

Christian Scholz/Joachim Zentes (Eds.)

# Strategic Management – New Rules for Old Europe



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## Preface

Perhaps it was not really meant the way it was said, but when Donald Rumsfeld used the term “Old Europe” in his famous speech of January 22, 2003, he coined a phrase to depict not the birthplace of modern society, but a graveyard of old and outdated ideas. Even though it is legitimate for many of us in Europe to oppose the underlying message of going to war in Iraq, it makes absolute sense to examine the rules of the game which Europe is currently playing and which it will play in the future.

In doing so, it becomes obvious that important changes are taking place: *Strategic Management – New Rules for Old Europe* makes the hidden rules governing strategic management in Europe transparent.

The book follows a “from – to” logic and takes the reader along the course of changing conditions and contingencies. Europe has not only witnessed major transformations such as the dramatic fall of the Iron Curtain, economic and monetary integration and the incorporation of new member states: Fundamental change can also be perceived with respect to the corporate responses to these ongoing dynamic changes.

*Strategic Management – New Rules for Old Europe* is divided into four parts. Each of these consists of several contributions, starting with the focus on people, then on culture, then on systems.

The first part, “Changes in the Institutional Environment”, describes how the European labour markets are becoming more elastic (people), how the sense-making processes around the European Constitution have reached a new stage (culture), how accounting in Europe is converging to new standards (systems), how banking supervision in Europe is proceeding to Basel II (systems), and how European entrepreneurship has evolved (systems).

The second part, “Changes for Companies: Outside-Inside-Perspective”, presents the external market-driven movements for European companies. It investigates how customer life cycle orientation is integrated in relationship marketing (people), how cross-cultural branding can be assessed (culture), and how a European perspective in retailing is reached (systems).

The third part, “Changes for Companies: Inside-Outside-Perspective”, presents the internal organisation-driven movements. It shows how European virtual team building has advanced (people), how corporate culture in Europe uses the advantages of divergence (culture), and how supplier relationship marketing advances to relational purchasing (systems).

The fourth part, “Consequences for Germany”, addresses the management and leadership challenges in Germany as one of the dominant European countries. It develops a strategy map that intends to focus on offensive self-renewal (people/culture/systems).

The majority of literature in international management is still based on the United States of America, with Americans as the underlying reference system. Given its focus on Europe, this book goes far beyond the scope of domestically-oriented books on management. Therefore, readers will become acquainted with some rather unfamiliar practices answering to the description of international management behaviour. They can add the distinct European perspective to their knowledge, and they can compare international management literature to the specificities of the European approach with all of its contemporary developments.

*Strategic Management – New Rules for Old Europe* expands the reader's understanding of people, culture, and systems issues in management and gives valuable insights into the complexity of today's European management.

*Strategic Management – New Rules for Old Europe* can be used by executives, managers, and (MBA) students in several ways: It is applicable to university teaching in strategic management, marketing, and Human Resource Management as well as to management seminars with focus on Europe.

We would like to thank the many people who have contributed to this book, each from his/her unique perspective and with his/her expertise. The authors are part of the faculty of the Europa-Institut and show their outstanding commitment to our MBA programme by their contribution. Special thanks go to Lambert Scheer, M.A., Jonas Bastian, Sabine Herwig, Matthias Schu and the team of the Europa-Institut for their excellent editing of this book.

Saarbrücken, January 2006

Christian Scholz and Joachim Zentes

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- Banking Supervision in Europe: From Basel I to Basel II
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Udo Broll and Sabine Hansen

# European Labour Markets: From Low to High Labour Demand Elasticities

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## 1. Introduction

Unemployment has always been a topic of economic concern. It became of particular interest from the late 1980s on, when most OECD countries were hit by high and growing unemployment rates, which, in addition, turned out to be persistent. Part of the decline in employment was due to changing economic structures, i.e. the transition from traditional manufacturing industries to services (see e.g. Blanchard 2004). Increasingly globalisation, understood as the international integration of the goods and capital markets, is claimed to be one source of the evil, with the primary losers the low and unskilled workers. They may either lose their jobs more easily due to foreign competition, or their jobs may be exported with greater ease. Over the past decades, the worldwide integration of markets has indeed proceeded at a great pace, bringing about a well-known range of economic advantages and disadvantages. Empirical studies document that the real-wage gap between low-skilled and high-skilled workers has widened over the past decades and keeps on widening. There is a skill premium that comes along with a substitution process between skilled and unskilled workers. But what if the skill premium no longer pays? A recent phenomenon is that white-collar employees, too, increasingly fear losing their jobs in an internationally integrated world.

One problem in assessing the impact of globalisation on the domestic labour market lies in how to measure it. There is consensus that the most important channels of globalisation in the goods market are exports and foreign direct investment (see Nicoletti et al. 2003). Whereas these two are directly observable and measurable, their impact on domestic labour markets is not, i.e. it is rather indirect or secondary. Furthermore, labour markets in particular are characterised by domestic regulations and institutions such as minimum wages and unions. In Europe, in contrast to the US, wages at the bottom end of the wage scale have risen more than those at the upper end at the expense of jobs. Put differently, in many European countries wages are rather rigid in the sense that rather than adjust, they result in unemployment. The way wages are set is one example of where union power is of importance. In a very recent contribution, Hellwig (2004) investigates whether, among other things, aggressive wage setting has a considerable effect on the relation between real wage rates and employment.

Many empirical studies that aim at assessing the effects of trade on the participating economies are based on the Heckscher-Ohlin framework. Another way to measure the impact of both international trade and foreign direct investment (FDI) on the domestic labour market is via the elasticity of labour demand. The more substitutable the domestic workforce becomes for foreign workers, the more elastic the demand for the former becomes: there is a shift from low to high labour demand elasticities. Rodrik (1997) shows that the elasticity approach allows an explanation for a range of consequences present in the labour markets which can be attributed, in part, to globalisation, namely the incidence of non-wage costs, the volatility of earnings, and unions' bargaining conditions.

In this contribution, we focus on the labour demand elasticity approach to assess the influence of internationally integrated markets on European labour markets. The trends in the European labour markets that we report, such as e.g. the declines in unionisation, seem to be strong evidence of the appropriateness of this concept. We proceed as follows: we start in section 2 with some stylised facts about unemployment in Europe and European labour markets over the past few decades. In section 3 we briefly introduce two approaches used to assess the relationship between economic openness and the domestic labour market, namely, international trade theory and labour economics. We include figures of German trade and FDI patterns to give an impression of economic interdependencies. Labour demand elasticity is explained in section 4. Section 5 examines three effects on the domestic labour market that emerge from a more elastic labour demand elasticity. Section 6 concludes our contribution.

## 2. Unemployment in Europe

### 2.1 Overview

This section serves to depict European labour markets over the past three decades, including unemployment rates and degrees of unionisation. Unemployment in Europe is a complex phenomenon with a variety of country-specific characteristics (see Heise 2002). Nevertheless, there are some key facts with general validity for most if not all European countries. One of them is that of hysteresis which has been observed from the early 1970s on, above all in European labour markets and to a lesser extent in the US. We will briefly sketch its meaning below.

### 2.2 Hysteresis

Hysteresis, which is also referred to as path dependency, postulates that the evolution of the labour market in recent years fundamentally determines current unemployment. Analytically this path dependency means that the unemployment rate  $u_t$  in period  $t$  is influenced not only by current supply and demand shocks  $s_t$  but also by the preperiod's unemployment rate and macroeconomic shocks:

$$u_t = u_{t-1} + s_t.$$

Even if an economy-wide shock  $s_t$  has been eliminated in period  $t+1$ , i.e.  $s_{t+1} = 0$ , it continues to have an impact on all future unemployment rates. With  $u_{t+1} = u_t$  future unemployment reads

$$u_{t+1} = u_{t-1} + s_t.$$

Current unemployment then reads

$$u_t = u_0 + \sum_{i=0}^{t-1} s_{t-i}.$$

Labour market research and modern real business cycle theory (RBC) intensely investigate the causal link between unemployment rates over time. Put differently, the question is why temporary macroeconomic shocks affect national labour markets permanently rather than only transitorily.

### 2.3 Unemployment and Unionisation

We begin the analysis of European labour markets with a report of standardised unemployment rates for Europe and the US. (Standardised unemployment rates are calculated in accordance with ILO guidelines to allow better comparison among economies. They may therefore differ from unemployment rates published by national statistical offices.) As can be seen from table 1, unemployment increased remarkably in all European countries until the mid 1990s. Most countries experienced recoveries in the late 1990s, which, however, did not last long. Throughout the 1990s unemployment was highest in Spain, but the figures in Finland, France, Germany, Greece and Italy also equalled or lay above the EU average unemployment rates in most years. Within the EU, the smaller countries performed better. Ireland is an exception among all countries as it obviously succeeded in fundamentally reducing unemployment.

As regards the structure of European unemployment, it is particularly characterised by long-term duration, by youth unemployment, and by the huge proportion of low and unskilled unemployed. (For a recent detailed analysis of the labour markets of the Euro area see Europäische Zentralbank (2002)). Besides, European countries are characterised more than the US by a widening wage gap, which is an expression of skill shifts.

	1970	1975	1980	1985	1990	1995	1997	1999	2001	2003
AUT	1.4	1.7	1.9	3.6	n.a.	3.9	4.4	4.0	3.6	4.4
BEL	2.1	5.0	9.3	10.4	6.6	9.7	9.2	8.6	6.7	8.1
DNK	n.a.	n.a.	n.a.	n.a.	7.2	6.8	5.3	4.8	4.3	5.6
FIN	1.9	2.2	5.3	6.0	3.2	15.2	12.6	10.2	9.1	9.1
FRA	2.4	4.0	5.8	10.1	8.6	11.4	11.8	10.7	8.5	9.7
DEU <sup>a</sup>	0.8	3.6	2.6	7.2	4.8	8.0	9.7	8.4	7.8	8.7
GRC	n.a.	n.a.	n.a.	n.a.	6.3	9.1	9.6	11.8	10.4	9.5
IRL	n.a.	n.a.	n.a.	16.9	13.4	12.3	9.9	5.6	3.9	4.7
ITA	5.3	5.8	5.6	8.5	8.9	11.5	11.6	11.3	9.5	8.8
LUX	n.a.	n.a.	n.a.	2.9	1.7	2.9	2.7	2.4	2.0	3.8
NDL	1.0	5.2	6.0	8.3	5.9	6.6	4.9	3.2	2.4	3.5
PRT	n.a.	n.a.	n.a.	8.7	4.8	7.3	6.8	4.5	4.1	6.4
ESP	2.4	3.6	10.5	21.7	13.1	18.8	17.0	12.8	10.6	11.3
SWE	1.5	1.6	2.0	2.9	1.7	8.8	9.9	6.7	4.9	4.9
GBR	3.0	4.3	6.2	11.5	6.9	8.5	6.9	5.9	5.0	5.0
Euro area	n.a.	n.a.	n.a.	n.a.	n.a.	10.6	10.8	9.4	8.4	8.8
USA	4.8	8.3	7.2	7.2	5.6	5.6	4.9	4.2	4.7	6.0

Table 1: Standardised unemployment rates in Europe and the US from 1970 to 2003, percent of total labour force

<sup>a</sup> Prior to 1993 data refer to Western Germany

(Source: CESifo, OECD)

Table 2 depicts degrees of unionisation in Europe and the US from 1970 to 1996. Data are not available for all years in all countries; there is a particular gap for US data. Nevertheless, some findings can clearly be stated from the data. The figures reveal that in most European countries the degrees of unionisation have declined over the last three decades, most remarkably in Portugal where the decline is from roughly 60% in 1970 to about 24% in 1996. The extreme differences in unionisation partly arise from differences in national administrative responsibilities. In many countries, the wage coverage, i.e. the validity of collective labour agreements for most employees, regardless of whether they are union members or not, is rather high. Sweden, e.g., is characterised by a strong linkage of the employed as well as the unemployed part of the total labour force to the trade unions as the latter are responsible for unemployment insurance, i.e. for functions which in other countries lie in the hands of independent social insurance authorities. Finland,

Denmark and Belgium have similar arrangements. It is remarkable that Sweden and Austria, which are two examples of highly centralised wage bargaining countries, have very low rates of unemployment.

	1970-79	1980	1985	1990	1991	1992	1993	1994	1995	1996
AUT	51.1	49.4	49.0	44.7	43.3	42.4	41.9	41.1	40.7	40.1
BEL	49.6	53.4	50.7	50.1	51.7	52.9	53.1	53.2	53.4	53.6
DNK	66.7	76.0	78.3	73.0	73.2	74.2	75.1	76.8	75.9	75.1
FIN	62.4	69.2	68.9	72.2	74.4	76.8	78.8	78.0	79.2	78.8
FRA	21.4	18.5	13.6	10.3	10.2	10.3	10.3	10.2	10.1	9.9
DEU	33.8	34.9	34.3	32.1	36.0	33.9	31.8	30.3	29.2	27.7
GRC	35.6	36.2	36.7	34.1	33.3	32.6	31.8	25.8	20.9	16.9
IRL	61.2	63.5	62.5	58.5	58.6	57.3	55.8	54.3	52.3	n.a.
ITA	45.1	49.3	42.0	38.8	38.6	38.8	n.a.	n.a.	n.a.	n.a.
LUX	46.6	50.8	50.6	47.1	46.3	45.4	44.6	43.8	43.0	42.3
NDL	32.9	31.1	26.3	25.3	25.7	25.8	25.7	26.4	26.2	25.8
PRT	60.1	60.7	55.8	30.4	29.3	28.2	27.1	26.1	25.1	24.2
ESP	n.a.	n.a.	10.3	12.1	16.1	18.1	19.8	19.6	18.2	17.8
SWE	73.6	80.0	83.8	84.0	84.2	87.3	90.5	91.1	89.5	89.0
GBR	52.4	55.3	49.6	42.6	42.3	40.5	39.5	37.5	36.1	34.9
USA	25.2	22.1	18.0	n.a.	n.a.	n.a.	n.a.	n.a.	14.2	n.a.

Table 2: Degrees of unionisation in Europe and the US from 1990 to 1996  
(Source: OECD)

The declines in membership are commonly attributed first to a structural change, above all a decrease in employment in manufacturing accompanied by an increase in services; second, a change in attitude, i.e. employees increasingly try to negotiate their own contracts when newly hired; and third, a change in jurisdiction in countries where union membership was formerly favoured if not required for a range of jobs such as e.g. in Great Britain (see *iwid* 1998). A look at a strike attempt last summer in Eastern Germany may suggest another phenomenon: the strike had to be ceased because too many workers refused their participation. This cease was unprecedented in history. Employees may have perceived wage demands by the trade union as a real threat to their jobs and hence to their existence. The trade union members may possibly have regarded the trade union not as the institution that secures their insider position but the one that risks their jobs.

## 3. Internationalisation of Economic Relationships

### 3.1 Overview

Although the internationalisation of economic relationships can have various forms from trade in goods and services at the bottom end of the scale and FDI at the top end, these two account for the greatest share of it. From the likewise wide range of theoretical concepts developed to determine the impact of the internationally integrated markets on domestic unemployment, we briefly reproduce the traditional trade theory à la Heckscher-Ohlin for its widespread application in empirical studies and the elasticity approach. (For a short but comprehensive overview of concepts see e.g. European Commission (1998).) We also present regional figures on German exports and outward FDI.

### 3.2 Trade Economists vs. Labour Economists

Part of the effects of internationalisation on the domestic labour market can be explained by traditional international trade theory while labour economics can explain other aspects. In this section we briefly summarise their respective conclusions and predictions.

#### *International Trade Theory*

In approaching the relationship between the domestic labour market and internationally integrated markets theoretically in a first step, a look at the facts found in the real world seems advisable. Empirical studies suggest that the largest share of international trade in goods takes place between industrialised countries, i.e. in the form of intra-industry trade, and that trade between industrialised and developing countries accounts for a rather small share of world trade (see e.g. Broll/Gilroy 1994 or Krugman/Obstfeld 2003). Therefore, the standard Heckscher-Ohlin framework of international trade theory which is often applied to explain the deteriorating labour market situation of the low and unskilled in developed countries is unlikely to tell the whole story. One of the fundamental assumptions of the Heckscher-Ohlin model is that trade takes place between countries that differ with respect to their relative factor endowments. Another assumption is that the factors of production, labour and capital, are mobile only within national borders and not across them. In the basic model set-up with two countries, one is assumed to be labour abundant and to export a labour-intensive product while the other country is capital abundant and exports a capital-intensive product. The theory states that factor prices change in reaction to changes in world product prices. In the extreme, wages and interest rates are equalised in both countries (Factor Price Equalisation Theorem): trade in goods is a perfect substitute for the mobility of the production factors.

It is important to keep in mind that the pure Heckscher-Ohlin model is essentially not a model to explain unemployment, as it departs from the assumption that countries do not specialise completely. Workers who lose their job in one sector will always be employed in the other, i.e. labour demand is perfectly elastic. Despite its basic assumptions, the model is often used to explain the decline in production of the labour-intensive good, as well as the wage gap in industrialised countries.

### *Labour Economics*

An alternative approach to measure whether and to what extent international trade and FDI have an impact on domestic labour demand, and the one we will describe in more detail in sections 4 and 5, is that of the elasticity of labour demand. The wider the range of goods consumers and employers can choose from and the easier domestic labour forces can be substituted by foreign labour forces, the more elastic the demand for the former becomes. More generally, trade expands the set of factors industries can substitute in response to higher domestic wages as it provides access to almost any kind of foreign factors of production. By construction, the labour demand elasticity comprises measures of market openness and of substitutability of production factors. It thus embraces almost any kind of internationalisation of economic activities, from exports to FDI. The labour demand elasticity additionally captures pressure on elasticities from trade with any kind of country, not only from trade with less developed countries.

In contrast to Heckscher-Ohlin, the elasticity approach reveals that international trade may cause fundamental changes on national labour markets without affecting wages or without inducing changes in product prices. This is well explained by Slaughter (2001) in his introduction to an empirical investigation on the pressure on US elasticities of labour demand due to international trade: "...This means that finding little effect of trade on wages can be entirely consistent with finding a large effect of trade on elasticities".

## 3.3 European Trade Patterns and FDI

### *German International Trade Patterns*

Table 3 shows the structure of German goods exports per country groups and individual countries from 1991 to 2003. The figures are percentage shares based on absolute trade volumes in current € billions, therefore they do not allow for effects of currency devaluations and revaluations. Although the reported data are on exports alone, we will also refer to the corresponding import streams. As can be seen, throughout the years the trade pattern was quite stable. Export streams and import streams were almost balanced, i.e. except for the reform states there is no region to where exports are much larger than the imports from that region or vice versa. About 56.9% of all exports were directed to other EU member countries compared to about 53% imported from them, the latter decreasing slightly in tendency, however. Another 21.4% were both exported to and imported from other industrialised countries. France and the US have always been Germany's two strongest single trading partners. Within the EU, France is followed by the United King-

dom, Italy, and the Netherlands with between 7 to 8.5% in terms of total German exports. However, a slight decrease in the trade volumes with the EU member countries can nevertheless be observed, possibly in favour of trade with the reform states, in particular the Central and Eastern European countries as well as China. Their shares in German exports increased remarkably in the 1990s. On the other hand, trade with less developed countries has decreased in terms of percentage shares.

	1991	1993	1995	1997	1999	2001	2003 <sup>a</sup>
EU countries	61.1	56.5	57.0	55.4	57.3	55.2	55.5
BLX	7.4	6.9	6.5	5.8	5.6	5.4	5.8
FRA	13.4	12.5	11.6	10.6	11.4	11.1	10.5
ITA	9.4	7.7	7.5	7.4	7.5	7.5	7.3
NDL	8.5	7.8	7.4	7.0	6.7	6.2	6.3
AUT <sup>b</sup>	6.0	6.0	5.4	5.2	5.5	5.1	5.4
ESP	4.1	3.3	3.4	3.7	4.4	4.5	4.9
GBR	7.8	8.1	8.0	8.5	8.4	8.4	8.4
Other industrialised countries	23.1	23.4	20.8	20.2	20.7	20.9	20.7
USA	6.4	7.5	7.5	8.6	10.1	10.6	9.3
JPN	2.5	2.5	2.6	2.3	2.0	2.1	1.8
Reform countries	4.0	7.7	9.0	11.6	11.3	13.1	14.9
LDC	11.0	12.7	13.1	12.4	10.4	10.4	8.7

Table 3: Regional shares in German exports from 1991 to 2003  
(Source: German Council of Economic Experts, several annual reports)

<sup>a</sup> Own calculations based on data from Deutsche Bundesbank.

<sup>b</sup> Listed as EU member country in all years although Austria only joined the EU in 1995.

Although the figures are only on German trade relationships, they are representative of all European countries. In its annual report of 2003 the German Council of Economic Experts (Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung) confirms that since the beginning of the third stage of EMU the regional distribution of good exchange has shifted further in favour of the Euro area. To sum up, the figures strongly affirm the dominance of intra-industry trade for these countries, i.e. they are evidence of the restricted empirical utilisability of the Heckscher-Ohlin framework.

#### *German FDI Stocks*

Additional information on the integration of markets is obtained from data on FDI. In table 4 we report percentage shares of outward German FDI stocks from 1991 to 2001 with the same partner countries as those in the previous paragraph.

	1991	1993	1995	1997	1999	2001
Absolute stocks in billions of €	132.3	164.3	196.7	278.1	405.4	699.0
EU countries	54.5	52.6	54.9	49.3	44.5	38.9
BEL	4.2	8.5	7.2	6.0	4.6	3.6
FRA	10.7	8.2	8.2	6.4	5.7	6.0
ITA	8.8	4.2	4.1	4.2	3.9	2.8
LUX	3.3	3.9	4.2	4.0	3.9	4.1
NDL	6.3	6.0	6.7	5.3	5.1	5.1
AUT	3.6	3.8	3.7	0.0	2.9	2.8
ESP	5.7	3.6	3.3	0.0	2.8	2.1
GBR	7.4	6.6	9.6	10.7	9.9	9.0
Other industrialised countries	35.8	34.8	31.3	35.3	39.8	47.3
USA	23.0	24.0	21.7	26.4	31.8	41.1
JPN	2.0	2.5	2.0	1.7	1.8	1.3
Reform countries	0.6	2.0	3.5	5.4	6.1	5.8
LDC	9.1	10.6	10.3	10.0	9.7	8.0

Table 4: Regional distribution of German outward FDI stocks from 1991 to 2001, percentage shares  
(Source: Deutsche Bundesbank, several monthly reports)

The figures reveal that by far the largest share of German FDI has been invested in EU member countries and the US. This remains valid when taking into account that from 1991 to 2001 the absolute German FDI stock more than quadrupled, particularly in the late 1990s. By far the largest increase thereof was invested in the US, although considerable increases can also be accounted for in all other country groups. The figures do not reveal that FDI directed to less developed countries more than tripled (in absolute terms) and FDI to reform countries even rose by factor 13.

As regards trends in the global distribution of FDI, Nicoletti et al. (2003) report that "Most ... activity goes on among OECD countries and takes the form of ownership changes in existing enterprises (mergers and acquisitions, privatisation), with so-called 'green-field' investment playing only a minor role. ..." Furthermore, the authors note that the EU member countries were both the largest recipients and the largest suppliers of FDI.

## 4. Elasticity of Labour Demand

### 4.1 Overview

In this section we explicitly derive the elasticity of labour demand and show what economic parameters influence its absolute size and how. It is instructive to start in section 4.1 with labour as the only input factor in the production process, as this basic model already reveals the dependence of the labour market on the product market. The extension to two input factors in section 4.2 adds substitution aspects to the analysis, i.e. the labour market is additionally linked to markets for other production factors.

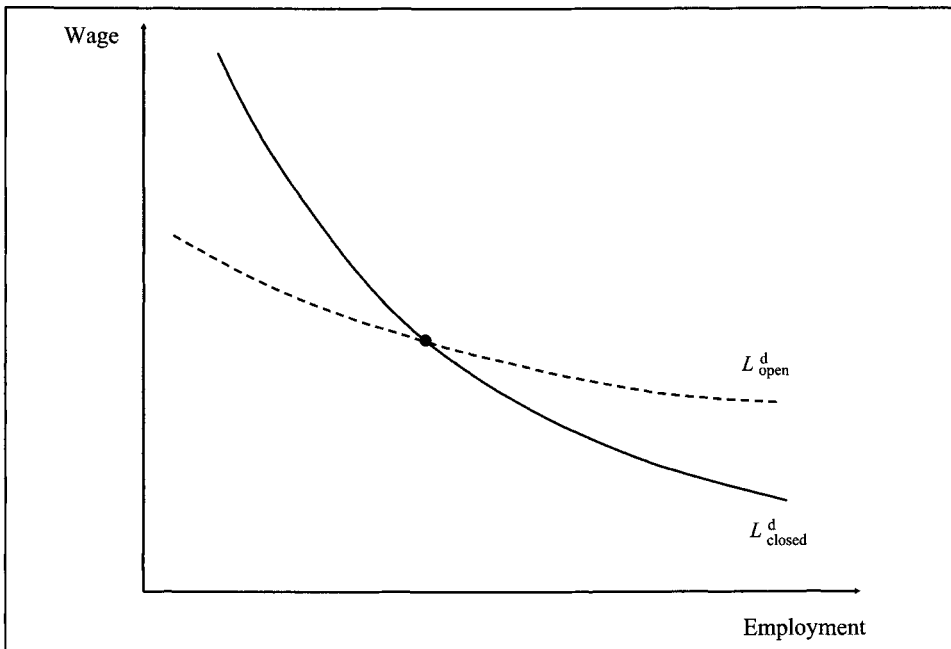


Figure 1: Labour demand curves for the closed and the open economy

Figure 1 is a graphic depiction of the problem under study and is referred to below. The dotted curve represents the labour demand curve for the open economy. It is flatter throughout than the labour demand curve for the closed economy, indicating that in the open economy labour demand is less elastic, i.e. the services of the working population can be substituted more easily by the services of other workers across national borders. (The reader is reminded that the slope of any continuous function is only one multiplier in the function's elasticity with respect to one of its arguments. See e.g. Chiang (1984).) Hamermesh (1993) lists a comprehensive number of empirical studies that di-

rectly or indirectly measure labour demand elasticities. Those studies that use highly aggregate US and European countries data find labour demand elasticities of about 0.5, a result confirmed in many empirical studies such as e.g. in Krishna et al. (2001) in a recent study on evidence from Turkey.

## 4.2 Labour Demand with One Input

Consider a price taking firm that uses labour as the only input in production, i.e. labour is essential for production and is transformed into output, with wage costs  $wL$  the only costs incurred. The production function  $f(L)$  is assumed to exhibit positive but decreasing returns,  $f' > 0$ ,  $f'' < 0$ . Profit maximisation reads

$$\max_L pf(L) - wL$$

which gives the first order condition

$$pf'(L) = w.$$

The optimal labour demand is  $L^* = L(w)$  and differentiation with respect to  $w$  yields

$$\frac{dL(w)}{dw} = \frac{1}{pf''(L(w))} < 0,$$

i.e. labour demand is downward sloping. It increases with a reduction in the real wage and vice versa. The important aspect for future analysis is that labour demand is a derived demand.

This simple model of a single input factor can be generalised for any market form in the product market by introducing the absolute elasticity of product demand  $\eta$ . The first order condition then reads

$$pf'(L) \left[ 1 - \frac{1}{\eta} \right] = w.$$

As can be seen, labour demand is more steeply sloped first, the more rapidly diminishing are the returns to labour and, second, the less elastic the demand for the consumer good. Correspondingly, the elasticity of labour demand  $\varepsilon_{L,w}$  reads

$$\varepsilon_{L,w} \equiv \frac{dL(w)}{dw} \frac{w}{L(w)} = \frac{w\theta}{pf''(L(w))L(w)}$$

with  $\theta = \left(1 - \frac{1}{\eta}\right)^{-1}$ .

### 4.3 Labour Demand with Two Inputs

The extension of the above model to the case of two input factors, labour and capital e.g., yields deeper insight into how changes in economic parameters make labour demand more elastic. We shall consider the same competitive firm. The production function  $Y = f(L, K)$  is assumed to be linearly homogeneous and to exhibit the standard neoclassical properties,  $f_K, f_L > 0, f_{KK}, f_{LL} < 0$  and  $f_{KL} > 0$ .

Assuming that Euler's theorem applies, the elasticity of labour demand  $\varepsilon_{L,w}$  reads

$$\varepsilon_{L,w} = - \left( \frac{rK}{Y} \sigma + \frac{wL}{Y} \eta \right) < 0.$$

(The derivation of  $\varepsilon_{L,w}$  involves several steps which are beyond the aim of this contribution. See Hamermesh (1993) for a more detailed derivation.)

As can be seen,  $\varepsilon_{L,w}$  consists of two single effects and is negative. ( $\varepsilon_{L,w}$  is also referred to as the negative own-price elasticity of labour demand.) For a given production technology the production factors' share is crucial for the size of  $\varepsilon_{L,w}$ . The two single effects are a substitution effect represented by  $\sigma = \frac{d \ln(K/L)}{d \ln(w/r)} > 0$ , the constant-output elasticity of substitution between capital and labour, and a scale effect which, as in the previous paragraph, is measured by  $\eta$ . Both single elasticities measure induced changes in aggregate output. An increase in the wage rate e.g. will increase aggregate production costs and hence the product's market price, which will in turn reduce the demand for the product. Consequently, both labour and capital will be demanded less. Furthermore, the increase in the wage rate will make capital relatively cheaper, inducing a substitution process.

As in section 4.1, the scale effect applies to the product market characteristics, i.e. it measures the degree of competitiveness. The more competitive the market, the higher  $\eta$  and consequently the higher  $\varepsilon_{L,w}$ . This relationship is well-established in trade theory; see e.g. Helpman and Krugman (1991). The substitution effect alone can be explained by the Le Chatelier principle, which states that the demand for a factor of production becomes more elastic when another factor of production can respond to changes in economic conditions with greater ease. (The mathematically interested reader is referred to e.g. Silberberg (1990).) In the real world, capital is essentially more mobile than labour. Openness and trade enlarge the supply of production factors firms can choose from. Slaughter (2001) notes that the mere ability to access foreign factors is sufficient to enlarge  $\sigma$ . We will come back to this argument in section 5.3.

In summary we can state that an increase in the elasticity of labour demand is a sufficient condition in the explanation of the pressure on domestic labour markets.

## 5. Impact of a More Elastic Labour Demand on the Domestic Workforce

### 5.1 Overview

In this section we retrace in detail how, according to Rodrik (1997), a more elastic labour demand has an impact on domestic working relationships. Rodrik identifies a change in the incidence of non-wage costs, an increase in the volatility of earnings, and a weakening of unions in wage bargaining.

### 5.2 Incidence of Non-Wage Costs

In many European countries as well as in the United States, the postwar period was characterised by increasing labour standards and benefits. According to Rodrik, keeping labour standards at high levels puts a greater burden on workers the more elastic the demand for labour becomes. He argues that employers are becoming more sensitive to these kinds of costs. Whereas Rodrik discusses the possibilities of keeping labour standards at high levels, from a worldwide perspective the proper implementation of labour standards is a topic of fundamental human rights. The ILO specifies as core labour standards the elimination of child labour exploitation, prohibition of forced labour, freedom of association, the right to organise and bargain collectively, and non-discrimination in employment. Another area of research is whether the non-existence or non-observance of labour standards per se may explain part of the unemployment in OECD countries (see OECD 1996). For the subsequent analysis of how labour standards affect the domestic labour market we compare their costs to a wage tax which is borne by the workforce. From tax incidence literature we know that employers optimise their labour input based on the gross wage rate, whereas workers decide on their labour offer based on the net wage they actually receive. (In practice, firms optimise their employment on the basis of total labour costs which comprise their part of total social security payments plus voluntary extra services for the workforce.) The problem lies in who bears the costs of implementation, or rather, maintenance of labour standards.

We begin our analysis by borrowing the well-known inverse elasticity rule from the literature on efficient taxation. The rule states that when two commodities  $x$  and  $y$  are liable to taxation, the commodity whose demand is more elastic should be charged at a lower tax rate (see e.g. Wellisch (2000) for a detailed explanation). Let  $t_x$  and  $t_y$  be the commodity tax rates for the two commodities and  $\varepsilon_x$  and  $\varepsilon_y$  the corresponding absolute demand elasticities ( $t_i, \varepsilon_i > 0, i = x, y$ ). The inverse elasticity rule reads

$$\frac{t_x}{t_y} = \frac{\varepsilon_y}{\varepsilon_x}.$$

Suppose  $\varepsilon_y > \varepsilon_x$ , then for the rule to hold we must have  $t_x > t_y$ . Assigned to the problem at hand now instead of the demand for two different commodities, think of the demand for two types of labour within one country, one at a low and one at a high degree of market integration. In particular, let the latter result from a rotation of the first as shown in figure 1. Assume that irrespective of the degree of openness, labour standards are kept at the same unique level with associated costs  $t_x = t_y$  the same, too. It follows that, everything else being equal, a unique level of labour standard costs is incompatible with different labour demand elasticities. The argument goes that if labour demand becomes more elastic for an industry due to market openness, the level of labour standards either has to be decreased or their cost shares have to be modified at the expense of workers. The modification of cost shares, however, consists in a reduction of the net wage rate  $w^n$  given by

$$w^n = w/(1-t_w),$$

where  $t_w$  is the wage tax rate or the costs of labour standards, respectively, and a simultaneous reduction of the optimal level of employment on the firms' part. To show this, we write the equilibrium condition for the labour market with  $L^d(w)$  the labour demand function and  $L^s(w, t_w)$  the labour supply function,

$$L^d(w) = L^s(w, t_w).$$

By assumption,  $\frac{\partial L^d}{\partial w} < 0$ ,  $\frac{\partial L^s}{\partial w} > 0$  and  $\frac{\partial L^s}{\partial t_w} < 0$ . At a zero wage tax rate we have

$$L^d = L^s \Big|_{t_w=0} \quad \Leftrightarrow \quad w = w^n.$$

With taxation or the introduction of labour standards, we have

$$L^d = \frac{L^s}{1-t_w} \equiv L^s \quad \Leftrightarrow \quad w > w^n.$$

If in the open economy we have  $\varepsilon_{L,w}^{open} > \varepsilon_{L,w}^{closed}$  (again in absolute values) due to  $\theta^{open} > \theta^{closed}$  but we keep the gross wage rate unchanged,  $w^{open} = w^{closed} = \bar{w}$ , the net wage  $w^n$  is the only variable that can adjust: it decreases. Accordingly, workers reduce their labour offer resulting in an employment rate lower than before. Graphically, the point can be seen in figure 2 where we have added  $L^s$  and  $L^s$  to figure 1 (see Rodrik 1997). The suffixes *c* and *o* stand for the closed and open economy, respectively. The imposition of labour standards shifts the labour supply curve up. As a consequence, the equilibrium shifts from  $E_c$  to  $E_o$  with the net wage  $w_o^n$  beneath the former gross wage  $w_c$ , and with the new level of employment  $L_o$ , too, lower than before.

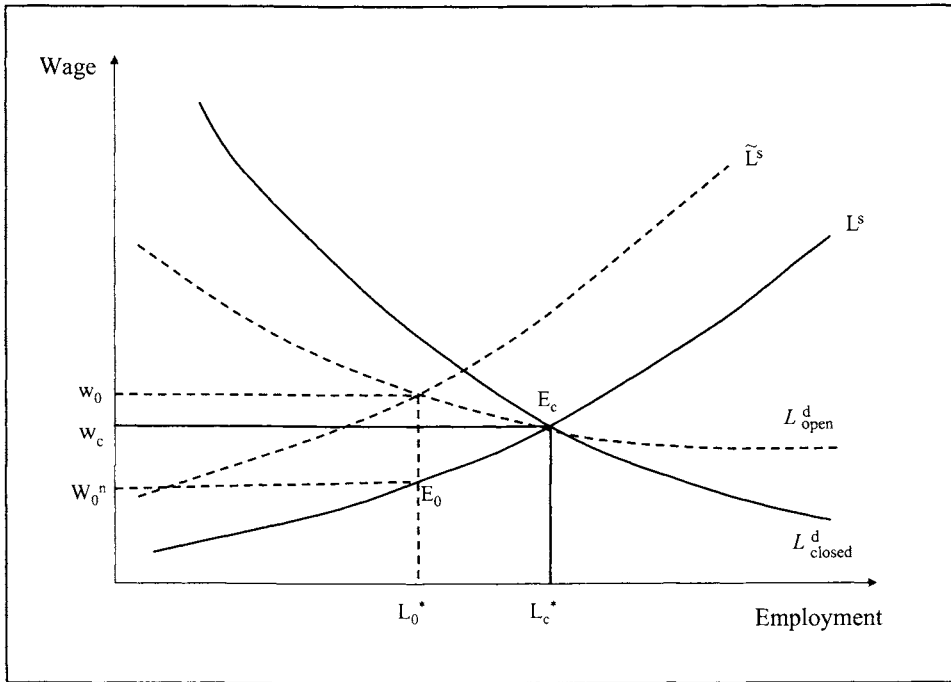


Figure 2: Shift in labour supply due to the imposition of labour standards

### 5.3 Volatility

Following Rodrik, the second implication of increased labour demand elasticity on the domestic workforce consists in an increase in the instability or volatility of earnings and hours worked. Macroeconomic shocks such as productivity shocks, e.g., have a far greater impact on the national economy when it is open, no matter whether the shocks are positive or negative.

