

Lecture Text

Professor Tarun Khanna

Scope and Global Strategy

(edited for clarity)

Introduction

Good morning. My name is Tarun Khanna, and we're here to spend a short amount of time talking about global strategy, to build on the rest of the sessions that you folks have had earlier this week, talking about business-unit strategy primarily.

Agenda

And as a way of starting, what I thought I would do is go over a quick agenda that will take a couple of minutes, connect it to some of the issues that you were addressing earlier in the week, and then jump right into the global strategy part.

The idea is that we have spent much of the earlier part of this week talking about the value chain, which is typically a construct that we think about at the level of the individual business unit. And just to remind you, the essence of this approach of thinking about strategy is to break down the individual business unit into the series of activities that typically could be caricatured as thinking about the inbound logistics of the firm, thinking about what happens to the stuff that we bring into the firm, how we transform it through the production process, how we ship it out through this outbound logistics function, how we market it, sell it, and think about the after-sales function. The important thing to remember is that this is all at the level of the individual business unit.

But what I want to talk to you about today, and what will follow my session, is trying to understand what happens when you embed the business unit within the broader corporate entity of which the typical business unit is a part.

So think about GE Medical, which would be a business unit, albeit a very big one, embedded within a broader corporation, that is the General Electric company, and being part of the General Electric company imposes certain benefits on GE Medical, as well as some costs. Also being part of a global entity imposes certain benefits and costs on GE Medical, the business unit. And it's this being part of a bigger ensemble of activities that I want to talk about today.

There are many dimensions of this broader scope that I'll quickly review, and then zero in on a particular piece of the scope decision, the global scope decision, which is how do we think about how broad or how narrow a global scope? What are the particular configurations of global activities that we want the business unit to have? What are the costs and benefits of these?

And then I quickly want to review some of the evidence that exists about whether or not broad global scope actually does or does not create value. So that's, in essence, the agenda for the next short amount of time.

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Dimensions of Scope

Very quickly, thinking about dimensions of competitive scope, an individual business unit is typically part of a broader entity, as I just mentioned a few minutes ago, and a simpleminded way to think about the different dimensions of scope are these little three-dimensional axes that are put up here.

The most simple to think about is this axis right up here, the *X* axis, which talks about what are the different products and services that we want the business unit to provide? So GE Medical we want to provide not just ultrasound systems, but we want to provide MRI machines, nuclear magnetic resonance, positron tomography, all sorts of other stuff. So that typically is referred to as the “horizontal of product scope.”

On the vertical axis here, there’s something here referred to as “vertical integration,” which in essence tries to think through how close to the end consumer of whatever it is that we’re producing do we want to get to, and how far back to the ultimate providers of raw materials and talent do we want to get to? So, that’s typically referred to as “forward vertical integration” and “backwards vertical integration.” And the decision about how much of this entire chain of activities we want to encompass within the firm, within the business unit, is referred to as a “vertical scope decision.” So that’s another dimension of competitive scope.

And finally, this axis that’s sort of shooting out, hopefully, towards you or is giving the impression of shooting out towards you, is the decision of how do we want to decide whether all of GE Medical’s activities want to be done in Milwaukee, which is where they’re headquartered, or do we actually want to do them in Johannesburg, in Canberra, and in Seoul. What is the appropriate global configuration of activities that would generate the most value for GE Medical?

And, as I said in this session, all we’re going to focus on is this little vertical axis, this little axis that’s coming out towards you, the geographic dimension. And in the next session, what you folks will get an opportunity to think about are the other two dimensions. So I’m going to ask you to abstract and think about this.

But it’s important to keep in mind that in some sense the economic logic of the scope decision is the same for all of these dimensions. In other words, what we’re thinking about is, as a manager of a business unit, if I expand the scope—whether it’s vertical, horizontal product, or geographic, as I expand the scope of activities—incrementally I am adding more costs and more benefits to whatever it is that I manage on a daily basis. And net, net, should I be thinking about this incremental addition of scope as increasing the complexity of my operations too much to justify that extra scope? Or is it actually generating certain economies of scope that offset the added complexity of what’s going on? That really is the dilemma. And what we want to think about is what are some of the factors that affect this decision of identifying the optimal geographic, the optimal horizontal, the optimal vertical scope. That’s the essence of what we’re talking about.

Elements of a Global Strategy

So I’m going to use the terms global strategy and global scope somewhat interchangeably. But one way to think about this is to say, what is the way in which I am going to spatially configure the different activities to generate the maximum advantage for a particular business unit? That refers to the configuration item that I

put up there on the left: What do we do? Where do we do it at a particular point in time?

