



The Hard Reality of Semiglobalization

AND HOW TO PROFIT FROM IT BY PANKAJ GHEMAWAT

THE HARD REALITY IS THAT MOST BUSINESS EXECUTIVES HAVE GOTTEN IT WRONG ABOUT GLOBALIZATION.

They have bought into the apocalyptic visions of the “Flat World” and the “Death of Distance” and their errors have produced tangible harm to their companies and shareholders.

My new book *Redefining Global Strategy* is meant to serve as a fact-based antidote. It delivers the hard data about today’s semiglobal environment and provides a set of tools for how to thrive in this more complex reality.

Yes, borders still matter. And that’s not bad news. For the sophisticated global strategist, the complex world of semiglobalization offers a far richer palette of business opportunities than a simple “borderless” world of uniformity and ubiquity. So, let’s dive into the complex reality and learn how to profit from it...

REALITY CHECK

Before we begin, take a moment to estimate the internationalization of each of the following aspects of business and everyday life:

1. Telephone Calls: International calling minutes as % of total calling minutes?	_____
2. Immigrants: Long-term international migrants as % of global population?	_____
3. University Students: Foreign students as % of total university enrollment?	_____
4. Management Research: Research papers that look at cross-border issues as % of total?	_____
5. Private Charity: International giving as % of total private giving?	_____
6. Direct Investment: Foreign direct investment as % of gross fixed capital formation?	_____
7. Tourists: International arrivals as % of total tourist arrivals?	_____
8. Patents: Patents involving international cooperation as % of total?	_____
9. Stock Investment: International stock holdings as % of total investors' stock holdings?	_____
10. Trade: Exports as % of GDP?	_____

Now check your answers versus the side note on the following page. If you are like most of the over 100 audiences to whom I have asked these questions, including the readership of *Harvard Business Review*, you far overestimated the state of globalization. In fact, I have only once seen a single dimension underestimated by an audience, and that was among the managers of a large Indian IT Services firm, one of the industries cited by Thomas Friedman as a harbinger of the Flat World. It seems the purveyors of offshore IT are among the few who really understand how hard it is to deliver high-quality professional services from the opposite side of the world.

SEMIGLOBALIZATION: THE 10% PRESUMPTION

Thank you for playing along with my little quiz. The average of the correct answers yields what I call The 10% Presumption. If I were asked to estimate the internationalization of a random aspect of business or life, 10% would be my starting point, not 100%. The data indicate that we are much closer to a world of separate domestic markets than to a fully integrated world of complete globalization. But neither extreme correctly describes reality. We live in a world of semiglobalization where neither the bridges nor the barriers between countries can be ignored.

If globalization is an inadequate term for the current state of integration, there's an obvious rejoinder: Even if the world isn't quite flat today, it will be tomorrow. But the verdict of history is mixed. Along a few dimensions, integration reached its all-time high many years ago. For example, rough calculations suggest the number of long-term international migrants peaked at 3 percent of the world's population in 1900—the high water mark of an earlier era of migration—versus 2.9 percent in 2005.

Along other dimensions, it's true that new records are being set. But this growth has happened only relatively recently, and only after long periods of stagnation and reversal. It wasn't until the late 1990s that FDI stocks as a percentage of the world's GDP matched and then overtook the previous record set before World War I. And while international trade as a percentage of GDP has been setting records since the 1960s, extrapolating the recent trajectory only implies growth from 27% to 35% by 2030. Important, but hardly a marker that we are reaching the "End of History."