To demonstrate how increasing volatility is transmitted, we again set up an example consisting of a labour demand function  $L^d(w, x)$  and a labour supply function  $L^s(w)$ . We assume  $L^d$  is decreasing in the wage rate  $w$  and increasing in technological progress  $x$  whereas  $L^s$  increases in  $w$ . The labour market equilibrium condition reads

$$L^d(w, x) = L^s(w).$$

Total differentiation and subsequent rearrangement of terms yields

$$\begin{aligned} \frac{\partial L^d}{\partial w} dw + \frac{\partial L^d}{\partial x} dx &= \frac{\partial L^s}{\partial w} dw \\ L^d \left[ \frac{\partial L^d}{\partial w} \frac{w}{L^d} - \frac{\partial L^s}{\partial w} \frac{w}{L^s} \right] \frac{dw}{w} &= \frac{\partial L^d}{\partial x} dx \\ \Leftrightarrow \hat{w} &= \frac{\varepsilon_{L,w}}{\varepsilon_{L,w} + \delta} \hat{x} \\ \text{and} \quad \hat{L} &= \frac{\varepsilon_{L,w} \delta}{\varepsilon_{L,w} + \delta} \end{aligned}$$

where  $\hat{w}$  and  $\hat{x}$  denote relative changes in the wage and in the productivity of labour, respectively, and  $\hat{L}$  denotes the relative change in optimal employment. As previously,  $\varepsilon_{L,w}$  denotes the elasticity of labour demand while  $\delta$  denotes the elasticity of labour supply. With an increase in the exogenously given labour productivity, the equilibrium wage rate and employment will increase. Globalisation makes the resulting increases stronger than they would be without integrated markets.

## 5.4 Bargaining

The easier the domestic workforce can partly or fully be transferred abroad, the weaker domestic unions become in wage bargaining processes resulting in less bargaining power over rent distribution. In this section we illustrate how the integration of markets may have an impact on union bargaining. In section 2.2 we mentioned some reasons why trade unions may have lost members over the past decades. However, in view of wage coverage in most European countries, union bargaining has not lost anything of its general importance in wage setting processes (see Heise 2002). Union models are one model among others that serve to explain the existence of unemployment. They, too, are characterised by wages set above the competitive level and by the existence of an exogenously given outside option. A characteristic of common union models, though not all, is that union members take the insider position, i.e. they care more about their own well-being inside the firm than about employment possibilities of that part of the workforce out of work. The union's trade-off lies in a utility gain from higher wages against a utility loss from the discharge of part of the workforce employed at the firm. In general, the enforcement of higher wage demands on the union's part is associated with less employment on the firms' part and vice versa. Again, the more elastic the labour demand, the higher the utility loss from discharge, and the lower the optimal wage.

In the following, we choose the right-to-manage approach to demonstrate the relationship between the distribution of bargaining power between the union and the firm on the

one hand and the bargaining outcome on the other. The bargaining process is described by the so-called “Nash bargaining solution”. The power parameters are set exogenously. Together with the fallbacks, these comprise all influences which are indeed inherent to the bargain but are usually not easy to quantify. Bargaining theory assumes that both parties have the same discount rate and that during the bargaining neither of them receives an extra income from other sources (Binmore et al. 1986). The violation of the second assumption on the part of one party by receiving an extra income as a consequence of a disagreement increases that party’s bargaining power; that party becomes stronger, or it has a higher fallback, respectively. In this context, the firm might announce that it is prepared to invest abroad in the case of a non-agreement. This seems to be observable in real life, as Mitchell (1985) e.g. notes in an early study on US wage norm shifts until the mid 1980s. He found that union membership notably decreased in some of those sectors which were exposed to foreign competition. Again, the mere announcement of FDI is sufficient and measurable. Additionally, in reaction to strikes, managements employed nonunion members, an act which in an era of job insecurity possibly discouraged other workers from striking. He further notes that in the 1980s managers were more concerned with the economic fortunes of their enterprises and less so with industry wage patterns than they were in the 1970s.

In the right-to-manage approach, the union and the firm bargain over the wage rate and the firm subsequently determines its optimal employment level. The maximisation of the Nash product is thus constrained by the requirement that the solution be on the firm’s labour demand curve. The outcome need therefore not necessarily be efficient. We take a single firm that employs only labour  $L$  for production and has the following profit function  $\Pi(L)$

$$\Pi(L) = R(L) - wL$$

where  $w$  is the wage rate per worker. The revenue function  $R(L)$  is strictly concave in labour  $L$ . The trade union’s utility function reads

$$U(w, L) = L[U(w) - U(w_o)]$$

with  $w_o$  the alternative income which those union members receive who are not employed by the firm. The utility function, too, is assumed to be strictly concave. If no bargain can be agreed on with the employer, union utility, i.e. its fallback, is  $L U(w_o)$ . The firm’s fallback is zero because in the case of non-agreement, output and thus rents are assumed to be zero: there will be nothing to be distributed. The corresponding asymmetric Nash product reads

$$NP(w, L) = [L[U(w) - U(w_o)]]^\alpha \Pi(L)^{1-\alpha}$$

with  $0 \leq \alpha \leq 1$  the relative bargaining power, and it is maximised subject to

$$w = R'(L).$$

Partial differentiation of  $NP$  with respect to  $w$ ,  $L$  and the constraint's parameter, substitution, manipulation, and rearranging of terms results in the following two expressions,

$$\varepsilon_{U,w} = -\varepsilon_{L,w} + \frac{1-\alpha}{\alpha} \frac{\varepsilon_{R,L}}{1-\varepsilon_{R,L}}$$

$$\Leftrightarrow \varepsilon_{L,w} = \frac{1-\alpha}{\alpha} \frac{\varepsilon_{R,L}}{1-\varepsilon_{R,L}} - \varepsilon_{U,w}$$

The union's wage elasticity of the net utility from work,  $\varepsilon_{U,w} = \frac{U'[w]w}{U[w]-U[w_o]} > 0$  equals the sum of the negative of the elasticity of labour demand  $\varepsilon_{L,w}$  and the firm's elasticity of revenue with respect to employment,  $\varepsilon_{R,L} = \frac{R'[L]L}{R[L]} > 0$ . For a given distribution of bargaining power between the union and the firm, an increase in  $\varepsilon_{L,w}$  increases  $\varepsilon_{U,w}$ , i.e. the union's net utility from work becomes more elastic, too. This means that the slope of the union's indifference curve becomes flatter, or, union utility decreases. Figure 3 shows the result graphically. The labour demand curves are drawn steeper and as straight lines for mere ease of exposition. As in the previous two figures, the labour demand curve of the open economy is flatter than is the labour demand curve of the closed economy. The corresponding utility level decreases from  $I_{closed}$  to  $I_{open}$ .

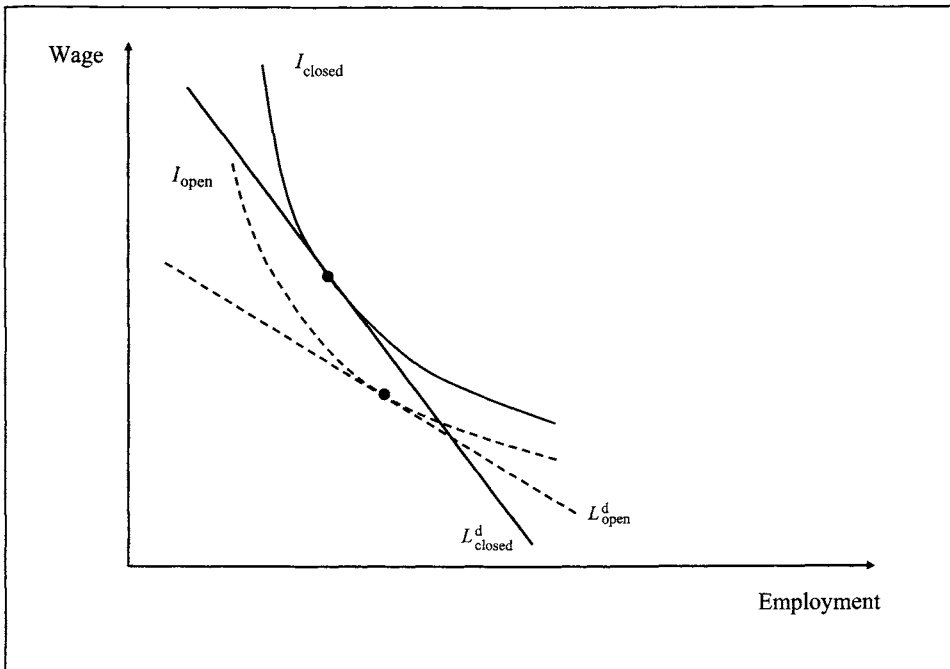


Figure 3: Right-to-manage approach and openness

## 6. Conclusion

European labour markets are characterised by high and persistent unemployment rates. The international integration of markets is said to be one of its sources. A rather new approach to show what consequences may arise for domestic labour markets from the integration of markets is the elasticity approach as presented by Rodrik. In this contribution we have described European labour markets and unemployment in particular, as well as trade and FDI patterns as evidence of the economic integration of markets. We have explained in detail how the substitutability of domestic workers by foreign workers may influence the domestic labour market. Although we have not conducted an empirical study, the trends found in European labour markets, such as the decline in unionisation, for example, strongly suggest that the labour demand elasticity approach is highly suited to explain these phenomena.

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Wichard Woyke

# Sense-Making Processes in the Council of Ministers: From the ECSC to the European Constitution

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References

## 1. Introductory Remarks

### The European Council

- is the key legislative institution of the EU,
- is the main formal point for the representation of national interests in the EU policy process,
- is the EC's main decision-making institution,
- has a central executive function and
- is the principal meeting place of the national governments.

The Council acts in its capacity as legislator when it adopts, on the basis of the relevant provisions of the Treaties, legally binding standards in or for Member States by means of regulations, directives, framework decisions or decisions. Internal measures, administrative or budgetary acts, acts concerning interinstitutional or international relations and non-binding acts such as conclusions, recommendations or resolutions are not regarded as legislative acts. As regards definitive legislative acts adopted by the Council, the summaries contain, where appropriate, the result of the votes and the statements for the minutes by the Council, the Commission or the Member States.

## 2. Historical Development

The European integration process according to the supranational approach started with the European Steel and Coal Community in 1950 when the then French Foreign minister Robert Schuman made his famous proposal of uniting the coal and steel market in Europe. In order to foster German reconstruction and reindustrialisation, France sought for a framework of planned production and distribution in its own coal and steel industry. To secure these aims, the Member States delegated certain competencies to a new supranational body – the High Authority, the predecessor of the Commission. Of course, besides the High Authority, a Special Council of Ministers was set up to make the general decisions. This Special Council of Ministers was introduced because of the pressure on the Benelux-countries to defend their national interest in the face of the dominance of France, Germany and Italy. Because the composition of this Council was one minister from each country, the ECSC-Council provided an intergovernmental balance to the supranationalist inclinations of the High Authority. For Schuman and his aide Jean Monnet, decision-making could only be efficient by delegating the responsibility for generating political ideas and for the day-to-day management of policy to a supranational body. This combination of intergovernmental decision-making and policy initiation and management by a supranational executive became the model for future treaties.

A separate Council of Ministers was created in 1958 when the EEC and the EAC were formed. The idea of defending national interests was taken a step further with a weighted system of voting designed to prevent large countries from overwhelming small ones. Like the Council of the ECSC the Council of the EEC had only six members, but among them there were different votes: four for each of the larger countries – France, Italy, Germany – two each for Belgium and the Netherlands, and one for Luxembourg. This principle of decision-making protected both the small states and the large states from being overruled in the case of a qualified majority. For a qualified majority a decision needed twelve votes, but from at least four countries. In 1967 the Merger Treaty of the ECSC, the EEC and the EAC created a single Council for the three communities.

When the integration process started in the early 50s, many political analysts were convinced that the role of the Council would gradually decline, especially in relation to the Commission. But in political practice it was the Council who won more and more influence in the decision-making process. The idea that the EC should become a mixture of supranational and intergovernmental structures gained more and more supporters. When in 1965 the then French President de Gaulle dismissed his Foreign Minister from the Council the EC was no longer able to make decisions, because each country had to vote in favour of a proposal that this initiative could become a law of the Community. In 1966 the governments signed the so-called “compromise of Luxembourg”, which introduced the power of veto, which was used from time to time. But the dominant measure of decision-making in the Council became the consensus decision until the end of the 80s. Then qualified majority voting was used more and more.

Nevertheless, the integration process became more and more exploited by national governments. This process resulted in a more intergovernmental than supranational EEC. Consequently the Council gained more and more influence and became the decisive actor. Several developments have added to the power and influence of the Council:

1. “It has increasingly reached its own non-binding agreements, reducing the need to agree on formal laws and thus bypassing both the Commission and Parliament.
2. As the interests and reach of the EU have spread, the Council has become involved in new policy areas not covered by the founding treaties.
3. The Presidency of the Council of Ministers has become an increasingly important part of the EU decision-making system and the source of many key initiatives taken on issues such as the EMU and foreign policy” (McCormick 1996, p. 126).

The Council of Ministers’ deliberations were rarely disclosed to the public until the ratification crisis of the Maastricht Treaty. The decision-making process in this cornerstone of the EU was really very intransparent so that the ministers decided to open their negotiations. Some of the Councils were held in public, which meant that TV and Radio were able to broadcast from some sessions. But there was no great onslaught of public opinion. An open discussion in the Council is more necessary because the Council acts as a legislative body in many cases.

## 3. Structure of the Council

### 3.1 Overview

The Council of Ministers (officially the Council of the EU, legally the Council of the EC) has four main elements: the Councils of ministers themselves, the Committee of Permanent Representatives (COREPER), the Presidency, and the Secretariat General. There are several councils, organised along sectoral lines (e.g. agriculture, interior, transport, women etc.). Originally there was one Council composed of the Foreign Ministers. The number of these councils has grown steadily over the years. In 1999 there were more than 20 councils because of the enlargement of the competencies of the EU. The policy segmentation of the council's work into distinct, separate formations is a hallmark of how the EU works. "The multiplication of councils not only increases efficiency by allowing government ministers to decide issues in their particular areas of expertise but also distributes responsibility for Community decision-making among a wider circle of cabinet colleagues" (Dinan 1994, p. 246f.). In December 1999 in the Helsinki summit it was decided to reduce the number to 16 and three years later, in Sevilla, the heads of state and government decided that the number of formations were to be capped at nine. The reduction in the number of Council formations and the corresponding broadening of the policy portfolios of each formation means that Member States send several ministers to the same Council meetings from time to time. The frequency of the Council meetings differs according to the volume of EU decision-making in that sector. The most important Council is the General Affairs Council (GAC). In 2001 the GAC met 15 times, followed by Ecofin 14 and Agriculture 9 and Justice, Home Affairs and Civil Protection 8. Altogether there are normally between 80 and 90 Council meetings in an average year, for example in 2001 there were 84 meetings. Maybe the decision made in Sevilla will reduce meetings. The GAC calls the Foreign Ministers of the Community states together at least once a month – except in August. The ministers discuss politically sensitive policies and proposals for new laws and deal broadly with internal and external relations. More sectoral matters are dealt with in the so-called "Technical Councils", which are made up of the Ministers of Agriculture, Environment etc. As far as the hierarchy of councils is concerned, the Council on Foreign Ministers is undoubtedly at the top. The Council of Finance Ministers (ECOFIN) occupies a prominent position one rung immediately below the GAC. ECOFIN meets monthly, too, and holds a biannual retreat. "The advent of the EMS in 1979 greatly increased Ecofin's importance, as did the emergence of EMU a decade later" (Dinan 1994, p. 249). This reweighting in the Council's balance of power reflects the new importance of EU macroeconomic and monetary policy. Of course there has been a decrease in the influence of the Foreign Ministers although their importance has increased with the successful steps of the project on Common Foreign and Security Policy of the EU at the beginning of the new century. In the informal council hierarchy, the Agricultural Council comes next. Although the importance of agriculture for the societies is declining, this field of politics still has its significance if you look

at the budget. Nearly 47% of the budget is spent in this sector. Each council normally consists of the relevant government minister from the national governments and the relevant member of the European Commission. The presence of the Commission aims to guarantee that the councils do not lose sight of broader EU interests. The multiplication of the councils not only increases efficiency by allowing government ministers to decide issues in their particular areas of expertise but can also distribute responsibility for Community decision-making among a wider circle of cabinet colleagues.

Formations of the Council 1999-2002:

General Affairs	Justice, Home Affairs and Civil Protection
Agriculture	Internal Market, Consumer Affairs and Tourism
Economic and Financial Affairs (Ecofin)	Research
Transport and Telecommunications	Culture
Employment and Social Policy	Development
Fisheries	Education and Youth Affairs
Industry and Energy	Health

### 3.2 COREPER

The ministers are only the top of the “iceberg Council”. Without the permanent staff, the Council would be unable to do its job. Art. 4 of the 1965 merger treaty recognised Coreper’s existence and competencies. The of Permanent Representatives (COREPER) is the institution which acts permanently and it is the body in which national interests are defended during the time when the councils do not work. In fact there are two COREPERS. COREPER I consists of the Deputy Permanent Representatives and support staff. COREPER II is the more important body because it acts as a key-information gathering and mediating forum between the Member States. Each of the Member States has a national delegation in Brussels which acts as a kind of embassy. As a body COREPER meets weekly, acts as a clearing house for proposals and a melting pot of ideas, where national positions are outlined and debated, and compromises are often made that result in most of the key decisions on proposals being taken before they even reach the ministers. COREPER plays a “key role in organizing Council meetings by preparing the agendas, deciding which proposals go to which council, deciding which of the proposals can be automatically approved and which need discussion, and overseeing the committees and working parties set up to sift through the proposals” (McCormick 1999, p. 98). The members of COREPER fulfil a dual role which perfectly characterises the function of the Council’s committee structure as a ‘hinge’ between Member State and European Union more generally. At any point in time, the Council has between 150 and over 250 working groups in existence.

### 3.3 The Council Secretariat

The main administrative support for the work of the Council is made by the General Secretariat. Its main responsibility is to serve the council machinery. It has to support the meetings of working groups, committees and ministers of the Council. The Council Secretariat prepares draft agendas, provides legal advice, processes and circulates decisions and documentation and monitors policy. The Council Secretariat, the institutional memory of the Council, provides organisational, logistical and legal backup for the meetings of ministers and officials. It is an important asset and ally of the presidency. The Secretariat is an element of continuity. In exercising many of its responsibilities, the Secretariat works closely together with representatives from the state holding the presidency in the European Union. This is essential because key decisions are primarily prepared by the presidency. Furthermore, there is a tendency of the presidencies to structure the policy process and it therefore needs the Secretariat. In the case of a weak presidency, the Secretariat can gain considerably in significance.

The office is headed by a Secretary General, appointed for a five-year term. Before the enlargement, the Council had a staff of 2,500 people from all the 15 member countries. Meanwhile, after the enlargement by ten further states from Central, East and Southern Europe, there are about 3,000 people working in the Council. In 1999 Javier Solana, the former Spanish Foreign Minister and Secretary General of NATO, was appointed simultaneously as Secretary General of the EU-Council and the EU High Representative for Foreign Affairs. His mandate was renewed in 2004 for another five-year period. Solana, a political 'heavyweight' in European Affairs, gained extended competencies when he simultaneously became Secretary General of the WEU, the military arm of the EU. "Solana's seniority together with his experience in foreign affairs and defence matters adds substantially to the actorness of the CSFP: now there is a central authority to communicate common positions, negotiate on the EU's behalf with third countries and oversee the growing number of EU missions and interventions in crisis regions. Nevertheless, the emphasis in judging the significance of this new post must be on the potential for enhancing the EU's foreign policy capabilities. Much still depends on the political will among Member States – often lacking in the past – to agree to common positions and subsequently to comply with these" (Christiansen 2001, p. 151). Since Solana chairs the Secretariat, the Deputy Secretary General is entrusted with the task of overseeing the day-to-day operations of the Council.

### 3.4 The Presidency

The Presidency of the Council of Ministers (and of the European Council) is held by a country for six months (see table 1 for a schedule of Presidencies from 1991-2007). One Member State assumes the role, and ministers and officials chair any of the meetings that are convened during the period. The Council presidency rotates according to alphabetical order. Meanwhile the EU has decided that there should always be at least one large

Member State in the Council's so-called Troika, consisting of the preceding, current and succeeding presidencies. In effect, the Prime Minister – and in the case of France, the President – and the Foreign Minister are those actors to hold the Presidency. “The true genius of the rotating presidency is that it acts as a great equalizer between big and small states, giving tiny Luxembourg the same chance to run things as, say Germany, France or Britain” (Lewis 2003, p. 152). The Presidency can increase the prestige and status of a member country, but it brings heavy administrative burdens. A disadvantage for a presidency is the fact that it must always seek a compromise, a consensus, so that the Presidency-country can not fight for its national interests.

The Presidency plays a crucial role in EU decision-making. Even though they cannot decide on things alone, “Presidency teams can exert a significant influence on how agendas are set, what levels of ambition are pursued, when negotiations can be brought to an end, how interaction is managed with the other European Institutions” (Schout/Guggenbühl/Bayer 2004, p. 24). The EU presidency involves much quiet diplomacy behind the scenes and often in bilateral talks, sometimes known as “confessionals” (Beichtstuhlverfahren), in order to make progress on new proposals as well as deal with the inevitable unexpected developments. The tasks for the Presidency are as follows:

- setting of the agenda for European Council meetings and for the EU as a whole;
- arranging and chairing most meetings of the Council of Ministers and COREPER, and overseeing Council relations with other EU institutions;
- mediating and bargaining of different views and attitudes of Member States;
- acting as the main voice of the EU on the global stage;
- launching and building a consensus for initiatives;
- hosting summits of the European Council (see McCormick 1999, p. 99).

“Holding the presidency allows a Member State to convene meetings and launch strategic initiatives on issues of particular national interest, to try to bring those issues and initiatives to the top of the EU agenda, and to earn prestige and creditability” (McCormick 1996, p. 132). The Presidency can be an important source of leadership in the community, and Member States see their turn at the helm as a chance to leave their imprint on the integration process.

	1 <sup>st</sup> half	2 <sup>nd</sup> half
1991	Luxembourg	The Netherlands
1992	Portugal	United Kingdom
1993	Denmark	Belgium
1994	Greece	Germany
1995	France	Spain
1996	Italy	Ireland
1997	The Netherlands	Luxembourg
1998	United Kingdom	Austria
1999	Germany	Finland
2000	Portugal	France
2001	Sweden	Belgium
2002	Spain	Denmark
2003	Greece	Italy
2004	Ireland	The Netherlands
2005	Luxembourg	United Kingdom
2006	Austria	Finland
2007	Germany	Portugal

Table 1: Schedule of EU Presidencies of the Council of Ministers (1991-2007)

#### 4. Principal Factors Determining the Progress of a Proposal through the Council according to Nugent

According to Nugent, the principal factors, which determine the progress of a proposal through the Council, are the following:

- the urgency of the proposal,
- the controversiality of the proposal and support/opposition amongst the states,
- the extent to which the Commission has tailored its text to accommodate national objections/reservations voiced at the pre-proposal stage,
- the complexity of the proposal's provisions,
- the ability of the Commission to allay doubts by the way it gives clarifications and answers questions,
- the judgements made by the Commission on whether, or when, it should accept modification to its proposals,

- the competence of the Presidency,
- the agility and the flexibility of the participants to devise (usually through the Presidency and the Commission) and accept a compromise form,
- the availability of, and willingness of the states to use, majority voting (see Nugent 2003, p. 164).

## 5. The Decision-Making Process

When the Commission proposes a new law, a bill is sent to Parliament and the Council of Ministers for debate and possible adoption. The Council has three different voting options: simple majority, unanimity and qualified majority.

The *simple majority* was once used to decide procedural issues or when working under treaty articles. Each minister has one vote. The Single European Act (1986) and the Maastricht Treaty (1991) broadened the number of issues and areas in which a majority vote could be used. That means that one needs at least 13 out of 25 votes today.

*Unanimity* was needed for new laws that would launch an entirely new policy area or when there was a substantial change in an existing policy. In the Amsterdam Treaty (1997) the possibility of a “constructive abstention” procedure was introduced. Thus, a Member State is not obliged to apply a particular decision, but recognises that the EU is committed. Again every minister has one vote. Since the Single European Act (1986) many areas of policy – especially those of the Big Internal Market – are no longer subject to unanimity.

*Qualified majority* was and is the option mostly used in the Council. Instead of each minister having one vote, each is given several votes very roughly in proportion to the population of his Member State. A system of proportionality would give Germany 160 times – rather than five times – as much weight as Luxembourg, to point out just the most obvious discrepancy. The states’ voting weights range from ten for the four larger Member States (France, Germany, Great Britain and Italy) to two for Luxembourg.

In the EU-15 (table 2) a proposal had to receive 62 of a possible 87 votes (71.3 per cent of the total), but it could also be defeated by a blocking majority of 26 votes (29.9 per cent of the total). Thus, at least two big states and Spain had to cooperate in order to prevent the introduction of a proposed measure. In the Treaty of Nice, the Heads of the States and Governments changed the weights of the states, reflecting the enlargement of the EU. In Nice the pressure for re-weighting had become strong, especially from the larger Member States who demanded a greater influence in the Council because they stood to lose at least one commissioner. In the Nice Treaty the issue was resolved only after lengthy and hard negotiations especially between Germany and France. The crisis

in German-Franco relations reached its climax in Nice. Germany's Chancellor Schröder demanded one vote more than France. Instead of 29 Germany would then have received 30 votes: This result would not have changed anything in the decision-making process as a minimum of 170 votes were necessary to obtain a qualified majority in the EU-15. Whether you have 29 or 30 votes, neither of these figures changes your weight in the Council. But it would be of important symbolic significance if Germany had received one vote more than France. Therefore France's President Chirac stubbornly defended the equality of Germany and France with regard to representation in the Council. In the end, the European Council decided to revise the weighting of the votes in the Council rather than to introduce a completely new voting system. From 2005 onwards the total number of votes has been increased, allowing for a greater range of individual countries' voting weights. Indeed, the larger Member States have gained greater weight in the decision-making process in the Council. These Member States received 29 votes whereas Spain got 27 and the Netherlands 13. Ireland and Luxembourg, the smallest states, received 7 and 4 votes respectively (table 3).

Member State	Population (millions)	Percentage of EU-15	Weighted votes in Council
Germany	82.2	21.08	10
United Kingdom	59.6	15.85	10
France	58.7	15.62	10
Italy	57.7	15.35	10
Spain	39.4	10.48	8
Netherlands	15.9	4.23	5
Greece	10.5	2.79	5
Belgium	10.2	2.69	5
Portugal	10.0	2.66	5
Sweden	8.9	2.37	4
Austria	8.1	2.15	4
Denmark	5.3	1.40	3
Finland	5.2	1.38	3
Ireland	3.8	1.01	3
Luxembourg	0.4	0.11	2
<i>Total EU-15</i>	375.9		87

Table 2: Qualified majority voting in the Council of Ministers 1995-2005

Member State	Popula- tion (millions)	Percent- age of EU-27	Weighted votes in Council		Per- centage of votes	Difference between Population and Council- votes in %
			pre-Nice	post-Nice		
Germany	82.2	17.06	10	29	8.41	8.65
United Kingdom	59.6	12.37	10	29	8.41	3.96
France	58.7	12.19	10	29	8.41	3.78
Italy	57.7	11.98	10	29	8.41	3.57
Spain	39.4	8.18	8	27	7.83	0.35
Netherlands	15.9	3.3	5	13	3.77	-0.47
Greece	10.5	2.18	5	12	3.48	-1.3
Belgium	10.2	2.12	5	12	3.48	-1.36
Portugal	10	2.08	5	12	3.48	-1.4
Sweden	8.9	1.85	4	10	2.90	-1.05
Austria	8.1	1.68	4	10	2.90	-1.22
Denmark	5.3	1.1	3	7	2.03	-0.93
Finland	5.2	1.08	3	7	2.03	-0.95
Ireland	3.8	0.79	3	7	2.03	-1.24
Luxembourg	0.4	0.08	2	4	1.16	-1.08
<i>Total EU-15</i>	375.9		87	237		
Poland	38.7	8.03	-	27	7.83	0.2
Romania	22.5	4.67	-	14	4.06	0.61
Czech Republic	10.3	2.14	-	12	3.48	-1.34
Hungary	10	2.08	-	12	3.48	-1.4
Bulgaria	8.2	1.7	-	10	2.90	-1.2
Slovakia	5.4	1.12	-	7	2.03	-0.91
Lithuania	3.7	0.77	-	7	2.03	-1.26
Latvia	2.4	0.5	-	4	1.16	-0.66
Slovenia	2	0.42	-	4	1.16	-0.74
Estonia	1.4	0.29	-	4	1.16	-0.87
Cyprus	0.8	0.17	-	4	1.16	-0.99
Malta	0.4	0.08	-	3	0.87	-0.79
<i>Total EU-27</i>	481.7			345		

Table 3: Qualified majority voting in the Council of Ministers post-Nice  
(Sources: see Wessels 2001, p. 12; see Nugent 2003, p. 85)

According to the new rule, qualified majority voting in the Council requires not only the threshold number of weighted votes (EU-15 170 out of a total of 237) and a majority of states, but also the support of Member States totalling at least 62% of the EU population. This additional population element to Council voting grants privileges to the larger member countries and it benefits Germany, with about 20% of the EU population, in particular. In the Nice Treaty, the qualified majority vote was mainly extended to procedu-

ral matters such as appointments of the President of the EU Commission, the Council Secretary General, or members of the Courts of Auditors, rather than to substantive policy areas. But QMV has, nevertheless, made policy easier, especially the appointment of politicians to the most important positions in the EU such as the President of the European Central Bank. In the "1998 Brussels Summit" the French President Chirac blocked the appointment of former Dutch Finance Minister and President of the European Currency Institute, Wim Duisenberg, to the position of President of the Central Bank for more than eight hours. Duisenberg's declaration that he would not work the whole eight-year period as President laid the ground for a unanimous decision in his favour. Meanwhile, even three opponents can no longer block the qualified majority decision.

Another big problem in the Nice Treaty negotiations was the weighted votes for the acceding countries. Poland received 27 votes, the same amount as Spain, and even Malta, now the smallest country in the EU with nearly the same number of inhabitants as Luxembourg, has only 3 votes, whereas Luxembourg was given 4 votes. The Nice decision on weighted votes has many illogical results. All in all, the larger countries have gained more weighted votes. Until Nice, the discrepancy between the smallest and the biggest ranged from two to ten votes whereas now it ranges from three to 29 votes. Nevertheless, coalition-building in the new, enlarged EU is much more difficult than in the EU-15. Meanwhile, the threshold for a positive vote in an enlarged EU-27 is 255 votes. This could be reached by the 14 largest Member States or from the 23 smallest, plus one large state. On the other hand, the blocking minority lies at 91 votes. This result is easily reached by the smallest 14 Member States who together represent only 11.6% of the EU-inhabitants, by the ten CEE-states, by three or four big states or by the states bordering the Baltic Sea, or the Mediterranean countries bordering the Mediterranean Sea. This solution shows that the architects of the treaty wanted to secure their national veto power. Thanks to the European Constitution, which is in the process of ratification at present and should be set forth in 2006, the decision-making process according to the Treaty of Nice will not exist very long.

There are different types of legislative acts adopted by the Council. In the traditional 'Community pillar' legislation is made in the form of directives, regulations and decisions. For Justice and Home Affairs (third pillar) and Common Foreign and Security Policy (CFSP/second pillar), most legislative acts are made in the form of a joint action or a common position. There is a large number of decision-making procedures, e.g. if Parliament is in session, there is the possibility of consultation, co-operation, co-decision and assent.

#### Types of Council acts:

- *Regulation*: is binding in its entirety and directly applicable in all Member States.
- *Directive*: is binding as to the result to be achieved, but leaves to the national authorities the choice of form and methods.
- *Decision*: is binding in its entirety upon those (and only those) to whom it is addressed.
- *Recommendations* and *opinions*: have no binding force.
- *Joint action*: addresses specific situations where operational action in the EU is deemed to be required; covers objectives, scope, the means to be made available to the EU, if necessary their duration, and the conditions for their implementation.
- *Common position*: defines the approach of the EU to a particular matter of a geopolitical or thematic nature; Member States shall ensure that their national policies conform.

The extent to which the Council must work with and is dependent upon the co-operation of the Commission and European Parliament in respect of policy and decision-making varies between policy areas and according to what types of decisions are being made. The Council is almost independent in pillars two and three, whereas in pillar one, it is less independent, especially where legislation is concerned.

## 6. The European Council

Although the European Council is not an official organ, according to the treaties, this institution is the most important political body of the EU. In 1974, at the Paris summit, the then French President Valéry Giscard d'Estaing and the then German Chancellor Helmut Schmidt were able to convince the other European politicians to institutionalise the meetings of the Heads of State and the Government. The main reason for the creation of the European Council was a growing feeling that the EC was failing to respond adequately and quickly enough to new and difficult challenges. There was at least one year of *Euro sclerosis*, which could only be overcome by the combined political will and decision of the chiefs of the governments. In the communiqué of the Heads of State and the Governments from 1974 we can read:

“Recognizing the need for an overall approach to the internal problems involved in achieving European unity and external problems facing Europe, the Heads of Government consider it essential to ensure progress and overall consistency in the activities of the Communities and in the work of political co-operation.”

The Heads of Government have therefore decided to meet, accompanied by the Ministers of Foreign Affairs, three times a year, and when necessary, in the Council of the Communities and in the context of political co-operation. The administrative secretariat will be provided for in an appropriate manner with due regard for existing practices and procedures.

It was not until 1986, when the first big reform of the EU was made with the Single European Act (SEA) that the European Council was legitimised by the treaties when this Act stated: The European Council shall bring together the Heads of State and Government of the Member States and the President of the Commission of the European Communities. They shall be assisted by the Ministers for Foreign Affairs and by a Member of the Commission.

The European Council increasingly became the most important political institution of the EU, and provided the guidelines for the development of the Community. Of course this institution was based on an intergovernmental approach and it was and is more intergovernmental because its political decisions cannot be corrected by the European Court. The European Council is not an organ of the EU but the most important political institution in the decision-making process. Only once, according to the Maastricht Treaty, the European Council changed into the Council. In order to create the monetary union the Council "meeting in the composition of the Heads of State or Government" had to decide, whether a majority of Member States fulfilled the necessary conditions for the adoption of a single currency, whether it was appropriate for the Community, and if so, to set the date for the beginning of the third stage of monetary union. This was done in May 1998 when the European Council decided that the beginning of the third stage was fixed for 1999 and the introduction of the single European currency (Euro) in practice for January 1, 2002. Normally the European Council cannot make decisions, but, according to the treaties, it provides the guidelines for the further development of the EU. The European Council can be perceived as a distinct component of the Council, which brings together the Heads of State and Government and the President of the Commission in multi-annual summits to discuss pressing business and provide strategic guidance.

## 7. The Council according to the New Constitution

Once the European Summit had definitely decided to accept the new Constitution – which was prepared in its broadest sense by the European Convention – it was agreed that: the Council shall, jointly with the European Parliament, exercise legislative and budgetary functions. The Council shall carry out policy-making and coordinating functions. Normally the Council shall make its decisions by qualified majority except where the Constitution allows otherwise e.g. in Foreign Affairs. The Council shall meet in different configurations. The General Affairs Council shall ensure consistency in the work of the different Council configurations. Furthermore, the Foreign Affairs Council shall

elaborate the Union's external action on the basis of strategic guidelines laid down by the European Council and ensure that the Union's action is consistent. By means of a qualified majority, the European Council shall adopt a European decision establishing the list of other Council configurations. To provide more transparency and to practise more democracy, the Council shall meet in public when it deliberates and votes on a draft legislative act. To this end, each Council meeting shall be divided into two parts, dealing with deliberations on union legislative acts and non-legislative activities respectively. A blocking minority will have to include at least four Council members, failing which the qualified majority shall be deemed attained. In future there will no longer be complicated decision-making with weighted votes. There will only be two components of a decision. For a qualified majority in the Council at least 55% of the members of the Council will be needed, comprising at least fifteen of them and representing Member States comprising at least 65% of the population of the Union. A blocking minority will have to include at least four Council members, failing which the qualified majority shall be deemed attained. When the Council is not acting on a proposal from the Commission or from Union Minister for Foreign Affairs, the qualified majority shall be defined as 72% of the members of the Council, representing Member States comprising at least 65% of the population of the Union. This new procedure is easier for the public to understand. But only the future will show whether this envisaged procedure is really the way to make decisions in the future.

## 8. The Council – The Chameleon of the EU Institutions

The Council manifests intergovernmental as well as supranational traits and behaviour. This means that the Council acts as a body of the EU as well as representing the national interests of the Member States. The Council of the EU is both an institution with collective EU functions and a body that represents national interests. The Council is the main decision-making body of the European Union. But the Council has lost responsibilities because of two reasons. First, the European Council has increasingly assumed greater responsibility for making the final political decisions – currency union, enlargement, institutional reform, constitution – and second, the legislative power of the European Parliament has been increased. Whether the Council will have as much importance as today will depend on the politicians who hold the chair of European President and European Foreign Minister. If these offices are held by strong personalities, it is possible that the Council will decrease in importance. Nevertheless, the Council will remain the concrete institution in which the different national interests are debated according to the intergovernmental approach and it simultaneously perceives itself as a European organ designed to manage community affairs on a supranational basis.