Secondly, having decided how to configure these activities across space, I have to tackle the horribly complex task of coordinating these activities. So as a simple stylized example, I might decide to procure all materials in Southeast Asia; to manufacture in southern Europe; and to sell this stuff in Central America and North America; potentially to raise capital in London and New York, maybe Tokyo; to do the back office stuff in Bangalore, in Southern India; and to have an agency perhaps in Paris managing my global branding operations.

I made that up but it's actually not so made up. It's very common that business units increasingly are asking, where do I get the best talent for this particular thing that I want to do? I'm going to go to that part of the world and get it. And they're asking, should I be actually doing this branding function only in Paris? Or is it better for a branding agency—can this Parisian branding agency cater to the needs of my customers in southern Africa? Maybe the answer is no, maybe the answer is yes. And that's a dilemma of how to coordinate, how to sort of configure these activities. And then what is the matrix, the management systems that I put in place to coordinate these very, very disparate activities? That's the coordination view: How tightly do we tie these different activities together? How do we tie them together?

And the important thing to step back from all of this and realize is that ultimately, whatever ensemble of activities we choose to identify, configure, and coordinate, and do within the boundaries of the firm, the boundaries of the business unit, we have to make the case to ourselves, to our employees, to our board that we are doing this better than any other viable alternative configuration of activities. That's a tough test to impose, that's a really tough test.

But I would submit to you that it's a test that a manager ought to be asking himself or herself on a daily basis, or on a weekly basis, at least: Am I somehow doing this? Is it justified for me to impose a complexity of imposing a global strategy on top of all this when there are so many other contractual means of accomplishing this? Why should I have an in-house branding agency when I can give it to the Parisians and get that off my books? Why should I worry about developing an IT in-house function when I can actually give it to people in Bangalore and Shanghai and have them manage that? These are questions that we want to struggle and think about a little bit.

So a viable global strategy configures and coordinates better than available alternative means for accomplishing comparable ends—a tough test that, I would submit, we should always be asking ourselves about.

Configuration

So let me speak a little bit about both the configuration and the coordination, and take those in sequence. First, the configuration.

Nokia

Here's just another example. So Nokia. This is a graph that actually is more representative of 2002, as opposed to 2005, but I'll just put together a quick list of where Nokia does its R&D. It's public information, it's not proprietary information.

This is where it does its R&D in 2002. This is where it does its production. And this is where it actually has a stock exchange listing.

A couple of questions arise from this. It's not at all clear. When I think of Nokia I think of Finland, and I think of ice, and I think of cell phones. It's kind of a cute example because Nokia used to be a forestry lumber company that had everything to do with Finland not so many decades ago. Today it has almost nothing to do with Finland, actually, other than the fact that its board and management are largely Finnish at the senior most level.

But in no sense would you look at the R&D units, would you look at all this and say this is a Finnish company. Most of the stock is traded in the United States, and admittedly a little in Helsinki. It's not manifestly a Finnish company. It truly is a global giant.

And what's more—it's interesting, sitting in 2004, 2005. This list would look very different; that the R&D has largely shifted towards south and Southeast Asia where it's cheaper to do the R&D. The manufacturing is centered in China much more—moved away a little bit from Malaysia and other places. The point being that this is an evolving system. So the configuration of activities changes, literally on a six-monthly basis, as and when managers make the decision that it no longer is cost effective for me to be manufacturing in Kuala Lumpur. Perhaps I ought to be doing this in Monterrey, or in Juarez, in Mexico, and move it somewhere else.

But again, a simple example of the tangible implications of identifying and articulating a global strategy is really to go down to the level of the activities of the firm and ask yourself where should each of these individual pieces that we have to do to get those cell phones out, where do we actually do this? And what's the justification that we can give to ourselves and our board for actually configuring them in this way?

When to centralize an activity

So one of the things that you have to ask yourself is when do you centralize an activity, whatever the activity might be? So I'm going to use the term "activity" as an abstract notion in much the same way that folks who have preceded me in this program used the term to refer to anything: manage a human resource function, managing the capital-raising function, coordinating the information technology needs of the company, actually running the production process, providing after-sales service to disgruntled customers; whatever it might be, that's the activity. And the question is, when do you it centralized?

Now, you guys have all experienced, in the last few months—those of you who live in the United States—you pick up the phone and some guy from southern India answers the phone, and is providing after-sales service to you. Southern India is my hometown. But I know that when I'm with my friends in Wisconsin, skiing, I pick up the phone and some guy in southern India answers the phone, that's centralized after-sales service. And it's not particularly good always, because that person doesn't really know the nuance. So that's a decision that in real time I'm constantly working with companies to say what's the justification for thinking about centralizing after-sales service in southern India?