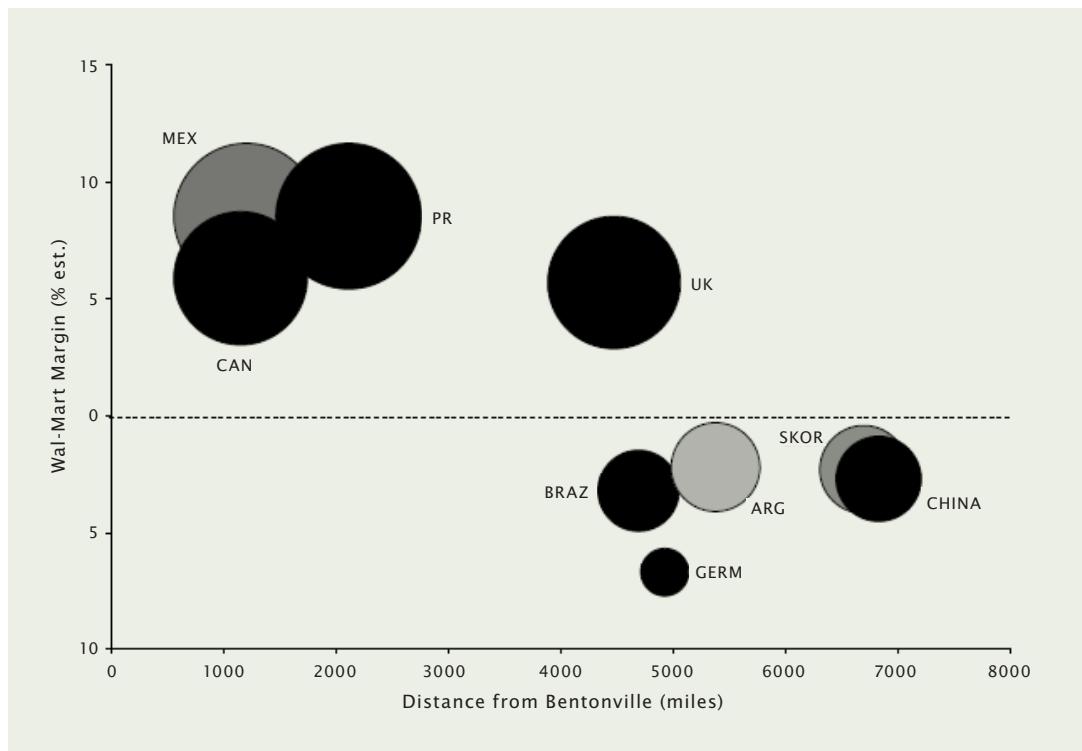
1. Telephone Calls: 3%, 2. Immigrants: 3%,
3. University Students: 5%, 4. Management Research: 6%, 5. Private Charity: 8%,
6. Direct Investment: 8%, 7. Tourist Arrivals: 9%,
8. Patents: 15%, 9. Stock Investment: 15%,
10. Trade: 27%

Free traders and optimistic multinationals may push my 10% presumption upward a few points in the coming decades, or anti-globalization protestors or a "Clash of Civilizations" might force it back downward. But think of someone driving across the Midwestern United States. She's going to be quite far from the coasts for some time irrespective of whether she speeds up or slows down—or even changes direction. Semiglobalization is here to stay.

DISTANCE STILL MATTERS

In a world of only partial integration of markets, distance still matters. Consider the following graphic showing Wal-Mart's operating margin by country in 2004:

First, note the impact of geographic distance. The capital city of each of Wal-Mart's four profitable countries is geographically closer to Wal-Mart's headquarters in Bentonville, Arkansas, than the capital cities of the five unprofitable ones. And two of the profitable countries (Canada and Mexico) share a common land border with the United States.



The Wal-Mart example also highlights other important elements of distance or difference. Unlike all of the unprofitable countries, Canada and the UK share a common language with the United States and have historical colony/colonizer ties, both markers of low cultural distance. And Canada and Mexico are part of a regional Free Trade Agreement (NAFTA), reducing administrative distance. Also, the other profitable “country” in Wal-Mart’s system is Puerto Rico, which is administratively part of the United States.

SPOTTING THE DIFFERENCES

The Wal-Mart example highlights the challenge distance poses for even one of the world's most successful companies. But profitability does not have to decline as a function of distance.

The first step toward crafting strategies that more adeptly manage the impacts of distance and difference is to carefully identify the relevant types of difference. But as any child who has struggled with side-by-side pictures with the instruction "spot the differences" will attest, unless you know what you're looking for, it's easy to miss even not-so-subtle differences.

To provide a roadmap for spotting the kinds of differences that matter for international strategy, I have grouped the key elements of "distance" into four headings: cultural, administrative, geographic, and economic. Together, they make up what I call the CAGE Framework, first shown at the country level:

	Cultural Distance	Administrative Distance	Geographic Distance	Economic Distance
Country Pairs (Bilateral)	<ul style="list-style-type: none">• Different languages• Different ethnicities; lack of connective ethnic or social networks• Different religions• Lack of trust• Different values, norms, and dispositions	<ul style="list-style-type: none">• Lack of colonial ties• Lack of shared regional trading bloc• Lack of common currency• Political hostility	<ul style="list-style-type: none">• Physical distance• Lack of land border• Differences in time zones• Differences in climates/disease environments	<ul style="list-style-type: none">• Rich/poor differences• Other differences in cost or quality of natural resources, financial resources, human resources, infrastructure, information or knowledge
Countries (Unilateral / Multilateral)	<ul style="list-style-type: none">• Insularity• Traditionalism	<ul style="list-style-type: none">• Nonmarket/closed economy (home bias vs. foreign bias)• Lack of membership in international organizations• Weak institutions, corruption	<ul style="list-style-type: none">• Landlockedness• Lack of internal navigability• Geographic size• Geographic remoteness• Weak transportation or communication links	<ul style="list-style-type: none">• Economic size• Low per capita income

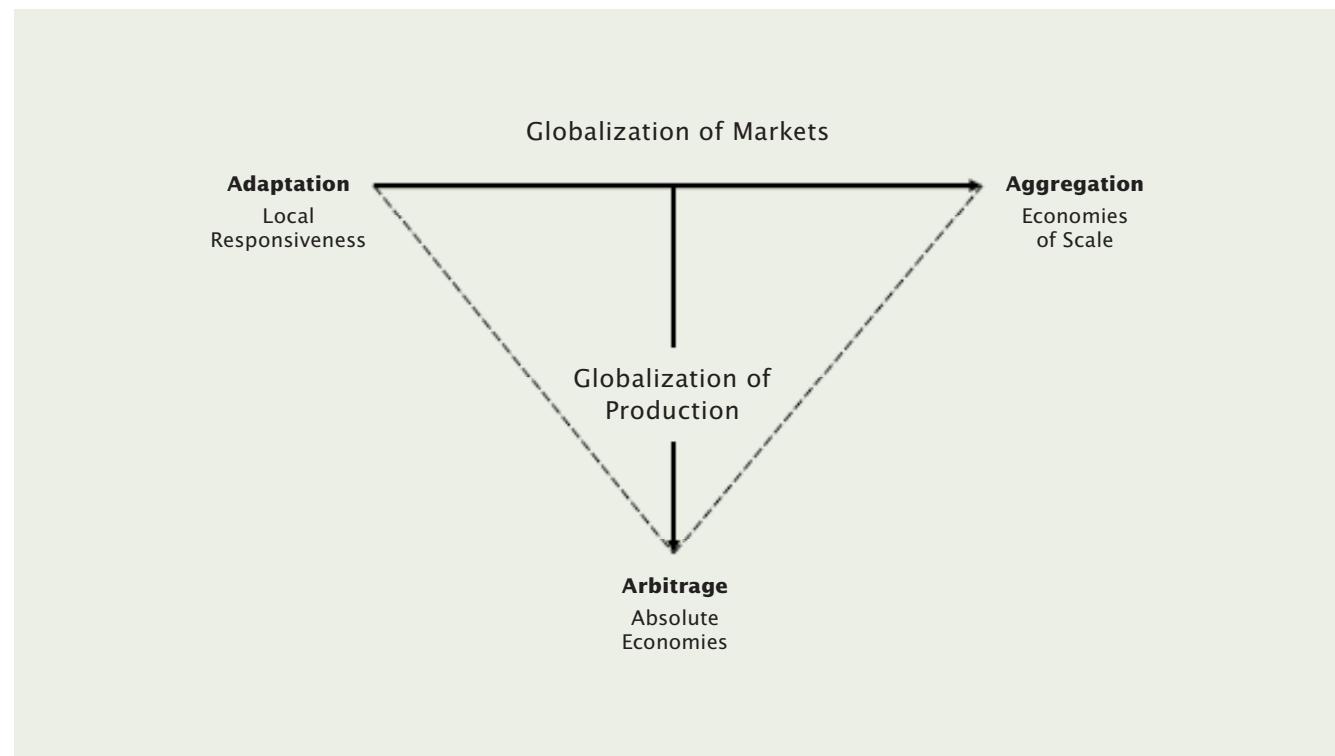
The impact of distance or difference varies markedly by industry.

To prioritize the elements of distance a strategy must address, one should also apply the CAGE Framework at the industry level:

Cultural Distance	Administrative Distance	Geographic Distance	Economic Distance
<p>Cultural differences matter the most when:</p> <ul style="list-style-type: none">• Products have high linguistic content (TV programs)• Products matter to cultural or national identity (foods)• Product features vary in terms of size (cars) or standards (electrical equipment)• Products carry country-specific quality associations (wines)	<p>Government involvement is high in industries that are:</p> <ul style="list-style-type: none">• Producers of staple goods (electricity)• Producers of other "entitlements" (drugs)• Large employers (farming)• Large suppliers to government (mass transportation)• National champions (aerospace)• Vital to national security (telecommunications)• Exploiters of natural resources (oil, mining)• Subject to high sunk costs (infrastructure)	<p>Geography plays a more important role when:</p> <ul style="list-style-type: none">• Products have a low value-to-weight or bulk ratio (cement)• Products are fragile or perishable (glass, fruit)• Local supervision and operational requirements are high (services)	<p>Economic differences matter the biggest impact when:</p> <ul style="list-style-type: none">• Nature of demand varies with income (cars)• Economics of standardization or scale are limited (cement)• Labor and other factor cost differences are salient (garments)• Distribution or business systems are different (insurance)• Companies need to be responsive and agile (home appliances)

MANAGING DIFFERENCES: INTRODUCING THE AAA STRATEGIES

Facing the broad range of cross-country differences an international strategy must address, one might be tempted to throw up his or her hands and take one of the easy ways out: compete the same way everywhere or delegate full authority to country managers to adjust each local operation to its unique conditions. But it would be a mistake to give up now. There is a rich palette of strategy options from which to blend unique competitive moves that address cross-country differences. I group them into three categories: adaptation, aggregation and arbitrage.



ADAPTATION: ADJUSTING TO DIFFERENCES

Adaptation is perhaps the most obvious strategy for dealing with differences. If local markets have different preferences, offer them different products or services. But adaptation is costly and in the extreme results in operations that are so different across countries that there is no value gained by keeping them together in a single company.

The essence of smart adaptation lies in prioritization and management of complexity. I suggest five general levers for adaptation:

- **Variation:** Despite the cost and complexity involved, vary products, policies, positioning, metrics, etc.
- **Focus:** Reduce the need for variation by focusing on a limited set of products, geographies, verticals, segments, etc.
- **Externalization:** Reduce the burden of variation by externalizing it via strategic alliances, franchising, user adaptation, networking, etc.
- **Design:** Reduce the cost of variation by designing in flexibility, partitioning elements that will be varied, creating platforms or modular designs, etc.
- **Innovation:** Improve the effectiveness of variation via innovations such as transferring ideas across geographies, explicit localization, recombination of elements of the home country business model, or even transformation of the local environment itself.

I recognize this is a dense list and more explanation of each of the levers and sub-levers is required. My book provides more detailed elaboration, but I wanted to show an overview here to emphasize that adaptation can take on a much richer variety of forms than simple tailoring of product design attributes to each individual country's buyer preferences. Smart adaptation blends together the benefits of local responsiveness and scale economies via active management of complexity.

AGGREGATION: OVERCOMING DIFFERENCES

Aggregation is all about using grouping devices to create greater economies of scale than country-by-country adaptation can provide. It means inventing and implementing cross-country mechanisms at levels somewhere between the individual country and the whole world.

Regional strategies, aggregating based on geography, are worthy of special attention. Since World War II, the growth of trade within regions has outpaced the growth of trade between regions.

Data on foreign direct investment also exhibit significant regionalization. This should come as no surprise because regions also tend to share commonalities along the cultural, administrative, and economic dimension of the CAGE Framework.

In order to help companies think more broadly about how to create value via regional strategies, I have identified six general types of regional strategies, also elaborated in my book: regional focus, regional portfolio, regional hubs, regional platforms, regional mandates, and regional networks. Regional strategy is about more than simply designating an office as regional headquarters and adding an additional layer of management. There are specific levers for value creation available to companies at the regional level.

Companies can also aggregate along the other CAGE dimensions. Tata Consultancy Services, India's largest IT Services firm, aggregated on the basis of language (a cultural base), in setting up operations in Uruguay to serve the Spanish-speaking market and in Hungary to serve German speakers. Raytheon created a "Commonwealth marketing group" to take advantage of administrative similarities among countries in the British Commonwealth. Cemex, a global cement company based in Mexico, focused its international expansion in the 1990s on emerging market countries (an economic base) before shifting to geographic aggregation.

ARBITRAGE: EXPLOITING DIFFERENCES

Arbitrage is the exploitation of differences between national or regional markets, often by locating parts of the supply chain in different places—for instance, call centers in India and factories in China. It is about seeking absolute economies rather than scale economies gained through standardization.

The original trading empires were built on arbitraging differences in cost and availability of luxuries across regions. The Spice Road, for example, developed because spices could (initially) be sold in Europe for several hundred times what they cost to buy in Asia. And arbitrage is still alive and well today. Wal-Mart, for example, generates more income from procuring lower cost goods in China and selling them at a profit in the United States than from sales at its international stores.

Despite arbitrage's long and storied history, many managers question whether arbitrage-based strategies can really be sustainable? Low-cost inputs are available to all competitors, right? And won't "spreads" be bid away over time? I respond as follows. First, many arbitrage spreads such as cross-country differences in labor costs are surprisingly long-lasting. Second, while cheap inputs are theoretically available to all, it often takes critical company-specific skills to employ them effectively. For example, any company can hire Brazilian engineers, but only Embraer has developed the capability to run a world-class aerospace operation amidst the turbulence and turmoil of contemporary Brazil. And finally, even arbitrage-based advantages that cannot be sustained indefinitely are often still worth undertaking if only to avoid ending up at a disadvantage relative to competitors that do engage in arbitrage.

The examples cited above focused on labor cost as a basis of arbitrage. However, the CAGE Framework is again a useful tool to remind us of the broader range of arbitrage opportunities presented by a semiglobalized world. French luxury brands and U.S. fast food chains engage in cultural arbitrage. More controversially from an ethical standpoint, examples abound of administrative arbitrage ranging from the use of offshore tax havens to locating factories in countries with lower

environmental or labor standards. Geographic arbitrage still exists, for example, around climate differences as seen in trade of fresh fruits and flowers. Newer forms of geographic arbitrage in services take advantage of time zone differences to enable teams to work around the clock. And while labor cost differences are the most prominent base for economic arbitrage, one can also find examples of capital cost arbitrage.

MANAGING DIFFERENCES: INTEGRATING THE AAA STRATEGIES

How should companies choose among the strategies of adaptation, aggregation, and arbitrage and should they be pursued separately or in combination? My general advice to companies is to choose a single “big A” first to develop a clear base of advantage, and then consider adding a second, “small a” to the mix. Generally it is very difficult to beat competitors on all three dimensions, but there are rare examples of the elusive trifecta.

While a company’s international strategy must be tailored to its own industry environment and internal capabilities, I can offer a few general guidelines from cross-industry analysis. Companies with high advertising-to-sales ratios are generally pursuing strategies that will require substantial adaptation to effectively connect with international customers. If the R&D-to-sales ratio is relatively higher, the company most likely is building up fixed investment in capabilities that should be leveraged across geographies, denoting an important role for aggregation. And while labor cost is only one potential base for arbitrage, companies with high labor-to-sales ratios are good candidates to consider arbitrage strategies.

Each of these types of strategies also raises its own set of managerial challenges. For example, adaptation generally calls for empowering managers in each country to achieve local relevance. Under this strategy, explicit care must be taken to avoid excessive variety or complexity and to support cross-country coordination.

Aggregation relies heavily on managers in the upper-middle ranks of the organization to implement cross-country mechanisms for coordination. Externally, firms engaged in aggregation must watch out for potential backlash against homogenization or hegemony. U.S. based companies need to be especially careful about this.

Firms engaged in arbitrage must maintain careful watch over their “spreads” as arbitrage opportunities do tend to be bid away over time (though they often last longer than many expect). To facilitate arbitrage, companies generally organize by function, dividing up the value chain across geographies to achieve absolute economies via international specialization. And companies that engage in arbitrage also need to mind their external communications and community engagement to protect their reputations at home.

GLOBAL VALUE CREATION: THE ADDING VALUE SCORECARD

The point that global strategy, whether based on adaptation, aggregation, or arbitrage must create tangible economic value for a company and its shareholders is often drowned out amid the rhetoric of the globalization imperative. At worst, companies get caught up in a crude “sizeism” racing to enter as many new countries as possible.

To place the focus of global strategy evaluation back on economic value, I offer a simple scorecard organized around the acronym ADDING value. The first four categories are drawn from well document research into single country strategy, while the last two are special additions reflecting important cross-border value drivers.