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# Accounting in Europe: From National Accounting Charts to Globally Converging Standards\*

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References

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## 1. Introduction

An ever growing body of literature has discussed various aspects of the entry of ten new Member States into the European Union (EU) as of May 1, 2004. Eight out of ten new members are situated in continental Eastern Europe, which is where we find two more candidates for EU membership willing to enter as of January 1, 2007. Both Romania and Bulgaria are trying to meet the various requirements of EU membership with great efforts. Scholars in the fields of economics and business administration have begun to analyse the emerging markets in Eastern Europe very early on. Their focus lies on broader macroeconomic analyses and on strategic management issues. With few exceptions, the dynamic legal framework of business activity in Eastern Europe in general and that of financial accounting in particular have been neglected in the literary discussion so far.

Analysts and academics have benefited from the fact that many developments and reforms necessary for EU membership have either been initiated relatively early or could be anticipated by potential candidates. Trade between the EU and its new Members, for example, has grown at double digit rates in recent years. Traders were followed by investors whose activities were enabled by improved opportunities for capital transfer and foreign exchange. At the same time, tax reforms were initiated. From the receiving companies' point of view, these steps had been urgent necessities in order to finance, privatise, and modernise formerly state-owned corporations. In spite of a continuing lack of experience in applying the new rules, the situation has further improved for German investors with the take-over of the EU regulatory framework (see *Diedrich/Kudert/Major 2001*, p. 53; for a different opinion: *Pfaff 2004*, pp. 193f.). These developments, however, do not alter the fact that the accession of the new Member States remains a date of great importance for trade and foreign investment. Although the larger multinationals have already established a presence in Eastern Europe, it should be noted that small and medium-sized enterprises have been hesitant to make use of the new market and production opportunities (see *Schmid 2004*, p. 28).

In the light of all this, we discuss EU Eastern enlargement from a financial accounting perspective. In spite of the European harmonisation process in this area, many preparers have remarked that financial accounting has proven to be a significant hurdle in implementing expansion strategies for Eastern Europe (see *Klein 2003*, p. 93; *Jungmann 2004*, p. VII). We shall not analyse the specific situation in every new Member State in detail. Due to the dynamic changes in the field of financial accounting, this is beyond the scope of this article. We intend, instead, to give an overview of accounting in Europe in the context of EU Eastern enlargement.

We begin with a review of the current legal framework for financial accounting in the EU before taking a look at the developments in some of the accession countries. Subsequently, the results are analysed from the broader perspective of global harmonisation efforts based on the example of the two major competing accounting systems (International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS)

vs. United States Generally Accepted Accounting Principles (US-GAAP)). (Since April 1<sup>st</sup>, 2001, the new standards are referred to as International Financial Reporting Standards (IFRS). The standard setting body, formerly known as International Accounting Standards Committee (IASC), is now called International Accounting Standards Board (IASB).) The so-called dual listing problem then serves as an example for the decision problem faced by European corporations which are either already listed on the New York Stock Exchange (NYSE) or plan a NYSE listing.

## 2. EU Harmonisation of Accounting Standards

The objective to harmonise European accounting rules derives from one of the Rome Treaties in the founding agreement for the European Economic Union dd. March 25th, 1957 (see Küting/Hayn 2003, Par. 101ff., for a discussion of recent developments). In line with its preamble, the treaty aims to establish the foundations for closer co-operation between the peoples of Europe and to secure economic and social progress through mutual co-operation. With the help of the Fourth (1978) and the Seventh (1983) EC Directives it was intended to align national accounting standards within the European Community (EC). Looking back, however, it can be concluded that the intended harmonisation of European accounting rules has not been achieved (see Lanfermann 1992, p. 442; Niehus 1992, pp. 443f.).

Broad dissatisfaction with this result renewed discussions about EU harmonisation of accounting standards and financial reporting. This led to the emergence of an overhauled EU strategy for the regulatory accounting framework. In the year 2000, the EU Commission was given the task of establishing a fully integrated financial services market by 2005. A central role was assigned to a set of comparable, internationally accepted and investor-oriented accounting standards. Obvious choices were US-GAAP or the accounting standards of the IASB both of which meet the above criteria (see Kommission der Europäischen Gemeinschaften 2000, p. 6). At that time, a final decision for one of these accounting systems was delayed.

In its discussion paper "EU Financial Reporting Strategy: The Way Forward" of June 2000, the EU Commission already announced very specific measures among which was the need for all listed EU companies to use the same set of accounting principles for their consolidated financial statements from 2005 onward, at the latest. It favoured the internationally widely-accepted standards of the IASC for this purpose (see Kommission der Europäischen Gemeinschaften 2000, p. 7; Luttermann 2000, pp. 1318ff.; Ignatowski 2004, pp. 58ff.).

The contents of this strategy paper formed the basis for a subsequent regulation in July 2002. According to Article (Art.) 4 of this so-called IAS Regulation (see Europäische Union 2002, L 243/2; van Hulle 2002, p. 179) companies governed by the law of a

Member State shall prepare their consolidated accounts in conformity with IAS/IFRS as adopted by the EU if, on their balance sheet date, their securities are admitted to trading on a regulated market of any Member State for each financial year starting January 1st, 2005. Member States may permit or require companies referred to in Art. 4 to prepare their annual accounts and companies other than those referred to in Art. 4 to prepare their consolidated accounts and/or their annual accounts in conformity with IAS/IFRS as adopted by the EU. Table 1 gives an overview of the options as per Art. 4 of the IAS regulation.

	IAS/IFRS in consolidated accounts	IAS/IFRS in annual accounts
Companies with securities admitted to trading in the EU (Companies referred to in Art. 4)	Mandatory	Member States may permit or require
Non-publicly traded companies (Companies not referred to in Art. 4)	Member States may permit or require	Member States may permit or require

Table 1: Options as per Art. 4 of the IAS regulation

The German reform of accounting law (*Bilanzrechtsreformgesetz – BilReG*) dd. December 4th, 2004 (see for the draft proposal Hüttemann 2004, pp. 203ff.) transfers the above options into German law (see Kahle 2003, pp. 263f., for a discussion of the pros and cons and different views presented in literature). Thereby, non-publicly traded companies shall be permitted to prepare their consolidated accounts in conformity with IAS/IFRS. The same applies to their annual accounts for informative purposes only. Management's declaration of dividends and the taxation of a business continue to be based on annual accounts in accordance with the German Civil Code for all companies.

An analysis of the governmental reactions in the new Member States (but also among the pre-2004 Members) reveals different approaches to the implementation of the aforementioned options (see European Commission 2004): Whereas the Czech Republic, Estonia, Lithuania, Malta, and Slovakia have decided to require IAS/IFRS in the annual accounts of listed companies, Poland only permits their application. Hungary and Latvia, however, do not permit IAS/IFRS for these companies. (In Hungary, the application of IAS/IFRS for informal purposes is permitted, and the listing rules in some cases require their application. Nevertheless, the companies are obliged to prepare annual accounts according to the Hungarian Accounting Act. A change in this governmental position is not anticipated until tax and legal issues have been solved. In Latvia, however, companies listed in official lists have to prepare separate IAS/IFRS annual accounts for listing purposes only.) Non-publicly traded companies are permitted to prepare their consolidated accounts according to IAS/IFRS in the Czech Republic, Estonia (this is a requirement for Estonian credit and other financial institutions), Hungary, and (basically) in Poland (see *HypoVereinsbank* 2004, p. 39). (This is a requirement for Polish banks. The preparation of consolidated accounts according to IAS/IFRS is permissible for compa-

nies having filed for admission to public trading and any parent company which is a subsidiary of a parent company that prepares its consolidated accounts according to IAS/IFRS.) IAS/IFRS have been made mandatory in Malta and Slovakia for these companies. Latvia has decided against this option – except for banks, insurance companies and other supervised financial institutions. (A proposal to introduce the option for all types of companies has been submitted to the government.) IAS/IFRS are required for non-publicly traded companies in Lithuania only if these companies are banks and their controlled financial institutions.

	IAS/IFRS in consolidated accounts	IAS/IFRS in annual accounts
Companies with securities admitted to trading in the EU (Companies referred to in Art. 4)	<i>Mandatory</i> in all EU Member States	<i>Mandatory</i> : Czech Rep., Estonia, Lithuania, Malta, Slovakia <i>Optional</i> : Poland <i>Not permitted</i> : Hungary, Latvia
Non-publicly traded companies (Companies not referred to in Art. 4)	<i>Mandatory</i> : Malta, Slovakia <i>Optional</i> : Czech Republic, Estonia <sup>a</sup> , Hungary, Poland <sup>b</sup> <i>Not permitted</i> : Latvia <sup>c</sup> , Lithuania <sup>d</sup>	<i>Mandatory</i> : Malta, Latvia <sup>e</sup> , Lithuania <sup>f</sup> <i>Optional</i> : Estonia <sup>g</sup> , Poland <sup>h</sup> <i>Not permitted</i> : Czech Republic, Hungary <sup>i</sup> , Slovakia

Table 2: Implementation of Art. 5 Member State options in respect of annual accounts and non-publicly traded companies excluding banks, insurers, and other financial institutions in the new Eastern European Member States

<sup>a</sup> However, this represents a requirement for credit and other financial institutions.

<sup>b</sup> However, this represents a requirement for banks.

<sup>c</sup> However, this represents a requirement for banks, insurance companies, and other supervised financial institutions.

<sup>d</sup> However, this represents a requirement for banks and their controlled institutions.

<sup>e</sup> This requirement only applies to banks, insurance companies, and other supervised financial institutions. Other companies not referred to in Art. 4 are not allowed to prepare annual accounts according to IAS/IFRS.

<sup>f</sup> This requirement only applies to banks and their controlled financial institutions. Other companies not referred to in Art. 4 are not allowed to prepare annual accounts according to IAS/IFRS.

<sup>g</sup> This is a requirement for credit and other financial institutions.

<sup>h</sup> The preparation of annual accounts according to IAS/IFRS is permissible for companies having filed for admission to public trading and those companies whose parent companies prepare their consolidated accounts according to IAS/IFRS (see Stachniak 2004, p. 8).

<sup>i</sup> See remarks about Hungary on the foregoing page.

Finally, companies not referred to in Art. 4 are permitted to use IAS/IFRS in their annual accounts in Estonia and Poland (see Annotation <sup>h</sup>). If these companies are credit or other

financial institutions, the Estonian government requires IAS/IFRS. This requirement for annual accounts also exists in Malta (all companies), Latvia (banks, insurance companies and other supervised financial institutions), and in Lithuania (banks and their controlled financial institutions).

At the end of January 2005, all these issues were only under legislative consideration in Slovenia. Polish accounting law was amended by publication of an amending Act dd. August 27th, 2004, in the Polish Law Gazette on September 30th, 2004 to incorporate the IAS Regulation.

According to the IAS Regulation, Member States are allowed to defer the application of certain provisions until 2007 for those companies publicly traded both in the Community and on a regulated third-country market which are already applying another set of internationally accepted accounting standards as the primary basis for their consolidated accounts as well as for companies which have only publicly traded debt securities. This has great implications for those companies listed on the NYSE preparing their consolidated accounts according to US-GAAP which we address below in our analysis of the dual listing problem. Companies who reconcile their accounts from local accounting standards to US-GAAP do not qualify for such exemption (see Kirsch 2002, p. 749). The German legislator permits the deferral for both of the above types of companies in its BilReG. Whereas Hungary and Poland use the option in respect to debt securities, the other new Member States will not allow for any deferral.

IAS/IFRS represent accounting standards developed and published by a private standard setting body without legitimate substantial authority like laws passed in the individual Member States (see Kirsch 2002, p. 750). This problematic issue is resolved through an endorsement mechanism in a so-called comitology process (see Ernst 2001a, pp. 823f.; Ernst 2001b, pp. 1442f.; Kahle 2003, p. 263). This implies that all IASB standards must meet the basic requirements of the Council Directives. At the same time, they have to be conducive to the European public good and lastly, they have to meet basic criteria as to the quality of information required for financial statements to be useful to addressees (see Europäische Union 2002, L 243/2). So far, the Commission has not intended to introduce EU-specific accounting standards. In order to avoid deviation from the IASB standards, a standard should either be adopted in its full IASB version or rejected completely (see van Hulle 2002, p. 180). Nevertheless, the possible differentiation between 'IAS/IFRS' on the one hand and 'endorsed IAS/IFRS' on the other hand would prove to be problematic in practice. A European go-it-alone approach would be contrary to the goal of enhancing comparability (see Brücks 2002, p. 166). However, the debate about the endorsement of IAS 39 (*Financial Instruments: Recognition and Measurement*) shows the difficulties the IASB faces in trying to resolve conflicts of interests in close co-operation with the EU without compromising its position as an independent private standard setter.

On a more positive note, it has to be mentioned that the European decision in favour of IAS/IFRS does not only strengthen the IASB's global position but also the German and European possibilities to influence the creation of International Accounting Standards.

IASB's position is further strengthened by moves similar to that of Europe in Australia and New Zealand.

### 3. EU Eastern Enlargement from an Accounting Perspective

Under the lasting influence of the command economy in the post war years, many Eastern European countries were faced with severe problems in their external financial accounting systems up until the mid 1990s. Prior to World War II, Eastern European financial accounting had been strongly influenced by developments in Germany (see Borda 2001, pp. 1533f.): "In the absence of sophisticated equity capital markets, there was an emphasis on creditor protection and tax collection, and a preference for national charts of accounts, mainly based on the pioneering work of Schmalenbach in the 1920s. Schmalenbach's chart was intended for a market economy but could be adapted to a planned economy, as happened in Nazi Germany in the 1930s and Vichy France in the early 1940s, and to a command economy, as in the Soviet Union in the 1920s" (Parker/Nobes 2000, pp. 301f.). Many of the occupied territories were forced to implement the German chart of accounts during the war which was followed by a Soviet version. The fundamental differences in the two emerging European economic systems were also reflected in almost fully divergent bookkeeping and accounting systems (see Parker/Nobes 2000, p. 302).

The dominance of the Soviet system in Eastern Europe resulted in the information and decision support function of financial accounting being neglected whilst the performance of duty was emphasised. The result was a reduction of financial accounting to pure bookkeeping (see Parker/Nobes 2000, pp. 302f.; Borda 2001, pp. 1534ff.). "Accounting as an instrument of control was incorporated into the centralized administrative system for overseeing the activities of all state enterprises. The primary task of accounting became the exercising of control over (i.e. monitoring) the fulfillment of the goals of the national economic plan imposed on enterprises. Another task was the safeguarding of socialist property entrusted to enterprises" (Bailey 1995, p. 597).

The end of the command economy resulted in a tremendous demand for capital in all countries. One of the fundamental issues to decide for each government to decide was the choice between a reform of its existing accounting system towards a system favouring creditor protection such as the German Civil Code or an investor-oriented i.e. more Anglo-Saxon system (see Parker/Nobes 2000, pp. 300ff.).

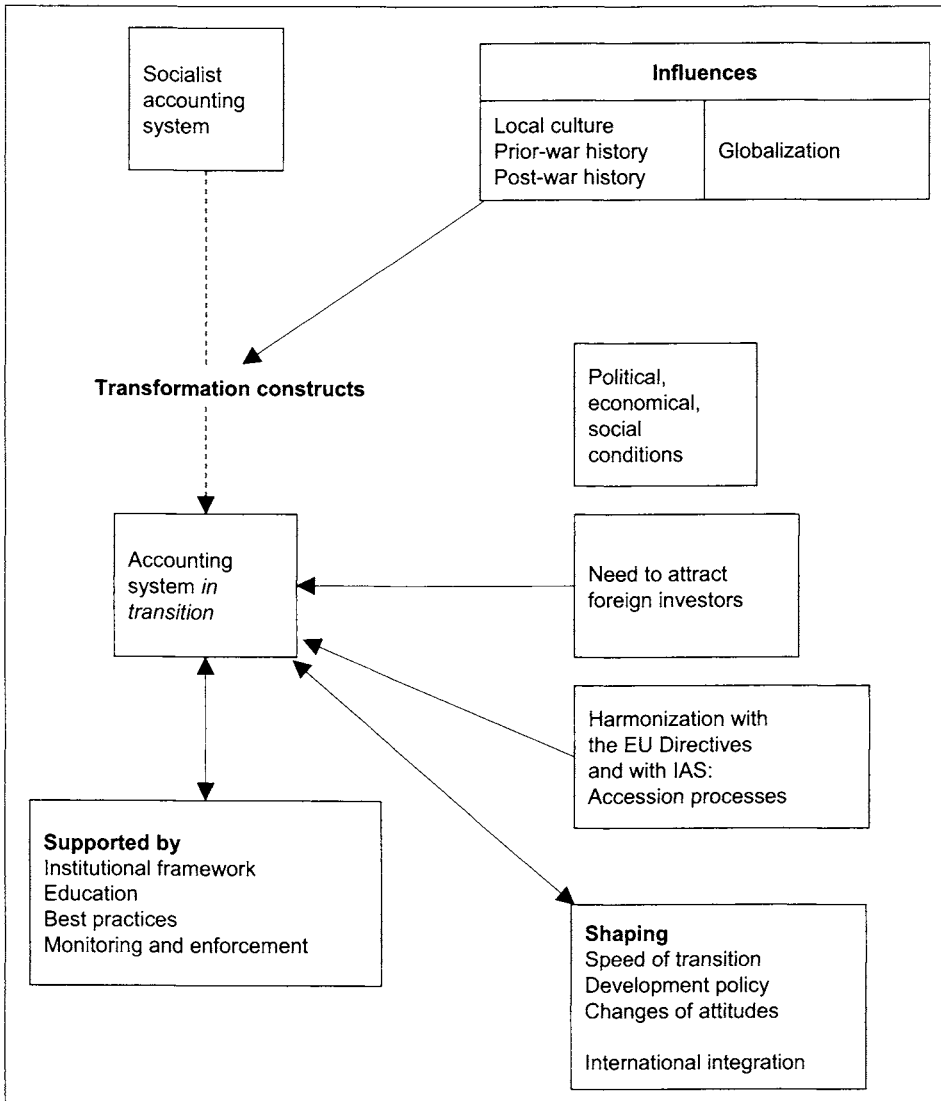


Figure 1: The process of accounting system reform – A conceptual framework  
(Source: Kosmala MacLulich/Gurău 2004, p. 10)

Figure 1 shows a conceptual framework for the process of accounting system reform in the new Member States as developed by Kosmala MacLulich/Gurău (2004, pp. 8ff.). It incorporates issues that determine, influence, shape, and support this process. In our analysis, we touch upon the major issues. While the importance of all influential factors is acknowledged, their detailed analysis would be beyond the scope of this paper. We

have included it as a reference point for readers for our analysis. Kosmala MacLulich/Gurău (2004, pp. 8ff.) focus on the relationship between economic performance and accounting system reform, using Poland and Romania as examples. They summarise their results as follows: "What emerges from the study are insights indicating that accounting system reform represents an essential medium in reducing the resistance to transition change, in particular in the processes of familiarization (socialization) with capitalist-based principles and ways of thinking supportive of the market-driven economy" (Kosmala MacLulich/Gurău 2004, p. 26).

Even prior to 1989 some Eastern Bloc countries had tried to make their accounting systems more flexible by moving towards Western benchmark practices. This was supported by theoretical discussions in accounting journals. The respective reforms in Poland and Hungary (see Jaruga 1993, pp. 118f.; Jaruga 1996; Jaruga/Schroeder 2001, p. 1598; Kosmala MacLulich/Gurău 2004, pp. 2ff.) but also Slovenia (see Turk/Garro 1996, pp. 149ff.) can be mentioned as relevant examples. Bearing in mind that the process of harmonising global accounting standards had already begun at that time, there had to be constant deliberations between accounting standards prevailing in Continental Europe and the more Anglo-Saxon IAS/IFRS (see Parker/Nobes 2000, p. 303). In the second half of the 1990s, a dynamic change process began, resulting in a clear move towards IAS/IFRS. The idea, however, that this meant harmonised and thus comparable accounting practices in Eastern Europe prior to the IAS Regulation would be jumping to conclusions (see Alver et al. 2001, pp. 1497ff.; Borda 2001, pp. 1576f.; Doležal 2001, p. 1515, and their respective analyses of the accounting situation in the new Member States prior to their membership).

After the opening of Eastern Europe, fundamental reforms in accounting and insolvency legislation were passed in many countries. Deficits in national laws and lack of experience in applying new principles were overcome relatively quickly. A result of the aforementioned reduction of financial accounting to bookkeeping was a shortage of experienced accountants and auditors which were strongly sought after for the transition to a market economy (see Mackevicius/Aliukonis/Bailey 1996, p. 56; Zelenka/Seal/Sucher 1996, p. 94). "The standardization of accounting practice and the heavy reliance on economic modelling, developed by the economic expert, led to a divorce between economic planning and accounting monitoring, and resulted in a gradual loss of creativity and innovation in practice" (Kosmala MacLulich/Gurău 2004, p. 2). This prevented both professional groups from getting involved in the early phase of the reform and standard setting processes which were mainly influenced by national governments. The lack of an historically grown accounting and auditing profession proved to be an obstacle to the reform process approached differently in the various countries.

Great influence was exercised by international law and accounting firms who had found a lucrative consulting market in Eastern Europe. The Polish 1994 Accounting Act, for example, was drafted with the assistance of PricewaterhouseCoopers (see Reczek/Lachowski 2002, p. 102). In many cases, these firms decided to expand into these new mar-

kets together with their clients if they had not already prepared the latter's market entry beforehand. The expansion of Western corporations into Eastern Europe had gradual implications for accounting practices in Eastern Europe (see Illés et al. 1996, p. 525; Bailey/Alexander 2001b, p. 1476). Many Eastern European companies have had to report their financials according to Western standards within a group reporting process to Western majority shareholders for a number of years.

At present, additional countries such as Bulgaria (see Tzonkova 2002), Romania (see King et al. 2001, pp. 150ff.; Kosmala MacLulich/Gurău 2004, pp. 20ff.), and Croatia, which has already adopted IAS/IFRS in full (see Collett/Godfrey/Hrasky 2001, p. 177), are trying to improve their relations with the EU, with the goal of accession. At least, in part, this also seems to be true for the Russian Federation and some of the former Soviet Republics. Russian accounting standards have been geared towards Western standards in a long and difficult process (see Bychokova 1996, p. 89; Sokolov/Kovalev 1996, p. 761; Sokolov et al. 2001, pp. 1669ff.). Since January 1st, 2004, all companies and banks in Russia are required to prepare their financial statements in accordance with IAS/IFRS. However, economic and accounting reforms have only just begun in the former Soviet Republics (see Bailey 1995, p. 619; Bailey/Alexander 2001a; Pankov 2001, p. 1635). The latter have to begin with the introduction of simple double bookkeeping systems in order to improve corporate efficiency. All countries are benefiting both from the experiences of other candidates as well as the historically close ties and/or politically motivated information exchange with older Members. This can be seen in the examples of the British-French influence in Romania (see King et al. 2001, pp. 150f.; Kosmala MacLulich/Gurău 2004, p. 6) and the Austrian-French influence in the Czech Republic. The Hungarian example, however, reveals that a direct road to convergence with the principles of the Fourth and the Seventh Directive can also be taken (see Borda/McLeay 1996, pp. 128ff.; Parker/Nobes 2000, pp. 303f.; Borda 2001, pp. 1531ff.). It has to be noted that countries such as Romania, Bulgaria, or Albania (see Devlin/Godfrey 2004) are having greater difficulties in reforming their accounting systems than their Eastern European neighbours as they "suffered from tighter controls at the level of national policy under the Soviet regime and experienced more severe levels of bureaucracy prior to transition" (Kosmala MacLulich/Gurău 2004, p. 2).

In the following, Poland shall serve as our example for a well-planned transition to decision-relevant financial reporting at an early stage: Like in many other countries in Central and Eastern Europe, the development of the Polish accounting system has inevitably been subject to many discontinuities, "such as the partition experience of Poland in the 19<sup>th</sup> century, and the influences from the pre-communist and the communist period" (Kosmala MacLulich/Gurău 2004, p. 2). During the German occupation (1939-1944), the rules of the German Uniform chart of accounts were to be applied (see Garrod/McLeay 1996, p. 5). Krzywda/Bailey/Schroeder (1995, p. 640) summarise the previous situation in the Second Republic (1918-1939) as follows: "The Period of the Second Republic saw the establishment of a tradition of state interest and involvement in financial accounting and audit." Under communist rule, financial accounting lost its importance in a command economy as very detailed Soviet principles had to be obeyed (see

Jaruga 1972; Krzywda/Bailey/Schroeder 1995, pp. 640ff.; Parker/Nobes 2000, p. 305). “Accounting became an instrument of central economic administration exercised through a uniform accounting system mandatory for all enterprises, and it was reduced to routinized bookkeeping” (Parker/Nobes 2000, p. 305).

After the fall of the iron curtain the accounting principles in force were not immediately abandoned as they had proven their ability to record business transactions in a command economy. Immediate reforms were brought on their way in the banking and insurance sectors. Tax and commercial codes were fundamentally modernised simultaneously (see Krzywda/Bailey/Schroeder 1996, pp. 68ff.). The quick steps towards a market economy in Poland soon required a new approach to income computation. In January 1991, the Polish Finance Ministry passed an Accounting Act for all businesses except banks and insurers implementing important measures of the Fourth Directive and thereby marking the beginning of a gradual IAS convergence process (see Krzywda/Bailey/Schroeder 1995, p. 648). This Accounting Act was received critically among theorists and preparers. “After a transitional period, during which new ministerial provisions were instituted (1992-1994), the parliament passed an accounting act, effective in 1995” (Gottlieb 1999, p. 37). The passing of this Accounting Act allowed the complete alignment of Polish accounting with the requirements set out in the Fourth, Seventh, and Eighth Directive including banks and insurers (see Jungmann et al. 2001, pp. 639f.; von Redecker 2001, pp. 203ff.; Idzikowska/Owczarek 2004). The Accounting Act was partly a result of the association treaty signed between the EU and Poland at the end of 1993 which laid out an integration time frame for legal issues including accounting legislation (see von Redecker, pp. 198ff.). Poland agreed to comply with the stipulations of the treaty in order to achieve gradual integration into the EU (see Kudert/Nabialek/Meinert 2001, p. 564). Thus, Polish accounting underwent fundamental reforms in 1995. This included, for example, a statement of cash flows becoming a fixed part of financial reporting. The historically close ties between commercial and tax accounting were almost nullified (see Parker/Nobes 2000, p. 307; Kudert/Nabialek/Meinert 2001, pp. 565f.). The Act also introduced the basis for deferred tax accounting (see PricewaterhouseCoopers 2002, pp. 55ff.). Since an amendment to the 1995 Accounting Act, which came into force in 2002, both deferred tax assets and liabilities have to be recorded in the balance sheet. Accounting issues not covered by the EU Directives such as long-term construction contracts, business combinations, or financial instruments were usually treated according to the more specific IAS standards (see Gottlieb 1999, p. 38). This, however, was only permitted if applying IAS did not mean violating conformity with EU Directives (see Kudert/Nabialek/Meinert 2001, p. 564). Until 2001, selective amendments to the 1994 Act, which had been in force since 1995, were adopted. Among these was an amendment to the 1994 Act in 2000 through which one more step in the harmonisation process with IAS was made (see Kudert/Nabialek/Meinert 2001, p. 625): “The Accounting Act 2000 as an amendment to the 1994 Act puts a strong emphasis on a notion of fair value and departure from the historic cost, decreasing the importance of prudence in the realization of the TFV [true and fair view]” (Kosmala MacLulich 2003, p. 483). Finally, another

substantial reform was introduced in 2002. Together with a further alignment with EU rules a wide reaching convergence with IAS/IFRS was intended (see Kamping/Becker 2004, p. 513). The 2002 Accounting Act also saw the introduction of the Accounting Standards Committee (ASC) (see Reczek/Lachowski 2002, p. 103), a private standard setting body comparable to the German Accounting Standards Committee (GASC).

Polish accounting has come a long way from uniform accounting charts to the IAS Regulation. The complete transition, however, of the whole system as shown in figure 3 will take more time. "Despite the advancement in legislative changes of accounting system, certain features of the former regime persist in practice. [...] Although Polish accounting came through revolutionary changes in the last decade, the approach to accounting appears, in large, legalistic" (Kosmala MacLulich/Gurău 2004, p. 20).

Considering the strong influence of German accounting culture in Poland, the described approach seems remarkable in so far as the decision usefulness of Polish accounting was clearly improved. Such an approach to accounting harmonisation through a gradual opening of national accounting standards to international accounting standards could have been an alternative for countries in Western Europe (see Jaruga/Schroeder 2001, p. 1619; Kudert/Nabialek/Meinert 2001, p. 625). It has to be conceded, though, that the Polish approach leads to certain inconsistencies and problems in inter-company comparability (see PricewaterhouseCoopers 2002, p. 3; Reczek/Lachowski 2002, pp. 103f.) which should be resolved by the implementation of the IAS Regulation.

In line with accounting reforms, financial reporting rules and the auditing profession were also modernised (see Idzikowska/Owczarek 2004; Krzywda/Bailey/Schroeder 1998). "The Polish Security Exchange Commission has established additional reporting requirements. The Warsaw Stock Exchange gets high marks from foreign observers for its regulations and compliance procedures" (Gottlieb 1999, p. 38). The Polish auditing profession looked towards international principles promoted by the International Federation of Accountants (IFAC) at an early stage. The market entrance of the big accounting and auditing companies had a positive influence on the developments in this field as their presence meant a significant know-how transfer. Whereas the attestation of the observation of legal accounting duties was the profession's focus in the beginning, it was quickly able to include good concern deliberations in its reports.

As a result of the aforementioned reforms, Poland has been able to establish a relatively stable accounting and auditing system which contributed successfully to the final transitional steps towards a market economy. Moreover, it stands to gain further credibility through the implementation of the IAS Regulation. Due to the previous convergence moves towards IAS/IFRS, Poland seems to be well prepared for this implementation process. Our optimism based on our theoretical analysis is only partly shared by Polish companies, most of which are in favour of IAS/IFRS accounting. Despite the fact that they seem well prepared compared to other countries, their enthusiasm for the internal implementation process declined as they approached January 1<sup>st</sup>, 2005 (see Pricewaterhouse Coopers 2004, pp. 16, 19, 21). This is mainly due to the recent changes to the

IAS/IFRS set of standards by the Improvements project described below (see Pricewaterhouse Coopers 2004, p. 23) which have not yet been transferred into Polish legislation.

A complete harmonisation of financial accounting as a result of the implementation of the IAS Regulation, however, can neither be expected in Poland nor in other Member States. This can be seen from our analysis of the implementation of Member State options in respect of annual accounts and non-publicly traded companies. A similar conclusion can be made for Member States in Western Europe if one takes into account the differences in national implementations of the Fourth and Seventh Directives. Furthermore, Member States options in the IAS Regulation will lead to specific national treatments. All EU Member States are faced with the problem that we will see the coexistence of various different financial statements for the foreseeable future in the different countries (see Küting 2004, p. 6):

- US-GAAP financial statements to meet the requirements of the American Securities and Exchange Commission (SEC),
- IAS/IFRS consolidated accounts for domestic filing,
- voluntary IAS/IFRS annual accounts,
- annual accounts based on domestic accounting standards,
- tax accounting based on domestic tax accounting rules,
- individual financial statements for management reporting purposes.

#### 4. The East German Experience – An Accounting Benchmark for Eastern Europe?

A review of the relevant literature reveals that companies from the new Eastern European Member States find themselves in a better starting position than companies were in the former *German Democratic Republic* (GDR), when the latter were faced with the provisions of the unification treaty between the GDR and the Federal Republic of Germany (see Küting 1990, pp. 537ff.). In the German case, the treaty between the two countries dd. May 18th, 1990, forced companies to change from their accounting charts prescribed to fulfil the quotas in the centrally planned economy to accounting based on the West German Civil Code and the D-Markbilanzgesetz (see Biener 1990, pp. 5ff.; Küting/Pfuhl 1990a, pp. 576ff.). This represented a significant change, resulting in a complete re-design of Eastern German balance sheets. In many cases, the necessary correction of the overestimation of asset values in East German balance sheets led to overindebtedness. In order to prevent such negative effects on equity, the D-Markbilanzgesetz contained a three-stage accounting method which allowed preparers to record an equali-

sation claim and liabilities respectively under certain circumstances. It also included special rules governing equity disclosures. The systemic differences between the two German states did not allow for a simpler conversion of East German accounting via reconciliations. Drawing up the opening balance sheets proved much more complex in practice than anticipated (see Küting/Pfuhl 1990b; Küting/Pfuhl 1990c). The simultaneous changes in currency, company law, and tax law created further difficulties for preparers. Therefore, the German harmonisation process cannot be described as harmonious with regard to financial accounting (see Küting/Pfuhl 1992, pp. 14f.). In addition to the usual aims of financial reporting, politically motivated economic deliberations played an important role in Germany as the new accounting rules for East German companies were also intended to provide an overview for future privatisation and recapitalisation projects as well as an overview of the state of the East German economy (see Küting/Pfuhl 1991, pp. 137, 143; Küting 1992b, pp. 323ff.).

Eastern European countries have been able to pass their accounting reforms more strategically, providing them with a chance for a softer transition towards IAS/IFRS accounting. The East German experience can only be regarded as a benchmark for accounting transition in so far as it shows the complexity of the issues involved and the problems arising from hurried reforms. Whereas the availability of decision useful financial information proved to be an obstacle in attracting foreign direct investments or federal funds to East Germany, today's investments in the new Member States are largely based on relevant information. Reconciliations to more investor-oriented accounting standards which were often demanded by potential investors in the early 1990s are no longer necessary in most current investment cases (see Bailey/Alexander 2001b, p. 1476). Many accompanying legal reforms were passed and implemented way before EU membership. "Statutory financial statements cannot be expected to be used as they are in the Member States of the EU until well-functioning and stable market economies, effective corporate governance, and efficient capital markets are established" (Bailey/Alexander 2001b, p. 1475). Unlike in the German case, the final steps towards IAS/IFRS accounting will not be interfered with by political discussions related to a state's own national economy. Some of the new Member States still have some work ahead of them. It seems, though, that the basic requirements for decision useful accounting and financial reporting, especially for publicly listed companies, are in place.

If one puts financial accounting issues in the broader context of EU accession, it becomes clear which tremendous efforts have been made in Eastern Europe. Within a few years the whole process of European integration, which has lasted for 50 years now, had to be copied. Transitional provisions in the accession treaties only provide limited relief. As shown, the accession process does not only concern formal adjustments to national legislation. It is also about significant changes in legal and administrative cultures which are much more time consuming (see Niedobitek 2003, p. 5). It remains to be seen which role cultural aspects will play in the European implementation process of the IAS Regulation.

## 5. US-GAAP – The Competing Accounting System

Although IAS/IFRS were referred to as a complete set of accounting standards in the above context of the European harmonisation of accounting rules, the ever more dynamic amendments to IAS/IFRS cannot be disregarded. Recently, we have seen a convergence towards US-GAAP in many instances. The influence of the latter can be described as very significant on the IAS/IFRS system as a whole. Therefore, we shall briefly introduce US-GAAP and outline the major differences with regard to European accounting.

In contrast to the European countries, there are no codified accounting laws in the U.S. governing the preparation of financial statements (see Haller 1994, p. 57). In lieu thereof, there are numerous rules and guidelines which are published by different standard setting bodies and institutions with a different degree of authority. In the context of financial accounting these are commonly referred to as US-GAAP although they only form part of all accounting related releases (see Hütten/Lorson 2000, p. 986).

There is no legally binding definition of US-GAAP. It is a rather unspecific term, which has been subject to several “definition attempts” over time. In 1970, e.g., the American Institute of Chartered Public Accountants (AICPA) issued APB Statement No. 4. Its Par. 138 reads as follows: “Generally accepted accounting principles [...] is a technical term in financial accounting. Generally accepted accounting principles encompass the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. The standard of ‘generally accepted accounting principles’ includes not only broad guidelines of general application, but also detailed practices and procedures”. Kieso/Weygandt/Warfield (2004, p. 6) take a slightly different approach in writing that “the term ‘generally accepted’ can mean either that an authoritative rule-making body has established a principle of reporting in a given area or that over time a given practice has been accepted as appropriate because of its universal application”. Felt (1968, p. 21) made reference to an AICPA publication from 1934 when stating that “the term, ‘accepted accounting principles’, was defined as those principles ‘which have substantial authority back of them’”.

These definition attempts reveal that US-GAAP are not a set of rules based on a rather inflexible legal codification but that they evolve more from practical accounting (see Hütten/Lorson 2000, p. 987). The criterion of general acceptance and wide usage is of great importance in this context. Addressees of financial information associate a minimum degree of uniformity and thus comparability with the application of US-GAAP in financial reporting (see Pellens/Fülbier/Gassen 2004, pp. 65f.). The global significance of these accounting standards is mainly due to the economic power of the U.S. in the goods and financial markets enabling it to simultaneously export the corresponding set of accounting principles (see Spanheimer 2002, p. 194).