Well, the answer is there are economies of scale in concentrating all that stuff in a place where cheap talent is available, but there are diseconomies, also, that come from the fact that the person in southern India really doesn't know the last thing about the individual needs of the users of product X in Bremen, in Brasilia, in Bombay; in some other part of the world. So there are economies and there are diseconomies, and we constantly make this tradeoff as we go through.

Some are pretty obvious. If you want to raise capital that's of any critical corpus—billion dollars plus—you've got to go to New York, you've got to go to London. If you want to grow grapes, chances are you want to go to France, you want to go to California, though increasingly it's okay to go to Santiago, to Chile. It's also okay to go to Canberra.

You want to mine diamonds, you used to have to go to southern Africa. That's still largely true. You want to go to Botswana and Namibia in southern Africa, but you could go to Germany, as well. You could go to Portugal; parts of Australia. Sometimes there's a compelling advantage to carrying out an activity in a particular location.

Other times the cost of customizing the activity to a particular location is very high. You have to tailor the activities of each particular location and suddenly the economies of scale argument of concentrating things in one particular location are not so compelling. And I'll give you a couple of examples of this in a minute or so.

But certainly, when do you centralize an activity is a critical piece of deciding how do you configure the individual activities in deciding this global strategy of the firm.

Locus of centralization

It's not at all clear that we want to centralize an activity in the home country. In fact, the essence of the global strategy might be to say that we have to transcend the limitations of our own backyard and go somewhere else to do X.

It may be that, if I'm a company in Poland, I decide that I have to come and recruit at the Harvard Business School because it's easy for me to find five talented people who are graduating from the MBA program or this Executive Education program who are to tap into, and that I don't have access to the same depth, critical mass of talent in a convenient form in Warsaw or in Vienna, so I come here. So I leave my home country and I go to wherever it is. I borrow the institutional structure, I borrow the assets of other countries to complement my own intrinsic capabilities, to build the best company that I can. So I go wherever I need to.

And to really get into this, we want to understand different structural aspects of what goes on in the home country. Typical things that you'd want to worry about are constraints on the government. Is the government in the habit of honoring its commitments in the country? If it's not, regardless of whether you think of yourself as a Swedish or Chinese company, you may decide it's not in the interests of your particular shareholders and managers to stick around in that country to do much of what the critical stuff is that you need to do.

Simple example: intellectual property. Companies around the world that are serious about their intellectual property will typically borrow the patenting system of the United States because most of the countries will not protect intellectual property to

nearly the same degree. And so you'll find Taiwanese inventors who are serious will patent under the U.S. system and buy the rights to their particular invention, a particular geography in the world under the U.S. system. That's an example of sort of saying that for managing intellectual property, which is one of the activities of an R&D-intensive firm, I will go to wherever in the world I need to go to do that. I'll hire IP lawyers in the United States to back me up. I'll use a court system in the United States to back that up, etc. So rule of law is certainly very important.

Understanding how the capital markets and the markets for talent and ideas work is very important—various things that we want to worry about.

But it's not clear. In fact, the essence of the global strategy might be—one way to say it would be that you don't want to be limited by the immediate institutional structure of your home base in thinking about how best to pull off the best business unit that you can. You go wherever you need to go, as long as the costs of coordinating don't overcome that.

So here are some more examples in recent years, the last four or five years, or perhaps some of them are a little bit older than that.

CEMEX: The world's most profitable, most interesting cement company. Many of you have heard of it. It's a Mexican company by origin. Decided initially, when it went through its global expansion, to borrow in Spain as a way of evading the Mexican emerging market discount that it had to suffer through.

Old Mutual: Old Mutual, a company that existed for over a hundred years in South Africa, decided that it couldn't become a global financial institution by remaining purely a South African company. So it went through this wrenching transformation to retransform itself, to explain to its millions of policyholders, many of whom were relatively uneducated Southern Africans who had been locked out of the economic mainstream for many years by apartheid, but had to go through them and explain to them that, "Look, we're not abandoning southern Africa. It's just that it's in your interest for us to be headquartered in London." That's a difficult explanation to go through with three million people who have never left places like Soweto. But they went through it because they felt that the costs of doing that were more than justified by being able to raise capital in London, and using that as a way to build more businesses in southern Africa and in other parts of the world. But these sorts of things involve nontrivial costs, right?

Compania Telefonos de Chile: When the telephone company in Chile decided that it needed a billion dollars to upgrade its telephone infrastructure in the '90s, it ended up going to the United States. But it had to come to analysts in New York and explain to them that it was a Chilean company. And the analyst said, "What's Chile? What is that? Is that a chili?" "No, it's actually a country that looks like a chili, but it's down in Latin America." But a lot of the costs were the telephone company Compania Telefonos de Chile basically internalizing the costs of explaining to the financial community in the United States that there was a stable market-oriented company called Chile in Latin America that actually was a great credit risk. And having done that, other Chilean companies, and then ultimately other Brazilian and Argentinean companies could free ride off them and also list the United States. But they have to incur the extra costs of doing that. So it is a nontrivial cost.

