ASSESSING THE GLOBAL BUSINESS ENVIRONMENT

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INTRODUCTION

“I’ve a feeling we’re not in Kansas anymore” (Dorothy in The Wizard of Oz)

Almost everyone has shared Dorothy’s feelings in the classic novel by Lewis Carroll of being overwhelmed by the strangeness and challenges of new situations when traveling far from home. Being a tourist in a foreign country imposes challenges of making oneself understood to those who do not speak your language, dealing (ordinarily) in a foreign currency, eating unfamiliar foods and so forth. To be sure, the differences one encounters also makes for excitement and insights, often about oneself more than about the new culture one finds oneself in.

Being a tourist in a foreign country is sufficient challenge for many. How much harder to do business of one form or another in that country as an international business manager? Being effective in carrying out international business transactions often requires not only the willingness of the manager to accept the challenges of different language, foods, climates and so forth, but also a knowledge of the salient differences between the home and host country insofar as carrying out those transactions successfully is concerned. Armed with this knowledge, the effective international business manager will also understand the strategic and tactical initiatives that are appropriate to successful transacting in the host country. Indeed, in some cases, understanding what is appropriate to be successful in specific international business situations may lead the manager to conclude that his or her organization is not in a position to benefit from doing business in a specific location.

While (hopefully pleasant) surprises and unexpected discoveries are part of the adventure of traveling as a tourist in foreign countries, one usually enjoys the tourist
experience more if one has done some preparation for the trip. For example, it is useful to have a map of one’s intended location in advance, along with a guidebook to the major sights of interest and affordable hotels and restaurants. One should know the current exchange rate between one’s own currency and the foreign currency one will be dealing in, both for purposes of budgeting for expenses, as well as to assess the relative prices of goods that are available for purchase abroad, as well as at home. It is also obviously useful to know at least some basic phrases in the local language, even if many people one will meet speaks one’s own native language. Even a simple knowledge of local customs and mores should help one avoid making uncomfortable social errors and also make for smoother interactions with the bureaucracy one inevitably encounters at customs and immigration crossings.

On the other hand, international business managers should try to avoid surprises, if possible. Unexpected outcomes, particularly if they are frequent occurrences in international business transactions, arguably reflect basic gaps in the manager’s understanding of important aspects of the environment surrounding those transactions. Contrary to the old expression “what you don’t know won’t hurt you”, inadequate knowledge of the global business environment is certain to be a lethal shortcoming of any organization trying to do business internationally. Indeed, knowledge shortcomings are a major source of what international business scholars call “liability of foreignness” (henceforth, LOF), or situations in which foreign-based organizations incur higher costs, or enjoy lower revenues, compared to local organizations when both sets of organizations carry-out the identical transactions.¹ Simply put, local organizations are more likely than foreign firms to know how to carry out transactions relatively cheaply in the domestic market or in which local markets it is possible to charge higher prices.

The challenges associated with knowing what an organization “needs to know” might well be a function of the geographic distance between the organization’s home country and the location in which the relevant transactions will take place. That is, one

¹ For discussions of the relevance of LOF to global business competition, see Menzies (2002), Petersen and Pederson (2002) and Chen, Griffith and Hu (2006).
“naturally” knows more about places closer to home. This might seem a silly assertion in the age of the Internet and the World Wide Web when seemingly limitless amounts of information are available to anyone with access to a computer; however, while it is hard to overstate the convenience and speed with which codified information is now available, tacit information is more likely to require direct experience in order to understand and appreciate. Codified knowledge is effectively information that can be readily conveyed in oral or written form with little or no loss of meaning. Certainly, much that is relevant to an international manager is codified information. For example, the tariffs levied by a country against foreign exports are easily identified from that country’s tariff code which, in turn, will be readily available in either electronic or hard copy form. On the other hand, the state of personal relations between high ranking foreign government officials and local managers of specific organizations with which one’s own organization might do business represents tacit knowledge. That is, one is unlikely to have an accurate assessment of the favorable (or, perhaps, unfavorable) personal relationships local managers enjoy with powerful government leaders unless one has lived or even worked in the foreign country or, at the least, has good contacts with people in that country who are in a position to make that assessment.