Accounting practices are only regarded as generally accepted if they are acknowledged and accepted by the SEC (see KPMG 2003, pp. 6f.) i.e., if they receive its substantial authoritative support (see Pellens/Fülbier/Gassen 2004, p. 66). The SEC itself has greatly contributed to the global significance of US-GAAP as it will only accept financial statements if they are prepared according to this set of rules. The SEC has not published detailed rules of its own for corporate accounting and financial reporting (see Hütten 2000, p. 121). It has seconded this authority so that the majority of rules has been drafted by the American accounting profession (see Haller 1994, p. 67). Due to its professional authority, the accounting profession seems particularly apt to develop accounting principles (see Eisolt 1992, pp. 94f.). The history of the different organisations which were in charge of developing accounting standards in the past is versatile (see Hütten 2000, p. 122): Initially the American Institute of Accountants (AIA) (the former AIA is today's AICPA) empowered the Committee on Accounting Procedures (CAP) which went on to publish so-called Accounting Research Bulletins (ARBs) in subsequent years. CAP was replaced in 1959 by the Accounting Principles Board (APB), which published its releases as opinions. 1973 saw the foundation of the Financial Accounting Standards Board (FASB), which has served as the American accounting standard setting body ever since. Standards of preceding organisations remain in force until replaced by a new Statement of Financial Accounting Standards (SFAS).

SFAS govern specific accounting issues in detail. They are commonly regarded as the most important FASB release form (see Siebert 1996, p. 49). They are the result of a multi-level due process in the course of which the accounting standard is developed through the input of various parties (see Hütten 2000, p. XXVII). Furthermore, there are additional kinds of releases used by FASB: FASB Interpretations (FINs), FASB Technical Bulletins (FTBs) and Statements of Financial Accounting Concepts (SFAC) (see Hütten 2000, pp. 123f.). As indicated above, however, they can be grouped by their differing degree of authority as only SFAS and FINs enjoy *substantial authoritative support* of the SEC (see Küting 1993, pp. 358f.).

The issue of which accounting releases should be assigned the highest authority has been widely discussed in the context of US-GAAP accounting. Rubin (1984, pp. 122f.) was the first to design the so-called House of GAAP. The different sources of GAAP are assigned to different tiers within the House of GAAP (see Hütten 2000, p. 127; Schildbach 2002, pp. 33f.). The lower the tier, the higher the authority represented. If an accountant has to make a judgement as to whether financial statements give a true and fair view, he has to measure the latter against those sources of GAAP with the highest authority.

The SEC requires that the auditor's report included in filed financial statements contains a section verifying the conformity of the financial statements with US-GAAP (see Haller 1994, pp. 57f.; Pellens/Fülbier/Gassen 2004, p. 69). US-GAAP application is equally binding for those companies which are not under SEC supervision but who need to have their financial statements audited. (This requirement is laid out in Rule 203 of the AICPA's Code of Professional Conduct.) The auditor's duty to attest conformity with US-GAAP, therefore, results in an indirect obligation to apply these accounting princi-

ples (see Haller 2000, p. 20). Other companies whose financial statements are not to be audited have no obligation to apply US-GAAP (see Haller 1994, p. 58; Hütten/Lorson 2000, p. 990).

A comparison of US-GAAP as a representative of Anglo-Saxon accounting with Continental European accounting standards as prescribed by the EC Directives reveals numerous differences. These are mainly due to differing accounting cultures and the resulting diverging basic concepts, requirements, and aims of financial accounting and reporting (see Hayn 1997, pp. 19ff.; Spanheimer 2002, pp. 24f.). Such fundamental differences become obvious when analysing the principles of distributable and taxable income as opposed to the concept of decision usefulness or the prudence principle vs. accrual accounting (see Kleber 1994, pp. 72ff.; Born 2002, pp. 595ff.). A few general critical parameters and differences shall be presented below (see Spanheimer 2002, pp. 26ff.). Throughout the comparison it should be kept in mind, though, that deviations exist within the different accounting cultures i.e., there are differences between US-GAAP and IAS/IFRS on the one hand and between different national European GAAP on the other hand. The latter are referred to as Continental European accounting standards.

Whereas Anglo-Saxon companies rely heavily on developed capital markets as their source of finance, Europe has seen the rise of capital markets in this regard and a growing share culture in recent years.

Whereas European companies tend to address all of their stakeholders in financial reporting, Anglo-Saxon companies tend to focus on their investors.

Anglo-Saxon accounting principles are not set by code law. They are primarily set by private standard setting bodies accompanied by individual case law decisions. The situation is different in Continental Europe where large volumes of code law can be found which can in part be traced back to Roman law. As the code law is to be applied to as many accounting problems as possible, it is rather extensive. However, it remains conceptual, requiring additional commentary and literature as well as court decisions to become more precise.

A major difference lies in the role played by tax legislation. Whereas tax and commercial accounting and financial reporting are strictly separated in the Anglo-Saxon accounting world, there are close links between the two in Austria and Germany. Consequently, tax accounting rules can have a distortionary influence on corporate financial statements.

In contrast to Continental European accounting which emphasises a legal perspective of business transactions, Anglo-Saxon accounting follows the substance over form paradigm. This implies that the latter focuses on providing investors with decision useful information whereas the former concentrates more on creditor protection aspects of legal liability.

One of the vital basic principles of Continental European accounting systems is the so-called prudence principle. The exercise of prudence often leads to an undervaluation of opportunities and an overvaluation of risks and thus an impediment of the true and fair view intended. It also encompasses the objective to compute a distributable measure of profit. The Anglo-Saxon principles to give a *true and fair view* and to achieve a *fair presentation* provide a presentation of the condition of the company which is intended to be as realistic as possible. Opportunities and risks tend to be weighted equally. The computation of a profit measure, however, is not an integral part of Anglo-Saxon accounting which is more concerned with the reporting of decision-relevant information.

The above enumeration reveals that existing differences are not independent of one another. The European idea of creditor protection, for example, can be enforced more easily when based on code law (see Spanheimer 2002, pp. 27f.).

## 6. IAS Improvements Project and Convergence Movements between Global Accounting Standards

The reorganisation of the IASB in 2001 led to a different perception of its role (see Gebhardt 2001, p. I). Its focus now lies on eliminating alternative treatments to further uniform accounting (see Bruns 2002, p. 174).

In May 2002, the IASB began an extensive enhancement of its accounting standards with its project 'Improvements to International Accounting Standards' which came to a preliminary end in December 2003 and resulted in the revision of twelve standards and the deletion of IAS 15. These results shall only be followed up by further minor amendments (see Zülch 2004, pp. 153ff.). The Improvements project is a central element of the IASB's strategy to raise the consistency of financial reporting in general and of the body of existing IAS in particular. In the interest of better reporting through convergence, the project has drawn on best practice from around the world. It removed a number of options contained in IAS whose existence had caused uncertainty and reduced comparability. Standards such as IAS 22 (Business Combinations) which are part of the IASB's project agenda were excluded from the Improvements project and are dealt with in the course of special projects. (In the meantime, IFRS 3 has replaced IAS 22 with the aim "*to improve the quality of, and seek international convergence on, the accounting for business combinations*", IFRS 3.IN6.)

In light of the EU's IAS Regulation all IASB projects had to be carried out under considerable time constraints in order to present preparers with a consistent and practical set of accounting standards whilst not neglecting the objective of increased comparability (see Bruns 2002, pp. 176f.; Bruns/Zeimes 2004, pp. 411ff.). The latter was to be achieved by eliminating selected accounting options through the Improvements project. IAS 2 revised (*Inventories*), for example, no longer allows preparers to apply the LiFo (Last-in-First-out) method in valuing their inventories, which had been one of the former alterna-

tives next to FiFo (First-in-First-out) and the weighted average method. The elimination of this alternative is of importance to German companies, as the tax authorities have regarded LiFo as the only permissible alternative so far. Thus, this method has been widely used in Germany until now (see Mayer-Wegelin 2002, Par. 19).

In its revised version, IAS 8 (*Accounting Policies, Changes in Accounting Estimates and Errors*) (see Zülch/Willms 2004, pp. 128ff.) also removed accounting options. Under the previous IAS 8 both the cumulative effect of changes in accounting policies and accounting estimates and the correction of fundamental errors could either be accounted for retrospectively, by including an adjustment in the profit or loss for the current period, or by presenting unchanged comparative information from financial statements for prior periods. As a result of the removal of the second alternative, comparative information for prior periods is now to be presented as if new accounting policies had always been applied and prior period errors had never occurred. Furthermore, the revised standard now eliminates the concept of a fundamental error and thus the distinction between fundamental errors and other material errors. An entity shall correct material prior period errors retrospectively in the first set of financial statements authorised for issue after their discovery by either restating the comparative amounts for the prior period(s) presented in which the error occurred; or, where the error occurred before the earliest prior period presented, by restating the opening balances of assets, liabilities and equity for the earliest prior period presented. The standard retains the 'impracticability' criterion for exemption from changing comparative information when changes in accounting policies are applied retrospectively and prior period errors are corrected. The standard now also includes a definition of 'impracticable' and guidance on its interpretation. It is intended to enhance the relevance and reliability of an entity's financial statements, and the comparability of those financial statements over time and with the financial statements of other entities.

The objective of IAS 1 revised 2003 (*Presentation of Financial Statements*) is to prescribe the basis for presentation of general purpose financial statements. It also intends to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities. To achieve this objective, this standard sets out overall requirements for the presentation of financial statements, guidelines for their structure, and minimum requirements for their content. The standard requires an entity to present assets and liabilities in order of liquidity only when a liquidity presentation provides information that is reliable and is more relevant than a current/non-current presentation. Thus, the option to choose between these two different balance sheet formats based on a company's kind of business has now been eliminated.

As already indicated above, the Improvements project was not an isolated IASB project. It was also carried out with the longer-term view to global convergence. The project represents first steps in this direction resulting from the closer co-operation between FASB and IASB. With a view to the evolvement of the EU's accounting strategy, both standard setters agreed upon a short-term convergence of selected accounting standards

beyond existing mutual projects in the so-called '*Norwalk Agreement*' in September 2002. (This agreement is available for download under [www.fasb.org/news/memorandum.pdf](http://www.fasb.org/news/memorandum.pdf) (last visit: October 21, 2004).)

In addition to this so-called '*Short-term Convergence project*', the FASB has authorised staff members to initiate a research project on global accounting convergence. (This research is available for download under [www.fasb.org/project/research\\_projects.shtml](http://www.fasb.org/project/research_projects.shtml) (last visit: October 21, 2004).) To achieve compatibility between US-GAAP and IAS/IFRS, this project under FASB's lead aims to identify and remove other differences between the two accounting standard systems through coordination of future work programmes by the mutual undertaking of discrete, substantial projects which both boards would address concurrently.

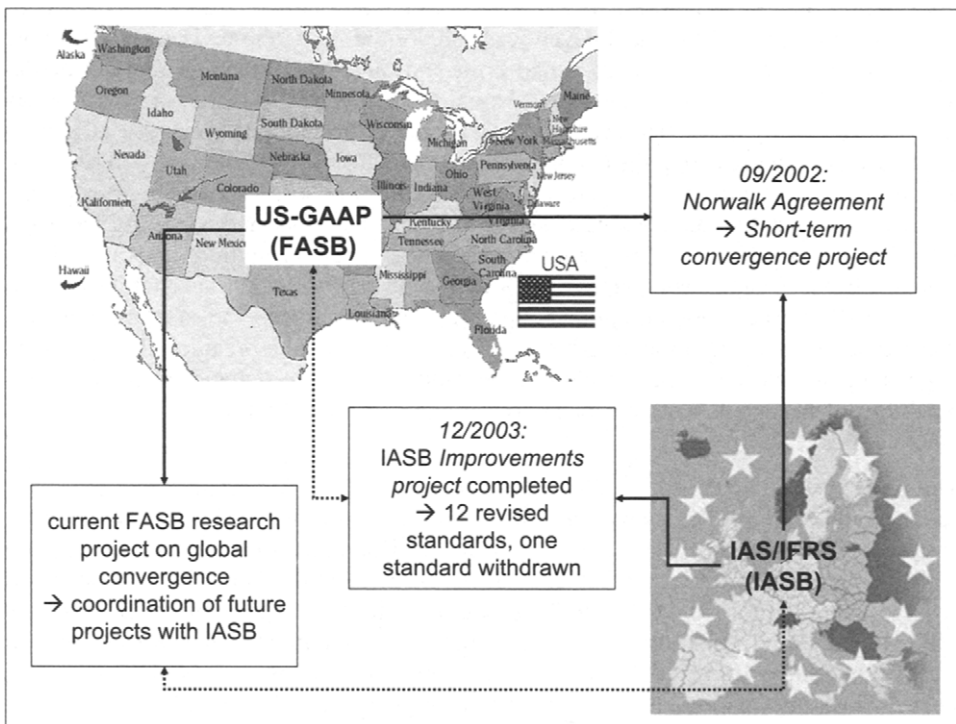


Figure 2: IAS/IFRS versus US-GAAP – Convergence of accounting standards

FASB is expecting to publish final releases on non-monetary asset exchanges, accounting changes, inventories and earnings per share beginning in the third quarter of 2004. (See [www.fasb.org/project/short-term\\_intl\\_convergence.shtml](http://www.fasb.org/project/short-term_intl_convergence.shtml) (last visit: November 2, 2004).) In part, they represent a reaction to the Improvements project. With the release of IFRS 5 (*Non-current Assets Held for Sale and Discontinued Operations*) in March 2004, the IASB has itself completed one of its convergence projects. IFRS 5 represents

very close harmonisation with SFAS 144 (*Accounting for the Impairment or Disposal of Long-Lived Assets*). At present the exposure draft for a revision of IAS 19 (*Proposed Amendments to IAS 19 Employee Benefits: Actuarial Gains and Losses, Group Plans and Disclosures*) published in April 2004 is under discussion with a final standard expected to be released in 2005. The wide-ranging convergence activities of the two standard setting bodies are reflected in a closer coordination of their activities. The major projects on the IASB's agenda reveal its strategy "to bring about convergence of national accounting standards and International Accounting Standards and International Financial Reporting Standards to high quality solutions" (IASB Foundation Constitution, Part A, 2. (c), available for download under [www.iasb.org/about/constitution.asp#1022595](http://www.iasb.org/about/constitution.asp#1022595) (last visit: October 21, 2004)). Figure 2 gives an overview of the convergence of IAS/IFRS versus US-GAAP accounting standards.

## 7. The Dual Listing Problem

As of October 19th, 2004 the Hungarian MATÁV (since November 1997) was the only company from the new Eastern European Member States with a listing on NYSE by means of an American Depositary Receipt (ADR) programme. From the ranks of membership candidates there are no further companies listed at present. Nonetheless, it can be expected that additional companies from the new EU Members will attempt to obtain a NYSE listing, the motives for which are varied. Their discussion and analysis would exceed the scope of this paper. The fact that five companies from the Russian Federation are listed on the NYSE serves as an example in this context.

From an accounting perspective, a NYSE listing poses a decision problem for company management to be analysed in further detail below. The problem arises from the fact that the SEC does not consider IAS/IFRS to be fully compatible with US-GAAP yet. Therefore, the SEC will not accept IAS/IFRS financial statements instead of US-GAAP-based financial statements. The future SEC position seems difficult to forecast at present.

From a theoretical perspective, there are five alternatives for European companies in dealing with SEC filing requirements (see Brandt/Hütten 2003, pp. 717f.):

1. two sets of consolidated accounts applying each accounting regime separately,
2. consolidated accounts based on IAS/IFRS with a reconciliation to US-GAAP,
3. consolidated accounts based on US-GAAP with a reconciliation to IAS/IFRS,
4. consolidated accounts which satisfy both IAS/IFRS and US-GAAP,
5. application of IAS/IFRS only.

The last alternative does not prove to be a valid option considering the SEC's current position. It could also limit a company's comparability with competitors applying US-

GAAP. A complete transition to US-GAAP accounting is not viable either, as the IAS Regulation needs to be adhered to. This is also the reason why the third alternative cannot be chosen as it is not permitted by the IAS Regulation. Due to the remaining incompatibilities between IAS/IFRS and US-GAAP, the fourth alternative is impractical (see Brandt/Hütten 2003, p. 717).

This leaves management with the first two alternatives. Further difficulties could arise from national tax legislation and the need to compute distributable income. As discussed, the need to draw up an additional set of financial statements could be necessary in practice (see Köthner 2004, pp. 154f.).

In spite of the convergence and harmonisation efforts presented, the future viability of the fourth alternative is not foreseeable. Even if it became viable at some point in time, other issues have to be considered when deciding on an accounting alternative. These include the comparability with competitors applying US-GAAP or the opportunity to increase brand visibility on the U.S. market by communication according to local accounting standards. At the same time, the internal efforts necessary to implement the accounting alternative in question need to be analysed carefully (see Brandt/Hütten 2003, p. 718).

Figure 3 shows the implications for European preparers when contrasting the above alternatives with three possible future SEC positions.

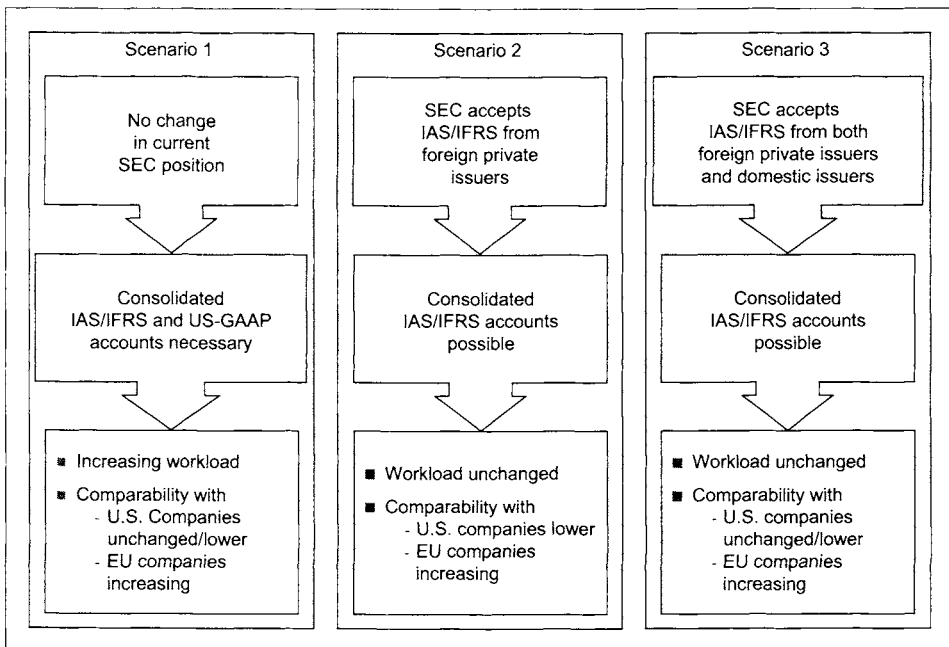


Figure 3: Scenarios of future SEC positions and their implications for European IAS/IFRS preparers with a dual listing (Source: Hütten 2004)

The Hungarian MATÁV prepares its consolidated accounts according to IAS/IFRS with a subsequent reconciliation to US-GAAP. From the point of view of Deutsche Telekom AG, listed on NYSE since November 1996, which held an equity stake in MATÁV of 59.49% as of December 31<sup>st</sup>, 2003, this creates an opportunity to realise synergy effects. The same applies to the consolidation of other equity investments in Eastern Europe in the consolidated accounts of Western European companies for which the situation has improved considerably during the last ten years. Difficulties such as extensive reclassifications or revaluations as well as other accounting or personnel problems have considerably lost in significance. Further improvements can be expected once the Euro zone is extended to the new Member States upon their meeting the necessary criteria. Consolidated accounting will face fewer problems in the future when companies will tend to make further equity investments in the pending privatisations of Eastern European telecommunications markets.

## 8. Summary and Outlook

We analyse EU Eastern enlargement from a financial accounting perspective. Many of the new EU Member States seem prepared, for accounting purposes, for current and future challenges such as the European IAS Regulation. Their experiences and preparatory steps should have benchmark character in the future EU Eastern enlargement process. We show that the East German experience only has limited benchmark character in this context.

It remains to be seen how the respective national use of IAS/IFRS will be influenced by historically rooted social and cultural differences between European countries. A possible Pan-European enforcement institution as well as the European Court of Justice face great challenges in ensuring uniform accounting across the EU. In this area European institutions strongly rely on the co-operation of individual Member States. With regard to consistent and uniform IAS/IFRS accounting across Europe and national peculiarities, much will depend on the contribution of national enforcement institutions and courts.

Our more detailed analysis of accounting developments in Poland shows that accounting systems in Eastern Europe have been strongly influenced by historical, social and cultural aspects, too. Such influences will continue to play an important role although the IAS Regulation which applies immediately to all Member States leads the way into the short-term future (see Kosmala MacLulich 2003, pp. 483f.). As shown, Polish accounting is built on IAS/IFRS principles in various areas. In practice, however, they are not always followed, with tax accounting rules or exceptions for small and medium-sized enterprises as the main reasons given for individual deviations (see Reczek/Lachowski 2002, p. 103; Kamping/Becker 2004, p. 519). The implementation of the IAS Regulation should be followed closely by academics, standard setting bodies, and enforcement insti-

tutions providing assistance wherever possible. Problems and experiences from the implementation process should be communicated to future Member State candidates in order to facilitate their accession process in the field of financial accounting. As the results by Kosmala MacLulich/Gurău (2004) indicate, a successful accounting system reform will also facilitate the transition change as a whole.

We demonstrate that Eastern European Member States have strategically prepared their respective national economies for EU membership over the years (see Weiss 1989; Küting 1992a, pp. 364, 379, each discussing the problems for the consolidation of joint ventures in Eastern Europe in the early 1990s). This can also be said of their financial accounting and reporting reforms. The quality assigned to financial accounting information is not only based on content but also on the trust regarding its credibility placed in it by the addressees. Such trust in national financial reporting, however, has so far not been enjoyed by many of the new Member States. It cannot be established by simple affirmations that no window dressing actions were taken by management. German financial reporting has had similar problems. In order to solve the (historical) credibility problem, voluntary steps towards Anglo-Saxon accounting principles are now followed by the mandatory implementation of the IAS Regulation. Even though IAS/IFRS still leave room for management to manipulate earnings, such opportunities have been recently reduced. In comparison to the German Civil Code, there are fewer (explicit) window dressing opportunities under IAS/IFRS, which is why they are favoured by the financial community. The application of IAS/IFRS can thus help in building trust. Therefore, the repeatedly raised question of whether IAS/IFRS are superior to national accounting standards remains a purely academic discussion which is of minor interest to preparers and users. They are more concerned with the signalling effect resulting from the application of IAS/IFRS which symbolises an improved investor orientation concerned with providing decision useful information.

The convergence of IAS/IFRS and US-GAAP contains great challenges for European standard setters, preparers, and users. This is shown on the basis of the example of the future development of European accounting standards and possible accounting scenarios for companies with a NYSE listing. With regard to the latter, the challenges are even greater for Eastern European companies as there are almost no examples of a dual listing on a national or regional level. According to advocates of U.S. capital market supremacy, European corporations are expected to continue accessing the U.S. exchanges in the future. We show that the IAS Regulation creates specific problems for companies with a dual listing or those who consider an initial public offering in the U.S. We recommend that standard setters, stock exchange representatives and company management understand it as a mutual strategic management problem.

We cannot foresee which way the process of international accounting harmonisation will ultimately take. With its decision to adopt IAS/IFRS and to support the IASB, Europe has decided to act as a counterbalance to the seemingly dominant SEC and US-GAAP. Even if Europe does not win the race towards accounting dominance, it has strengthened its position in the harmonisation process. The new Member States will add additional

weight to the European voice in the international accounting bodies. The consultations of the national legislators after the IAS Regulation can be described as efficient, leaving preparers enough time to plan their conversion projects.

Despite our analysis of the use of Member State options, the picture remains fuzzy in the area of non-publicly traded small and medium-sized companies. The IASB has added a related project to its agenda which could result in IAS/IFRS tailored to this group of companies which could lead to a change of position in some countries as well as more IAS/IFRS preparers across the EU (see Ballwieser 2004, pp. 18ff.; Haller/Eierle 2004).

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Hartmut Bieg and Gregor Krämer

# Banking Supervision in Europe: From Basel I to Basel II

1. The Development of Basel II
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# 1. The Development of Basel II

## 1.1 The Basel Capital Accord of 1988 (“Basel I”)

Since the beginning of the 80s the Basel Committee on Banking Supervision (the Committee) has been dealing with the creation of a framework to measure capital adequacy on a multinational scale as a guideline for an appropriate capital level of internationally active banks. It was initiated because of an alarmingly low level of capital which was held by the most important banks worldwide. The aim of the Committee was not only to guarantee an appropriate capital level for the banking industry as a contribution to improve the safety and soundness of national and international banking and finance systems. At the same time the framework aimed at eliminating the disadvantages in competition between banks, which resulted from the different capital requirements of different states (see Basel Committee on Banking Supervision 1988, par. 3). The results of the Committee’s work were summarised by the so-called “International Convergence of Capital Measurement and Capital Standards” (also known as “Basel Capital Accord”, “Basel Capital Adequacy Framework”, “Basel Accord”, “1988 Accord”, or in short “Basel I”) in 1988. Basel I became effective as of year-end 1992 and has had a substantial influence on the corresponding European Union’s Directives ever since. This is the reason why the Basel Accord may be seen as a basis for German banking supervisory regulations e.g. principle 1 concerning the capital of institutions.

Table 1 gives a short overview of the development from Basel I to Basel II.

July 1988	Adoption of Basel I ( <i>Basel Capital Accord</i> )
End-1992	Implementation of Basel I
January 1996	Changes of the Capital Adequacy Framework to include market risks ( <i>Market Risk Amendment</i> )
End-1997	Implementation of the Market Risk Amendment
June 1999	First consultative paper concerning Basel II ( <i>The New Basel Capital Accord</i> )
End-March 2000	End of the first comment period
January 2001	Second consultative paper concerning Basel II
End-May 2001	End of the second comment period
December 2001	Changes of the initial schedule for the implementation of Basel II (from end-2004 to end-2006)
April 2003	Third consultative paper concerning Basel II
End-July 2003	End of the third comment period
June 2004	Adoption of Basel II
End-2006	Implementation of Basel II

Table 1: Chronology of the Basel Capital Accord  
(Source: Bieg/Krämer/Waschbusch 2003, p. 298)

Basel I requires internationally active banks to hold total capital equivalent to at least 8% of their risk weighted assets to cover their credit risk exposure. This capital base serves as an instrument for banks to absorb losses mainly resulting from credit transactions. Since the size of the credit exposure depends on the probability of default of the contracting party (concerning credits it is the debtor) it is not reasonable to take the credit's nominal amount as its basis. The amount of the credit may only be seen as a basic figure which has to be multiplied by a risk weight depending on the probability of default of the debtor. Hence we speak of risk weighted assets.

In order to calculate the risk weight, Basel I gives rough and fairly simple instructions on how to classify the debtors. In short, this means a weighting as described in the following (see Basel Committee on Banking Supervision 1988, Annex 2):

- Credits for OECD-members receive a capital charge of 0%,
- Credits for banks with residence in one of the OECD-Member States receive a capital charge of 20%,
- Credits for other debtors (e.g. especially on the non-bank and private sector) receive a capital charge of 100%.

(These three risk weights represent the most important ones. In addition, some assets may be risk weighted at 10% and 50% respectively. But we will not go into that here.)

Multiplied by the relevant risk weight, the result has to be covered by 8% of a bank's liable capital. In fact this means that banks, for example, have to cover credits to the Federal Government without any liable capital at all, and credits to other German banks with liable capital of only 1.6%. In contrast, credits for enterprises and consumers have to be covered by liable capital of 8%.

Credit Volume	Debtor	Risk weight	Required liable capital
1 Mill. EUR	Federal Republic of Germany	0%	0 EUR
1 Mill. EUR	German bank	20%	16,000 EUR
1 Mill. EUR	Enterprises (non-banks)	100%	80,000 EUR

Table 2: Example to determine the required liable capital concerning credits to different debtors

According to table 2, a simple example shows that the lending bank has to provide different levels of liable capital for a credit of the same amount, depending on the respective debtor. (For an extensive description on how to determine the required liable capital with comments and further examples for calculation please see: Bieg/Krämer/Waschbusch 2003, p. 126-168.) Holding liable capital causes costs for banks which generally exceed the costs of its refinancing. The more liable capital a bank needs to cover a credit, the more expensive the credit becomes. If a bank takes these costs into account while fixing the interest rate, the debtor obtains, *ceteris paribus*, an interest rate which will be fairly high if the risk weight representing his creditworthiness is high.

In principle, it is sensible to take the creditworthiness of a debtor as a guideline for the amount of liable capital required, since this enables the creditor to take the credit risk adequately into consideration. But the provisions of Basel I in everyday business are not really helpful at all in this respect. The assignment of debtors to their risk weights is not risk-adequate because of the following two reasons. Firstly: The criterion of OECD-membership is not a suitable instrument to determine the probability of a debtor's default since some non-OECD-member countries are meanwhile considered to have higher creditworthiness than certain member countries. Secondly: The system mentioned above does not enable the creditors to differentiate the probability of default in the case of claims on corporates. According to Basel I, every corporate claim has to be covered by 8% liable capital, whereas the debtor and the respective probability of his default are not taken into account. According to this, banks are neither given incentives to charge their credits risk-adequately nor to select their debtors in a risk-sensitive manner. In this respect, Basel I does not constitute a good instrument to meet the Committee's main target, namely, to achieve stability in the international banking system.

## 1.2 Changes and Revisions of Basel I

Meanwhile, Basel I has been changed on a small scale by amendments and revisions such as, e.g., the inclusion of netting agreements. An exception, however, is the “Amendment to the Capital Accord to Incorporate Market Risks” (the so-called “Market Risk Amendment”) regarding the treatment of market risk. This document was published after two comment periods in January 1996 and involved an important modification of Basel I. The changes were necessary since Basel I limited only a bank’s credit risks. Actually, the losses based on credit risk are the main reason for a bank’s poor performance. Therefore it is necessary to consider the reasons for the problems which have occurred in the banking sector in the last few years. Besides this, further risks which may threaten a bank’s existence should be taken into account. In this context we have to mention market risk, which can mainly be classified into interest rate risk, equity risk, foreign exchange risk, and commodities risk. (An extensive description of these risks is given in Bieg/Krämer/Waschbusch 2003, p. 101-115.)

The changes to the Basel I framework made by the Market Risk Amendment became effective as of year-end 1997. As the European Commission implemented these changes in a Directive, they are now valid for all German banks.

## 1.3 The New Basel Capital Accord (“Basel II”)

### 1.3.1 First Consultative Paper of 1999

The present changes to Basel I, however, have not been able to eliminate the serious deficits in the field of credit risk. In the years since the implementation of Basel I in 1988 the banking business, risk management techniques, approaches of banking supervisory authorities and financial markets have undergone far-reaching changes. Thus, the capital framework is no longer up-to-date and is ineffective in reaching the target of the Basel Committee on Banking Supervision. This is why the Committee considers fundamental revision of the 1988 Capital Accord necessary.

This view is based especially on the criticism of banks which consider the standardised calculation of credit risk to be a far too rough and inaccurate instrument to reflect their economical risk. Besides, up to now it has not taken new financial instruments and methods to manage credit risk (e.g. credit derivatives, on-balance sheet netting, asset securitisation, and credit risk mitigation techniques) into account (see Deutsche Bundesbank 2001, p. 16). In addition, banks complain about the fact that the sole consideration of credit risk and market risk does not show their actual overall risk profile, since supervisory regulations do not require banks to cover their operational risk with liable capital.

In addition to this, banks also try to manage their overall risk in a qualitative way, but it does not result in a decrease in the required minimum regulatory capital.

Therefore the Committee published the first consultative paper on 3 July 1999, one which serves as a proposal for a revised version of the Basel Capital Adequacy framework of 1988 and which will replace, in its end version, the actual agreement on capital adequacy by a new, more risk-sensitive regulation in the future (see Secretary of the Basel Committee on Banking Supervision 2001, p. 1). Interested parties (first and foremost, banks) were given the chance to comment on these proposals until the end of March 2000. This opportunity was used extensively, with more than 200 comments sent to the Basel Committee on Banking Supervision.

### 1.3.2 Second Consultative Paper of 2001

This document, published on 16 January 2001, contains the revision of the first consultative paper of 1999 concerning the fundamental adjustment of the capital adequacy framework of 1988 and took into consideration many comments and suggestions made by banks within the first comment period. Once more they were given the opportunity to comment on this second consultative paper. Banks complained that the deadline to hand in the comments was too short, since the second comment period already ended on 31 May 2001. Nonetheless, the Committee obtained more than 250 comments this time. In order to be able to include the suggested comments for improvement in the framework, the Committee decided to postpone the completion of Basel II, which should actually have been adopted at the end of 2001, and to first publish a third consultative paper in the spring of 2003. In this way the planned implementation of Basel II at the year-end of 2004 was postponed until the end of 2006.

In addition to many small changes, the following fact in particular represents a fundamental modification of the suggestions concerning Basel II (the New Basel Capital Accord). While the first consultative paper contained the regulation that banks were required to calculate the creditworthiness of the debtor and consequently the respective risk weight in general by means of external ratings, banks received a general right of choice, as had been suggested, in the second consultative paper. (The first consultative paper contained a regulation which said that only several financial institutes of high complexity and sophistication should be allowed to use internal ratings, whereas every other institute should have to use external ratings (see Basel Committee on Banking Supervision 1999, p. 4).) Now they are allowed to choose whether to use external ratings or internal rating-based approaches to estimate the risk weights.

### 1.3.3 Third Consultative Paper of 2003

The third consultative paper concerning Basel II was published by the Committee on 29 April 2003. Even to this proposal, banks were allowed to make comments. The deadline

for the third comment period was 31 July 2003. Since the third consultative paper was not intended to be followed by a further update, this was the last chance for banks to send their amendments directly to the Basel Committee on Banking Supervision. In this respect the large number of almost 200 submitted comments is not surprising.

The most important amendments in the third consultative paper consist of a reduced amount of liable capital for credits issued to small and medium-sized enterprises, which will represent an improvement in financial conditions concerning credits, especially for the medium-sized enterprises in Germany. Long-term credits, which are preferred especially by German enterprises will benefit from the modifications of maturity charges.

It has become apparent that the New Basel Capital Accord will be implemented into an EU Directive without any far-reaching changes. After the implementation of the EU Directive into the national German legal system it will become valid for all financial institutes which are active in Germany. Parallel to the Committee's activities, the EU is working on an update of Directives concerning regulatory capital requirements for EU credit institutions and investment firms, in order to avoid a delay. The differences between future EU Directives and the New Basel Capital Accord are expected to be quite small. Although the European Commission's consultative papers have hitherto widely adopted the results of the Committee's work on the first two consultative papers concerning Basel II, the Commission places the stress mainly on European banking and economical systems. This is supposed to make the use of the new Directives easier for small and medium-sized banks.

The work on the third consultative paper is considered to be the final stage in a process of reforms that lasted for more than six years. After considering all comments concerning the third consultative paper and after the final adoption of the Basel II framework by the Basel Committee on Banking Supervision in June 2004, the New Basel Capital Accord may be implemented at the year-end 2006.

## 2. Contents of Basel II

### 2.1 Overview

The approach of the adjustment to the 1988 Capital Accord is based on three pillars, as shown in figure 1: Minimum capital requirement, supervisory review process, and market discipline. Apart from a risk-adequate capital base (pillar 1), the profile of risk and profit defined by a bank's management in connection with its ability to supervise and manage their risks is of vital significance for the existence of a financial institute. This is why a review by supervisory authorities seems reasonable (pillar 2). As a completion to the supervisory authorities' requirements, market discipline serves as an additional regulation (pillar 3). Therefore the New Accord includes higher disclosure standards for

banks (see Deutsche Bundesbank 2001, p. 17). For this reason, the three mutually reinforcing pillars will together serve as an instrument for a safer and sounder banking and financial system on a national and international basis (see Basel Committee on Banking Supervision 2001a, p. 1).

The regulations concerning the capital level named in pillar 1 were the decisive factor governing the adjustment to the Basel Capital Accord. This first pillar describes the minimum capital requirements a bank has to maintain to cover its risks.

The second pillar (supervisory review process) defines the regulations of the review process with an intensive dialogue between supervisors and banks.

The third pillar is designed to help professional market participants to ensure a better understanding of a bank's risk profile by means of enhanced reporting. This includes, concerning the so-called "market discipline", particularly the enhanced disclosure requirements pertaining to the structure of a bank's regulatory capital and information about its risk profile (see Basel Committee on Banking Supervision 2001b, p. 130-131). This third pillar focuses on the market's powers of self-regulation which means that, depending on which scale and in which way the disclosure takes place, banks will be rewarded or punished by market participants.