Siemens: Siemens in yesterday's *Financial Times* talked about how they had upgraded their R&D infrastructure in Bangalore as a major part of their ongoing strategy. But managing R&D in Bangalore when you're sitting in Germany is a nontrivial task. Lots of other examples.

Mexican ADRs in New York: And very often, some of the things that you think you're getting by listing overseas, or by borrowing the institutions of an overseas country, you don't actually get them. So, Mexican companies frequently issue capital in New York, and the proposition made often is that, by doing so, we are essentially guaranteeing you more stable property rights. But, when there are disputes, U.S. courts have often ruled that we don't have actually jurisdiction over this particular activity in Mexico. So when push comes to shove, it's not really clear that you're really buying all the things that you think that you're buying.

My point is very simple: that it may make a lot of sense, increasing the essence of a global strategy, to realize that you do not need to be restricted by your home country limitations. You can go wherever in the world you need to go, but that decision to go wherever you need to go is a nontrivial and a costly decision, and it needs to be done with an adequate amount of thought.

So we're still talking primarily of where do we centralize a particular activity and whether it makes sense to centralize it or not. Again, all this is still part of the configuration piece of the global strategy. And the second piece I'll just remind you to keep in the back of your mind is how do you coordinate all this stuff at the end of the day?

When not to centralize an activity

Staying with the issue of when it does not make sense to centralize something. The most common reason why it does not make sense to centralize a particular activity to a location is that it's very hard to do it the same way, and serve people in different parts of the world to the same extent by being in one particular place. So my example of the southern Indian call center inadequately providing customer support to somebody in Wisconsin would be an example of this. I'll give you another example.

Morgan Stanley Japan: This is an example of Morgan Stanley in Japan, a blue chip investment bank. All of you are familiar with it. They have a very, very successful Japanese operation. Enormously popular. Built up over the last thirty to forty years. But here's an example of some of the activities that Morgan Stanley Japan has to think through, or Morgan Stanley has to think through and decide whether the activity should be located in Japan, whether it should be centralized somewhere else, or whether we should be doing it all the time in different places in different ways.

So if you look at the research function—an important piece of what any investment bank does; by research I mean researching companies, issuing analysts' reports, etc.—well, it turns out that you need to be local to really know the scuttlebutt about particular companies. You can't just rely on finances that are issued through the public process for several reasons. Companies don't reveal everything in their public records. Different countries have very different standards about what they require companies to reveal, etc., etc. So you need to be local to get the scuttlebutt.

But even more so, it turns out that what Morgan Stanley has realized is that even if the information were the same, the way in which people—Japanese people, Chinese people, Brazilians, Americans, the Brits—the way they process the very same data and information, whether they think in terms of graphs, think in terms of spreadsheets, they think in terms of regression analysis, or they prefer stories, differs radically from place to place. So Robert Feldman, a very impressive guy who runs the research function in Japan, says that, “I frequently take the same data. I analyze it the way I’m most comfortable in analyzing it, but then I package it as a story somewhere, and I package it as an analysis somewhere. I package it as a bunch of pictures somewhere else.”

The localization piece of how you gather the information, how you do the research, and how you communicate the research is so different, even though we’re still talking about finance. In fact, even more narrow: investment banking. In fact, even narrower than that: the capital-raising function. It seems like it’s a very narrow thing. It seems that you ought to be able to do it similarly in different advanced countries of the world, but you don’t. London, New York, and Tokyo turn out to be very different on this particular activity. So this activity is not centralized. It does not make sense. The economies of getting a single set of analysts in one place are more than overwhelmed by the better service that you can get by not centralizing it and spreading it around the way.

I’m not going to go through this in very great detail, but you think about new products—this is something that’s centralized. So what they’ve decided as a strategic imperative is that they are going to take their advanced experience in capital markets in the United States and Europe, and try to sell those products to the Japanese financial markets, even though financial markets in Japan are considerably behind in adopting some of these newer products and services. But that’s a decision that they’ve made.

Marketing: Entirely local. Makes no sense in this case to try to centralize this. Very difficult to penetrate local relations in Japan, if you’re trying to run this out of London, or New York, or Singapore. Human Resources: Again, very difficult to centralize from Morgan Stanley, as a corporation. Makes much more sense for it to look like a Japanese company in Japan, and so its Human Resource function is very much localized to different parts of the places that it works in. Etcetera.