Components of Value	Guidelines
Adding Volume/Growth	<ul style="list-style-type: none"> • Look at the true economic profitability of incremental volume • Probe the level at which additional volume yields economics of scale (or scope): globally, nationally, at the plant or customer level, etc. • Calibrate the strength of scale effects (slope, percentage of costs/revenues affected) • Assess the other effects of volume
Decreasing Costs	<ul style="list-style-type: none"> • Unbundle price effects and cost effects • Unbundle costs into subcategories • Consider cost increase (e.g. due to complexity, adaptation, etc.) as well as decreases and net them out • Look at cost drivers other than scale/scope • Look at labor cost/sales ratios for your industry (or company)
Differentiating/ Increasing Willingness-to-Pay	<ul style="list-style-type: none"> • Look at R&D/sales and Advertising/sales ratios for your industry • Focus on willingness-to-pay rather than prices paid • Think through how globality affects willingness-to-pay • Analyze, in particular, how cross-country (CAGE) heterogeneity in preferences affects willingness-to-pay for products on offer • Segment the market appropriately
Improving Industry Attractiveness/ Bargaining Power	<ul style="list-style-type: none"> • Account for international differences in industry profitability • Understand the structural dynamics of your industry • Look broadly at the impact of trends and moves in changing important elements of industry structure • In particular, think through how you can deescalate/escalate rivalry • Recognize the implications of what you do for rivals' costs or willingness-to-pay for their products (worsening their positions can do as much for added value as improving one's own) • Attend to regulatory/nonmarket restraints—and ethics
Normalizing (or Optimizing) Risk	<ul style="list-style-type: none"> • Characterize the extent and key sources of risk in your business (capital intensity, other irreversibility correlates, demand volatility, etc.) • Assess how much cross border operations reduce or increase risk • Recognize any benefits that might accrue from increasing risk • Consider multiple modes of managing risk or optionality
Generating Knowledge (and other Resources or Capabilities)	<ul style="list-style-type: none"> • Assess how location-specific versus mobile knowledge is, and what to do about it • Consider multiple modes of generating (and diffusing) knowledge • Think of other resources/capabilities in similar terms • Avoid double-counting

GETTING STARTED: A FIVE-STEP PROCESS

Now you have the tools to identify differences, craft strategies tailored to the complex world of semiglobalization, and assess the economic value created and captured by cross-border activity. To conclude, I offer a five-step road map for getting started applying these concepts in your company:

1. Performance Review: Assess current performance of global operations. Disaggregate performance along geographic and other dimensions. Take cost of capital into account. If your company is like most I have studied, performance varies widely and there are many units that are producing negative economic returns.

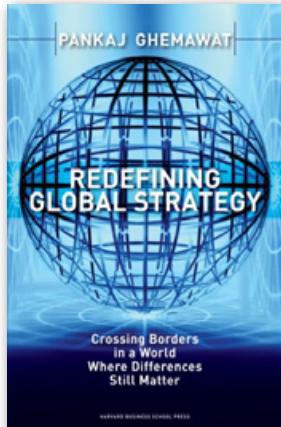
2. Industry and Competitive Analysis: Understand trends in industry concentration, market share, trade, and foreign investment. Are competitors standardizing products across countries? What does the rate of real price declines say about minimum targets for productivity improvement? How does industry profitability vary across countries and does it relate to scale at the global, regional, national, or plant level? How do economic profits in different countries get distributed among suppliers, competitors, complementors, and buyers/intermediaries: where's the money? And finally, don't forget advertising, R&D and labor intensity ratios and their implications for selecting among the AAA strategies.

3. Distance Analysis (CAGE Framework): Prioritize the aspects of distance that matter most for your industry and company. Complement single country analysis with evaluation of distance at the bilateral/multilateral level.

4. Articulation of Key Value Components (ADDING Value Scorecard): Parse the sources of value embedded in the strategy and quantify where possible. Use the ADDING Value Scorecard: adding volume, decreasing costs, differentiating, improving industry attractiveness, normalizing risks and generating knowledge and other resources. Be careful to avoid double-counting.

5. Development and Assessment of Strategic Options (AAA Strategies): Identify at least two serious strategy options, document them carefully and analyze them in terms of the full range of value creation and value capture dimensions. ↗

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ABOUT THE AUTHOR

Pankaj Ghemawat is the Anselmo Rubiralta Professor of Global Strategy at IESE Business School in Barcelona and the Jaime and Josefina Chua Tiampo Professor of Business Administration (on leave) at the Harvard Business School. He has also been a consultant with McKinsey & Company. In 1991, at age 23, he was appointed the youngest full professor in the history of Harvard Business School. He has written for *The Wall Street Journal* and *The New York Times* and one of his bestselling *Harvard Business Review* articles won the McKinsey Award for the best article published in 2005. For more information, please visit: www.ghemawat.org.

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