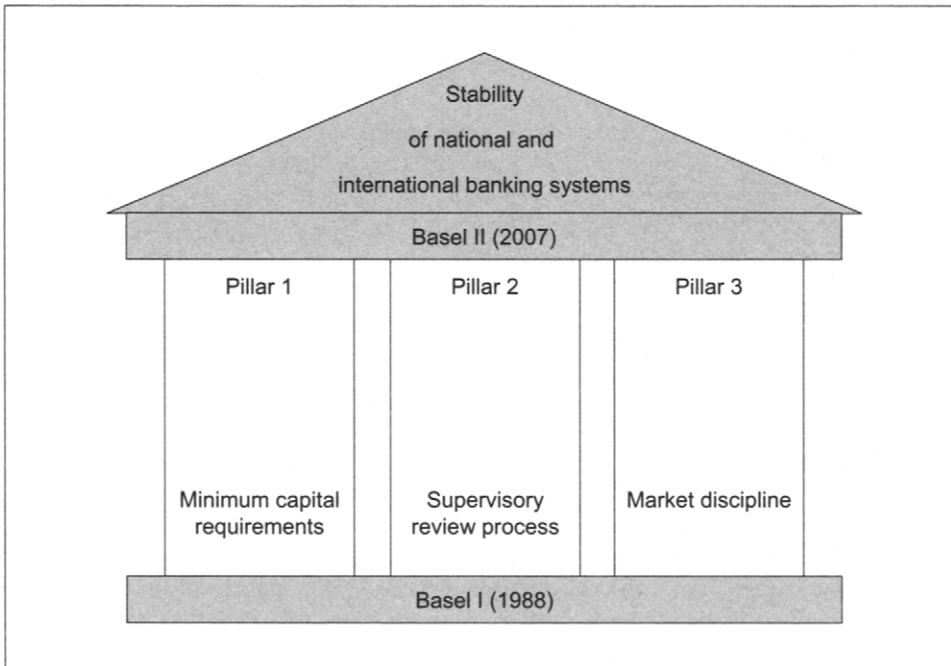


Figure 1: The three pillars of Basel II  
(Source: Bieg/Krämer/Waschbusch 2003, p. 300)

## 2.2 Changes in Requirements of Regulatory Capital Based on Basel II

According to the new framework, as far as capital requirements are concerned, more focus will be placed on a bank's economic risk. Additionally, new developments in the field of financial markets and a bank's own risk management will be taken into account (see Deutsche Bundesbank 2001, p. 15). However, the Committee's 1988 definition of the regulatory capital will not be changed. As hitherto, regulatory capital will consist of Tier 1 capital (core capital), Tier 2 capital (supplementary capital) and Tier 3 capital.

Even a bank's 8% minimum capital ratio of its risk weighted assets (risk weighted assets ratio) will remain unchanged (see Secretary of the Basel Committee on Banking Supervision 2001, p. 3), whereas banks may now choose between internal and external ratings to measure their credit risk. This will result in many cases – compared to the usual situation in the past – in a smaller amount of regulatory capital required.

Also new is the calculation of liable capital to cover operational risk. The required amount will be approximately as high as the reduction in liable capital which is required to cover credit risk. All in all, a bank's required liable capital is not intended to be changed considerably. In order to cover operational risk, banks may only use the amount of liable capital which is not already used to back credit risk.

The new obligations to cover operational risk with liable capital have caused changes in two different spheres. The first sphere concerns market risk. Although the regulations to calculate this risk will not be modified by Basel II, the limit for maximum market risk will be changed. The sum of the capital charges for the market risk positions may not exceed the remaining regulatory capital, which consists of Tier 3 capital and liable capital not used to back operational risk (which is new) and credit risk.

A similar change will take place in the second sphere concerning the so-called total capital ratio. Since operational risk will be included in the number of risks which have to be covered by regulatory capital, the denominator of the total capital ratio will be changed. In future it will consist of three parts: The sum of the risk weighted assets (credit risk) (RWA) plus the capital charges, multiplied by 12.5, for operational risk and for market risk. No changes will occur to the numerator of the total capital ratio. It represents the amount of a bank's regulatory capital.

$$\frac{\text{regulatory capital}}{\text{RWA} + 12.5 (\text{capital charge for operational risk} + \text{capital charge for market risk})} \geq 8\%$$

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# European Entrepreneurship: From Deterministic Government Policy to Market Experimentation

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## 1. The EU Goal of the Lisbon Strategy for 2010 and Where Are We Now?

“The Union has today set itself a new strategic goal for the next decade: to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion” (European Union – European heads of states and governments, Lisbon European Union Summit, March 2000; Paragraph 5 of the Council conclusions).

The EU goal for 2010 is set, the vision seems clear, and European heads of states seem committed to making their region the most innovative and dynamic in the world.

They have further underlined their commitment to reach these goals, and are concentrating their efforts on economic growth and job creation through entrepreneurship, investments in R&D, and a leadership role in science, innovation, and technology development in preparation for the European Council’s mid-term review of the Lisbon Strategy in March 2005 (Council of the European Union 2005, pp. 7-9).

This leading position is currently occupied by the US. To offer an understanding of the magnitude of the challenge facing Europe, table 1 below contains a comparative analysis of some key indicators that reflect the degree of innovativeness and dynamism of an economic region.

	US	Europe
GDP per capita (PPP):	\$38,093 (2003)	\$27,535 (2003) [E-15]
	In 2003 the EU-15 lagged behind the United States by 29 percent in per capita income. For the EU as a whole, the gap in per capita income relative to the US was in the range of 27 to 29 percent between 1990 and 2003.	
GDP real growth rate:	2004: 4.4%	2004: 2.3% [E-25]; 2.2% [E-15]
	2005 est.: 3.6%	2005 est.: 2.0% [E-25]; 1.9% [E-15]
Labour productivity per person employed:	2003: 29.6% higher in the US compared to the Europe-15-Average 2004: 44% higher in the US compared to the Europe-25-Average	
Number of new companies as a percentage of existing companies:	11.4%	9.9% [E-15]
Number of high-growth companies as a percentage of all mid-sized companies:	19.0%	4% [E-6]
Nascent Entrepreneurs per 100 adults:	7.0%	3.44% [E-14] (without Portugal)

	US	Europe
Entrepreneurship education and funding by school (average endowments):	€ 6 million	€ 1 million
New funds raised for private equity per capita:	1991: € 25 2001: € 446	1991: € 11 2001: € 97
From bankruptcy to start-up – length of time in years that creditors still have claims on a bankrupt's assets:	1	8.5 [E-12]
Taxation on business disposal – tax rate on sale of small "model" company, based on percentage of wealth created:	9.9%	18.1% [E-15]
Employment growth:	0.9% (2003)	0.20% (2003)
Unemployment rate:	6.0% (2003)	8.10% (2003) [E-15] 9.10% (2003) [E-25]
R&D Expenditure in % of GDP:	2.8% (2001)	1.98% (2001) [E-15] 1.99% (2002) [E-15]
Number of patents granted (USPTO) and patent applications (EPO) per million inhabitants:		
EPO 1991:	81.51	79.76 [E-15]
EPO 2001:	177.28	168.33 [E-15]; 141.96 [E-25]
USPTO 1991:	203.40	48.82 [E-15]
USPTO 2001:	306.56	71.79[E-15]; 60.25 [E-25]
Number of high-tech patents per million inhabitants in 2000:	49*	30*
Score Innovation Capacity Index 02/03 (Highly correlated with GDP per capita: $R^2=0.8289$ )	6.6	E-15-Average: 4.0
Believe that entrepreneurship can not be taught (2002) on a scale 0-10 (with 10= strong):	4.5	5.3

Table 1: Comparative analysis of the US and EU on key economic indicators. (Summarised by the authors from following sources: Twaalfhoven 2000, p. 5, 9; European Commission 2002a, p. 47, 71; European Commission 2002b, p. 2; European Commission 2002d, p. 31; Neck et al. 2002, p. 8; Sternberg/Bergman 2002, p. 13; Schartler 2003, p. 542; CIA World Fact Book 2005; Global Britain Briefing Note 2004, p. 2; European Commission 2005a, p. 13; European Commission 2005b; GrowthPlus, p. 1, 5)

Further very interesting comparisons are possible with the "time distance measure". (This methodology was developed by Professor Pavle Sicherl, Professor of Economics at the Ljubljana University and founder of SICENTER (Socio-economic Indicators Center). The special concept of time distance, S-time distance, is a generic concept like static difference at a given point in time and the growth rate over time. It compares two time series in horizontal dimension for a given level of the indicator and calculates the difference in time when the two compared units attain the level of the indicator. In our case it

expresses the development gap between the EU and the US by showing how many years earlier a given level of an indicator for the EU was attained in the indicator time series for the US.)

<b>Employment</b>
■ It will take the EU until 2023 to reach US levels of employment, and then only if EU employment growth will exceed that of the US by 0.5% p.a.
■ Europe's employment level for 2003 was already reached by the US in 1978.
<b>Research &amp; Development</b>
■ It will take the EU until 2123 to reach US levels of R&D investment, and then only if EU investment will exceed that of the US by 0.5% p.a. (Note: Since 1995 the average growth for the US has exceeded the EU rate.)
■ Europe's R&D investment for 2002 was achieved by the US in 1979.
<b>Income</b>
■ It will take the EU until 2072 to reach US levels of income per capita, and then only if EU income growth will exceed that of the US by 0.5% p.a. (Note: Since 1997, the average US growth has been higher.)
■ Europe's income for 2003 was achieved by the US in 1985.
<b>Productivity</b>
■ It will take the EU until 2056 to reach US productivity rates per employed, and then only if EU productivity growth will exceed that of the US by 0.5% p.a. (Note: Since 1994, the average US growth has been higher.)
■ Europe's level of productivity for 2003 was achieved by the US in 1989.

Table 2: Time distances between the EU and the US  
(Source: Eurochambres 2005, p. 4)

It appears that since 2000 when the goal was set, the distance between Europe and the US has become even bigger (European Commission 2002b, p. 65). Tables 1 and 2 show clearly how far the old Continent is still lagging behind the US. It can be argued that it is difficult and not always appropriate to compare Europe with the US. However, it must be acknowledged that the US outperforms Europe (and Japan) in most economic measures, and we must explore the reasons for these differences in order to understand how Europe can improve its situation and meet its own goals. Furthermore, "it remains prudent to continue to compare the development of the European economy with the most vibrant economy in the world. At present, that means the US. In economic terms, there is no better international benchmark for the European Union" (Eurochambres 2005, p. 1).

In this essay we will be looking mainly at regions, though we will also take account of comparisons between countries at a national level. We shall also focus on several entrepreneurial fast-growing, successful, and innovative regions from around the world to

gain a better understanding of the factors that put these regions on the road to high growth in the first place, and the factors that sustain their innovative and entrepreneurial character. (The literature on economic geography uses both clusters and regions as units of analysis. In this paper, our focus will be mainly on regions, which can include one or more clusters.) In particular, we will examine the role of public policy and governmental intervention in the birth and subsequent development of geographic regions.

However, as has already been pointed out by other scholars (Bresnahan/Gambardella/Saxenian 2002, p. 837), it would be a mistake to look for easily transferable recipes for success, because the phenomenon that we are examining is influenced by a very large number of variables and is consequently far too complex for anyone to draw unequivocal conclusions about causes and effects. At the same time, we believe that by analysing and understanding some of the deeper similarities and differences, we can obtain an insight into the necessary conditions that might contribute to the innovativeness and dynamism of individual regions.

We will be paying special attention to the role of entrepreneurship in Europe, which in recent times has been proclaimed “the” key to solving existing economic problems: overcome high unemployment rates, ensure continuous innovation and growth, and bring wealth to an economy and its people. This represents a considerable change in economic thinking. For a long time, industrialisation and economic development were assumed to be based on mass production with relatively standardised products that were produced with specialised assets and technology. “Large companies were believed to be more efficient as well as the most important driving force behind technological development” (Huse/Landström 1998, p. 4). Given the current growing interest in small companies and small-scale activities (especially after the recent economic crises), the expectations that policy makers have of small firms as creators of employment and reorganisers of the economy are very high. (The European Charter for Small Enterprises, approved by the EU leaders at the Feira European Council on 19-20 June 2000, as well as the contributions to the Spring Council Meeting in March 2005 for the review of the Lisbon Strategy at its mid-term, underlines the importance of small enterprises and entrepreneurs for growth, competitiveness and employment in the Union.) Clearly, the popularity of the “entrepreneurial hero” is on the rise (Arthur 1989; Mankiw/Romer/Weil 1992; Cabelero/Jaffe 1993; McCann 2001; Neary 2001). According to Huse and Landström these expectations may be, to some extent, unrealistic (Huse/Landström 1998, p. 7). Furthermore, Europe has to grow faster if it is to keep unemployment levels low and if it wants to maintain the welfare state that its leaders claim is so important for social cohesion.

## 2. Where Can We Learn From?

### 2.1 Overview

During a two year project (“Silicon Valley and its Imitators”) organised by the Stanford Institute for Economic and Policy Research (SIEPR), the research group compared the early Silicon Valley (of the 1960s) with other regions in the US, Taiwan, Israel, India, Scandinavia, Cambridge (UK) and Ireland in order to identify success drivers. We want to take a deeper and more focused look at some of the most successful regions in Europe, North America and Asia in order to broaden the field for sound findings and discuss factors which do not form part of the mainstream debate on high growth regions.

We want to take a look at what led regions like Silicon Valley, “Route 128” (Massachusetts), and Bangalore, to name just three examples of high growth regions, start up and become so successful. We are interested in questions such as whether these regions benefited from financial support from government, how they were influenced by migration flows, what role education played in their development, and how legislation, such as the rules governing bankruptcy, has favoured their entrepreneurial character.

Some of the successful regions in our study, such as Catalonia and Bangalore, are made up of several clusters, whereas others, such as Silicon Valley, can be regarded as one single cluster. A “cluster” is defined as: “geographic concentrations of interconnected companies, specialized suppliers, service providers, firms in related industries, and associated institutions (for example universities, standards agencies, and trade associations) in particular fields that compete but also co-operate.” (Porter 1998, p. 197)

There are several benefits to clustering, such as increased levels of expertise, the ability of firms to draw together complementary skills, the potential for economies of scale to be achieved by further specialisation, the strengthening of social and other informal links that lead to new creative ideas and businesses, joint purchases and joint marketing, improved information flows or the development of an infrastructure of professional, legal, financial and other specialist services (DTI 2004, p. 5).

It is not difficult in hindsight to tell which clusters were innovative and which were high-growth. Growing clusters are cohesive and automatically develop external effects. The problem is to identify where a cluster began and determine what factors contributed to its start-up and subsequent growth. Bresnahan/Gambardella/Saxenian (2002) describe it well:

“The positive feedback logic of the theory and of established and successful clusters makes it difficult for analysts to identify a starting point. Positive feedback, when it is working, appears as a virtuous cycle, and, when it is not working, as a difficult chicken-and-egg problem. For a region that is not yet succeeding, ‘nothing succeeds like success’ is an empty remark” (p. 870).

Therefore, we want to analyse the beginnings of some of the clusters and regions mentioned above. In most cases when the question arises as to how and where a cluster started (or could have started), factors like venture capital, infrastructure, skilled people etc. are offered as explanations. It is true that all of these factors are important for speeding up entrepreneurial activity. However, we believe that less attention has been paid to other factors that also contribute to the start of clusters, such as military and government spending. We will explore the critical role that such publicly funded investments have played in the birth and early stages of some clusters and regions.

## 2.2 Military Spending

### 2.2.1 Overview

Alberto Alesina, professor of economics at Harvard University and Francesco Giavazzi, professor of economics at Bocconi University in Milan, compare the conditions in Europe and the US:

“Europe lags behind the US in R&D, and its stinginess over defense contributes mightily to a growing high tech ‘investment gap’. Data concerning patents documents America’s advantage: in the late 1990’s 56% of all global patents in high-tech fields were granted to US applicants, only 11% to EU applicants. The connection between R&D and growth is too obvious to doubt that Europe’s sluggish economies are a direct result of European backwardness at innovation – and that this in turn may reflect the absence of critical military spending to drive investments in research and development” (Alesina/Giavazzi 2002).

In this section we want to show the huge impact military/defence/aerospace spending has had on the birth and growth of some of today’s most successful regions. We will therefore examine three high-growth regions in the US, and one in Asia.

In the US, the Second World War and ensuing Cold War played a major role in reshaping the economic landscape. “The federal government spurred the growth of new industries and regions by channeling resources to university labs to develop war-related technologies” (Saxenian 2000, p. 11). Two regions, Eastern Massachusetts and Northern California, formed the spearhead for these economic transformations and we will here take a closer look at both of them.

Saxenian (1994) has conducted in-depth research into the impact of military spending on the growth and development of both these regions. Her findings clearly show the influence of military investment on these regions. Both experienced major economic transformation due to huge government investment in university labs for the development of war-related technologies during the Second World War and the subsequent Cold War.

The first part of this section draws mainly from the work of Saxenian (1994, 2000) who has done some of the most authoritative research in this field. The second part offers the examples of Bangalore and the Washington DC/Maryland areas to underline the relationship between military expenditure and economic dynamic “Route 128”, located in Massachusetts, was the first high-tech cluster in the US, and was already a booming area when California’s economy was still based on the export of fruit, agricultural products, and food. The region benefited from top tier universities such as Harvard and MIT, the latter playing a key role in developing military technologies. According to Saxenian (2000),

“MIT laboratories received one-third of the \$330 million in contracts awarded by the Office of Scientific Research and Development (OSRD), the first federal agency dedicated to science and research, during the 1940s and 1950s.” (This money went to 25 universities and non-profit institutes. MIT received nearly \$117 million; Harvard received \$31 million (Rosegrant/Lampe 1992, p. 80).)

Other universities in the region also received millions of dollars for research in such emerging fields as radar, missile guidance and navigational systems, and submarine warfare, this massive government funding fueled the industrial revitalisation of the New England economy.

Many top scientists and engineers from all over the country found their way to the research labs of MIT and Harvard, and furthermore, many stayed in the fast-growing companies after the Second World War and the Korean War.

“As the war drew to a close, the greater Boston area’s so-called Research Row – composed of MIT, Harvard, and other local universities and growing concentration of industrial laboratories – offered an intellectual and technological labor pool unsurpassed in the nation, if not in the world” (Saxenian 2000, p. 14).

According to Saxenian (2000), in 1961 there were 24,000 people employed on the highway, out of which around 5,000 were scientists and engineers working in the big laboratories and their spin-offs. The number of companies was 574 in 1965, a number that more than doubled in the following eight years. During the 1960s, the MIT labs, the defence-focused Raytheon (the state’s largest employer), and the electronics division of Sylvania were the source of 364 new start-ups.

“These [technology] start-ups, [the most important new source of industrial activity in this period] like the region’s established electronics producers, were heavily supported by military and aerospace contracts” (Saxenian 2000, p. 17).

Until 1970, as a result of the Cold War, the Korean War, and the space race, the region continued to receive funding for these defence-related technologies.

Defence-related funding in Massachusetts (Saxenian 2000, pp. 14-16):

- During the 1950s: more than \$6 billion of Department of Defense (DOD) prime contracts.
- During the 1960s: more than \$1 billion annually.
- 1962: Federal government purchases accounted for fully half the sales of Route 128 firms (Estall 1963, pp. 189-216).
- 1970: The Route 128 region had established itself as the nation's leading centre of innovation in electronics and built technologically sophisticated components and military electronics that required high levels of skill and constant innovation.

The region's strong dependence on the military, defence, and aerospace sectors, which first led to its growth, later contributed to its decline as the Vietnam War ended and the space race slowed down in the early 1970s. Military contracts to the region fell precipitously:

- 30,000 defense-related jobs were lost between 1970 and 1972.
- The unemployment rate in the high-tech sector reached 20%.
- Raytheon alone laid off 10,000 workers – 40% of its workforce.

The region emerged from its difficulties largely due to the advent of the minicomputer. Like other important technologies, the minicomputer was also developed through the combined efforts of both military and academic researchers.

“By 1975 the technology complex along Route 128 employed close to 100,000 workers. This turnaround and a decade of explosive growth, referred to as the ‘Massachusetts Miracle’ – was fueled primarily by the expansion of the minicomputers manufacturers and a continuing flow of military contracts to firms like Raytheon” (Saxenian 2000, p. 19).

The Route 128 example illustrates the impact that military and defence investments had on the birth, take off, decline, and revitalisation of this cluster. In the remainder of this section, we will provide examples of three other regions that can also trace their origins and early growth to military spending.

### 2.2.2 Silicon Valley

Silicon Valley similarly benefited from defence-related spending. Hewlett Packard, whose birth in 1939 is taken as marking the starting point of the Silicon Valley phenomenon, received contracts for electronic measuring devices and receivers very soon

after it was founded. Stanford played a similar role in California to that of MIT in the Boston area.

“A small cluster of pre-war technology firms [...] grew up alongside HP to provide a foundation for the region’s emerging electronics industry.” [...] One important step (beside many others) to become a major player in this field, was that “Stanford established the Stanford Research Institute (SRI) to conduct defense-related research and to assist West Coast businesses.” [...] “The cluster of industrial activity around Stanford grew rapidly during the 1950s, its growth fueled in part by continued military spending. National aerospace and electronics firms [were encouraged] to locate facilities in the Palo Alto area” (Saxenian 2000). (E.g. Lockheed Aerospace Company set up a research laboratory in the Stanford Industrial Park; other companies and institutions followed.)

In spite of these developments, Silicon Valley was less dependent on military spending than Route 128; in Silicon Valley, venture capital replaced the military as the leading source of financing for start-ups by the early 1970s (Saxenian 2000, p. 26).

However, the statistics for California show that, even today, large amounts of money come from the government in defence-related fields:

Defense-related funding in California (Lee/Walshok 2002, p. 4-5):

- \$579 million dollars in Small Business Innovation Research (SBIR) funding came to the State of California over the six-year period studied (1993-1999).
- There have been significant increases in SBIR funding in San Diego County for example, where there is a lot of entrepreneurial activity.
- More recently, federal funding for life science and advanced computing has given rise to important industry clusters in biotech, medical devices and telecommunications.

### 2.2.3 Bangalore, Karnataka, India

In Bangalore, which is nowadays called the “Silicon Valley of India”, we also find the involvement of the military, defense, and aerospace sectors, along with strong financial influence from the government, which helped start up this highly innovative cluster. Bangalore did not emerge as a “phoenix out of the Indian ashes”. The seeds of the electronics revolution were laid in the mid-1950s with the establishment of high-profile, large-scale public sector units like Bharat Electronics Ltd. (BEL), Indian Telephone Industries (ITI), Hindustan Machine Tools (HMT), Hindustan Aeronautics Ltd. (HAL), National Aerospace Laboratory (NAL), Bharat Earth Movers Ltd. (BEM) and Bharat

Heavy Electricals Ltd. (BHEL). The presence of such a pool of companies paved the way for a technological revolution (Anonymous 2004a). The Indian Institute of Science, established in 1909, has, along with other academic institutions, played a similar role in the Bangalore region to that played by MIT and Stanford in the US.

#### 2.2.4 Washington DC/Maryland, USA

(This section draws on the work of Steffan Heuer (2002).) These examples clearly show the important impact government funding for defence-related research and technologies has had on some of the most successful and innovative regions in the world. Having illustrated the importance of military investment in the birth, take-off, and revitalisation of certain regions, we will now focus on the Washington DC/Maryland area and illustrate how this region is currently benefiting from security-related government and military spending, and how the profile of the recipients of this spending differs from the profile of those in the 1940s and 1950s such as Raytheon.

Linkages and partnerships between the military and IT-industry are very tight in the field of IT security. Not far from Washington DC around 500 CEOs founded the organisation “Business Executives for National Security” (BENS) and half a dozen experts (former military people and “insiders”) have been trying to ensure an efficient knowledge flow between both sides. (The marines, for example, were consulted in the field of logistics to co-ordinate 207 of their computer systems by the New-Economy-company Sapient and experts of the PennState University and from Wal-Mart, UPS, and Caterpillar and today they are using handheld-scanners to manage the procurement flow.)

According to Heuer (2002), to keep up with the pace of development in the IT sector, the NSA, the Pentagon, the Secret Service and other federal institutions had to recognise that they needed to soak up expertise and innovation from “the outside” (private companies), especially in the sector of the 4Cs; control, command, communications, and computers. The CIA was the first to found its own venture capital firm with 28 million US\$ starting capital. This was located in Silicon Valley in order to be in touch with cutting-edge technologies that they might otherwise not hear about.

“The exchange of IT-innovations between government and industry is nowhere else as vivid as in the area around Washington, where approximately 2,000 security companies are located. There is an agglomeration of similar companies who are all more or less connected with the government. More than half of all companies were founded by former government employees and they are working on products, which are interesting for soldiers, agents, as well as CEO’s” (translated from Heuer, 2002).

The boundaries between the military, government, and industry are becoming less defined. This tight network and the many existing contacts within this cluster are making it

fast, innovative, and entrepreneurial. "This paramilitary Valley works in a similar way to its predecessor in California." Roger Novak, Venture Capitalist of Novak Biddle Venture Partners from Bethesda (Maryland) with a \$200 million fund has said that there was never a greater willingness and interest in this area to sit down at the table with VCs and start-ups. The government states what it wants and needs and asks companies if this exists already or if it can be achieved. In this way, many young companies with proprietary technologies receive contracts from the federal institutions.

The new Military-Industrial Complex does not have much in common with its earlier incarnation, when just a few names dominated this sector. Today it is an increasingly fragmented network of outsourcing partners. If a big company lacks expertise in a new field, start-ups can become sub-contractors and a whole string of new companies can become attached (Heuer 2002, p. 40). C. Paul Robinson, President of Sandia National Laboratories, indicates that "homeland security has been a major spark for innovation", especially in the aftermath of September 11. One example: Sandia researchers developed a tiny "lab-on-a-chip" for detecting anthrax and other biowarfare agents, which could also help in diagnosing disease by spotting telltale proteins associated with particular illnesses (Carey 2004, p. 125).

Although the positive impact of military spending on particular regions seems evident from the data available, the effect of such spending on the overall growth of a nation's GDP is less clear, with some findings pointing to a positive correlation (for example, Benoit 1973) and others finding no relationship (for example, Smith/Dunne 2001).

Anthony J. Tether, the director of Pentagon's Defense Advanced Research Projects Agency (DARPA) said in an interview (Carey 2004, p. 125): "DARPA's only charter is radical innovation," going on to say that:

"Looking far down the road and throwing money at what you see doesn't guarantee innovation. But it's one fruitful way to inspire heroic efforts from scientists and engineers while leaving the gates open to serendipity."

With its \$2.8 billion budget, DARPA represents only a small fraction of government defence dollars.

While military spending did play a role in the economic development of the regions discussed above, we would like to point out that other regions, such as Cambridge (UK), Lombardy (Italy), "Wireless Valley" (Scandinavia), and Flanders (Belgium) developed into innovative regions without any large scale military spending. Furthermore, military spending has not helped all regions.

Nevertheless, bearing in mind the effect that this military investment had in Silicon Valley and Route 128, we have to ask what role the government should play in the development of clusters and regions from a financial point of view. In general, the current data suggests that most of the successful regions receive a high proportion (and often the highest) of public R&D spending from their respective governments. However, it is dif-

difficult to separate the cause and the effect in this relationship. One reason for this pattern might be that the R&D investments made by governments (as well as by foreign companies) today are due to attractive conditions such as strong businesses or an agglomeration of the best scientists. The money goes where the best people in a specific field are found and where the highest returns on R&D investment can be expected. From an entrepreneurial perspective, the financial assistance available to entrepreneurs from government is another issue that should be examined.

Taking the example of Germany, we can see that money alone does not make a cluster, a region, or a country more entrepreneurial. In 2001, 36,000 new companies could look forward to a share in the 3.7 billion euros that the state was offering entrepreneurs as financial support. However, the number of start-ups and recipients of this money fell by 20% this year, having already dropped by 19% in 2000 as compared with 1999 (Pfeiffer 2002, p. 78). Leading banks and the VC Society say that there is no lack of money, but rather a lack of entrepreneurs willing to start up new businesses. Jochen Struck from the Deutsche Ausgleichsbank explains that this is due partly to people's fear of starting their own business and partly to the culture and mentality in Germany (Pfeiffer 2002, p. 78). We will explore this issue further below.

## 2.3 Immigration and its Influence on Regional Development

### 2.3.1 Overview

Immigration is a sensitive topic. On the one hand it is associated with positive outcomes such as "Brain Gain", where i.e. foreign entrepreneurs create jobs and wealth for the region, etc. ("...foreign-born scientists and engineers are starting new businesses and generating jobs and wealth for the state economy at least as fast as their native counterparts" (Borjas 1994, 1995; Smith/Edmonston 1997)), but on the other it generates fear among local people who see immigrants as a threat to their own employment and income stability. This is even a controversial topic in countries like the US (and in Silicon Valley!), where immigrants have been creating thousands of new jobs. (E.g. in 2003 in the US the H-1B visa legislation was the issue of a battle: the industry lobbying for an increase in the 195,000 level established in 2000; weary, displaced American software workers who want their jobs back want the total to revert to its original 65,000 – or less (Anonymous 2003a).)

There have been a number of studies that have analysed the impact of immigrants on natives, such as job loss and welfare spending (Borjas/Tienda 1986; Borjas 1994, 1995; Friedberg/Hunt 1995), but depending on differences in methodology, the scope of impacts as well as political ideology, the results of these studies are either positive or negative (Motoyama 2003, p. 1).

In addition to immigration, a region can have a “local brain gain” through internal migration of a country’s own nationals. Furthermore, it is important to distinguish the type of immigration when drawing findings from the statistical numbers. In the area of discussion here, it makes a huge difference if the immigrants are highly skilled people with university degrees who are able to access high level jobs, or if they are working in the low-wage sector or are recipients of financial aid.

Another issue that is relevant to our study involves assessing the impact of (im-) migration on the economic development and entrepreneurial activity of a region, also referred to as “re-immigration”/“re-patriation” or “brain circulation”: as we will see, this can also turn out to be a crucial factor for the development and/or emergence of a cluster/region. (Recent research suggests that the “brain drain” may be giving way to a process of “brain circulation”, as talented immigrants who study and work in the United States (or elsewhere) return to their home countries to take advantage of promising opportunities there (see Johnson/Regets 1998).)

### 2.3.2 National Migration/Local Brain Gain

In the section on military spending, we have already cited data concerning the national migration to Massachusetts, particularly around “Route 128”, and the hugely positive impact it had on the development of this region. (At the end of the war, the “Brain Gain” had created an intellectual and technological labour pool in universities, industrial laboratories, and companies, which was unsurpassed in the US, if not in the world (Saxenian 2000, p. 14)).

This kind of national migration can be seen as the precursor to immigration and it occurs mainly in the initial stages of a cluster creation or in a region with high economic potential. In the following sections we will look at certain regions and the influence of migration, immigration and repatriation on their development.

### 2.3.3 Immigration

To begin with we will take a detailed look at Silicon Valley, which offers a good illustration of the benefits of immigration in the early stages of becoming one of the most successful regions of the last century. Following this, we will focus on Singapore, which is facing a critical transitional phase as it tries to stem the outflow of highly skilled workers, and Shanghai which is currently emerging as one of the most dynamic and fast growing regions in the world. By way of contrast, we will briefly illustrate the example of Lombardy as a region that is successful but displays different characteristics.

#### *Silicon Valley*

The role immigrants played in the development of Silicon Valley and their impact on the rise of this region up to the present is impressive. According to research done by Anna

Lee Saxenian of the University of California and Stephen Moore from the Cato Institute, Chinese (mainly Taiwanese) executives headed 20% of Silicon Valley's high-tech startups in the 1990s (National Commission on Entrepreneurship 2002). Table 3 below shows the employment figures and total sales (in \$ millions) of Silicon Valley high-tech firms led by Chinese or Indian CEOs in 1998. (We recognise that not all CEOs were part of the original founding team. As most are, the data provided is indicative of the phenomenon we are describing.)

	Number of Firms	Total Sales (\$ millions)	Total Employment
Indian	774	3,588	16,598
Chinese	2,001	13,237	41,684
Total	2,775	16,825	58,282

**Table 3:** 1998 employment of Silicon Valley high-technology firms led by a Chinese or Indian CEO

(Source: Dun & Bradstreet database 1998; Saxenian 1999, p. 23)

(The analysis of Saxenian is drawn from a customised Dun & Bradstreet database of 11,443 high-technology firms founded in Silicon Valley between 1980 and 1998. Immigrant businesses were identified as all of the companies with chief executive officers (CEOs) with Chinese and Indian surnames.)

Silicon Valley and Immigration (Saxenian 2001, p. 1; Motoyama 2003, p. 2):

- Close to one quarter (24%) of Silicon Valley's technology firms in 1998 had Chinese or Indian executives.
- One-third of all scientists and engineers in Silicon Valley are from foreign countries.
- About one in five of those high-tech firms were founded by immigrants – employing some 67,500 American workers in 1996 and generating annual revenues of \$27.9 billion. (“Immigrant” is used here in a broad sense by including those who were born abroad and came to the US, and those who were born in the US.)
- Just the 10 largest of the firms founded, or co-founded, by immigrants employ 50,000 workers today and account for \$20 billion in revenues.
- Immigrant professionals are an important segment of the high-skilled labour force in Silicon Valley and they represent over 30 percent of the engineering workforce of the industry in this region.

From the region's early development right through to today, the continuous influx of highly skilled people has been crucial for further successes and new innovations. Leaders of high-tech firms claim that their continued growth depends upon the availability of more "high potential" from abroad, since the local U.S. labour pool is insufficient to satisfy demand.

In general about half of California's annual growth is due to net migration from other countries and 25% of all California's residents were born outside the US, compared to one in ten nationwide (California Legislative Analyst's Office 2001; NPG 2005).

### *Singapore and Shanghai*

Singapore recorded very high immigration rates during the economic boom of the 1990s, with a particularly large influx of skilled foreigners. As a percentage of the country's native population, this was one of the world's highest rates for a decade. Now that the economy is slowing down there has been an outflow of skilled people (27,000 foreigners left Singapore in 2002, including bankers, senior managers and professionals), the worst exodus in 16 years (Nee 2003). Shanghai is particularly benefiting from this and is attempting to establish itself as the hub and main portal to Asia. Between 10% and 20% of those leaving Singapore are believed to have headed for China (Anonymous 2004b):

Immigration Shanghai (Anonymous 2004b):

- The number of foreign professionals expected to grow at an annual rate of over 20% in the coming three years.
- In 2004: 28,000 foreigners are currently working in the city (statistics from the Shanghai Labor and Social Security Bureau (SLSS)).
- In the first quarter of 2004 alone, about 3,000 foreigners got their work permit – an increase of 25% compared with the number of the same period last year.
- Foreigners can apply online for a work permit (Shanghai being the only city in China offering this to foreigners; more than 50% used this service).
- Officials believe the influx of skilled foreign professionals will further boost the development of the city.
- Statistics from the Shanghai Labor and Social Security Bureau indicate these foreign employees are indeed of the highest quality – not only in terms of professionalism but also bringing significant work experience from the world's leading companies.
- Among all foreign employees in Shanghai: 3,600 are general managers of companies and over 60% of the total 28,000 are working as senior executives.
- Most numerous: managers from Japan, followed by the US, Singaporeans, Malaysians, and Germans.
- Skilled professionals from India are growing at the highest speed and they mainly work in the software industry, which is stimulant for the local software sector.

Despite these impressive numbers of highly skilled immigrants, a survey of Shanghai human resource managers indicates that this is not the answer to eastern China's shortage of senior technicians. Problems stem from the fact that salary expectations are too high and that many will be only available for short-term assignments. As a result, the focus is on training locals (Anonymous 2003b).

#### *Lombardia (Italy)*

Though Lombardy has an above average influx of foreign workers compared to other Italian regions, this influx is very low when compared with other international regions. Lombardy seems to be successful despite the fact that there is hardly any inflow or outflow of skilled workers, in fact this seems to be its strength, since nothing is destabilising existing (labour) relations, and stable inter-SME linkages can therefore be created. As a result of these conditions, a positive feedback "milieu" has been established in which dynamic synergies can exist and interactive mechanisms lead to innovation (Capello 1999).

The final aspect of (im)migration discussed in this section involves some of the influences and effects of "repatriation" or "brain circulation".

### 2.3.4 Repatriation/Brain Circulation

When former expatriates have worked for years in a foreign market (or even set up a company there) and then decide to return home, they can be of great value to their own country and society, bringing with them knowledge, contacts, experience and also opportunities.

Aware of this potential, Taiwan began a repatriation programme in 1989, aimed at bringing back technical and professional workers who had moved overseas. The result was a huge boost to the country's economy (Stough 1999).

India has also hugely benefited from such "repatriates", especially in the IT-industry, with Bangalore offering a good example of the value associated with this kind of re-immigration. Many expatriates returned to India from the US and UK to set up new companies and leverage the knowledge and skills they had gathered abroad. Bangalore became a corridor for international mobility (inward and outward) for Indian professionals (OECD 2004).

Baden-Wuerttemberg has recently advertised in the US with the slogan "Come back to Germany!", in order to attract tens of thousands of highly skilled people who had gone to work there. The government of Singapore has announced a worldwide media advertising campaign in the world's top newspapers to emphasise Singapore's continuing policy of attracting world-class talent in many fields.

The picture drawn by the statistics, surveys and cases discussed so far looks very favourable towards a pro-immigration policy. However, this cannot be the only pillar that an emerging cluster or region is to lean on if it really wants to be entrepreneurial and successful, as mentioned in the paragraph on Shanghai. As we have already indicated, immigrants mostly arrive after a cluster's starting phase, and highly skilled labour as a classic element for growth is only attracted due to the effect of agglomeration (see Marshall's agglomeration theory).