And this quote at the bottom I think captures attention nicely, so I’m just going to read it out to you. This is one of the senior people who run Morgan Stanley Japan: “One group says that this office is Morgan Stanley—Morgan Stanley applied to Japan. The other says that this is Morgan Stanley Japan”; that Japan is where the essence is. The fact that it’s Morgan Stanley is, well, it’s important, but it’s kind of neither here nor there. “That is, keeping New York off our backs is an important piece of what we do in this office.” We really want to run a local operation in Japan. We really want to be a U.S. corporation with a Japanese face. “And there’s a very healthy tension between these two views.”

This is a person who is very successful in building up the Japan operations of one of the world’s most successful investment banks talking about the tension that he’s had to navigate for the last few decades on a daily basis. He’s managing the tension between those who think this is Morgan Stanley Japan, versus this is really Morgan Stanley and it happens to be in Tokyo.

So this is an example of a place where you would not centralize too much a particular activity. And I think it gives you some flavor of this. This is something that companies do wrong all the time, all the time: overestimating their ability to understand what is needed in particular countries; overestimating their ability to say that the particular way in which you manage human relations ought to be done the same in different parts of the world.

Notable localization failures

The laundry list of failures recently:

Microsoft: Microsoft's colossal misreading of the importance of localization of its PC software in China in '93: a big mistake that it made in thinking that it could essentially cut off the local software vendors. The economic logic of for what they were doing was impeccable. They said, "Look, we've built PC software successfully in Redmond, Washington. Why don't we do it in Redmond, Washington, and then we'll impose it on the Chinese? The local Chinese said, "No, we aren't going to play this game." And, in retrospect, it sounds kind of straightforward, but was actually a wrenching decision.

And they were thinking the economic logic is so compelling to do it in Redmond, but we're going to end up alienating this vast important constituency. Let's go with the economic logic and try to explain it to them. Big mistake in that particular instance. And what's important is that now sitting in 2004, 2005, eleven years later, I would say that they still have not recovered from that first decision. They continue to lose hundreds of millions of dollars in China with no end in sight. And this is a really impressive well managed company.

Kellogg: Kellogg was trying to sell breakfast cereal in India, in the early '90s, saying, "Indians ought to eat corn flakes." Why? "Well, we eat corn flakes. Indians ought to eat corn flakes." They spent a lot of money trying to get Indians to eat corn flakes. And the Indians said, "No, we don't want to eat this. We eat some other stuff just as healthy." Big mistake.

McDonald's: McDonald's was trying to sell its kind of burgers in the Philippines, and just getting wiped out by a local upstart that just realized that the Filipinos just like to eat sweet things: sweet burgers, or burgers with a sweet tinge. It sounds crazy to somebody coming out of Chicago, but that's what they like, and that's how they won.

STAR TV: Rupert Murdoch, media celebrity extraordinaire, deciding that he was going to go into south Asia, all of Asia, south, southeast, east Asia with *Dynasty* reruns: "I have content. I've already incurred the fixed costs of developing this content. Let me just amortize it. Pump it through the airwaves in China, and India, and Indonesia and see if I can get money. Nah, *nada*, zero, zip, no money, wipeout. Quick reengineering of the strategy: entirely local content of these different places. Very, very successful company all over Asia now, but took seven, eight, ten years to figure this out.

Closing Remarks

My point is that it's so easy to find bloopers, overestimation of the importance of centralizing. So centralizing of particular activities is important. The economic logic is often compelling. On the other hand, you have serious reasons why that

centralization comes with important costs. The imperative to localize—whether it's human relations, marketing, managing the political interface of the government—is equally compelling. And making that decision—the Morgan Stanley Japan versus this is Morgan Stanley in Tokyo—that tension is really an important tension that we need to learn to navigate. And this is why deciding how to configure activities across space is a tough decision.

Coordination

Let me turn to coordination as an example.

GE Medical Systems

I like this GE medical example because it's unbelievably complex what these guys do. This is a high-tech machine, this is a technological forefront of the GE company. This is what's going to drive the GE company forward, if anything does, for the next few decades.

This is a simple example of an ultrasound machine that we came up with five, six years ago. Ultrasound machine is kind of biggish—this big. Not one of the tiny little things that you think of. Not an X-ray machine; biggish. You kind of go in the room and it's dominated by an ultrasound machine.

This particular machine—Proteus is an example—it has 719 nontrivial parts in the machine. This is a schematic that I got from Milwaukee that has a subsystem assembled in Beijing. That sub-system has 117 parts. The subsystem is assembled in Bangalore. It has 122 parts. And it has an important subsystem set up in Monterey, in Mexico, that has 330 parts.