A striking, if fictitious, illustration of the importance of “first-hand” knowledge is provided in the iconic movie Godfather II. In the movie, the protagonist, Michael Corleone, is invited along with other potential foreign investors to Cuba by the then-Cuban dictator, Fulgencio Batista. At the time, Fidel Castro was leading an insurrection against Batista, and one of the dictator’s goals was to assure potential foreign investors that Castro’s army was nothing more than a rabble and a minor nuisance to “business as usual” in Cuba. This was a widespread belief among American executives at the time who were continuing to invest in Cuba, as Castro led his revolutionaries in their fight against the Cuban government. While being driven by taxi from his hotel to a meeting with the dictator, Michael observes one of the revolutionaries detonating a bomb which kills both the revolutionary and several police. The absolute dedication exhibited by the suicide bomber helps convince Michael that Castro’s army presents a real threat to the
continued existence of the corrupt Batista regime and that investments in Cuban casinos was not a good business proposition for him.

In short, unlike codified knowledge, acquiring tacit knowledge often involves time and the expenditure of money in order to gain valuable (and sometimes indispensable) direct experience. The costs and practical difficulties associated with acquiring tacit knowledge are likely to be higher the further one needs to go geographically in order to attain the relevant experience.

It is also true that understanding the strategic implications of codified information frequently requires an understanding of the broader context surrounding the information. For example, one can fairly readily compare the market salaries of chemical engineers working in different parts of India to chemical engineers working in different parts of Canada; however, if one is thinking of hiring chemical engineers from one or the other country, one also wants to know what differences in productivity exist between the two sets of engineers. In particular, one wants to know if Canadian engineers work more efficiently and effectively than Indian engineers, such that higher salaries enjoyed by chemical engineers in Canada are more than compensated for by higher productivity, including better quality work. It seems obvious that potential employers based in the United States will find it easier to acquire information about the work habits and performance of chemical engineers in Canada than in India and to assess more readily the net advantages of outsourcing chemical engineering work to Canada as compared to outsourcing to India.

Some well-known international business scholars argue that most multinational companies concentrate on doing business “regionally” precisely because differences in economic, political and social conditions are likely to be more marked the further business is done from the home country, while the costs and other disadvantages of learning about and “managing around” the relevant differences are relatively high compared to the potential benefits of expansion outside one’s “home region”. This is essentially the explanation offered by Rugman and Verbeke (2008) for their observation
that the overwhelming majority of the world’s largest multinational companies have their revenues and assets located in at most two of the three major triad regions (North America, Europe and Asia) with many having a disproportionate concentration of sales and assets in the triad in which they have their headquarters.

Other scholars have argued that the costs and disadvantages of doing business at greater distances from the home country can be mitigated, particularly if international business managers understand the salient differences between the home market and the foreign markets in question and address those differences, often in alliances with organizations located in those foreign markets. While it is beyond the scope of this chapter to evaluate the pros and cons of the Rugman and Verbeke thesis, it is obvious that unless managers understand the sources and nature of the relevant differences between the business environment of the home country and the environments of those foreign countries one is transacting with (or might transact with in the future), successful diversification into foreign markets is unlikely however far away they are from the home market.

WHAT SHOULD MANAGERS KNOW ABOUT THE GLOBAL BUSINESS ENVIRONMENT?
“there are things we know we know. We also know there are known unknowns; that is to say, there are some things we know we do not know. But there are also unknown unknowns- the ones we don’t know we don’t know.” (Donald Rumsfeld, former U.S. Secretary of Defense).

Managers can obviously spend all of their available time and resources becoming ever-more educated about the global business environment without knowing all that they think they should know in order to be effective decision-makers. As in all aspects of life, priorities must be established- in this case, to focus on what is arguably most important to know in order to compete successfully in the global business environment.
Even a cursory consideration of what constitute potentially important considerations in the global business environment can lead to a daunting list of possibilities. For example, the list could include broadly defined attributes of the global business environment such as the macroeconomic outlook for specific countries and regions, emerging political and social developments in those countries and regions, the availability of skilled labor and other demographic attributes of specific countries and regions and so forth. It might also include more specific characteristics of countries and regions such as trade and foreign investment laws, availability of input suppliers, consumer buying behavior, existing physical infrastructure, including roads, seaports and airports, the number and competitive strength of rivals, the availability of potential strategic partners and many, many other factors. Prioritizing what one should understand about the global business environment is obviously not an easy thing to do given the many unknowns that confront international business managers.