It is clear that the results are very diverse. In some clusters, immigrants have played, and continue to play a major role in their development (e.g. Silicon Valley), while in others, the "sourcing" is mainly domestic (e.g. Route 128). In yet others there has been a significant inflow of workers due to the high density of people who were there already (e.g. Lombardy).

The examples show that in almost all cases, national migration represents the first kind of agglomeration, and only afterwards does a cluster need "input" from outside in order to achieve further growth and ensure a creative and innovative climate. In today's globalising world with an increasing international scope, it will become more and more important for a cluster to attract "high potential" from different parts of the world if it wants to establish itself in a leading international position.

A sufficient number of examples (Wireless Valley, Sweden, Baden-Wuerttemberg, Germany, etc.) have shown that immigration is not necessarily needed as a success driver for the start-up or emergence of a cluster. Silicon Valley, on the other hand, is an example of the power of immigration. Considering the accelerating dynamic of future developments, particularly in the high-tech/bio-tech sector, it may be crucial for a region's survival to be able to attract international talent and top performers in a specific field.

It will not be sufficient to tear down bureaucratic barriers and decrease "red tape"; the challenge is rather to attract the brightest and most highly skilled foreigners to a region and integrate them properly. Lowering the barriers to entry does not ensure that a region will suddenly profit from a significant "brain gain" with the inflow of entrepreneurs and talented people from abroad, as the "Green Card" example in Germany showed when demand turned out to be much lower than expectations. This is just one of the necessary premises on which a "brain gain" or "brain circulation" can be based. The "talent war" will no longer be restricted to the company level but will increasingly take place at a regional or cluster level.

There are increasingly positive effects for regions which are already home to high-potential immigrants, because these people will be in close touch with their home countries and will operate as representatives/informants/network agents for the region itself, with the potential to promote the region and make it more probable that others will follow when business conditions are favourable. Saxenian (2001) shows in her survey that 56% of immigrants 'sometimes' exchange information about "jobs or business opportunities in the US", with 24% doing this 'regularly'. From this perspective immigrants can

even be looked on as potential “marketing and/or procurement channels” (Saxenian 1999, pp. 1, 3, 53, 56). Twenty-seven percent of immigrants who responded to her survey report that they have served as advisors to companies in their native country. More immigrants (46% of the total) say they helped to arrange business contracts in their home country (Saxenian 2001, p. 6).

In addition to economic and career factors, another important issue when attempting to attract highly-skilled workers relates to social framework and conditions, especially when it comes to spouses or other family members. Housing conditions, safety, job prospects for spouses, the attitude towards foreigners and their acceptance by the host population (a famous sentence of a German politician concerning the strong immigration flows in the 50s-70s to Germany and the social perspective concerning their integration was: “We were asking for workers and human beings were coming”), the possibility of maintaining their culture (in Silicon Valley two big Shiva-temples exist – visited by thousands of Indian immigrants over the weekends), and the educational system for children are all direct indicators for this environment (Motoyama 2003, p. 10). A positive example can be seen in Catalonia in Spain: when the cluster of consumer electronics businesses emerged in the Vallés area and several Japanese and Korean companies (among them Sony, Panasonic, Sharp, Pioneer and Samsung) decided to invest in Vallés County during the 1980s, the strong policy aimed at attracting investment included the creation of a Japanese School (Sölvell/Lindqvist/Ketels 2003, p. 64).

### 2.3.5 Universities as “Entrance Portals”

The role universities played in relation to immigrants during the development of the US (and the role they can play in any country that is able to attract foreign high potentials) is crucial. The market for top talent is now global and highly competitive.

Since September 11, 2001, US visa procedures have become far more restrictive and many more applications are being refused than ever before. This development has led to a foreign visa crisis for companies as well as for universities and other institutions. If things do not change, this will have a lasting effect on American competitiveness (Zakaria 2004). There has been a dramatic decline in the number of foreign students in the United States (the first downward shift in 30 years); undergraduate enrolment in 2003 was down 20 percent from China, nine percent from India, and 14 percent from Japan. In graduate schools, numbers have dropped 45 percent from China and 28 percent from India. The impact of this becomes clearer when you consider that the most important economical and scientific advances in technology are based on research, which is now done largely by foreigners. Thirty-eight percent of doctorate holders in America’s science and engineering workforce are foreign-born, as a document from the National Science Board (NSB) shows. Foreigners make up more than half of the students enrolled in science and engineering programmes, an indication that America’s scientific edge is largely produced by foreigners and immigrants (Zakaria 2004).

In addition to this, universities and educational institutions play a major role in many ways, and have proved to be important catalysts for cluster development in some cases. Universities may play an educational role but can also be key players in promoting R&D and innovation within a particular cluster (DTI 2004, pp. 6-7). Furthermore, one aspect worth mentioning here is the way universities act as “immigration portals”, creating important social networks which are of great benefit to immigrants who want to start up a business in a foreign country. Going through an educational programme of one or two years duration with classmates from the host country and from other countries leads to life-long friendships and strong social networks. Immigrants who arrive on work visas typically do not have such strong networks, and are at a relative disadvantage at the time of launching their own ventures. This in turn offers a great benefit for the region in question, since the potential for success is increased.

Returning once again to Saxenian (2001) and her survey of immigrants in Silicon Valley, 79% of immigrants from Mainland China entered the US through school and stayed. Only 2% were “recruited by intermediaries”, 12% “through work”, and 7% “other”. As regards immigrants from Taiwan, 79% arrived in the US through school. The number of Indian immigrants entering through school is lower, though more than half of them (54%) entered through educational channels (Saxenian 2001, p. 5).

“In the local business environment, people share a common culture, speak the same language and develop networks based on trust. Even the most modern forms of communication technology are inferior to face-to-face contact between people when it comes to communicating non-codified types of information. While physical capital (digitized information, components, machinery etc.) and to some extent human capital travel the world, social capital is embedded in local cultures and institutions” (Sölvell/Lindqvist/Ketels 2003, p. 21).

From all these perspectives, universities (and other educational institutions) are therefore extraordinarily important, both for the region itself and for any immigrant who is planning to stay there and start up a company.

## 2.4 Entrepreneurship Education

### *The Importance of Entrepreneurship Education*

Europe has many outstanding educational institutions in science, engineering, and economics, and a handful of elite business schools that are on par with the best in the world. It is important for these academic institutions to play an active role in heightening awareness of entrepreneurship as a viable career option, and in emphasising the benefits of entrepreneurial initiatives for individuals, firms, sectors, and the economic system as a whole. The positive impact of high human capital individuals taking up entrepreneurial initiatives cannot be over-emphasised.

However, entrepreneurship education in Europe is faced with many challenges. One is the prevailing opinion of some people that entrepreneurship cannot be taught; according to them, entrepreneurs are born, not made. A second one is the difficulty to obtain direct measures of its impact. Most graduates start companies several years after they graduate, and many schools do not track alumni starting companies. Additionally, intrapreneurship activities are difficult to measure and to trace back systematically to individual entrepreneurs. Finally, the indirect benefits of entrepreneurship education may far outweigh the direct ones, in that individuals sensitised to entrepreneurship and its importance may be more likely to support the entrepreneurial initiatives of others.

Thus, the importance of entrepreneurship education becomes clearer to the extent that it relates to the shaping of attitudes, skills, and culture. Entrepreneurship education must be embedded into the educational systems from the beginning, i.e., right from primary school. The earlier the exposure and the illustration of self-employment as a realistic and attractive professional alternative, the more likely it is that students will consider becoming entrepreneurs in the future.

As entrepreneurship is still a relatively young discipline, clearer definitions are needed in Europe to ensure that the proper programmes and incentives are put in place for various types of organisations, such as high growth firms, family owned businesses or other small and medium-sized companies. Each of these organisation types has distinct characteristics and needs, and requires very specific policy instruments.

#### *Entrepreneurship Education and Necessary Improvements*

Data from a joint pilot online survey conducted in May 2004 by the European Foundation for Entrepreneurship Research (EFER) and the European Foundation for Management Development (EFMD) show that entrepreneurship education at European universities and business schools has been growing dramatically over the past five years and is expected to continue growing. The largest increase was in the late nineties until 2000, fueled by the start-up euphoria, the Internet boom, and the bull market for stocks and shares. However, entrepreneurship remains primarily an elective (undergraduate 73%; postgraduate 69%) and tends to be offered in stand-alone courses with no deeper integration throughout the curriculum. A greater critical mass of entrepreneurship faculty, research and course material is needed. While innovative teaching approaches are being tested throughout Europe, there has been little sharing of these practices across borders. In general, there is a strong need for training in the teaching of entrepreneurship, for sharing of international research and best practice between faculty members to ensure students get the best learning experience.

Outreach activities, i.e., the actions taken by educational institutions in the larger communities, are an important responsibility of entrepreneurship faculty members. These include training business angels, setting up business angel networks, and other services to promote entrepreneurial activity.

Many respondents commented that the heavy focus on the start-up phase may be overshadowing the more important needs in entrepreneurship in Europe: the change of culture, attitudes and skills; growth phases of entrepreneurial firms, differences between SMEs and high growth companies; and intrapreneurship within companies.

Only if these important aspects are tackled on a broad basis throughout Europe and entrepreneurship education receives the attention and support it needs and deserves, we will derive benefit from it in the long term.

## 2.5 Bankruptcy Legislation and Culture

When the European Council adopted the Third Multiannual Programme for Small and Medium Sized Enterprises (SMEs) in the EU (1997-2000) on December 9, 1996, it laid the cornerstone for the Community's SME policy. Even then, the target was to improve the conditions under which SMEs operate. Some of the programme's main objectives involved simplifying and improving the administrative and regulatory business environment, improving the financial environment for enterprises and improving SME policy instruments (European Commission 1997, p. 25). Following this programme, the Risk Capital Action Plan proposed ensuring that entrepreneurs who had gone bankrupt could have a second chance (whilst protecting the interests of creditors and consumers) (European Commission 2005c). (In progress reports in 1999 and 2000, the European Commission observed that insufficient progress was made to address the issue and that insolvency law reforms should become a clear priority for the Member States.)

The European Charter for small enterprises (which got adopted by the General Affairs Council on 13 June 2000 and welcomed by the Feira European Council on 19-20 June 2000 (European Commission 2000)) considers that

“some failure is concomitant with responsible initiative and risk-taking and must be mainly envisaged as a learning opportunity”

and also:

“Europe must re-examine its attitude to risk, reward and failure. Thus, enterprise policy must encourage policy initiatives that reward those who take risks. Europe is often reluctant to give another chance to entrepreneurs who failed. Enterprise policy will examine the conditions under which failure could acquire a less negative connotation and it could be acceptable to try again. It will encourage Member States to review bankruptcy legislation to encourage risk-taking” (Commission of the European Communities 2000, p. 3).

The Multiannual programme for Enterprise and Entrepreneurship and in particular for Small and Medium Sized Enterprises (SME's) 2001-2005 is aimed at progressing towards the objectives set by the Charter (European Commission 2000).

Bankruptcy legislation seems in general to have a strong influence on entrepreneurial behaviour, not only between countries with different cultures, but also within a single culture. This is illustrated by Fan and White (2003) in their study of "personal bankruptcy and the level of entrepreneurial activity" in the US. "In case of bankruptcy, the owner of a firm must give up assets above a fixed exemption level. Because these levels are set by the states, they vary widely. The study shows that higher bankruptcy exemption levels benefit potential entrepreneurs who are risk averse by providing partial wealth insurance, and therefore that the probability of owning a business increases as the exemption level increases. Results indicate that the probability of households owning businesses is 35 percent higher if they live in states with unlimited rather than low exemptions" (Fan/White 2003, p. 545).

"It is impossible to foster some parts of a new culture artificially overnight – despite the best efforts of politicians. In many parts of Europe a lingering abhorrence of debt and especially default prevents the emergence of the 'pick yourself off the ground and start again'-mentality so important to the American model of entrepreneurship" (Johnson 2002, p. 4).

Apparent risk aversion is still more pronounced in Europe than in the United States, as also statistically supported by the figures in table 4.

Not setting up a business if risk of failure				
	2001	2002	2003	2004
European Union	43%	46%	44%	50%
United States	26%	25%	29%	33%

Table 4: The attitude towards risk and failure  
(Source: European Commission 2002a, p. 46; European Commission 2004a, p. 53; European Commission 2004b, p. 52)

As the data shows, the United States clearly stands out from the other countries regarding the weight of the risk of failure when setting up a new business.

"In many Silicon Valley companies, failure is like a rite of passage. Unless you have failed you don't really understand what it takes to build up a high tech company. There are some companies which will not employ anybody in a senior position who hasn't failed at least twice" (Hauser 2000, p. 1).

This risk of failure and the associated stigma seems to be a major deterrent to the development of the entrepreneurial spirit and entrepreneurial initiatives in Europe (European Commission 2003, p. 29; European Commission 2004a, p. 53; European Commission 2005b). Nevertheless, these changes in the legal system are a very important milestone and key aspect on the way to an entrepreneurial future. Scientific studies in the US as well as in Germany (e.g. from the Institut für Mittelstandsforschung, Bonn) have shown that the experience of a crisis or failure can also have its positive effects. Compared to first-time-entrepreneurs, “serial entrepreneurs” have a higher probability of being successful, since they seem to have gained valuable experience and above-average management capabilities (Europäische Kommission 2004, p. 15).

It is interesting to observe the “dissonance” between common attitudes in most European countries with a strong aversion to risk and stigma of failure, like Germany for example, and the results of a survey concerning serial entrepreneurship after a bankruptcy. (Personal wealth creation or bankruptcy, though common consequences of entrepreneurship, are both regarded negatively among the German people. Though the key informant thought there were ample entrepreneurial opportunities in the marketplace, only 15 percent of the adults surveyed did. This is consistent with the huge risk aversion and “safety-first” mindset prevalent in German society (Reynolds/Hay/Camp 1999, pp. 37-38).) When asked whether the risk of failure should prevent one from starting a business, European respondents agreed to a larger extent (giving it a 4.8 on a ten point scale, where ten meant strong agreement) than their US counterparts (3.7). However, both the EU and the US respondents agreed fairly strongly that failing entrepreneurs should be given a second chance (7.3 (US) and 7.4 (EU)) (European Commission 2002a, p. 46).

“The European Charter for Small Enterprises, endorsed at the Feira European Council in June 2000, considers that ‘some failure is concomitant with responsible initiative and risk-taking and must be mainly envisaged as a learning opportunity’ and called for assessing national bankruptcy laws in the light of good practice” (Philippe & Partners/Deloitte & Touche 2002, p. 1).

We can conclude that there is an evident stigma affecting entrepreneurs that have previously been bankrupt (Philippe & Partner/Deloitte & Touche 2002, p. 354). As a result, even if the lawmakers at European and domestic level adopt legal measures in order to promote a fresh start (which is highly recommendable!), there is still a need for a cultural change and encouragement for new entrepreneurship after bankruptcy. Naturally, as mentioned above, such changes need lots of time to become culturally diffused.

## 2.6 Governmental Interventions

### 2.6.1 Overview

In the GEM 2002 Report “entrepreneurial contextual structure” was one of the key areas on which research focused. The national teams analysed nine entrepreneurial framework conditions (18 different aspects) with the help of expert interviews and questionnaires in 34 of the 37 GEM 2002 countries. Three items were found to be given the most emphasis as regards national strengths – cultural and social norms (25%), government policies (15%), and education and training (15%) (Reynolds et al. 2002, p. 45).

Regarding national weaknesses, there is even far more consensus across countries, as four domains receive 70% of the comments: government policies, cultural and social norms, financial support and education and training (Reynolds et al. 2002, p. 46).

As we can clearly see, three areas – government policies, cultural and social norms, and education and training – are leading issues mentioned as both a national strength and a national weakness and are therefore regarded as key areas with the highest potential impact on the stimulation of entrepreneurial activity. The following section will focus particularly on the role of government policy, as we observed in the last section how close the connection between policy and culture can be.

However, we agree with the general opinion of experts in the field of entrepreneurship research that a wide range of factors that may facilitate entrepreneurial activity and growth of new firms cannot be measured with existing cross national measures and that it is impossible to eliminate the impact of a single factor due to correlations between the causal (independent) variables. \*

Until now we have mainly focused on regions, and at this point in our analysis we need also to look at data which is aggregated on a national level to be able to extract findings relating to the influence of government intervention on entrepreneurial activity. This is necessary due to a) the undeniable impact of national policies on regions, b) the lack of appropriate data and indicators on a regional level, and c) the difficulty of comparing regional policies first within a country and then across national boundaries.

As the federal structures that remain in many European countries (like Belgium, where entrepreneurship policy is independently established in Brussels, Wallonia, and Flanders) lose influence due to the increasing impact of European authorities and the concentration of policy decision-making power, it is important to indicate the consequences that might result from liberal as opposed to restrictive policies.

In the earlier section on military spending, we referred to the positive impact of government intervention on the innovativeness and economic dynamism of a particular region. In this section, we take the opposite view and look at the impact of government intervention with a focus on regulation.

In an OECD study (1999), “state control” was measured using seventeen detailed indicators, which summarised information on economy-wide or industry-specific regulation provisions (in the broader regulatory domains of public ownership, involvement in business operation, barriers to entrepreneurship, barriers to international trade and investment) for 21 OECD countries (Nicoletti/Scarpetta/Boylaud 1999, p. 17).

The following section examines the results from 19 of these countries, which were also covered by the Global Entrepreneurship Monitor, in order to study the relationship between government intervention and entrepreneurial activity. This is aimed at offering some findings regarding the influence of state control on entrepreneurial activity.

### 2.6.2 The Impact of State Control on “Total Entrepreneurial Activity”

In order to find a potential relationship between state control on the TEA-rate (Total Entrepreneurial Activity) of a country, we have compared the ranking of “state control” with the one based on the “TEA-Ranking” from the Global Entrepreneurship Monitor data set. This is one of the most visible measures of the level of entrepreneurial activity in a country.

The TEA index is a measure developed as a prevalence rate, reflecting the number of individuals among all those 18–64 years old in the human population involved in either the start-up phase or the managing of a new business less than 42 months old (Reynolds/Bygrave/Autio 2003, pp. 5-6).

We have divided the 19 countries for both measures (state control and TEA-rate) into two groups, one including all those who scored above the average for our sample and the other including those who scored lower. We then compare how many of the countries with below average TEA have above average state control. We do the same with above average TEA and below average state control. This exercise is aimed at offering a clear picture of whether state control has a positive or negative influence on entrepreneurial activity. (The stability of the TEA measure proves to be very high and statistically significant. Data from the GEM project for the past four years show that the three year-to-year correlations are 0.81, 0.74, and 0.93 – this provides strong evidence that it is appropriate to consider the TEA measure of business start-up activity as a relatively stable national characteristic.)

Country	State control	Country	TEA-Rate 2003
Italy	3.92	Japan	2.3
Greece	3.87	France	2.4
Norway	3.19	Belgium	3.4
Belgium	2.78	The Netherlands	4.1
Finland	2.68	Sweden	4.1
France	2.63	Italy	4.6
Spain	2.59	Germany	5.2
Denmark	2.46	Finland	5.7
The Netherlands	2.28	United Kingdom	6.0
Switzerland	2.08	Denmark	6.2
Germany	1.76	Spain	6.3
New Zealand	1.66	Greece	6.8
Sweden	1.51	Switzerland	7.3
Canada	1.29	Norway	8.1
Japan	1.29	Canada	8.5
Australia	1.26	Ireland	8.6
Ireland	0.94	Australia	9.9
United States	0.55	United States	11.3
United Kingdom	0.55	New Zealand	13.8
<i>Group Average:</i>	2.00	<i>Group Average:</i>	6.56

Table 5: State control and total entrepreneurial activity (TEA) 2003  
 (Source: created by the authors on the basis of data from: Nicoletti/Scarpetta/Boylaud 1999, p. 23; Reynolds/Bygrave/Autio 2003, p. 9)

As we can see in table 5, four out of six countries with the lowest TEA-rate have above average state control (France, Belgium, The Netherlands, and Italy). Japan and Sweden have low total entrepreneurial activity though the state control is below average. The negative influence of state control becomes even clearer when considering the results of the countries with the highest TEA-rate: the five countries with the highest total entrepreneurial activity – Canada, Ireland, Australia, the US, and New Zealand – are all countries where the state control is below average.

### 2.6.3 The Impact of State Control on “TEA Opportunity Prevalence Rate”

As the TEA-rate used in our first comparison combines two different kinds of entrepreneurship – necessity vs. opportunity – we now compare the state control scores only with the opportunity entrepreneurship rates (table 6), since these naturally show the favourable motivation-based entrepreneurship activities, and with entrepreneurship as a valid career alternative in a country.

Country	State control	Country	Opportunity Rate 2002
Italy	3.92	Japan	1.2
Norway	3.19	Belgium	2.0
Belgium	2.78	France	2.8
Finland	2.68	Italy	3.3
France	2.63	Sweden	3.3
Spain	2.59	Spain	3.4
Denmark	2.46	Finland	3.9
The Netherlands	2.28	Germany	3.9
Switzerland	2.08	The Netherlands	4.0
Germany	1.76	United Kingdom	4.4
New Zealand	1.66	Denmark	5.9
Sweden	1.51	Switzerland	6.0
Canada	1.29	Australia	6.7
Japan	1.29	Norway	7.4
Australia	1.26	Canada	7.4
Ireland	0.94	Ireland	7.8
United States	0.55	United States	9.1
United Kingdom	0.55	New Zealand	11.6
<i>Group Average</i>	1.97	<i>Group Average</i>	5.21

Table 6: State control and TEA opportunity prevalence rates  
(Source: created by the authors on the basis of data from: Nicoletti/Scarpetta/Boylaud 1999, p. 23; Reynolds et al. 2002, p. 16)

Similarly to our first comparison, five of the seven countries with the lowest TEA-opportunity-rate have above average state control (Belgium, France, Italy, Spain, and Finland). Japan and Sweden also show low levels of opportunity-driven entrepreneurial

activity though state control is below average within this sample. Our findings from the first comparison remain stable for the pure opportunity-driven entrepreneurship rate. Five of the six countries (and all top 4) which score the highest on the GEM scale – New Zealand, the US, Ireland, Canada, and Australia – have all below average state control. Norway reaches a respectable 7.4 above-average TEA opportunity rate, though having high state control according to the OECD-index.

Additionally, for 2002 the GEM results across all participating countries showed a statistically significant positive correlation between the ease of regulation and taxation-related issues on the one hand, and the prevalence rate of high-potential ventures on the other (De Clercq et al. 2002, p. 34).

An example of regional differences within a country and the negative influence of restrictive government policies on entrepreneurship is Canada. While Canada altogether maintains a favourable position among GEM countries and is one of the strongest G7 performers, this is due largely to Western Canada (British Columbia, Alberta, Saskatchewan, Manitoba) and Ontario. These regions display an entrepreneurial activity clearly superior to Eastern Canada (the four Maritime provinces) and Quebec (Riverin 2002, p. 28). As well as enjoying territorial and cultural proximity to the US, Western Canada and Ontario offer – among other things – a much more liberal environment. Perhaps the most protectionist inter-provincial trade barriers are found in Quebec – such as Quebec's policy in the past of favouring provincially-based manufacturers, which even made other companies transfer their operations to other provinces (Fuller 1993, p. 16). Other measures recorded in earlier years in Quebec were restrictive licensing policies for out-of-province tradesmen and the fact that out-of-province companies were not allowed to even bid on tenders that could be handled internally (Fuller 1993, p. 16). The GEM data shows that the TEA-rates in Western Canada and Ontario are far higher with 10.8 and 10.3, than those in Quebec and Eastern Canada with 6.2 and 3.2.

#### 2.6.4 Findings

The figures show the strong positive relationship between high entrepreneurial activity and less restrictive legislation.

The comparisons allow us to draw conclusions regarding the negative influence of state control and onerous regulations on entrepreneurial activity.

Bearing these results in mind, we may ask how consistent they are with examples from “interventionist” Asia, like Bangalore (India), the South-East Asian Tigers, Shanghai (China), and Singapore or even from Europe, such as Catalonia (Spain) or Scotland (UK), which are successful regions and which have been strongly influenced by the state.

Until recently, many governments in Asia embraced a model that has been called “developmentalist”. This relied on government intervention as well as placing a heavy emphasis on manufacturing and export-oriented industries. Its success is documented by decades of rapid economic growth among the “Asian Tigers” (DTI 2004, p. 14).

At present, with China tipped to become the “new world superpower” in the near future, based on the success of regions such as Shanghai, we find that they are “taking a page from the old book”, with the state being clearly one of the main protagonists in the development and emergence of the region. Similarly in Europe, successful clusters have developed in Flanders (Belgium), which has implemented a regional cluster policy since 1994, and in Scotland, with the active involvement of “Scottish Enterprise”.

How can we reconcile these interventionist examples that seem to contradict our thesis about the negative impact of state intervention and control on entrepreneurial activity?

Today, the “old recipe” in the emerging countries (such as Malaysia and Taiwan) no longer seems to work as well. Further, Singapore, which in its early stages was also “constructed” with great success, is now suffering an economic decline (its economy shrank by 2.2% in 2003), which is the largest decline since its independence. Hong Kong, long the region’s entrepreneurial leader, is also suffering from record rates of unemployment and little growth in its economy.

One possible approach to finding an answer to these questions might be to bring in the time perspective. In the beginning, the state influence in the Asian Tiger states, Singapore, Hong Kong, the United States (see the Route 128 example) and others was strong and proved to be successful for a certain period of time and at certain stages of development. However, we believe that the potential positive impact of state intervention on regional economic development is inversely related to the level of economic activity that already exists in the region. In industrially advanced nations, state intervention in the form of economic and administrative regulation certainly has a negative impact on entrepreneurial activity.

“Singapore offers a classic example. Its current institutions do not encourage new business starts. State control of the economy is still strong; the education system rewards rote learning over creative thinking; and the overall business culture is tilted away from risk-taking. Not surprisingly, Singapore (along with Japan) ranks near the bottom of cross-national comparisons of entrepreneurial activity undertaken by the Global Entrepreneurship Monitor project” (National Commission on Entrepreneurship 2002).

In Scotland, regional development was and still is strongly influenced by the activities of “Scottish Enterprise”. However, this agency has articulated a clear exit-strategy after 3-5 years (Sölvell/Lindqvist/Ketels 2003, p. 63).

“Hong Kong has long been viewed as one of the world’s most entrepreneurial places. The challenge is not to get entrepreneurial activity started, but to restart a tradition that has been somewhat neglected. Asian governments have been reluctant to embrace such approaches in the past. If they are to succeed on this new path, Asian governments must learn not only to rely on the leadership of entrepreneurs, but to also start acting like entrepreneurs themselves” (National Commission on Entrepreneurship 2002).

Denmark, France, the Netherlands, Portugal, Sweden, and Scotland (UK) have a more or less distinct national cluster policy that aims to support national and regional clusters in different ways. In the federal states of Austria and Germany the selected policy instruments are designed and implemented at a regional level, and not the national one (European Commission 2002c, p. 46).

“On balance, cluster managers should also be cautious about intervening too heavily, the market should lead and interventions should be designed to facilitate the operation of market forces” (DTI 2004, p. 14).

Government plays a very important role in providing seed financing in the initial stage of a newly started cluster or regional initiative. At this level, government funding dominates completely, though the finance factor changes greatly over time and with age (Sölvell/Lindqvist/Ketels 2003, p. 54). A cluster/region has then to reach the point of being self-sustaining and being able to attract money from the market due to innovations and corporate growth prospects. As a result of this link with market demand, reliance on government backing decreases.

Bringing all these pieces together, we can focus on three important aspects: the time aspect, the “role” of the government, and the capital issue, along with the implicit dynamic relationships between all these three elements.

It seems that the government/state can (and perhaps must) do a lot in the initial stages of the development of a cluster or region, especially with capital. But there seems to come a point for most clusters and regions, individual differences notwithstanding, when other forces need to take over. As soon as a cluster is successful and self-sustaining, the government does not need to back it any longer, though of course it has to ensure that the infrastructure continues to be competitive.

Entrepreneurship has invited considerable attention not only in Europe, but also in other parts of the world, and it sometimes seems to be the only solution that policymakers everywhere come up with. But to be able to exploit the complete potential of entrepreneurship, the settings need to be adjusted, not only once, but constantly. Appropriate forms of intervention will change over time and strategies have to be dynamic and focused on need. That might mean that the state has to be strongly involved at the beginning and step back

later, and maybe even become more closely involved again in a third phase of a cluster or region life cycle. The data and the multiple findings from the above analysis show that “successful entrepreneurship policies require a light touch from government and a heavy reliance on market forces” (Sölvell/Lindqvist/Ketels 2003, p. 85) – especially from the long-term sustainability perspective.

To summarise, the public sector has to try to participate as little as possible and as much as necessary.

### 3. Conclusions & Implications: How to Bridge the Gap?

The results of our enquiries have shown that there can definitely be *no* single recipe for regional development. Firstly, there are big differences between the clusters and regions in almost all areas we selected, with each having its specific history and growth framework. In some cases a certain strategy worked, in the next one the same strategy failed or worked only at the beginning. Only a few guidelines can be sketched out, and they must remain general. It is much more important to step back and to take a look at the “big picture” of a cluster/region, its history, status quo and potential future, and then apply some detailed guidelines to adapt the findings collected.

As regards government interference, it was shown that this had more positive effects at the early stages of some clusters, a finding that is understandable when one considers that it is the government’s responsibility to create a business-friendly environment and infrastructure. In some cases governments did much more and were effective. There was and is no highly innovative cluster that has already survived several cycles and is still influenced in a deterministic way by a government.

If we take these explanations back to our original question, we can draw the following conclusions: the dynamic development of businesses, clusters, and regions, the accelerating forces which are connected with multiple external effects, the growing complexity of all systems surrounding us, the countless links all around the world and their increasing interdependence, all this can no longer be controlled by governments or public institutions through restrictions that mostly lag far behind in time and are seldom flexible enough to adapt to changing conditions. No matter how fast and innovative a government or policymakers may be, they still could not manage such complexity.

Governments have enough to do in ensuring the best possible framework for their national clusters/regions and all their related industries, there is no need for them to decide anything more than is absolutely necessary. At a certain level, they have to let their clusters/regions go in order to receive returns in the long-term and remain competitive in the future.

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# Changes for Companies: Outside-Inside-Perspective

- Relationship Marketing in European Consumer Goods Markets: From Marketing Mix Orientation to Customer Life Cycle Management
- The Delights and Dangers of Global Branding: From Worldwide Brands to a Global/Local Dialectic
- Dynamics of the Internationalisation of European Retailing: From a National to a European Perspective

Ralf Terlutter and Peter Weinberg

# Relationship Marketing in European Consumer Goods Markets: From Marketing Mix Orientation to Customer Life Cycle Management

1. Introduction and Goal of the Paper
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## 1. Introduction and Goal of the Paper

During the recent past, the idea of relationship marketing has gained more and more recognition in both scientific and professional literature (Berry 1983, 2002; Gordon 1998; Bruhn 2001; Gummesson 2002). When utilising relationship marketing, firms seek to build, develop and nurture relationships with interest groups (e.g. consumers, suppliers, financial sources), with an aim to making these relationships profitable. The majority of the resulting relationships, although exceptions do exist, tend to be long-lasting.

Initially, the idea of relationship marketing arose in business-to-business markets and in the service sector (and within the latter in particular, in the business-to-business-sector, but also in the business-to-consumer-sector). The concept of relationship marketing, in regards to consumer-producer-relationships in the consumer goods sector for the marketing of transferable (physical) goods, has only recently gained more interest (Sheth/Parvatiyar 1995).

The goal of this paper is to clarify the concepts of relationship marketing in consumer goods markets. More specifically it aims to help the reader:

- To become familiar with the basics of relationship marketing in consumer goods markets.
- To provide a conceptual framework, in which the attempts of entrepreneurs to portray the organisation of relationship marketing in consumer goods markets are shown. The focus will lie on the structure of the employment of instruments, with regard to consumer treatment.

## 2. Basics of Relationship Marketing in Consumer Goods Markets

One of the pioneers of relationship marketing is Leonard Berry (1983, p. 25). He defined relationship marketing as “attracting, maintaining and...in multi-service organizations...enhancing customer relationships”. Shani and Chalasani (1992, p. 44) supply us with another definition. They understand relationship marketing as “an integrated effort to identify, maintain, and build up a network with individual consumers and to continuously strengthen this network for the mutual benefit of both sides, through interactive, individualized and value-added contacts over a long period of time”. According to this definition, a relationship between sellers and consumers develops from a succession of singular transactions from which both parties derive benefit. The goal of the sellers is to create a deepening relationship or network with the individual consumer. The contact between the seller and the consumer should be interactive and personalised so as to benefit both parties involved. An individual consumer loses his/her anonymity when the

seller seeks to build a personal relationship. This view from Shani and Chalasani (1992) relates directly to the theme of this paper.

For a better understanding of relationship marketing, it makes sense to differentiate between types of exchanges. In order to understand relationship marketing, one must recognise the substantial differences between *transactional* (discrete) and *relational* exchanges (Jackson 1985a, 1985b; Dwyer/Schurr/Oh 1987).

In its purest, most basic form, a transactional or discrete exchange would involve both parties only working together for a single transaction, with no contact before or after. As an example of this model form of a discrete exchange, Dwyer, Schurr and Oh (1987, p. 12) describe the one-time cash purchase of non-labelled petrol from an independent petrol station in a foreign region. These types of single transactions have a clear beginning and end with little investment and transaction costs for both parties. During the transaction, neither party has much concern for the interests of the other, only economic concerns such as price or availability matter. After the transaction, it is clear what both parties have gained and lost. In a transactional relationship, all that matters to a seller is the sale itself. Shapiro (1991, p. 433) describes the basic mentality of the seller in a transactional exchange as “selling dominates learning” and “talking dominates listening”.

Relational exchanges are more long-lasting and complex than transactional exchanges. Relational exchanges are constantly changing as time goes on and a single transaction in the framework of the relational exchange is affected greatly by the history of the overall relationship and the expectations of its future. Investment and transaction costs tend to be much higher than in transactional exchanges (Gundlach/Murphy 1993). In addition to economic considerations, one must take into account psychological and social considerations that play a large role in the relationship (for example, satisfaction, retention, trust; see for instance, Weinberg/Terlutter 2003). In a relational exchange, the seller strives to define his goal from the customer’s point of view and tries to bring as much value to the customer as possible. Sometimes, the aims of both parties are not clear in the beginning of the relationship and develop in its course. The benefit of one single interaction in a relational exchange is not always clearly attributable to the interaction itself (Gundlach/Murphy 1993). There are often partial results that exhibit a compensatory character. In a relational exchange, Shapiro (1991, p. 433) describes the mentality of the seller as “learning dominates selling” and “listening dominates talking”.

Table 1 clarifies these aspects of the important characteristics of relational and transactional exchanges.

Characteristics	Form of exchange	
	transactional	↔ relational
Time dimension	short, isolated transactions with a clear beginning and end	long-lasting, transactions run over into each other, generally no restrictions in continuance
Investments	low	low to high
Switching costs	low	low to high
Importance and reason of exchange	low importance, supply dominates, exchange on the basis of economic aspect such as price	high importance, exchange on the basis of economic and social aspects, high importance of satisfaction, trust
Complexity	low	low to high
Goal of exchange	goal is usually clear before the transaction, The supplier's point of view characterised by: "Selling dominates learning" and "Talking dominates listening"	goal is clear or develops in the course of the relationship, the supplier's point of view characterised by: "Learning dominates selling" and "Listening dominates talking", definition of aim from customer's perspective, production of value for the customer
Result	clear result, clearly attributable to the single transaction	often partial results, compensatory character

Table 1: Characteristics of transactional and relational exchanges  
(Source: adapted from Shapiro 1991; Gundlach/Murphy 1993)

Which form of exchange is predominately found in consumer goods markets, especially in markets of physical goods? The results of "Contemporary Marketing Practice" (CMP) studies (e.g. Brodie et al. 1997; Coviello/Brodie 1998, 2001; Pels 1999; Lindgreen et al. 2000; Brodie 2002; Coviello et al. 2002) which systematically and empirically researched the meaning of relationship marketing and relational concepts in regards to business enterprises in multiple nations, show seller-consumer relationships in consumer goods markets, especially in FMCG (Fast Moving Consumer Goods) as mostly transactional, with only a small number of firms using relational strategies. In these consumer goods spheres, many firms assume that the individual seller-consumer interaction will remain more or less isolated. The reason for this view can be traced to the fact that for a firm in a consumer goods market that deals with a mainly anonymous mass public, the individual consumer and transaction have only a relatively small economic effect. Even in the case of a consumer has regularly or sporadically done business with the same firm for many years, these interactions would be considered isolated, discrete interactions. Naturally there are still many examples of relational exchanges in the consumer goods sector, as well. Examples of this include many smaller fashion stores or other (usually smaller) stores that deal with their customers face to face. However, in the large portion of trading of consumer goods and especially in large stores, in companies with many

chain stores and in many manufacturers of consumer goods, seller-consumer interactions remain primarily transactional.