This is just a numeric count. The parts vary in their technological sophistication. And then it has little parts coming from Morocco, Canada, Poland, Korea, Taiwan, other parts of western Europe. And these parts and subparts are moving around like you won't believe. They're crossing borders, they're crossing in back. They're getting subassembly. They're coming back, and eventually they're showing up in Milwaukee, and being sold in the United States, or showing up somewhere else and being sold.

Now, the question you ought to ask is does this make any sense? Why should all this be done within the company? Why can't we just subcontract the Monterrey piece out to somebody else and say, "Hey, you're an independent company. Just take care of these 330 parts. Don't bother me with it. Just ship it over to me"? Or, "You guys in China, you work with the Koreans and Japanese. You make your own little piece and send it over to western Europe when you're done, and we're going to concentrate on Milwaukee, London, and Paris. And basically that's what we'll do within the company"? That's a viable alternative.

Well, it turns out in this case that the system is so technologically complex that hiving off of parts is difficult, especially hiving off parts in geographically disparate locations is too difficult. Coordinating the technology involved in the piece that you hived off with your own in-house technology would be prohibitively costly. So they decided to do it in-house. But it's absolutely a decision that they have to make. Coordinating these different pieces, you better believe that the advantages you get by lumping them all together—these disparate activities across all the five

continents—are strong enough to offset the very difficult task of coordinating these activities.

Now, GE Medical is a phenomenally successful company. It's the reason that Jeff Immelt is now chairman of General Electric, because this was his claim to fame: to build this company up. So it's a company that time has said has done a pretty good job. But it's a good illustration because it's such a complex product that you would begin to realize that the coordination task is prohibitively costly.

Citibank and HSBC

But there are many ways to skin a cat. So I like this example of Citibank and Hong Kong Shanghai Bank, now referred to as HSBC. These are the world's two largest banks now. At some level they're very comparable. They compete in the same lines of business. They're both in 100-plus countries. They've both been around for several decades. And the curious thing is that they run their global strategies fundamentally differently; that the way they have decided to configure and coordinate their activities in the same businesses is fundamentally different. And I would actually say that it's very hard to rank them in terms of success. It's very hard to make the case that HSBC is more successful than Citibank, or Citibank is more successful than HSBC on a sustained basis.

In fact, if you look at an analysis of their stock market performance over the last, I don't know, few decades, you will see, as I say that down here, that Citibank has a faster stock price appreciation but it's very volatile: shoots up; falls all the way down; shoots up. Hong Kong Shanghai Bank has a lower mean return but it's very, very rock solid and steady. Now, which one you prefer depends on your preference function and your needs, and so on and so forth. So it's hard to rank all of them. But look at some of the things that they do differently.

HSBC bills itself as "the world's local bank," which is a very curious choice of words, right? It says I'm local in every country that I operate in, but I'm also of the world. That is, being part of HSBC worldwide is helpful to HSBC in the United States, HSBC in Brazil, HSBC in China—emphasis on the geographies.

Citibank, to caricature, has the emphasis on the line of the business, which means that the primary reporting entity is really more investment banking at Citibank, wealth management at Citibank, as opposed to HSBC China, HSBC India. Now I'm caricaturing. So these are extremes. And if we had Sir John Bond, chairman of HSBC, sitting in this room, he would object vociferously to what I just said. He would say, "No, actually, we do this also," and he'd be right. But as a caricature, these are the two different polar extremes, and they try to mix and match and are constantly involving the two business models.

Citibank runs a single balance sheet globally. Hong Kong Shanghai Bank: Every local country operation runs its own balance sheet. Now, this has serious implications for the way the banks are perceived in different countries, the way they interface with the regulators in different countries, whether or not they can accumulate capital from the different countries that they're collecting through deposits and other means, and funnel them to a single large bet. And in brief, and again at the risk of doing violence to technical accuracy, Citibank can basically take capital from everywhere and make a very large bet quickly.

Hong Kong Shanghai Bank has set up a system which is much more conservative. To be able to do that, it would have to go to local regulators, convince them that it was okay to take money for their country and make a bet somewhere else, and that's not going to happen. So the possibility of making very large bets is constrained. That's consistent with its decision to basically be much more local focused, much more steady, rock solid, and stable.

And Citibank's decision to have a single balance sheet is consistent with its decision to say, "We're just going to be the very fast moving bank that's opportunistic. We're going to go in and out of countries as we need to. And that has costs and benefits. The benefits are that we can move fast and get the opportunity. The costs are, but we're not always perceived the best way in different parts of the world sometimes when we get out."

So HSBC will never hedge a position in a local country. Think about that. It's extraordinary. Why would they not hedge a position, if they were exposed to, I don't know, pesos, in a particular country? Well, their logic is, "We're here indefinitely. We don't plan to leave." In fact, they have never voluntarily, in their 100-plus-year history, left a country. They've been escorted out of some countries a couple of times, but they've never voluntarily left a country. Citibank has gone in and out of many countries many times.

So my point just is that the world's two largest banks, arguably the world's two most successful banks—each in 100-plus countries; each has been around for several decades: fundamentally different choices of configuring and coordinating different activities; both successful. Many ways to skin a cat.

Clothing worldwide

One more example along the same line. Thinking about clothes worldwide—this stuff, what you're wearing today: different companies providing casual clothing. You'll recognize some of these, if not all of them. Zara is a company based in Galicia, in Spain, that actually runs a very globally vertically integrated operation, all the way from manufacturing to managing the stores. If you walk around Barcelona, you'll see a lot of Zara stores very nicely arrayed, welcoming to the casual shopper, etc. Esquel [Esquel Group of Companies], a similar company. Perhaps you are less likely to have heard of this company, based in China and Hong Kong: also vertically integrated, all the way back to manufacturing and the sourcing, to the extent of basically growing its own cotton in western China, all the way up to running very chichi stores in downtown Shanghai today. Both very successful. Benetton, that you see locally, only does this piece, even though it's also a global corporation. The Gap only does this piece. It just runs branded stores and retail. Li & Fung, basically a trading intermediary that's set up not just for clothing but for many other operations in Hong Kong. It basically helps Gap because Li & Fung plus Gap can replicate a little bit of Esquel and Zara.

Now, it's not to say that those two are better than these, or vice-versa. The costs of running that operation across the globe are very complex, very complex. It's like a GE Medical example—not as complex but very complex. And so they think that they get the benefits of very fast response times by having everything in-house. So they're able to respond to minute demands for changes in fashion taste very quickly. But the costs of being able to respond that way are to have this very complex entity

within house. Gap will not be able to respond nearly as fast because it has to coordinate with all of its suppliers, but it has a simpler operation. They're just concentrating on running the brand. Again, many ways to skin a cat in the same industry.

Viable alternatives to multinationals

Let me switch gears a little bit. Remember I said at the beginning that, to have a successful global strategy, you have to decide how to configure and coordinate your activities, but you also have to be asking is there a better way to do this on a daily basis? What's the viable alternative? Here's an example that I like, that one of my students put together a couple of years ago. It's not a company. Baseball: everyday pastime of many people in this room as they grew up, especially, right?

What is this? This is how talent from the Dominican Republic ends up playing Major League baseball. And it's a great example, because it's something that does not happen in a single firm, or in a single organization, even though it is a global value chain, just like the Zara example in clothing, or the Li & Fung example, or the GE Medical example. This is the opposite of that. This is a situation where it does not appear to be sensible for a single entity to be running all this.

Let me just describe to you what actually happens here. On the right-hand side is the age of the kids. So kids under ten years old are playing in slums in the Dominican Republic. When they're up to fourteen, they play in Little League. They're up to seventeen: If they have some promise, they play in the baseball academies. Then they get to Minor League baseball in this country, and finally Major League baseball. The chance of success, starting from the beginning to the end, is 0.000006 percent—essentially zero. That's how few people actually make it.

But the point is that each stage of this global value chain of moving talent is run by different people—some unsavory, some less unsavory. This is sort of an indication of what you make on each of these stages. The details perhaps aren't important. The point is that there is an interesting value proposition, which is that there's a lot of talent here in the Dominican Republic and other Latin American countries that's hard for somebody running a Major League baseball team to actually figure out, sitting in wherever they're sitting in the United States.

There's a demand for that talent over on this side for people who like to watch baseball and play baseball. How do we get that here? It has never made any sense for a Major League baseball team to be globally integrated all the way to owning the playgrounds and the slums in the Dominican Republic. It sounds preposterous. But, as a thought experiment, it's not. It could have been. In fact, there were attempts, but it's too difficult to coordinate that. So they've said, "That's not the best way to run a global operation. The better way is for me to contract with people." Unfortunately, some of them are unsavory. And I'm leaving aside comments and all that aspect of this, the dirty side of this. But the economic logic is that the cost of coordinating this global activity that would be needed to get the talent into the U.S. Major Leagues is too prohibitive. And so some alternative to that global strategy is needed, and that's what's actually paid out over time.

When does global strategy make sense?

Let me address the issue of how do we think about when it makes sense to be actually running a global strategy, and when does it make sense to be going with the counterfactual. And I'm going to do it through another example.

