Seizing Opportunities and Facing Threats: Post-Industrial Companies and Trade in Emerging Markets

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Abstract

Emerging markets present an opportunity for businesses in the increasingly important service sector, to expand their operations and to manage economic risk by diversifying away from post-industrial countries which may experience very similar economic cycles. On the other hand, emerging markets carry many significant risks, including the risk of economic or political crises and hostile actions by governments. This paper investigates issues related to international companies from a post-industrial world seeking greater involvement in emerging markets. Firms need to take care when operating in emerging markets as they can deliver sudden and dramatic economic shocks but also to produce disappointing financial results due to inflation and currency movements. Firms should see an expansion into these markets as a means of genuine diversification of their industrial base, rather than as a easy substitute for continued engagement in regions where they have a longer-standing presence.

Keywords

Post industrial world; emerging markets; SWOT Analysis; politics; culture and finance.

INTRODUCTION

Many enterprises from today's post-industrial economies are primarily concerned with providing a service and not with selling a physical product. This may give rise to several difficulties. Firstly, some service industries are heavily dependent on the concept of intellectual property, in its broadest sense. Some intellectual property can legally be patented and protected. However, the issue is not whether intellectual property enjoys legal protection but whether it can be practically protected. Cultural, political and technological issues can all influence the extent to which protection is either possible or viewed as acceptable. In many cases, the dissemination of intellectual ideas or technological know-how actually is the service being offered and the customer primarily benefits by being able to pass on the information inside or, for that matter, outside the company. There is also likely to be strong resistance, especially from managers in older industries, to the idea that anyone should be prohibited from using an idea just because someone else thought of it.

There are other problems. Some intellectual property, especially in the arts and entertainment is designed for a very specific social group and a particular era of short duration. The application of some business advice and education is limited by the law, institutions and human geography.

Firms involved in service industries must also contend with legal restrictions on their access to the markets. The erection of trade barriers is a feature of all economies. However, lack of familiarity with the systems operating to protect a national market may make it more difficult to overcome these barriers.

A FRAMEWORK FOR SWOT ANALYSIS

In deciding whether to enter an emerging market and if so how best to do so, firms could benefit from the use of SWOT analysis (*e.g.* Weihrich 1982, Wheelen and Hunger 2000).

The following section lists a number of possible strengths and weaknesses which service organizations may possess which may affect their ability to function effectively in an emerging market, followed by a discussion of the potential opportunities and threats which may make these strengths and weaknesses important.

Strengths and Weaknesses

A company considering an involvement in an emerging market needs to consider the characteristics of its own organization and operations which may become strengths or weaknesses in the host country environment.

Characteristics which could be strengths

- Understanding of local culture, customs, working methods
- Existing presence
- Experience with managing subsidiaries and joint ventures
- Local knowledge
- Ability to cope with long supply lines, geographical problems and logistics
- Sufficient resources to absorb economic shocks and setbacks
- International reputation

Characteristics which could be weaknesses

- Cultural inflexibility
- Inexperience in international markets
- Lack of understanding of objectives of international business partners
- Lack of structures to allow development and dissemination of knowledge
- Poor logistical ability
- Economic vulnerability resulting from overstretched resources
- Lack of international brand recognition

We now turn to explaining the significance of these strengths and weaknesses with reference to the opportunities and threats which can arise in emerging economies.

Opportunities

- *Rapid development of emerging economies*

Many developing countries not only have large populations but are experiencing high rates of economic growth. In fact, it tends to be harder for developed economies to grow rapidly in percentage terms, because of the extent of industrial regulation and because growth is more dependent on the development of already advanced technologies, rather than the extension of older ones.

For example, between 1976 and 2001, China's GDP grew by an average of 9.2%, India's by 5.3 % and Indonesia's by 5.6% *per annum* (based on figures from United Nations 2003, adjusted for inflation), compared with 3.1% for the United States, 2.9% for Japan and 2.3% for the United Kingdom. This is all the more significant in view of the fact that China, India and Indonesia are, respectively, the largest, second largest and fourth largest countries in the world by population (the United States being the third largest).

Firms will only be able to take advantage of this rapid economic growth if they possess relevant strengths. Firms which possess plentiful resources are in less danger of suffering liquidity problems as business volumes increase. Firms with an existing presence in an emerging market will incur less in the way of set-up costs, while those with no existing presence will incur construction costs and licensing and other legal and administrative fees, as well as suffering from delays. Organizational and logistical ability and local knowledge will also play a part in the success or failure of enterprises' efforts to claim a share of emerging markets' economic growth.