The reason for the increase in the relational view of seller-consumer relationships in consumer goods markets with the goal of long-lasting connections between the seller and buyer can be traced to the following developments:

- The increased competition due to high-quality, functionally exchangeable products has led to customers being able to choose between many sellers with identical offers. Customer satisfaction and customer retention are becoming increasingly important.
- Many consumer goods markets are currently in a phase of stagnation. The acquisition of new customers in this case is only possible by attracting customers of competitors. However, the competitors will resist the loss of customers by increasing their own efforts to keep customers.
- The progress in information and communications technology has allowed firms to collect information on individual customers, making processing, storage and use of this information possible (Palmer 2002). Furthermore, through mass customisation, firms are increasingly able to offer individual products at prices competitive with mass products (Gilmore/Pine II 1997; Feitzinger/Lee 1997).
- One development that can be found in many industries and represents a very basic condition for the individual firm is the increase in loyalty programmes (for instance, customer cards and discount programmes). It is to be assumed that this increased presence of loyalty programmes has influenced the expectations of customers in regard to the measures to be offered by a specific firm in the future. If, for example, many firms offered a customer a discount card, the possibility exists that customers would miss such a card in a firm that did not offer one. The abandonment of customer loyalty efforts can therefore be viewed as a disadvantage for firms in comparison to those that maintain them.
- For firms doing business in Europe, the potential decrease in population in many European countries is a substantial factor when determining future business practices. This means that the number of potential consumers will sink dramatically. This development highlights the idea of developing a long-term relationship with a customer.
- Many consumer goods markets are characterised as being highly price-competitive (Diller 2000). Relationship marketing with the intent of creating a long-term oriented consumer-seller relationship to treat and solve the price problems of the customers is seen by many as one possible way to avoid price competition (Diller 1997).

### 3. Conceptual Frameworks for the Employment of Instruments by Firms

#### 3.1 Overview

If consumer goods producers and retailers decide to strengthen their customer-relationships efforts according to relationship marketing, i.e. if they try to build relational exchanges with their customers, they should ask themselves how to best employ the instruments of customer treatment. In the later parts of this paper, the emphasis lies on the discussion of how the employment of instruments on the part of the sellers can be best arranged to best adhere to the ideas of relationship marketing. In principle, a firm has access to many different instruments and tools usable to improve customer relationships. Most firms follow an approach by classifying the instruments according to the “marketing mix”. In the following, the classification of instruments according to the marketing mix is discussed and a suggestion is made for an alternative structuring of the instruments. The latter follows the idea of a “customer life cycle”.

#### 3.2 From Marketing Mix Orientation...

The best known and most widely-spread classification to structure the instruments of a firm follows the idea of the marketing mix, which traditionally classifies according to the four P’s (product, promotion, price, place) (McCarthy 1960). However, in the course of the discussion of relationship marketing, the marketing mix strategy and the structuring of instruments according to the four P’s have increasingly been criticised. The points of the critique that are discussed in literature can be displayed together as follows:

- The employment of instruments according to the four P’s arranges itself towards the initiation of transactions with unspecific customers, i.e. with an anonymous mass-public, which, for industries with long-term business-relationships and well-known customers is becoming less and less suitable (Gordon 1998, p. 39ff.; Bruhn 2001, p. 9). If consumer goods producers or retailers strive to create relationships in the vein of relationship marketing, the orientation towards the marketing mix seems to be less suitable.
- Marketing mix methods are further criticised for their tendency to lead firms to focus more on short-term (sale)-goals and less on long-term, successful seller customer relationships (Grönroos 1994; Gummesson 1994). The orientation towards short-term minded marketing mix methods appears unfavourable for the lasting existence of business relations.
- Further criticism can be placed on the structure of market activities based on the four P’s leading to a production- and achievement-oriented definition of marketing. Gum-

messon (1994, p. 9) has compared this type of marketing to “manipulation” of customers. For example, when a customer buys a product due to price reductions, and later determines that he/she really did not need the product, the customer has been manipulated through price reduction to purchase a product he/she would not have otherwise purchased. This temptation was not in the customer’s best interests. The basic idea of the four P’s is that the firm produces its product and seeks to sell these products to customers by using the methods of the four P’s. By doing so, the firms are not operating in the best interests of the customers, which translates into sub-optimal customer relations.

- Van Waterschoot and van den Bulte (1992, p. 85) further point out in their critical review of the classification scheme of the four P’s, that problems arise regarding the classification of new instruments and concepts when utilising the four P’s. Instruments such as quality management or recovery management will be considered either arbitrarily ordered according to the four P’s, or isolated by them (Bruhn 2001, p. 9). Van Waterschoot and van den Bulte (1992) discuss a category in addition to the four P’s, in which all “others” are placed. As this category grows, it points to the inadequacy of the four P’s.
- A further critique-point of the four P’s regards marketing organisation. The four P’s lead to an isolation of market activities, in which marketing departments in firms are established, which have to work towards the fulfilment of customer needs (Grönroos 1994, p. 7; Bruhn 2001, p. 9). Thus, the task of fulfilling customer needs as represented in the firms marketing department, takes the same level of importance as other tasks such as purchases or accounting. In the framework of a firm with a customer-oriented plan of action, the firm will seek to give its marketing department a more distinct function (see Meffert 2000, p. 6). This function would entail fulfilling customer-needs and making the customer the centre of all business activities. The entire firm is expanding its functions to focus on the needs of current and potential customers (Meffert 2000, p. 7). The development of the meaning of marketing could, for example, display that the personnel in the accounting department are also customer-friendly (for instance by offering an easily understandable invoice or by customer-friendly answering of questions concerning the invoice). Webster (1992) also pointed out that a marketing organisation focused on individual transactions, such as those of many firms would eventually be replaced by one focused on long-lasting seller-customer relationships.

In summary, an orientation towards classification based on the classic marketing mix method would not be suitable for a firm wishing to use relationship marketing to ensure the development of strong customer relations. Therefore, one should ask the question of whether an alternative structure of employment for instruments exists, and whether it would make the build-up, development and conservation of relational seller-customer relationships possible. The following pages will present the possibility of structuring the employment of instruments on the basis of “customer life cycles”.

### 3.3 ...to Customer Life Cycle Management

Based on the idea of product life cycle concepts, seller-customer relationships can also be characterised by a life cycle (Stauss 2000; Bruhn 2001, p. 44). Seller-customer interactions change over time. They point to a dynamic character and change depending on psychological processes such as emotion, motivation, attitudes or cognition, as well as behaviours of the parties involved. A firm will try within the framework of customer life cycles to identify typical phases of seller-customer interactions that show similar characteristics.

The customer life cycle places the focus on the interactions between sellers and customers. It can be viewed from the perspective of both seller and customer. Many suggestions for the differentiation between and characterisation of the phases of the customer life cycle exist in literature (i.e. Dwyer/Schurr/Oh 1987; Stauss 2000; Homburg/Sieben 2000; Bruhn 2001). These suggestions can be summarised in three basic phases of the life cycle:

1. Customer acquisition phase
2. Sales phase
3. Customer recovery phase

The *customer acquisition phase* is the first step in the seller-customer relationship. The seller strives to win new customers, making the first seller-customer contact. The firm gathers information on potential customers and uses means of communication to get in contact with the customer. During this phase, the customer searches for information about different sellers and offers.

The *sales phase* begins when both the customers and sellers are satisfied with the *customer acquisition phase*. This phase is characterised by an intensification of the seller-customer relationship, with personal contacts improving, mutual confidence increasing, and repeated purchases by the customer.

In the *customer recovery phase*, the potential or actual completion of the customer-seller relationship is reached and one, both, or neither side attempts to possibly re-establish the relationship. Reasons for potentially or actually ending a relationship can include unhappiness or efforts by competitors. Measures such as discovering the reasons for the business risks or the possible end of the relationship are counted among the *recovery phase*, and can lead to measures being taken to repair and strengthen the relationship. The measures can also include price reductions or service improvements.

The customer life cycle presents an ideal view of seller-customer relationships. The following diagram attempts to portray this model (figure 1):

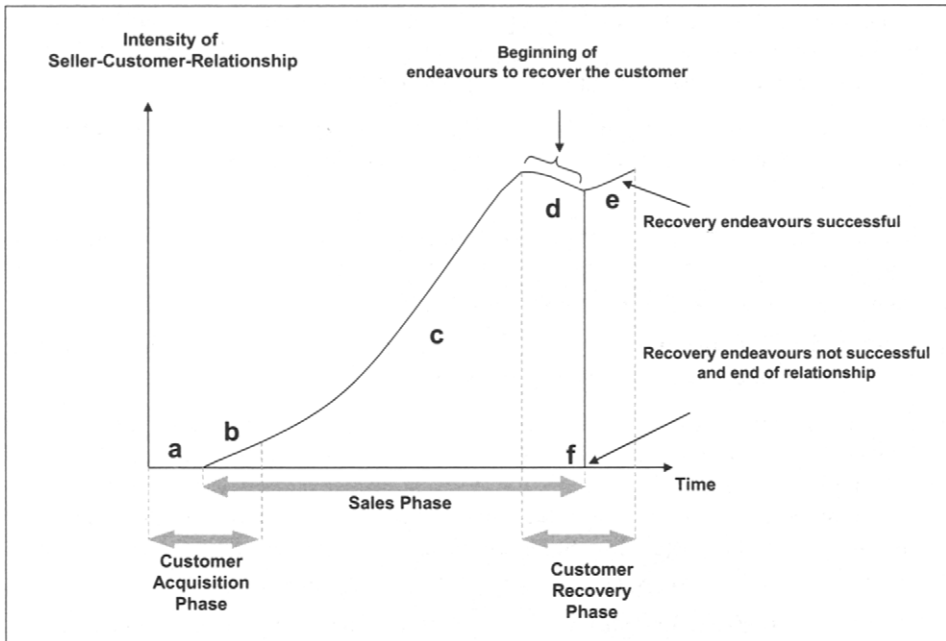


Figure 1: Customer life cycle (ideal type)

During the process of the *customer acquisition phase*, the seller-customer relationship begins. While striving to locate potential customers, sellers usually begin the *customer acquisition phase* well before the first actual contact between sellers and customers. The firms procure information for themselves on potential customers; this process is represented in figure 1, in the section labelled “a”. If the customer himself initiates the contact to the seller, the *customer acquisition phase* begins for the seller with this first contact. In both cases, following the first contact, there is an increase in the intensity of the seller-customer relationship and a transition into the *sales phase*, in which characteristics of both phases are present (represented by the portion labelled “b” in figure 1). The exact boundaries of each phase must be set arbitrarily. Reasonable possibilities for these boundaries include the first purchase or order placed by the customer. One could also suggest the time at which the customer makes the first repeat purchase from the firm. The core of the *sales phase* consists mainly of the intensifying of the seller-customer relationship (“c”). Both sellers and consumers get to know each other better and develop their cooperation. If disturbances arise (such as unhappiness on the part of the customer) or the customer-seller relationship draws nearer to its end (possibly for positive as well as negative reasons, the completion of a contract for example), the intensity of the relationship is reduced (section “d”). The *sales phase* runs over into the *customer recovery phase* or into the beginning of a new *acquisition phase* (e.g. with both parties attempting to create new contracts). If the attempts to renew the relationship are successful (through

the removal of dissatisfaction, and through possible compensation of the customers, for example), the customer-seller relationship can once again begin to intensify (“e”). If the endeavours are not successful, the relationship and the life cycle end (“f”).

The model of a customer life cycle is an ideal type of model. It shows how the phases of a customer-seller relationship would typically progress. However, the model is subject to the following restrictions:

- In the beginning of a seller-customer relationship, the customer life cycle can only be roughly predicted. The real demarcation of a relationship cycle between sellers and customers can only be precisely identified ex post.
- Further, the customer life cycle can vary depending on factors such as the type of service being exchanged, the type of industries, etc.
- The individual phases, or parts of a phase do not necessarily have to run over into each other (Bruhn 2001, p. 51f.). After the *customer acquisition phase*, there could potentially be no sales phase at all, due to the customer breaking off contact after the first purchase. It is also possible that there would be no *recovery phase*, due to the abrupt end of the customer-seller relationship (possibly because of the customer moving to another city, etc.).
- The individual phases can vary in their duration (Bruhn 2001, p. 51f.). For example, the *acquisition phase* can last much longer for a seller trying to sell a house as compared to a seller trying to rent out an apartment. The *sales phase* of a doctor-patient relationship or a bank-customer relationship can last decades, whereas a hospital-patient relationship is usually much shorter.
- The graphic-model assumes that every phase, *acquisition*, *sales* and *recovery* takes place strictly one after another, and begins and ends after a specific duration. This organisational rigidity is usually not apparent in the real world. Also, the definition of when a phase runs over into another is arbitrary.
- Between the phases there are periods of overlap and interaction, especially between the *sales phase* and the *recovery phase*, when there exist numerous interactions. For instance, picture a relationship that has lasted for many years and experienced many interactions. This relationship will have had many uncomfortable periods which led to an endangerment (and subsequent *recovery phase*) of the relationship. Following the removal of the danger (i.e. through the reinstatement of satisfaction), the seller and customer re-enter the *sales phase*.
- Also, between the *acquisition phase* and the *sales phase*, the amount of crossover is much less rigid than the graphic-model infers. If a seller and customer, after a period of intense interactions (*sales phase*) have little or no interactions for a longer period of time and then later attempt to reinstate contact, their actions will most likely take on the character of a new acquisition (*customer acquisition phase*). After these acquisition actions, the relationship may re-intensify (*sales phase*). This type of process is typical of a consumer goods market in which the relationships between seller and

consumer often last many years, although not necessarily concurrently. Figure 2 displays how a customer-relationship life cycle in the consumer goods sphere might look. It is an example of how the relationship between a consumer and a retail store may look.

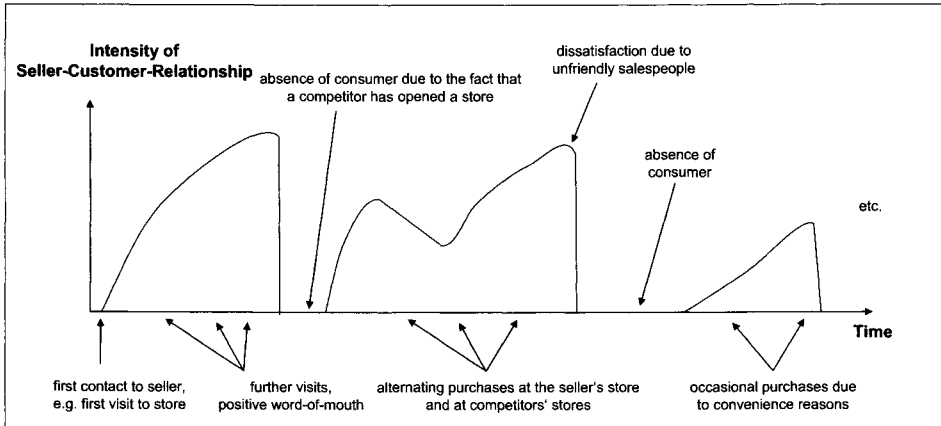


Figure 2: Example of a possible customer life cycle of consumer and retailer

Figure 2 shows that in a seller-customer relationship that is currently in the *sales phase*, there will always be specific interactions that exhibit more the characteristics of the *acquisition phase* or the *recovery phase*.

Despite the restrictions listed earlier, the customer life cycle has numerous advantages:

- For the seller, the customer life cycle makes the structuring of marketing instruments according to the phases of the seller-customer relationship possible. The division of the phases gives the seller a guideline for the integration and arrangement of the marketing instruments. Consumers require different things in the *acquisition phase* than in the *sales* or *recovery phases*. The seller must employ its instruments in such a way as to fulfil these needs. Because of this, the customer life cycle seems advantageous for the pursuit of a long-lasting seller-customer relationship.
- The structuring of the instruments of customer-relations on the basis of the phases of a relationship clarifies the importance of the customer-seller relationship within the firm. The nature of the seller-customer relationship becomes the focus of the firm's efforts if the arrangement of the firm's instruments is made to coincide with the seller-customer relationship.
- The allocation of the customers in the phases of the customer life cycle makes an estimation of the balance of a firm's customer-portfolio possible. The firm can then assess how many and which customers are in each phase and can then employ the instruments accordingly.

- As the focus of the firm's activity turns to successful customer relations, there is the danger that customer acquisition will be neglected, leading to a lack of new customers. The successful acquisition of new customers is of the utmost importance to a firm, since, with or without a focus on customer-relations, there will always be customer fluctuations. The classification of the customers according to which phase of the cycle they are currently in shows the firm if a sufficient large number of new customers can be acquired.

In addition to the instruments that a firm can use within each phase of the cycle, there are instruments that can be applied in all phases of the cycle (for example quality management, complaint management and personnel development). These tools are applied in all or several phases. They are not discussed in detail in this article. Terlutter and Kricsfalussy (2004) give a descriptive overview of the intensity of employment of instruments according to the customer life cycle. They differentiate between instruments applied within the phases of the cycle and instruments applied across the different phases.

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Benoît Heilbrunn

# The Delights and Dangers of Global Branding: From Worldwide Brands to a Global/Local Dialectic

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## 1. Overview

The opening of borders between national markets and the rapid development of a global economic space has resulted in a homogenisation of the supply and demand for goods and services. The gradual lowering of trade barriers and increased competition have obliged companies to rethink the principles that govern the strategic management of their brand portfolios. In view of this context, it is essential to take into account the degree to which a brand can be included in a global strategy where consistent principles of brand management are applied to a full range of geographical zones.

A global strategy must take into account the factors that have changed our understanding of brands over the last twenty years, notably the extension of branding into spheres such as services (McDonald's, MasterCard) and processes (Lycra, Intel). This dematerialisation of branded entities has also been accompanied by the development of umbrella brands: a brand name which has established a strong reputation over time within the market, or brand equity, is often used when launching products in new product categories. The problematic of global branding is best explored when considered in the context of the elements that make up the identity of a brand. Brand identity is temporal in so much as over time the same brand can be extended to include products in several sectors (Bic built up its business activity by developing its pens, razors, lighters, windsurfing equipment, perfume etc.) and spatial in as much as brand business can be extended to cover several geographical zones.

In the light of significant developments in the field of brand management, the goal of this chapter is to highlight the challenges and factors of globalisation, and to propose a framework for the analysis of global branding strategies, with a view to answering the following questions:

- What motivates companies to implement global brand management?
- What sectors provide the best conditions for global strategies?
- What are the limiting and braking factors for global brand strategies?
- How can a global approach to the brand be reconciled with local adaptations required by differences in culture, or environmental and market conditions?
- Do brands adapt to existing cultures, or do they create new cultural schemes?

## 2. Worldwide Brands and the Global/Local Dialectic

An international brand is a brand with products and services that are sold in a significant number of geographical zones. Within this category, a wide range of strategic approaches can be observed. These are largely determined by the degree of centralisation

or externalisation of production methods, and methods of control exercised by the parent company over subsidiaries, the organisation of marketing teams, and the standardisation of marketing strategy. As a general rule, the international management of a brand implies an understanding and an ability to control factors that enter into the “global-local” dialectic. From the point of view of companies, it is as though a range of “forces” exerted pressure for or against globalisation. On the one hand there are forces that promote the *integration* and *worldwide coordination* of geographical distributed businesses (mainly for reasons of economies of scale and comparative advantage between countries), on the other hand, a significant number of forces encourage companies to adapt to local conditions and local demand (customs barriers, non tariff-related obstacles like quotas, standards, and bureaucracy etc.; the level of public contracts, divergence in consumer tastes, effects linked to the national origin of products or services, the diversity of distribution systems, the historical position of certain companies, the predominance of local buyers). Every sector is affected to some extent by these factors. Some sectors are largely *globalised* because the pressure exerted by forces of integration and coordination is strong and the pressure exerted by forces that imply local adaptation is negligible (electronic components, sports shoes). At the other end of the spectrum, certain sectors are “*domestic*” because the forces imply integration and coordination are weak, while pressure exerted by forces implying local adaptation is strong (fresh produce with a short shelf life, delicatessen). Between these two, there are a wide range of “mixed” sectors: some are largely “*multi-domestic*”, because the overall pressure exerted is weak; others largely “*transnational*” because the overall pressure exerted by the factors is strong.

Many reasons may exist for globalising a brand, but at the same time a company’s propensity to globalise its brand management is also very closely linked to its strategic approach. The works of Bartlett and Ghoshal (1998) highlight three major strategic approaches:

- A *local* approach that consists of managing a brand for a particular country by adapting in response to local market conditions and cultural conditions. This approach may be used where a brand only exists in one single country or group of countries (i.e. Montblanc cream dessert or the Ricorée hot drink which only exist in France), or where the company does not have the necessary organisation, the necessary size or the strategic will to expand abroad; e.g. the Hollywood chewing-gum brand, which apparently has all the necessary credentials to penetrate the international market, has remained within the confines of the French market to avoid the high cost of entering markets elsewhere; the same is true of Orangina which sells only 10% of its product outside France.
- A *multi-domestic* approach that aims to develop a strategic position and an organisational structure that promotes awareness and responsiveness to the different national environments. A case in point is the European management of a brand like Ovomaltine, which has a range of different market positions: in France (children’s beverage), in the UK (a chocolate flavour night-time drink), or in Germany (an en-

ergy drink for athletes). The same is true of the Mr. Clean (P&G) brand which is sold under a variety of names (Meister Proper, Mastro Lindo, Monsieur Propre). The formula, the colour (yellow or green) and the price are also adapted to local market conditions.

■ A *global or worldwide* approach prompted by a standardised and uniform vision of brand strategy that is applied to all countries disregarding as much as possible the cultural differences and local market conditions. Underlying this approach is the idea that the competitive position in one country is largely influenced by the competitive position in other countries. On this basis, it targets the world market as an integrated whole and benefits from the cost advantages of large-scale centralised operations. Brands as different as Coca-Cola, Gillette, Swatch and McDonald's make use of this type of approach. Acknowledgement of the interdependence between countries and the will to rationalise strategy from a global point of view implies the following decisions:

- a *standard range* and *standard communication* based on the idea that customer expectations are homogeneous or can be made homogeneous, regardless of the geographical location. Coca-Cola, McDonald's and Microsoft make systematic use of this idea and their brand strategies are globalised on this basis,
- a strong *commitment* to all major national markets with a view to optimising volumes and synergies. Such a commitment enables the company to take advantage of consumer trends and/or technological changes that cross over a diversity of geographical locations,
- a *concentration* of value at a reduced number of sites (research and development, production, advertising campaigns), with a view to obtaining economies of scale and/or benefiting from advantages that are specific to individual locations,
- the coherent construction of a significant and sustainable *commercial advantage* to ensure a good position on the world market, and the use of coordinated strategic manoeuvres in the main countries in anticipation of interdependency. The implementation of a global strategy for the brand is one of the levers that allows for the construction of such a position.

### 3. The Factors that Prompt the Globalisation of Brands

#### 3.1 Overview

Now that we have explored the characteristics of a global brand, let us take a look at the factors that drive the globalisation of brand strategies. We can identify three series of factors: factors associated with managerial and strategic considerations (which are supply side factors), factors that are associated with the development of methods of communication and distribution (which are linked both to the supply side and the demands of

the market), and lastly, factors that are linked to the development of consumers' tastes (and thus solely linked to the demands of the market).

### 3.2 Strategic Factors

A company's propensity to globalise its branding approach is largely a question of strategic initiative. Depending on its individual style of management, history and culture, a company will tend to favour more or less centralised structures. For example, Mars', Ferrero's and Michelin's branding strategies have been largely determined by corporate goals and methods of management rather than by the development of demand on the market. The globalisation of strategies is also prompted by a desire to reduce the cost of bringing products to market; either by centralising R&D at one or two sites or by attempting to benefit from economies of scale. Raider was renamed Twix to harmonise the European packaging, while a recent Nescafé advertising campaign marks the shift from a multi-domestic approach to a global approach based on multi-culturalism. Finally, globalisation is often associated with some firms' attempts to limit the number of their brands and concentrate their efforts on a handful of heavyweights. In other words, the main thrust of umbrella brand strategies is the rationalisation of brand portfolios. The reduction of the number of brands may be encouraged by the removal of certain brands (e.g. replacement of the Chambourcy brand by the parent brand Nestlé), by the development of brands in related sectors (e.g. the Colgate brand's expansion into toothbrushes and shaving foams), or by the extension of brands with powerful brand equity amongst customers and suppliers into new product sectors (Hermès perfumes, Porsche sunglasses, Marlboro clothing etc.). The launch of new products under a very well known brand that has strong brand equity can play a key role in reducing the risks and costs associated with the launch of a new product. It also allows the new product to benefit from synergies with other products under the same brand. Companies like Sony, Kellogg's and Nestlé often make use of twinned advertising campaigns in order to reduce the cost of advertising design and advertising space purchases. This is even more important when creating international communications that aim to present a uniform image of the brand.

### 3.3 How Access to the Markets Has Evolved

The concentration of the number of brands is also driven by the very high cost of participation in numerous cultural and sporting events which generate high media attention, such as the Olympic Games or the World Cup. Both of these offer a unique opportunity for global brands to obtain immediate international visibility, but the cost of participation is such that only a small number of brands in a restricted range of categories can take part (fast-food, photographic film, sports equipment, soft-drinks, computer products etc.). It is mainly these categories which target a large segment of customers who travel

regularly and are frequently exposed to airport shops, international retailers and international media (Time, The Economist, MTV, CNN, etc.). However, the importance of these travellers should not be overestimated, since they represent a relatively small percentage of the overall figures for audience and advertising expenditure (in the region of 5%).

Finally, the globalisation of branding strategies is also prompted by the progressive concentration in the distribution sector and the rapid development of a number of international retailers (Toys'R'Us, Ikea, Aldi) who make use of rigorous and systematic purchasing strategies on a European or worldwide scale, and whose stocking strategies vary very little from one country to the next. The desire of companies to have their products sold in these types of shops implies a necessary concentration of the number of brands, but also a certain global harmonisation of pricing, positioning, and communications strategies. A case in point is the Barbie doll. Barbie is a global brand because the product does not require local adaptation – the world of toys is largely unaffected by cultural difference – and also because sales of the product are concentrated in a limited number of retailers.

### 3.4 The Partial Harmonisation of Tastes and Methods of Consumption

The focus on a restricted number of brand names is also prompted by the excessive amount of information available to modern society and the increased number of new products in sectors such as food products, clothing, and audio equipment. This increase in the number of products has had the paradoxical effect of reducing the number of brands that can be used to represent new products. In general consumers have a very low level of involvement in the majority of product categories, and a limited cognitive capacity for the interpretation of consumer information (resulting in a difficulty in deciding between more than seven alternative versions of the same product). This has resulted in fierce competition between brands for access to the reduced amount of shelf space available in sales outlets. The rationalisation of the number of brands also goes hand in hand with the development of transnational segments of consumers who relate to the universal value systems espoused by a certain number of major brands such as Nike, Reebok, Coca-Cola, Swatch, etc. These brands take advantage of a degree of convergence in the expectations of some consumer segments in fields like sports, music, travel etc. These megabrands are the only ones capable of devising a discourse to which consumers from virtually every culture can relate, although by adopting this attempt to gain universal approval, the brand message is somewhat diluted.

## 4. What Sectors Are Appropriate for Global Brands?

### 4.1 Overview

In the light of the above, it is possible to identify a range of sectors that provide the best possible conditions for global brands:

- Sectors built upon the embracing of new values and setting aside of values inherited from the local culture. Coca-Cola, Levi's and Nike offer teenagers the opportunity to consume the image of the American dream. French and Italian luxury brands provide the global elite with a chance to purchase distinction. Brands that market products with a strong image (cosmetics, clothing, jewellery, liqueurs) – especially those which make use of advertising that emphasises values such as sensuality, social status, elegance, solidity, and comfort – and brands that emphasise the country of manufacture as a key aspect of product positioning have a strong propensity to globalise their approach. The same is true for retailers that focus their positioning on a key attribute: for example Toys'R'Us, or Ikea.

A large proportion of these brands do indeed make use of the country of origin. In the same way that companies like Danone, Nestlé and Kellogg's label their products with a company brand that is supposed to demonstrate their commitment to the consumer, certain brands make use of their country of origin as an implicit label of quality and expertise. The commercial leverage exerted by the "country of origin effect" explicitly aims to promote the nation of origin of a product or a brand with a view to reassuring the consumer and increasing perceived value. The marketing rhetoric of country of origin has allowed brands like BMW and Mercedes to make use of "made in Germany" to lay claim to values of solidity and performance. Pasta maker Barilla and espresso producer Ily make explicit use of the "Italianness" of their products. Marks & Spencer promotes an English concept of quality and comfort, Volvo is undeniably Swedish, and Bailey's clearly Irish etc. The Country-brand is initially developed by the promotion of a specific expertise often linked to a kind of cultural excellence; this was the strategy adopted for Swiss watchmaking, British marmalade etc. Some brands have no hesitation in deliberately promoting a fictitious "country of origin effect". Hollywood chewing gum, which is only sold in France, lays claim to an American identity: Georges Killian's presents all the signs of an Irish cultural heritage for a beer that is actually brewed in France, and the shoe brand Weston offers consumers a quintessentially English product that is in fact manufactured in Limoges. The country-brand can be an extremely effective positioning tool when a country is acknowledged for its expertise in a specific product category. The French country-brand plays a key role in the export of luxury products, and it is also used to generate a certain snobbish cachet for products like Evian or Perrier (though it should be noted in passing that Perrier is in fact managed by a Swiss company, Nestlé). The country of origin effect also gives rise to dual positioning strategies because the

country of origin effect offers no significant advantage when a product is on its home territory. It is for this reason that the French positioning of Evian and Nestlé differs from the positioning used in the rest of the world.

- Sectors built on technological change, which encourage the creation of a set of new systems of radically different values. High-tech brands in computing, electronics, and telecommunications not only build their own markets, they also create the values that define them. In these sectors (personal computers, game consoles, audio equipment, mobile telephony etc.), a global outlook is an essential pre-requisite for the creation of new products, more eagerly adopted by younger generations than their elders as emblems of “their consumer universe”. And yet in the food products sector, where cultural tradition usually plays a predominant role, innovation in the chocolate bar sector also tends toward this type of consumption. Inexpensive products for common use (disposable lighters, cheap writing instruments, mechanical razors etc.), with prices that are largely determined by the size of production volumes, also benefit from this trend;
- Sectors, especially those providing services, built upon mobile and cosmopolitan customers (car rental agencies, airlines, hotel and restaurant chains, travel agents etc.). Products associated with travel, notably baggage, also enter into this category. There is no difference between rigid structure suitcase models (i.e. Delsey or Samsonite) sold in Paris or Japan. The makers of these products limit variation to elements that do not require costly modification of industrial processes (paint, wheels, handles);
- Sectors with products that do not require any special adaptation (or *customisation*) for the tastes or conditions of specific markets. For example, ITT found that a global approach can be applied for a product like the pacemaker, whereas a multi-domestic approach is required for products that require integration like phones, which have to be adapted for use with the local telephony system.

As a general rule, typical distribution for these so-called “global” brands is in shopping malls at international airports.

## 4.2 Taking Cultural Factors into Account

The homogenisation of lifestyles across the planet has led marketers to seek out global market segments. However, it does not necessarily follow that all companies should make universal segments their first priority. Globalisation has resulted in the creation of homogenous and gigantic markets, but it has also prompted a dialectical response from consumers who are increasingly attracted by values such as a local or historical presence, unique values and human scale. In other words, the trend for universalism, which has accompanied globalisation, has also led to a resurgence of clans, tribes, gangs and other community phenomena. The first obstacle to the establishment of a global brand is the salience of specific cultural schemes. This influence of culture on methods of consumption is more pronounced for staple convenience goods than it is for industrial products or

services. With regard to everyday consumer goods, it has been noted that the influence of culture on the perception and consumption of a product decreases as the product shifts towards the periphery of a symbolic domestic circle, which is centred on the kitchen and spreads outward through the bathroom, the toilet, shared domestic space (living room, dining room), the bedrooms, to the garage and finally the garden. It follows that food and household cleaning products have stronger cultural connotations than coffee tables, beds (except in Japan) or lawnmowers. Notwithstanding the international presence of Coca-Cola or McDonald's, the food sections of supermarkets vary extensively from one country to another. A simple comparison between Paris, Barcelona, London and Geneva immediately shows that the type of breakfast, the use of seasoning or sugar, and the role of cheese etc. are all radically different within the family. In general, the specific nature of national tastes in food products is strongly resistant to the supposed harmonisation of lifestyles. It is for this reason that McDonald's serves coconut, mango and tropical mint milkshakes in its Hong-Kong restaurants and offers such local specialities as McSpaghetti in the Philippines and lamb burgers (Maharaja Macs) in New Delhi. In France, the chain has also catered to local tastes with the launch of country potatoes, an alternative to fries, croque-monsieurs (toasted cheese and ham sandwiches) and fruit salads. In the realm of restaurant design, the chain offers franchise holders a choice between a dozen different decoration schemes, which are markedly different, so as to avoid having two identical restaurants in the same urban area (Kupferman 2002, p. 18). The websites are also localised. Similarly, the composition of Coca-Cola varies in terms of sugar, gas, and sweetener content in different parts of the world. This phenomenon can also be observed in the fur trade. The Dior fashion house, which sells furs in Europe, has refrained from distributing these products in the US. There are a number of reasons for this: furs entering the US are subject to heavy taxes, and furthermore the American perception of fur is less influenced by fashion and more concerned with protection against the cold. Dior has also refrained from exporting furs to countries in Latin America and the Persian Gulf where the climates are completely inappropriate for products in this category.

A retailer like Carrefour is obliged to take cultural specifics into account and adapt its departments accordingly. A case in point is the fish counter. When purchasing fish, French customers like to "sniff fish and inspect the eyes, the Japanese prefer to buy them prepared and pre-packed; the Turks like to turn over their gills; the Chinese prefer to take them home alive; while the Poles and the Czechs – who are avid carp eaters – like to see them stunned at the counter". Stores are required to adapt a variety of parameters:

- The *type of products sold*: in Brazil retailers have to include in their stock leading products like bacalhau (dried cod), chimarrao (traditional tea), cachaça (a strong alcohol used in caipirinha cocktails) and salted and dried pork (which along with black beans is a key *feijoda* ingredient – a traditional Saturday dish in Brazil). In China, the retailer does a brisk business in live turtles and snakes...and every year, Carrefour stores in Taiwan sell 43 million fake bank notes, which are burned as offerings to the spirits of the dead.

- *Packaging*: in China, the majority of consumers use bicycles for transport, somewhat limiting the market for heavy products like 9-litre packs of mineral water! At the same time, the lower level of purchasing power has reduced pack sizes (the average Kellogg's cereal packet is 175g instead of 375g). In Indonesia, dehydrate pastas (goreng) are sold in boxes of 40 or 50 sachets, rice is sold in 10 or 20 kilo sacks and even in barrels. Finally in Japan, fruit and vegetables are marketed in pre-packs, and are hardly ever sold loose or by weight.
- *Store organisation*: in the car parks of its stores in Brazil, Carrefour pays singers to entertain customers with traditional music. In response to the difficulty of finding sites and high real estate prices, in South Korea the retailer has built a number of multi-level hypermarkets to take full advantage of more expensive locations. At its Seoul store, parking levels and selling space are alternate floors within the same building. In Columbia, the retailer provides free nursery services, bodyguards, and secure taxis for customers at all of its sites. Carrefour Columbia also organises an annual in-store Christmas vigil (Novanas de aguinaldo) from December, 16 to 24, and even lays on regular Sunday Mass. Similarly in Malaysia, the retailer has provided a prayer room for staff in every one of its stores.

The need to adapt different aspects of brand strategy is also illustrated by the household cleaning products sector. In the 1980s when Procter & Gamble launched their Vizir Europe, the product had to be sold with a vizirette (in-machine dispenser) because the continent's washing machines had not been designed to function with a liquid detergent. The same group also had to adopt a multi-domestic strategy for Mr. Clean with different colours (yellow or blue), formulae, and names (*Meister Proper* in Germany, *Mastro Lindo* in Italy, Flash in the UK etc.). Similarly in 2002, P&G launched a new range of detergents – Ariel Style – and a range of feminine hygiene products specifically designed for the French market and only sold in France.

Many leisure activities are also strongly rooted in tradition and value systems. Despite efforts to universalise its concept, Club Med continues to encounter “resistance” from German and North American consumers. The press and publishing sector, for linguistic and historical reasons, has largely remained unglobalised. Notwithstanding the success of the Olympic Games and the football World Cup, a large proportion of sports and leisure activities are still restricted to a limited cultural space (e.g. Base Ball), and geographical space (seaside and mountain sports). As a result, mainly local markets dominated by national players, and in some cases regional players, continue to prevail. It was on the basis of such considerations that Club Med was adapted to take into account the different expectations of Asian consumers. The brand that offers western consumers a concept of permissive individualistic and hedonistic relaxation was refocused on values of learning, dedication, and family orientation for Asian countries, most notably for Japan (figure 1).