Simple example: toys. Many of you have kids. You buy toys, you go to Toys R Us—well, these days, you don't go to Toys R Us as easily as you go to Wal-Mart—and you pick up a toy, right? But, here's an example. There are buyers of kids' toys over in New Jersey, let's say. There is a little company there called International Playthings—a real live company, a small company in New Jersey that specializes in educational toys. And there are people who make these educational toys in Hong Kong cheaply.

Now, it turns out that these guys basically had to contract with all sorts of financial institutions, and with letters of credit for managing the customs process, for managing various regulatory barriers, things of that nature, to make that happen, right? But then, through a bunch of different innovations, all sorts of intermediaries emerged that facilitated this transaction, this cross-border transaction. Coface Group began to provide credit insurance. Thomas Cook got into the fund transfer business. Jardine Logistics said, we've got to do transfers in shipping. And the resulting financial supply chain began to work at 10 percent of the cost of what it used to work at—10 percent! That's like a 90 percent fall in cost. Extraordinary. Simple example: toys.

But innovations are happening. Entrepreneurs are popping up to make it easier to coordinate across space. This is going to have a radical implication for how you think about configuring your activities, whether you think you can remain a New Jersey based-player, whether you think you need to contract or open up operations in different places, or vice versa.

So again, this goes back to the point I was making earlier. As a manager, this is something that you want to evaluate almost as a matter of course. Is the particular configuration I've set up the right one, or should I be thinking about this somewhat differently?

So this provides a basis for thinking about the comparable multinationals of global scope. What else could have happened? And in some sense, I think it's often inappropriate to do the following. So I'm often working with some managers of the board. The board will say, "Well, this is the way we've always done it," and, "Look, look out of the window," and, "You don't see any other way in which it's done." That's wrong. You ought to be asking, "Can I imagine some other way of doing things? If I had to start with a blank sheet of paper, what would I try to do? How do I get that creative process going among my management team, among my people in my organization, with my board members, to somehow drum up crazy ways of doing things?" because there are a lot of people who are drumming up the same crazy ways of doing things. You might as well participate in that process before you get undercut out of there, right?

Do Multinationals Create Value?

Lots of people, lots of academics, lots of my colleagues do studies of whether multinationals actually create value or not. And, just to summarize, this is what it

shows. If you compare a multinational with comparable portfolios of local firms, what do I mean by that?

Take the GE Medical example. If I could do a thought experiment that said I'm going to compare GE Medical with somebody who produces ultrasound machines in all of the countries in which GE Medical actually ends up selling, and somehow lump them all together in a portfolio, and ask, "Does GE Medical outperform that portfolio, or not?" I would implicitly be asking, if I were able to do a close enough apples-to-apples comparison, "Is the GE Medical global strategy ultimately generating more value than cost?" Do the benefits of running a global organization, fiendishly complex global organization, offset the costs of doing so?

Or I compare the Hong Kong Shanghai Bank with the portfolio banks that run in Brazil, in Poland, in Germany, in the United States, in China, and in India. And I say, in this portfolio of banks, as an investor would I rather invest in this portfolio—put a dollar here, a dollar here, a dollar here—rather than put three dollars in Hong Kong Shanghai Bank? When will I do better?

And the answer is, on average indeed multinationals create value. So on average they do better than the standalone things. But the variance is extremely high. In other words, there are a lot of lemmings in that picture. We're just doing things blindly. The variance is extremely high.

And, in general, multinational investment tends to go from the developed world to the developed world: from Germany to Japan, from Japan to the United States, among the triad countries. And you include countries in the margin that are entering the world force, like Korea, Taiwan, etc. A lot of opportunities left on the table still.

And now what you're seeing in the last five to six years is you see credible multinationals coming out of Korea—Samsungs of the world—now cleaning up the clock of all the U.S. and European companies and the Sonys of the world. You see CEMEXes of the world coming out of Mexico. You see the Infosyses coming out of India competing head-to-head with IBM and winning. So times are a-changing a little bit, but the logic is still the same. The logic is still the same: How do I think about configuring and coordinating the activities that I have?

Summary

A quick summary slide. Value creation through broad geographic scope requires the provision of some cross-border function that would not otherwise be easy to replicate if you were not part of the same entity. That's the essence of any broader scope decision, whether it's geographic, or vertical, or horizontal scope that we started out with.

We want to identify and track alternative means through which this cross-border function can be done, like the example of International Playthings and toys from Hong Kong, right? Some innovation happens. Some bright spark entrepreneur comes up with a new way of doing something. It is going to have fundamental implications for whether it still makes sense for me to configure and coordinate the activities the way I currently do so.

What the data suggest, over the last three or four decades, is that global scope has a mixed track record of value creation. So we need to be careful. And coordinating

geographically disparate activities on the one hand can deliver a lot of value but is difficult and a judgment call, ultimately. Thank you very much.