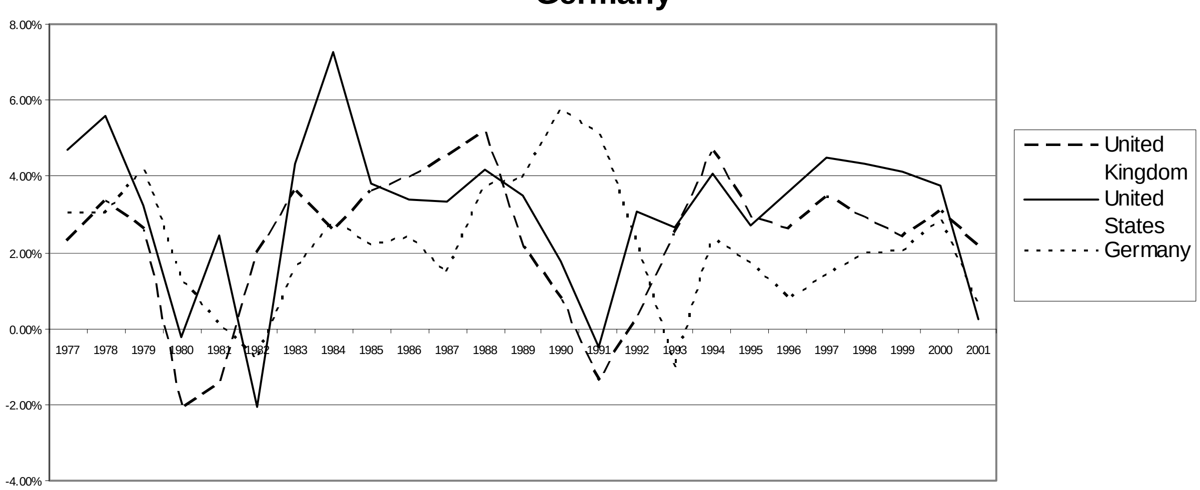
- *Diversification away from older economies*

The present wealth of post-industrial countries still makes them attractive markets. However, they carry risks, which can in part be alleviated by diversifying into other markets. These risks include:

- Economic Cycles**:** All countries in the modern world experience economic cycles. Businesses can never escape from what is going on around them but they can mitigate their losses by diversification.

Figure 1 shows the annual economic growth rates for three post-industrial countries, the UK, the US and Germany. Their cycles are not always synchronized but in the 1990s the patterns were similar.

Figure 1. Annual Economic Growth Rates for the UK, US and Germany

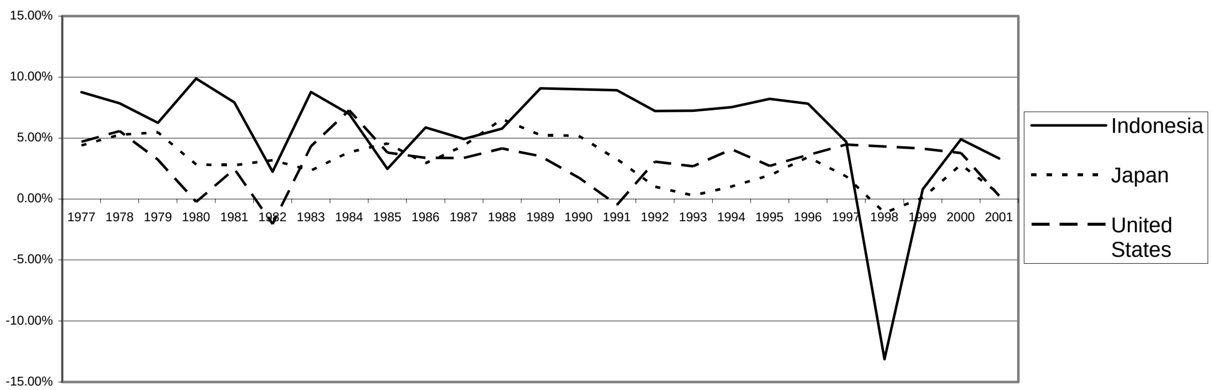


Source: Calculated from economic statistics (constant prices in US$, 1990 exchange rate) in UN (2003)

In 1992, both the US and the UK suffered a recession. The US suffered simultaneous recessions with the UK in 1981 and Germany in 1983.

Figure 2 shows the economic cycles for Indonesia, Japan and the US. Here the contrast is more marked. From 1989 to 1997, Indonesia experienced eight years of high growth, while the Japanese economy struggled and the US went through the decline and recovery phase of a normal cycle. In 1998, however, the Indonesia suffered a severe economic crisis, while the US economy grew rapidly. A firm doing business in all three countries would have been less vulnerable to economic cycles than a firm doing business in only one. The more markets a business can access, the better its chances of avoiding the worst effects of a local downturn.

Figure 2. Annual Growth Rates for Indonesia, Japan and the United States



Source: Calculated from economic statistics (constant prices in US$, 1990 exchange rate) in UN (2003)

- Competition for employees: A further issue faced by companies in highly developed economies is the potential for labour shortages, particularly in highly specialized activities and especially at the peak of an economic cycle. Industries which cannot afford to pay the highest rates will be forced into decline unless they can tap into new pools of labour. It is possible to outsource some activities, such as software development, ticketing, call centres and to some extent manufacturing, while continuing to serve existing markets, as these activities do not have to be carried out close to the customer. Other activities, such as retailing, transport or auditing require a local workforce. Companies primarily involved in these activities may face declining profits if they operate solely in high wage economies, especially if the market price of their services does not keep pace with the price of labour. This may be a further factor in increasing the attractions of diversification.
- Extensive Regulation: All countries regulate service industries both in order to guarantee quality and safety standards and in order to protect domestic markets. The degree of regulation varies from country to country and by diversifying into a wide range of markets, firms can look for a regulatory regime which suits them, avoiding countries

where regulation is too cumbersome to allow the company to put its goods or services on the market within a reasonable timescale or at a reasonable price or too slack to deter competition from less conscientious competitors. Again the emphasis must be on diversification, not on retreating from post-industrial markets to operate in emerging markets.

Diversification requires economic strengths. Because diversification increases the number of risks to which the company is exposed, substantial resources are required to enable the business to absorb these risks.

In addition, a firm's ability to diversify depends on its own flexibility. This flexibility is likely to be a function of a number of factors, including organizational ability, logistical preparedness and the willingness to engage with people in a wide range of cultural settings.

- *Experience*

By diversifying into new markets, a company can gain experience which it may be able to utilize in serving its existing markets. This experience may be relevant to the geographical or economic conditions of the new market or new customer needs or expectations which may give the firm the opportunity to experiment with new products and services.

Threats

Businesses seeking to enter emerging markets must reflect on the possible dangers which they may face, as well as considering the opportunities.

- *Political Risks*

Any new market presents an unfamiliar political environment. Managers may find that their own assumptions about natural justice, private property, freedom of contract or the limits of the political sphere are not shared by regulators and business partners. They must also weigh up a range of risks which are heightened by the simple fact of being away from home and not understanding local attitudes and expectations, such as:

- Involvement in corruption: Corruption essentially means the exercise of favouritism or solicitation of special treatment on grounds of personal relationships or affinity or the provision of bribes. It is condemned everywhere, practiced everywhere and punished everywhere. In China, the death sentence is regularly passed on public officials who have received bribes, proving both that the mere existence of corruption is no barrier to prosecution and that not even those who have grown up in a country can be trusted to know what will or will not be punished. Companies doing business in overseas markets which they do not understand may come under pressure from local partners, regulators or customers to engage in practices which are regarded as corrupt in their home country or contrary to their own policies on bribery or conflicts of interest. The pressure may be intensified if requests for bribes are presented in terms which are quite legal at home – appointment of local agents, employment of lobbyists, arrangement fees and so on. In addition, there may be a risk that other market entrants will engage in corrupt practices, whatever the consequences, anyway, making it more difficult to gain a foothold in the market any other way. However, a company which is involved in corrupt practices runs a number of serious risks, including damage to reputation, fines, imprisonment, cancellation of contracts obtained by unfair means and loss of future contracts, especially in the event of a change of national or local government.

- Risk of Forced Nationalization of Assets: This rare but potentially disastrous outcome is a risk for domestic companies as well as overseas entrants. Nationalization may take the form of compulsory purchase at a price fixed by the government, as with the nationalization of foreign oil fields in Venezuela in 1976, or no compensation may be offered, as in the case of the Mexican oil fields in 1938. The possible loss of investments as a result of nationalization must be considered before entering any overseas market in a capital-intensive industry.
- International Politics: International political developments may lead to an enforced cessation of trade between a firm's home country and the target market, as a result of war, embargoes or technology transfer bans. This can have serious consequences for a company which has concentrated its efforts on a single market.
- Political Instability: The relative poverty of many emerging markets is often the result of an authoritarian or unstable political history. Business, domestic or foreign, cannot escape the threats which emanate from an unpredictable political and constitutional environment. Business may even be the focus of political troubles, especially in countries with nationalized industries or very dominant industrial sectors. The immediate trigger for the crisis in Venezuela in April 2002, in which Hugo Chávez was initially deposed and then restored as President, was an abortive attempt to replace the board of the nationalized oil company, PeDeVeSA, which contributed over half of the government's revenues (Weintraub 2002).

Economic risks

Although many emerging markets have experienced high rates of nominal growth, businesses which rely on emerging markets may face economic issues, such as:

- Currency devaluations: The 29% devaluation of the Argentine Peso in January 2002 (Maniam *et al* 2004.) was an extreme and sudden example of the dangers of a fall in the value of a currency. However, a gradual decline in the value of a currency can also present problems, as the convertible revenues are reduced over time as a result. This can cancel out the beneficial effects of nominal economic growth. The figures given for GDP growth earlier in this paper reflected values adjusted for local inflation but not for currency fluctuations. If instead the values are adjusted for the movement of local currencies against the US $, China's annual growth rate falls to 5.6%, while that of US (being now purely the nominal growth rate) rises to 7.1% (United Nations 2003).
- Inflation: Inflation rates are related to currency fluctuations as, over time, a currency with higher inflation tends to depreciate against a currency with lower inflation to maintain purchasing power parities. However, other factors, such as interest rates can have a temporary effect on currency exchange rates and, in addition, emerging markets may not have fully convertible currencies, leading to a lack of a realistic, market-based exchange rate at any given time. Inflation is a consideration in emerging markets. While high inflation is often a concomitant of economic decline, as in the UK in the 1970s, it can also be associated with rapid economic growth, as in Japan in the 1960s. Inflation raises the following issues. Where a firm is deeply involved in an emerging market, especially

if its operations there cover the whole of the cash cycle, inflation will be a threat to the company's development because of the following effects of inflation.

- Erosion of capital base: Where the inflation rate over the purchasing, production, sales and debt collection cycle exceeds the company's gross profit margin, the company will be unable to maintain its working capital. Additionally, asset price inflation can lead to a situation where a profit based on historic cost depreciation and amortization is insufficient to enable the company to replace its long-term assets.
- Long-Term Fixed Income Contracts: A company involved in a long-term contract may find that its income is fixed in advance, while its expenses are unpredictable because of inflation. This may sometimes be overcome by including indexation clauses in contracts. However, clients may not always agree to this. Another possible solution is to use futures and options to fix or limit the price of supplies. There is, however, no equivalent solution for labour costs.
- Financial crisis/inability to pay: In times of economic difficulty, clients may become insolvent, leading to bad debts. Naturally, this happens in countries at all stages of economic development. However, before entering any market, business planners should consider not only the probable levels of bad debt but also the degree of uncertainty about these levels.

Demography

Changes in the age structure and size of the population of any country may affect the market for specific services. A reduction in the size of families may lead to a lower demand for education or an increase in the elderly population may increase the demand for domestic services. An increase in the proportion of the population of working age may lead to increased demands for transport, tools and labour-saving devices. Demography may also affect the prospects of long-term government projects on which businesses may depend for a substantial part of their revenues. The effectiveness of these projects can be affected by the rapidly changing social, demographic and economic environment of an emerging nation (Handley-Schachler and Gao 2001).

Regulatory Issues

Entrants to any foreign market must comply with local regulations. Industry regulation and licensing is not confined to any particular type of market and often serves a dual function of maintaining standards and restricting competition. Businesses must spend time understanding the requirements for licences and professional recognition. They must then take steps to comply, which may necessitate the employment of senior local staff and the formation of joint ventures.

Cultural factors

Kogut and Singh (1988), Root (1983) and Davidson et al. (1980) indicate that the greater the similarity in culture between the home and host markets, the easier it is to avoid any lack of understanding of the business environment. Buckley and Casson (1988) suggest that partners in joint ventures should have comparable cultural backgrounds to make the relationship successful.

Culture issues influence the effects of managerial practices, so that what has a positive effect in one culture may have a negative effect in another (Hofstede, 1980, Rosen, 1986, Trompenaars and Hampden-Turner, 1997). Moreover, according to Tse et al. (1997), firms from high uncertainty avoidance (Hofstede 1980) countries seeking to enter overseas markets which are also uncertainty avoidant prefer to operate through wholly owned subsidiaries or joint ventures which give them a high degree of control, because the methods of dealing with uncertainty may be different in the two cultures.

SUMMARY

It is suggested that firms should take careful account of the potential of emerging markets not only to deliver sudden and dramatic economic shocks to businesses established there but also to produce disappointing financial results after taking account of inflation and currency movements. Firms should see an expansion into these markets as a means of diversification of their industrial base, rather than as a substitute for continued engagement in regions where they have a longer-standing presence.

Directions for Future Research

We would recommend three directions for future research in this area.

- More work is needed to investigate the effects of inflation and currency fluctuations on the performance of overseas operations, especially those in emerging economies.
- A more comprehensive model for SWOT analysis in relation to emerging markets is needed, taking account of the political, economic and demographic risks and institutional and cultural factors.
- Further investigation is needed of the factors which can affect service enterprises in emerging markets, such as intellectual property issues, licensing requirements and institutional barriers.

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