**Institutions**

Many social scientists and management experts believe that economic and business behavior, as well as the performances of organizations in different parts of the world, is heavily influenced by the formal and informal institutions that characterize societies in different locations. Indeed, some scholars, such as the Nobel Prize winning economic historian, Douglass North, argue that institutions surrounding the security and transferability of private property are disproportionately important influences on the economic performance of national economies. North defines institutions as “humanly devised constraints that structure human interaction.”

Mike Peng of the University of Texas describes the institutional framework governing individual and firm behavior as consisting of formal and informal institutions. Formal institutions include laws, regulations and statutory rules imposed by home countries and host countries. The primary distinguishing feature of formal institutions is that their influence on the behavior of individuals and organizations ultimately rests on

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the legitimacy and power of the state. Informal institutions include norms, cultures (including religion) and ethics. The influence of informal institutions on behavior derives from social and peer pressures, as well as the “conditioning” that individuals receive from parents, relatives and friends and educators in the course of growing up in a particular cultural setting. While religion is the basis for the legal system in Shariah-compliant Muslim countries, in most countries, the power of norms, ethics and religion to influence behavior derives from a widespread belief in their social beneficence notwithstanding that there is no state-mandated requirement to behave in accordance with them.

This broad institutional view of human and organizational behavior suggests that managers seeking to understand the global business environment should focus on key formal and informal institutions that exist in different countries and regions around the world. This seemingly monumental task is made somewhat more tractable by the fact that many countries are signatories to international agreements such as the World Trade Organization (WTO) or have membership in international organizations such as the International Monetary Fund (IMF). Hence, an understanding of major international legal agreements and formal institutions can provide important insights into key aspects of the business environment in many countries and regions of the world.

OTHER INFLUENCES ON STRATEGY AND PERFORMANCE

*Is That All There Is?* (Title of a popular song from 1969 written by Jerry Lieber and Mike Stoller and most famously recorded by jazz legend Peggy Lee).

It would clearly be oversimplifying things to claim that knowledge of formal and informal institutions is all that matters to successful international business diversification. Indeed, Peng, Wang and Jiang (2008) emphasize that international business scholars also highlight the roles of industrial competition and the firm’s resources and capabilities as relevant factors affecting the international business performance of organizations. Specifically, the nature and intensity of competition with other organizations will influence the organization’s own competitive strategy. Furthermore, the assets and skills
available to the organization will condition how that organization can compete, as well as the success or failure experienced by the organization with its competitive strategy.

As summarized in Figure 1, Peng, Wang and Jiang (2008) argue that industry-based competition, firm-specific resources and capabilities and institutional conditions separately influence corporate and competitive strategy which, in turn, determines the performance of the organization; however, it can certainly be argued that industry competition and even the resources and skills of organizations can be influenced by formal and informal institutions. For example the number of competitors in an industry, as well as the vigor and nature of competition, can be prominently shaped by the presence of tariff and non-tariff barriers, laws restricting inward foreign direct investment and the scope and strength of anti-trust (or competition) legislation. Indeed, social values and customs can also affect the degree to which firms compete vigorously with each other or forebear from competing through a “live and let live” attitude. Cultural attitudes towards competing versus cooperating can also affect the intensity and scope of industrial competition.

Institutions can also influence firm-specific resources. For example, companies headquartered in countries providing relatively strong protection of intellectual property rights can be expected to invest more in research and development (R&D) and innovation which, in turn, should result in those companies having stronger technological capabilities than companies headquartered in countries that offer relatively weak protection of intellectual property assets. As another example, in societies characterized by relatively high levels of honesty and inter-personal trust, organizations can more readily and cheaply form alliances with other organizations to gain access to skills and resources that they might otherwise find prohibitively expensive to acquire in some other manner.

In sum, formal and informal institutions exert direct and indirect influences on the global business strategies of organizations, and ultimately upon the economic performance of organizations given their global business strategies. (Figure 2) To be sure,
institutions can also be potentially influenced by organizations through, for example, government lobbying activities, promises of job creation or threats of layoffs and plant closures, actions affecting the physical environment, the health and safety of workers and customers and so forth. Indeed, an important and ongoing debate amongst international business scholars is whether the process of globalization is itself contributing to the erosion, if not the complete disappearance, of institutional differences amongst countries and regions. We shall have much to say about the phenomenon of “convergence” associated with globalization. For now, it suffices to say that the available evidence highlights the persistence of institutional differences, particularly differences in informal institutions.

The persistence of institutional differences underscores the relevance of “location” to managers. That is, differences in institutional attributes continue to oblige managers to assess whether the skills and resources of their organizations, in conjunction with chosen competitive strategies, offer similar or different prospects for economic performance in different countries and regions of the world. Fulfilling this obligation means that managers should be cognizant of the major institutional influences at work on a global basis, as well as how the institutions vary by country and region. They must also be able to integrate the institutional analysis into the formulation and implementation of strategy. In particular, institutional differences are likely to affect the degree to which global organizations standardize or differentiate their value chain activities depending upon the geographic location of each specific activity. They are also likely to affect the degree to which decision-making is centralized in headquarters or left to the discretion of local managers.

**CONCLUDING THOUGHTS**

The basic notion underlying this course is that a focus on formal and informal institutions, particularly differences across countries and regions with respect to the institutions, is a robust and feasible focus for analyzing and interpreting the global business environment. Of course, this leaves open the question of what specific institutions one should focus on. A facile answer would be: “the ones that are most
important in terms of influencing the strategies and economic performances of global companies.” The answer is facile both because the relevant academic literature is far from definitive or conclusive when it comes to identifying the absolute and relative importance of specific formal and informal institutions. As well, the relative importance of individual institutions is likely to vary by country and region. For example, “guanxi” or networks of relationships represents an informal institution that is of substantially greater importance when doing business in China than when doing business in North America and most parts of Europe. At the same time, formal institutions, such as contract law, will play an increasingly important role compared to informal institutions such as networks, as a country becomes more economically developed and does more international business with developed countries in North America and Europe particularly.

In short, it is not possible to identify a “short list” of institutions that are of particular importance in international business for purposes of discussion in this course. Nor is it possible to go into detail about the relevance of specific institutions varies by country or region. Hence, the procedure we will follow is to concentrate on major formal and informal institutions that are likely to have a significant impact on the business environment in most, if not all, countries and regions to a greater or lesser extent. The institutions to be examined are clustered into several broad categories. One category consists of major domestic laws and regulations governing business activity in different parts of the world. Obviously there are substantial differences in domestic laws and regulations, so our focus is to discuss broad indicators of domestic governance that have been used to compare countries for purposes of evaluating their overall attractiveness as places to do business.

A second category encompasses informal domestic institutions including cultural practices, norms and attitudes towards ethics. Again, since these informal institutions vary substantially across countries, we focus on a set of cultural attributes that have figured prominently in cross-country comparisons performed by international business

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4 For an overview of Guanxi and its social and economic relevance, see Gold, Guthrie and Wank, eds., (2002).
scholars. A third category consists of major formal international institutions, most notably the World Trade Organization (WTO) and major regional agreements including the European Union (EU) and the North American Free Trade Agreement (NAFTA). The fourth consists of informal international institutions, most notably codes of conduct for multinational companies and sovereign wealth funds and the activities of international non-governmental institutions such as Greenpeace.

Finally, we also discuss as a separate institutional arrangement, exchange rate relationships including the role of the International Monetary Fund (IMF). Exchange rate changes can have profound effects on the economic performances of both global and purely domestic companies. It is therefore important to understand the different exchange rate regimes characterizing individual groups of countries, as well as the strategic implications of those arrangements for companies thinking of doing business in those countries.

It must be acknowledged that this course will only skim the surface of how important institutions shape the business environments of different countries. Nor will it discuss all prominent institutions in detail. For example, religion is only briefly discussed as a factor conditioning the business environment, notwithstanding the prominent attention given in recent years to the growth of Islamic financial and business practices. Inevitably, choices and compromises must be made in covering the breadth of material relevant to the role of institutions in shaping the global business environment.
References


Figure 1
Uni-directional Links Between Institutions and Organizational Performance

Interactive Linkages Between Institutions, Other Factors and Organizational Performance

Source: Authors adaptation of Peng Wang and Jiang (2008)