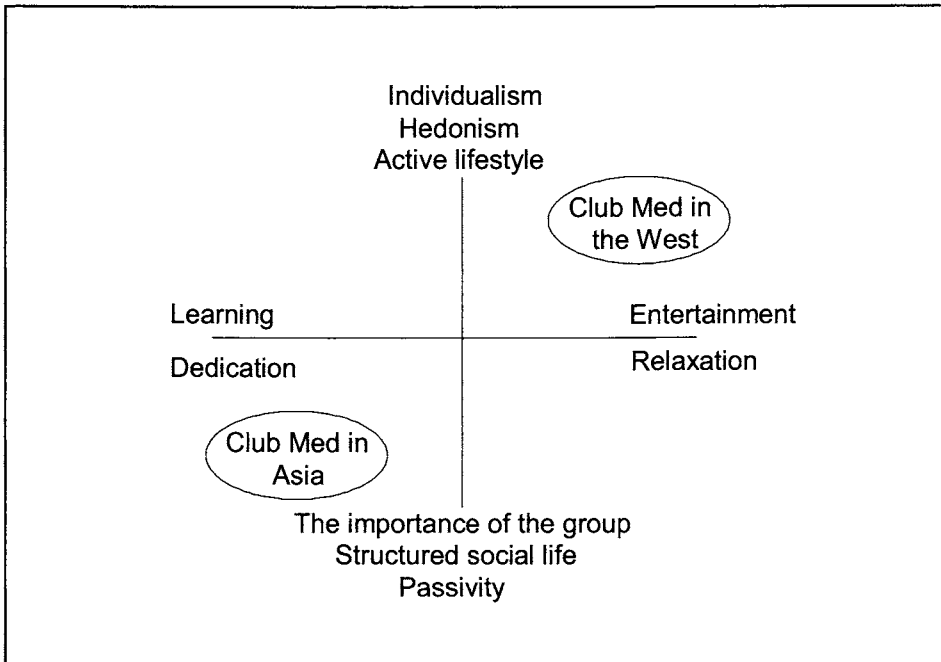


Figure 1: Perceptual mapping graphic of Club Med positioning for different cultural zones

Globalisation also requires an awareness of variations in purchase processes between different countries. A brand like Lego, which has based its success on similarities in children's tastes and play behaviour in different countries, still had to adapt to take into account the diversity of parents' purchasing behaviour. These differences in purchasing behaviour can influence such factors as product packaging, as well as promotion and sales methods. The Danish manufacturer, which does its utmost to standardise brand strategy, was obliged to bow to consumer pressure in the US and present its products in transparent plastic boxes and in buckets, like those used by its main competitor Tyco. This transportation of US practices in Japan (promotional campaigns that make use of packaging with bonus points and free gifts) left local consumers cold. The Japanese consider these types of promotion to be pointless, expensive and not at all appealing.

### 4.3 Taking into Account the Locations of Different Markets

The implementation of a global strategy has to take into account the variations of market structure in different countries, especially variations in the development of different types of trading. For example in Europe, major variations can be observed in the retail-

ing and mail order sector (often determined by habitat structure, the degree of urbanisation, regulations on opening hours and localisation). Notwithstanding the progressive adjustment of European legislation, large-scale sales points have a more dominant role in northern rather than southern Europe. A tried and tested retail formula like a French style hypermarket has to be adapted for use on the Spanish market, and small retailers continue to play a vital role in all developing countries. These factors render market access dependent on a number of variables – the choice of a distribution strategy, the choice of a media plan, decisions on pricing for different distribution circuits – which are not easy to globalise.

Nonetheless, although price is an example of a variable for which global standardisation seems in theory difficult to achieve, a certain harmonisation is still possible. This harmonisation is implemented by the establishment of an international price corridor that takes into account different levels of taxation, purchasing power and competition in line with a technique outlined notably by Hermann Simon (1989). This price corridor is determined by the group's headquarters in consultation with national subsidiaries, and takes into account such local variables as the price elasticity of demand, the phenomenon of parallel markets resulting from differences in price, exchange rates, production costs, competitors' structures and the structures of distribution. Once the corridor has been established, all subsidiaries must situate their price within its defined limits. Countries that are below the minimum threshold are forced to increase their prices, and countries with prices above the maximum limit are obliged to lower theirs. This approach is particularly useful in sectors such as the car industry, where the phenomenon of parallel reimportation is no small matter. One strategy Simon (1989) envisaged to facilitate access to the corridor was to introduce new brands for top-of-the-range segments in countries where the prices are high, and new brands for low-end segments in countries where the prices are low.

These factors highlight two important comments on the implementation of global strategy:

- The global approach requires careful evaluation of the architecture of a group's brand portfolio. The simplest approach consists of using the same brand for all of a group's products and services. It is the solution that is most often used in tandem with an umbrella brand: Décathlon, Fisher Price etc. However in most cases, the group portfolio will include a selection of brands with complementary positioning allowing for the greatest possible coverage of the world market. For example, the Nestlé brand portfolio has a mosaic of brands: global brands, multi-domestic brands and local brands. The coexistence of different brands allows the establishment of a complex system with several levels of branding: product brand, range brand and masterbrand. In this case, the portfolio is designed to capitalise on the name of the group, its roots (Swiss), its values (quality, rigour etc.). Whereas in the past, the subsidiaries were named Sopad, Chiprodal, and Indulac etc., today, all of them are called Nestlé. The hierarchy in this portfolio of 7,000 to 8,000 brands is as follows: there are ten global corporate brands controlled by group management (Nestlé, Carnation, Nescafé, Maggi, Buitoni, Perrier etc.), worldwide strategic brands that are the responsibility of

strategic business units (Kit-Kat, Crunch, Smarties, After Eight etc.), strategic regional brands that are under the dual control of strategic business BUs and local management (Vittel, Herta, Findus, Stouffer’s etc.), local brands directly controlled by local management.

- Every global approach requires a standard approach for local and regional management, as emphasised by the catchphrase “Think global, act local”. Essential standards for the achievement of global objectives have to therefore be combined with local action. In some cases, it may be necessary to suspend compliance with international standards to respond to changing conditions on certain markets. It is interesting to note that some global brands like McDonald’s allow franchise holders to control local marketing, whereas others, such as Benetton, oblige franchise holders to contribute to global communication campaigns that are devised and managed by group headquarters.

Most international brands make use of a “glocal” approach that allows them to standardise certain elements in their mix, and to adapt others which for cultural or historical reasons have to remain country specific (figure 2).

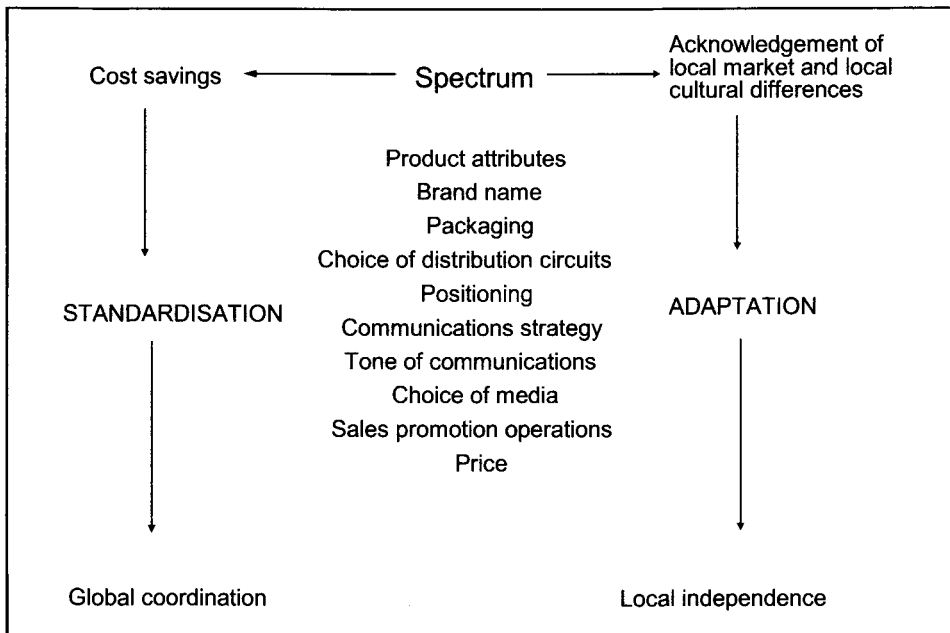


Figure 2: The standardisation/adaptation spectrum for international brands

## 5. The Far East and an Examination of the Tri-Functional Approach to Branding

### 5.1 Overview

In the West, brand management is based on a tri-functional ideology (Dumézil 1968), which attributes sovereignty, warrior and reproduction functions to every brand. However, issues encountered in international brand management have often expounded the problems of this view. This is notably the case with brand management for Asian cultures, and especially for Chinese culture, which is worth considering in depth because it enables us to distance ourselves from the implicit understanding of brands that prevails in the majority of western countries.

### 5.2 The Semantic Significance of Products and Brands

In view of the fact that the cultural context has a significant impact on the way in which consumers perceive brands and their functions, it is important to evaluate the validity of brands' Western metaphors and their relevance in other cultural contexts. A strong emphasis on the personalisation of brands based on an individualistic approach and extensive symbolic semantisation may not be relevant in Confucian societies like China, where the focus is on people rather than goods, and interpersonal relations rather than the relations between people and objects. Chinese consumers do not project emotion on to everyday consumer items to the extent that their western counterparts do, although the status of each particular item is all-important. The extent to which Chinese consumers are involved with products and brands is largely determined by the function of the products concerned (Yang 1989), with a much higher level of involvement for products that are used in public than for products used in private. Furthermore, as sinologist Jullien (1991) has pointed out, the over-semantisation of objects can also pose difficulties in a culture where blandness is perceived as a positive value. Blandness should not be considered a mere absence of taste, but should be acknowledged as a real value relating to the 'centre', and to the 'basis' (*zhong, ben*) of life. Blandness corresponds to an experience of the world based on inner detachment. Whereas taste attaches us to the world, blandness grants us detachment. The former traps us and provides a focus for obsession while the latter liberates us from external pressures, sensation, and artificial intensity. The value attributed to blandness, which is a fundamental aspect of Chinese thought, can be understood as an antidote to the ideology of over-differentiation and over-semantisation of objects that is prevalent in Western civilisation.

### 5.3 The Question of Sovereignty (and of Effect): Effectiveness or Efficiency?

In the West, the ideology of brands is mainly concerned with the notion of performance and the powers provided by brands (to consumers). The main focus is on effect, which is often spectacular, prompted by the deployment of a brand. It is on this basis that we can say that the Western conception of brands is essentially Promethean in as much as a brand can be understood as a magical object with magical powers (transformation of a natural object into a cultural object, transformation of a distant object into a nearby object, of a past object into a present object etc.) Brands are often equated with magical objects in fairy tales, offering the gift of special powers (rapidity, omniscience, safety, comfort, etc.) to consumers. This approach, which is particularly prevalent for products targeting a global market and cosmetic products (which are often presented using scenarios where the cultural artifice of the brand triumphs over biology), is often quite inappropriate for cultures that are not rooted in the Promethean tradition. Its model of effectiveness is implicitly based on an understanding of phenomena as the results of cause and effect. This is the domain of advance planning, the heroism of action, of means and ends, of the relationship between theory and practice. Moreover, the approach presented in this document bears the stamp of this ideology, notably when it explores the value created by a brand in terms of terminal values (or expected effects) and instrumental values (possible causes). The Western vision of the effectiveness of a brand, as with all other phenomena, is largely informed by the notion of abstract forms that are presented as goals to be achieved. However, as Jullien (1992) reminds us in *La propension des choses*, Chinese thought has little to do with the principle of causality that is so prevalent in western thinking. In China, effectiveness is understood as allowing an effect to occur. An effect should not be targeted (directly) but implied (as a consequence). It should not be sought after, but should be allowed to occur (Jullien 1992). For the Chinese, effectiveness cannot be a directly targeted goal on the basis of a plan worked out in advance or a cause and effect model, it occurs, rather, indirectly as a consequence (Jullien, 1998). Chinese thought is therefore characterised by an anti-Promethean vision in so much as once a process has been initiated, it will continue under its own volition, prompting a consequence that is simply waiting to occur. The playing out of a process is contained in the current state of things, and this is the natural way. It is possible to provide conditions that will facilitate a process, to assist natural occurrences and favour their emergence. Reasoning in terms of indirect rather than direct effects is accompanied by a focus on processivity. Reality is nothing more than process and only finally becomes real when the process becomes its own goal. Unlike direct effects (which derive from means and ends), indirect effects can not be sought but simply allowed to occur naturally (Jullien 1997, p. 146).

The necessity for effort, choice of method and its conscious application which constitute the means and ends relationship is therefore challenged (Jullien 1997, p. 157). Jullien

gives a clear difference by comparing the efficiency of the sun and the effectiveness of a remedy (1997, p. 158).

Clearly, there is a considerable distance between this epistemological position and the model of effectiveness presented by many Western brands. It might be advantageous to imagine a model of efficiency in which a brand would no longer be endowed with magical powers that model the real, but rather function more discretely as a kind of catalyst that favours the progress of inexorable processes in a manner similar to biological or natural phenomena.

#### 5.4 The Question of Reproducibility

Reproduction, which provides the basis for the establishment and continuity of strong brands in the West, can constitute a potential hazard in certain Asian cultures. “Reproduction” can mean at least two things. Firstly, the possibility of assuring the brand development in an arena defined by laws and patents that protects industry. However, the significant quantities of counterfeit products can compromise brand reproduction, and this is especially the case with everyday consumer goods (like shampoo and detergent), which are often targeted by organised units capable of manufacturing products at low cost that mimic major Western brands. This is rendered even more problematic by the fact that some counterfeiters have access to the traditional distribution networks, notably to small local shops. As a result, consumers are often unable to distinguish counterfeit products from real ones. An extensive discussion of the legal issues involved is beyond the scope of this document. However, it is worth noting that counterfeiting seriously hampers the development of many Western everyday product brands. It follows that Western businesses must (1) exert pressure in political circles to ensure that the laws against counterfeiting are really applied, and also (2) invest heavily in advertising that aims to enable the consumer to distinguish between genuine and counterfeit products.

As we saw in the first chapter, reproduction also allows brands to offer the consumer a reproducible experience, and ensure that every encounter with the brand will be duplicated by identical experiences in the future. Confidence in a reproducible experience plays a key role in protecting consumers from disappointment, but it is worth noting that it also does away with any magical dimension in the act of consuming. The magical quality of an object largely depends on preserving a certain degree of mystery and distance and avoiding being forgotten in the simple goal of usage. If a branded object loses its magical quality, this can radically affect the perception of consumers in cultures with a strong focus on history and traditional rituals, which is prevalent in both Chinese and Japanese cultures.

## 6. The Specifics of the Global Brand

The construction of a global and local system around a brand necessarily implies consideration of the brand's identity. It should be possible to distinguish the primary characteristics of the brand, which must remain constant in every country, and secondary characteristics that can be adapted to local markets. The essential role of a brand is to make sense of a product range by telling stories (on the origins of products, the manner in which they are manufactured, the manner in which they are used etc.) that include it in an ongoing narrative. It follows that the key issue with regard to global brands is whether this narrative should be fully consistent in different geographical zones. When treating a brand as a system, it is important to highlight the part of the system that has to remain unchanged and the part that can be adapted, either spatially or temporally, in response to diversity, and the variety of expectations and conditions that prevail on different markets.

Let us return to the tri-partite conception of the brand. The first level focuses on the core identity of the brand, the brand's genetic code and fundamental values (i.e. childhood, health and nature for Danone, user-friendliness and non-conformism for Apple). These fundamental values are closely linked to factors such as the expertise and special abilities of the brand, as well as ethical and business values. They are an expression of the brand's vision of the world, characteristics that distinguish its products from those of its competitors, the content of communication it addresses to consumers, and the articulation of its understanding of the socio-economic environment. Two brands on the same market segment can present completely opposed views of the world. For example a brand like Body Shop, which espouses a vision of cosmetics rooted in respect for nature and the environment – a vision that lays claim to a kind of continuity between nature and culture – can co-exist in the same sector as a brand like L'Oréal, which promotes a vision of the world largely based on the primacy of technology over nature as well as biological and bodily processes, or an opposition between culture and nature. It is reasonable to conclude that this primary level of identity must remain the same from country to country, and provide the basis for a global strategy. The next step is to move on to the definition of fundamental values that are truly transnational, and the semiotic square of positive vectors plays a vital role in this regard. What varies between cultures is not the nature of positive vectors (in our axiology) but rather the relative importance of positive vectors with regard to specific product categories.

It is worth noting that the majority of truly global brands attempt to develop a multicultural position that includes the four positive vectors. A case in point is Swatch, which is a global brand that has been noted for its ability to adapt to local market conditions.

The strength of a brand like Swatch is derived from its capacity to express four vectors of value in all the countries where it is present (figure 3).

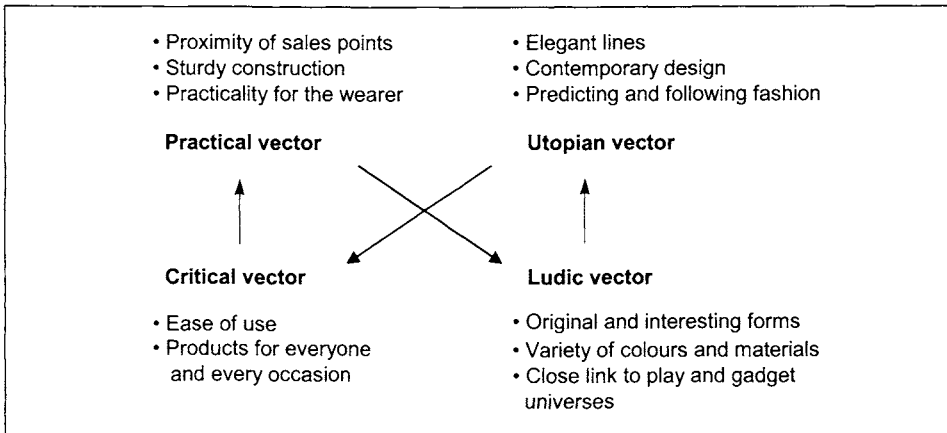


Figure 3: The different values expressed by Swatch products

The second step is the inclusion of these values in narrative to provide communication themes, and the communication tone. These expressions of the brand are usually standardised in each geographical zone, but they are subject to local adaptations. This is the procedure followed by Coca Cola, which standardises its communication themes but uses locally adapted TV advertisements. McDonald's makes use of a specific agency in each country to adapt communication themes to local cultural conditions.

Finally, the third step is the definition of figurative elements of the brand: products, product shapes, product colours, packaging and brand emblems. These elements are largely dependent on cultural factors and market conditions. Most of the time, they are precisely adapted to the needs of the local market where this does not hamper the implementation of a global strategy. The fact that sugar and gas levels in the composition of Coca-Cola vary from one zone to another has no impact on its status as a global brand because the brand vision remains constant. Conversely, a brand like Burger-King, which maintains a standard product range but varies its positioning strategy from one country to the next, cannot be considered a global brand.

Global brands remain few and far between, and only a few companies can meet the diverse and demanding criteria required to launch a global brand: organisational culture, corporate strategic initiative, size and organisation of structures, financial and ideological weight, existence and identification of transnational customer segments, capacity to circumvent varying market conditions and eradicate cultural differences. The global brand seems to result from a virtuous circle that combines very well-known products, an image characterised by extensive and specific features, earning distribution network's trust, and faithful consumers that are attentive to the brand and its future. Global brands are brands that have succeeded in identifying values and principles that aspire to universal validity; they are also ideological legislators with the capacity to create micro-cultures by offering, or even imposing on their customers, meaningful universes that are regulated by specific values, rules and references. The influence of global brands extends

well beyond economic, managerial and financial spheres into areas of mainstream society. Corporate entities that have the capacity to impose micro-cultures on consumers and take on the role of ideological systems should be monitored carefully.

## 7. Adapting to Cultures or Traversing Cultures

This study would not be complete without some consideration of the possible tensions between existing cultural schemes and brand cultures. It is common nowadays to talk about Nike culture, Barbie culture or even Disney culture.

The structuralist approach to culture (which was extensively influenced by Lévi-Strauss), defines a culture as a grouping of three types of rules:

- **taboos:** actions that are strictly forbidden in a given culture (prohibition of incest, murder, theft etc.),
- **rules of permission:** defining what people are allowed to do in a given culture,
- **prescriptive rules:** rules of behaviour that are implicitly accepted by a group (rules of decorum, politeness, courtesy, food and clothing codes etc.).

As we mentioned earlier, a brand has three dimensions: a physical dimension, a rhetorical dimension and a behavioural dimension. Put another way, this means that every brand is a prescriptive ideological system. We can therefore say that a brand such as McDonald's adapts to different local cultures by changing:

- **its menus:** the non-availability of Orangina or country potatoes outside France etc.
- **its communications and sponsorship campaigns.**

However, it should be noted that these cultural adaptations only affect the figurative elements of the brand (that is to say elements linked to the brand expression plan) without altering the ideological content of the brand. Moreover, the American sociologist Ritzer (1996, p. 125ff.) noted in his now famous thesis on the "McDonaldisation" of the world that the founding values of the brand were so salient that they have been gradually absorbed by Western society as whole.

- **Efficiency** (streamlining the process, simplification of product, putting customers to work etc.);
- **Calculability:** emphasis on quantity rather than quality, illusion of abundance etc.
- **Predictability:** replication of interiors, definition of framework for interaction with customers, standardisation of range and employee behaviour.
- **Control** exercised on consumers, products and processes.

- The *appearance of leisure*: linked to the illusion of efficiency, McDonald's development of theatrical restaurant space, links with amusement parks (the concept of 'restotainment'), the role of the McDonald's clown to incessantly remind children of the amusement they shall have at their next visit.

When read through the prism of consumer values, it is obvious that the power of the brand is its ability to articulate and pass on a comprehensive set of consumption values (figure 4).

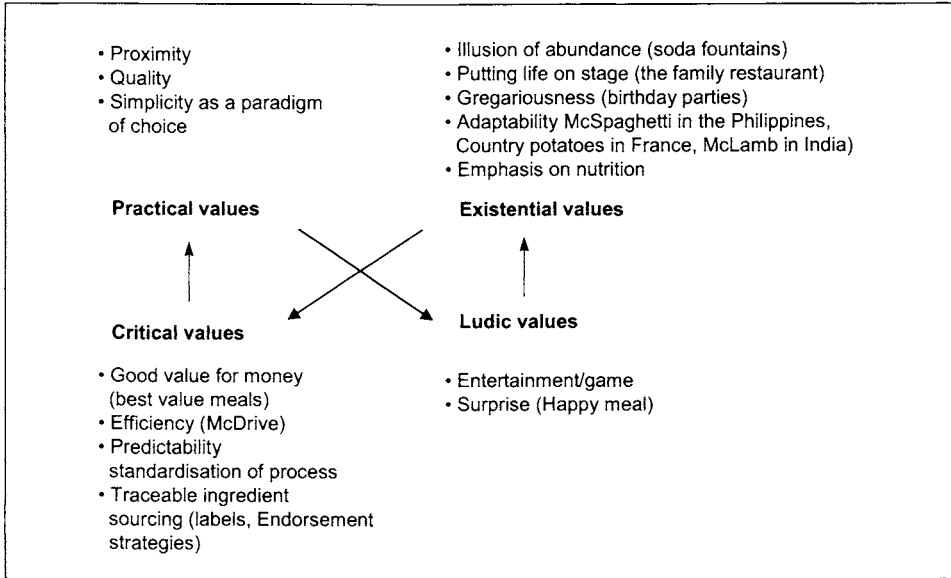


Figure 4: Orchestration of different values underpinning McDonald's

The fundamental aspect of the McDonald's system is the organisation of "ordinary transgression" via the imposition of an ideology that changes cultural rules. For children, the principal attraction of the brand is its transformation of prohibitions (eating with your hands, leaving the table in the middle of a meal to go and play) into a prescriptive rule (playground). It follows that McDonald's can be interpreted as a machine for negating cultural rules. Only figurative elements of the brand are changed in response to existing cultural rules, and the overall influence exerted is counter cultural. It is perhaps time we abandoned the evidently naïve notion that global brands are brands that succeed in adapting to local differences, and consider the following propositions:

- the fundamental values of a global brand are necessarily contradictory
- global brands function by offering customers a utopian micro-universe
- global brands often espouse their own style of consumer culture

- global brands are strongly prescriptive and notably transform pre-existing cultural systems.

These propositions will force brand managers to think of their branding approach out of sheer managerial principles.

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Bernhard Swoboda and Sandra Schwarz

# Dynamics of the Internationalisation of European Retailing: From a National to a European Perspective

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## 1. Introduction

Internationalisation is one of the key factors of European economic development. As WTO-statistics show, world foreign trade volumes grew from US-\$ 280 billion in 1970 to US-\$ 8,900 in 2004 and the direct investment volumes grew from US-\$ 520 billion in 1980 to 8,200 in 2003 (UNCTAD estimates a slight but steady increase for 2004; UNCTAD 2005; WTO 2005). As generally known, they are both dependent on each other: Direct investments involve trade activities and vice versa. This fact can be observed in the last decade in Japan. The former world champion in exporting is today ranked fourth among the leading exporting countries behind the USA, Germany and China.

The majority of development relies on producing firms. In trading, internationalisation is not new, if one considers the trading companies in ancient times or the British and Dutch trading companies at the beginning of the industrial revolution. The internationalisation of modern retail occurred by the 1960s. It had increased dynamically by the beginning of the 1990s. Many articles in newspapers and journals or practical surveys increasingly prove this, e.g. today internationalisation – measured on a five-point scale – is very important in purchases for 68% of German companies and in sales for 30%; for the future the scores amount to 84% and 62% (Liebmann/Zentes 2000).

In this paper we will follow these dynamics, with primary focus on food retail. Some food retail firms have explicitly changed their perspective during the last decade from a national to an international perspective. As the empirical data on retail internationalisation is quite weak, we aim for a review: We refer both to practical surveys and to mainly explorative research publications. As European companies dominate retail internationalisation, it could be asked according to the anthology's tenor "what can the new world learn from old European retailing?" Concretely, we will provide answers to the practical question "high relevance of internationalisation or just the beginning?" and the more research-oriented question "internationalisation of retail as a choice between single decisions or global advantages?"

## 2. Practical Status and Dynamics: High Relevance of Retail Internationalisation or just the Beginning?

### 2.1 Development Overview

Compared with other questions of retail management (for competitive strategies see Morschett/Swoboda/Schramm 2005), internationalisation is seldom discussed (for an overview see Findley/Sparks 2002, Palmer/Quinn 2005). Studies are mostly concerned with Anglo-American and South European retailers. A focus on the dynamic view of

food retail and also of German retailers is to a large extent lacking. In contrast, firms such as the Metro Group, Tengelmann, Aldi, Schwarz or Rewe Group rank – measured by percentages of foreign turnover to total turnover – among the top ten most internationalised food retailers.

No. in World Company	End 2004			End 1992			No. in World Company	End 2004			End 1992		
	TT in € bn	FT in %	No. countries	TT in € bn	FT in %	No. countries		TT in € bn	FT in %	No. countries	TT in € bn	FT in %	No. countries
4 Ahold (NL) <sup>a</sup>	52	82	14	11	42	5	8 Costco (USA) <sup>d</sup>	38	20	8	12	<2	3
27 Delhaize Group (B) <sup>b</sup>	18	78	9	2	7	2	17 Safeway (USA)	29	15	2	12	n.a.	2
2 Carrefour (F) <sup>c</sup>	72	51	32	34	25	11	20 Edeka (D)	25	8	5	13	2	2
22 Tengelmann (D) <sup>d</sup>	27	51	16	12	11	4	15 AEON (J)	31	8	9	n.a.	n.a.	n.a.
3 Metro Group (D) <sup>e</sup>	56	48	29	40	19	12	19 Leclerc (F)	26	5	6	17	<1	2
10 Auchan (F) <sup>f</sup>	36	46	12	12	15	3	15 Walgreens (USA) <sup>d</sup>	30	1	2	6	0	1
14 Schwarz Group (D)	34	42	19	6	4	3	24 Sainsbury (GB) <sup>g</sup>	30	1	2	6	0	1
13 Aldi (D)	34	40	12	16	22	8	25 Coles Myer (AUS) <sup>d</sup>	19	<1	2	6	<1	2
23 Casino (F)	23	39	15	9	<1	3	28 Woolworths (AUS) <sup>d</sup>	18	<1	2	6	<1	2
18 Ito Yokado (J)	27	32	12	n.a.	n.a.	n.a.	6 Kroger (USA) <sup>d</sup>	45	0	1	n.a.	0	1
7 Rewe Group (D)	41	28	13	19	0	1	9 Target (USA) <sup>d</sup>	38	0	1	14	0	1
11 ITM Intermarché (F)	35	28	9	17	<1	1	14 Albertsons (USA) <sup>d</sup>	32	0	1	8	0	1
1 Wal-Mart (USA) <sup>d</sup>	228	22	11	36	<1	3	21 CVS (USA)	24	0	1	5	0	1
5 Tesco (GB) <sup>d</sup>	50	21	13	11	5	2	26 Morrisons (UK) <sup>d</sup>	18	0	1	2	0	1

Legend: TT = Total net turnover (rounded); FT = Turnover in foreign countries; n.a. = not available

<sup>a</sup> Spain and Thailand were divested during 2004; Brazil, Argentina, and Belgium will be divested in 2005; three new countries since January 2005: Estonia, Latvia, and Lithuania.

<sup>b</sup> Slovakia was divested in June 2005.

<sup>c</sup> In 1992 the activities of Carrefour, Promodès, Comptoirs Modernes with above estimated data; Japan and Mexico were divested in March 2005.

<sup>d</sup> Data from fiscal year ended 04/2004 (Tengelmann), 01/2005 (Albertsons, Kroger, Morrisons, Target, Wal-Mart), 02/2005 (Tesco), 03/2005 (Sainsbury), 06/2005 (Woolworths), 07/2005 (Coles Myer), 08/2005 (Costco, Walgreens).

<sup>e</sup> In 1992 activities of Metro Group and Makro-SVH wholesale with estimated data; one new country since Jan. 2005: Serbia.

<sup>f</sup> Argentina was divested during the first half of 2005.

<sup>g</sup> USA was divested in April 2004.

Table 1: International most active food retailer – 28 largest retailers  
(Source: M+M Eurodata 1993; LPinternational 11/2005; own research)

Both demand a discussion on this topic, as the largest firms emerged as quite dynamic during the last decade (table 1). Even in the beginning of the nineties most of them were

active almost only in their home markets. Today some firm's turnover in foreign countries has reached over 50% and they are present in over 20 markets. Also, due to their large home market, US companies do not feature in the top ten international most active food retailers. Wal-Mart only entered Mexico in 1991 (Fernie/Arnold 2002), whereas Carrefour went abroad for the first time in 1973 and Metro in 1968.

Most firms are still primarily influenced by their country of origin. High foreign sales are due notably to acquisitions, especially in the case of companies like Ahold, Delhaize, Tengelmann or Rewe Group. In contrast, the internationalisation of companies such as Metro, Auchan, Aldi or Schwarz Group is mainly based on internal growth. Different forms exist, as in the case of e.g. Carrefour, Wal-Mart, Intermarché or Ito Yokado. Casino primarily focuses on franchise agreements.

Measured by the number of country markets with established activities, Carrefour and Metro follow – with activities in about 30 country markets – a more dislocated strategy. The configurations of Tesco and Wal-Mart are more concentrated with a dozen markets.

All in all it can be stated that the international dynamics in food retail (as opposed to fashion retail, for example) have existed for no more than a decade and that international corporations are primarily emerging first (for an explanation of terms see Zentes/Swoboda/Morschett 2004).

## 2.2 Driving Forces behind Internationalisation

The driving forces behind the international dynamics are manifold. A set of papers exists on this, partially split up into barriers and chances and linked with the motives of internationalisation (Treadgold 1989, 1991; Hallsworth 1992; Myers 1995 etc.). Guy (2001) considers many driving forces, but does not point out any main ones. We differentiate between a company's external and internal (exogenous and endogenous) factors as driving forces behind internationalisation: liberalisation/deregulation, homogenisation of markets, information/communication technologies, limited/restricted options of growth in home countries and the willingness of managers.

The exogenous driving forces centre on the *liberalisation of worldwide trade and regional integration*. From the sales side of the internationalisation of European retailers, the liberalisation of Eastern European countries is a central topic (see Myers 1995). The liberalisation for trade activities in Asia is also helpful. Both facilitate procurement or supply side activities. The homogenisation of markets is – with regard to the customers' needs – of significance, considering just the address of similar target groups in the case of IKEA, McDonald's, H&M etc. Also the needs of international retail companies seen as customers are of relevance. The latter enhances globalisation among other things on the suppliers' level, e.g. considering brand strategies or Euro-organisations of well-known brand manufacturers (see Fearne 1994 as an example). Regarding specific boundaries dividing the European consumer market (national, cultural, lifestyle, socio-economic, demographic, regional etc.), Myers (1995) considered national boundaries to be the

most important (but believed they would become less important in the future), followed by cultural boundaries (which will become more important).

New technologies provide a basis for cross-border communication, which enables a more efficient management of foreign activities internally in companies. This includes the realisation of ERP-/SCM-systems on the basis of EDI/WebEDI, new (electronic) purchasing-options etc. Finally, many Western European (home) markets are characterised by stagnation in demand, a crowding out etc. Due to tendencies of market saturation in the home market, a push effect is occurring for expansion into new markets. It runs parallel to a pull effect, i.e. sales opportunities in new foreign, and hitherto often closed, country markets.

From the resourced-based strategic management perspective, it is mainly endogenous driving forces that determine internationalisation. Thus it is the estimated growth in new markets, the entrepreneurial behaviour and managerial ambition in particular, which pushes a company's internationalisation. Achieving cross-border competitive advantages increasingly shapes the perspective of (food) retail internationalisation.

### 2.3 A Note on the Dynamics in Different World Regions

On the one hand, cross-border activities are one of the characteristics of internationalisation and on the other hand, country-specific but particularly cross-national thinking and actions. The latter constitutes the real challenge.

Activities inside a special country market are – in the case of them being from this specific market – a national view. Nevertheless, a look at some individual countries is insightful. This is supported by the following short overview of the evolution of the dynamics of food retail in selected regions. We draw on different sources and brief on three aspects: the situation of the economic/food retail industry, outgoing and incoming internationalisation at company level.

#### *Western Europe*

During the last decade Western European markets have been extensively characterised by increasing concentration; i.e. by a growth of chain stores, of retail area and crowding out. The market volumes in food retailing (and customs goods) are highest in Germany (approximately € 210 bn), followed by France (approx. € 190 bn), the UK (approx. € 170 bn), Italy (approx. € 150 bn), Spain (approx. € 75 bn), the Netherlands (approx. € 40 bn), Belgium, Turkey and Switzerland (all approx. € 30 bn). The level of concentration – with respect to other world regions – is enormous. On average in Western European countries the top five food retailers generate around 55% of the total sales volume and the trend is increasing. At the same time, there is a substantial gap between countries like Great Britain, the Netherlands and Sweden, with more than 70%, Belgium, Portugal, Germany and France, with more than 60%, and Turkey, Greece, Italy, and Spain, with somewhat less

than 50%. Market penetration activities are dominant in most countries, while market entries are becoming increasingly realisable only through mergers & acquisitions.

Internationalisation is pursued mainly by Western European companies. In more general terms, in the food retail branch, French companies perfected the hypermarkets, UK companies the supermarkets and German companies the hard discount and the Cash & Carry wholesale formats. At company level, Metro could be considered as the pan-European C&C market leader and Carrefour the market leader of Southern Europe.

Currently food retailers from other world regions do not have a strong presence in Europe and are also less successful, with the exception of fast food companies. This applies to Wal-Mart's activities in Germany, or to Gap and Starbucks in Europe. Regarding the near food retail industry, the first entries of Asian firms occurred recently, at least in terms of capital investments.

#### *Middle/Eastern Europe*

At the beginning of the 1990s, the food retail industry was almost entirely controlled by the government. The unveiling Mid/Eastern European markets act as driving forces in European retail internationalisation. This applies mainly to the recently acceded countries of the European Union. To a lesser extent it applies to the more eastern located countries such as the former Soviet Republics, which have only a gloomy retail business. The GDP and private incomes are quite low, therefore the estimated market volume of food retailing in Poland is at the level of the Netherlands' or twice the level of Portugal's market volume. In the Czech Republic and Hungary, volumes are below the Republic of Ireland's level or a third of Belgium's. In terms of market volume, Russia ranks at number five in Europe (approx. € 110 bn). The degrees of concentration are also low. In Hungary, the Czech Republic and Slovenia alone, it amounts to above 50%, in Poland and Slovakia it is less than 30%. A shakeout among the food retail companies is to be expected.

The internationalisation of Eastern European companies is negligible. In an increasing number of countries foreign firms dominate food retailing. Most of the former local state-owned companies are increasingly of little importance. Entrepreneurial companies do not have as great a tradition there as they do in Western Europe.

The EU accession countries in particular represent a type of playground for Western European food retailers. In Poland, more than twenty European food retailers are present. Apart from the Metro Group, for example, many of them are very far from achieving a return on investment. Some do not achieve the breakeven point. To a marginally lower extent they are present in Hungary and the Czech Republic. The situation is somewhat different in Romania, Bulgaria and the former Soviet Republics. High barriers exist in terms of the infrastructure, the trade conditions, the low private income rates etc. In Russia, the Metro Group is one of the few Western European food retail companies.

#### *Asia and Oceania*

Asia currently represents the motor of the World's economic cycle. Also due to the population figures, the Asian markets appear extremely attractive, which is of course

only a short-term view. The cultural and geographical distance, low-level incomes, regional and state controlled market conditions etc. are problematic. