as fast as China’s or India’s, but it will certainly be higher than US or EU growth. Russia exports more than 30% of its GDP, in contrast to 26% for China, 25% for India, and 13% for Brazil.

Because Russia is so large and complex, how to “read” Russia has remained a constant debate. The debate centers on political, economic, and legal dimensions. Politically, Russia has indeed become less democratic. Certain segments of the population (especially the better educated) are disappointed by the return of Putin. But a more relevant question is: Is Russia better off under Putin’s more authoritarian rule since 2000,



compared with Boris Yeltsin's more democratic (and more chaotic) rule in the 1990s? Russia under Putin between 2000 and 2008 grew 7% annually, whereas Russia under Yeltsin during the 1990s experienced a catastrophic economic decline.

Economically, the Russian economy indeed has great room for development. It is overly dependent on oil and gas exports, contributing 70% of its US\$515 billion exports. In the World Economic Forum's *Global Competitiveness Report*, Russia ranks only 51st in innovation (out of 133 countries), behind China (26th) and India (30th). Dmitry Medvedev, who served as president between 2008 and 2012 (while Putin was prime minister), published an article in 2009 titled "Russia Forward!" He asked a provocative question: "Should we drag a primitive economy based on raw materials and endemic corruption into the future?"

Legally, establishing the rule of law that respects private property is important. In a society where nobody had any significant private property until recently, how a small number of individuals became super-rich oligarchs (tycoons) almost overnight is intriguing. By the 2000s, the top ten families or groups owned 60% of Russia's total market capitalization. The government thus faced a dilemma: Redistributing wealth by confiscating assets from the oligarchs creates more uncertainty, whereas respecting and protecting the property rights of the oligarchs results in more resentment among the population. Thus far, the government largely sided with the oligarchs, as long as the oligarchs played by Putin's rules: (1) mind your own business—do not get involved in politics, and (2) pay taxes.

Internationally, the sanctions were designed to target Putin's inner circle first. They soon spilled over to the financial, energy, and defense industries. In retaliation, Russia banned agricultural imports from any country that imposed sanctions. As a result, US\$6.5 billion worth of EU agricultural products that normally would have gone to Russia ended up being dumped in the EU. Since Russia accounted for one-third of the EU's fruit and vegetable exports and one-quarter of EU's beef exports, the Russian ban caused prices for Dutch beef, Finnish dairy products, Latvian cabbage, and Spanish peaches to *collapse*. Dealing with the more abundant and cheaper food, the German agriculture minister urged Germans to eat fruits at least five (!) times a day. While governments butted heads, European farmers could not sustain their losses. In August 2014, European taxpayers had to cough up US\$200 million in new subsidies to farmers. Firms withdrawing from Russia due to its peril obviously cannot benefit from its promise, and can only salivate over rivals that can tap into the promise of Russia. Since Russians had to eat, Chinese farmers happily started to fill the market vacated by EU farmers. Likewise, as European demand for Russian gas declined, in 2014 China National Petroleum Corporation (CNPC) signed an unprecedented US\$300 billion deal with Gazprom, unlocking the vast promise of Russia's underground wealth.

Sources: Based on (1) *Bloomberg Businessweek*, 2014, Putin's paradox, September 1: 12–13; (2) *Bloomberg Businessweek*, 2014, This apple was once headed to Russia, not anymore, September 15: 13–15; (3) *Economist*, 2012, Moscow doesn't believe in tears, March 10: 62–63; (4) *Economist*, 2012, Moscow spring, February 11: 12; (5) *Economist*, 2014, The long game, September 6: 15; (6) S. Michailova, S. Puffer, & D. McCarthy, 2013, Russia: As solid as a BRIC? *Critical Perspectives on International Business*, 9: 5–18; (7) [www.freedomhouse.org](http://www.freedomhouse.org).

### Institutional transition

Fundamental and comprehensive changes introduced to the formal and informal rules of the game that affect firms as players.

Why is Western news reporting on Russia so negative? Does Russia really have a democracy? Does it matter? Is democracy the best political system to develop Russia's economy? Does Russia have the rule of law? If your firm is currently doing business in Russia, should it consider withdrawing from Russia? As the Opening Case illustrates, answers to these questions boil down to institutions, popularly known as the "rules of the game." As economic players, firms play by these rules. However, institutions are not static, and they may change, resulting in **institutional transitions**—"fundamental and comprehensive changes introduced to the formal and informal rules of the game that affect firms as players."<sup>1</sup> Examples of institutional transitions include Russia's transitions from a communist totalitarian state to a market economy with regular elections (never mind the imperfections).



Overall, the success and failure of a firm around the globe are, to a large extent, determined by its ability to understand and take advantage of the different rules of the game. In other words, how firms play the game and win (or lose), at least in part, depends on how the rules are made, enforced, and changed. This calls for firms to constantly monitor, decode, and adapt to the changing rules of the game in order to survive and prosper. As a result, such an **institution-based view** has emerged as a leading perspective on global business.<sup>2</sup> This chapter first introduces the institution-based view. Then, it focuses on *formal* institutions (such as political, legal, and economic systems). *Informal* institutions (such as cultures, ethics, and norms) will be discussed in Chapter 3.

## 2.1 Understanding Institutions

Building on the “rules of the game” metaphor, Douglass North, a Nobel laureate in economics, more formally defines **institutions** as “the humanly devised constraints that structure human interaction.”<sup>3</sup> An **institutional framework** is made up of formal and informal institutions governing individual and firm behavior. These institutions are supported by three “pillars” identified by Richard Scott, a leading sociologist. They are the (1) regulatory, (2) normative, and (3) cognitive pillars.<sup>4</sup>

Shown in Table 2.1, **formal institutions** include laws, regulations, and rules. Their primary supportive pillar, the **regulatory pillar**, is the coercive power of governments. For example, while many individuals and companies may pay taxes out of their patriotic duty, a larger number of them do so in fear of the coercive power of the government if they are caught not paying.

On the other hand, **informal institutions** include norms, cultures, and ethics. The two main supportive pillars are normative and cognitive. The **normative pillar** refers to how the values, beliefs, and actions of other relevant players—collectively known as **norms**—influence the behavior of focal individuals and firms.<sup>5</sup> The recent norms centered on rushing to invest in China and India have prompted many Western firms to imitate each other without a clear understanding of how to make such moves work. Cautious managers resisting such “herding” are often confronted by board members and investors: “Why are we not in China and India?” In other words, “Why don’t we follow the norm?”

Also supporting informal institutions, the **cognitive pillar** refers to the internalized, taken-for-granted values and beliefs that guide behavior.<sup>6</sup> For example, what triggered whistleblowers to report Enron’s wrongdoing was their belief in what was right and wrong. While most employees may not feel comfortable with organizational wrongdoing, the norm is to shut up and not to “rock the boat.” Essentially,

**Table 2.1** Dimensions of Institutions

| Degree of formality   | Examples   | Supportive pillars   |
|-----------------------|--|--|
| Formal institutions   | <ul style="list-style-type: none"> <li>• Laws</li> <li>• Regulations</li> <li>• Rules</li> </ul> | <ul style="list-style-type: none"> <li>• Regulatory (coercive)</li> </ul>          |
| Informal institutions | <ul style="list-style-type: none"> <li>• Norms</li> <li>• Cultures</li> <li>• Ethics</li> </ul>  | <ul style="list-style-type: none"> <li>• Normative</li> <li>• Cognitive</li> </ul> |

### Learning Objective

Explain the concept of institutions and their key role in reducing uncertainty.

### Institution-based view

A leading perspective in global business that suggests that the success and failure of firms are enabled and constrained by institutions.

### Institution

Formal and informal rules of the game.

### Institutional framework

Formal and informal institutions that govern individual and firm behavior.

### Formal institution

Institution represented by laws, regulations, and rules.

### Regulatory pillar

The coercive power of governments.

### Informal institution

Institution represented by cultures, ethics, and norms.

### Normative pillar

The mechanism through which norms influence individual and firm behavior.

### Norms

Values, beliefs, and actions of relevant players that influence the focal individuals and firms.

### Cognitive pillar

The internalized (or taken-for-granted) values and beliefs that guide individual and firm behavior.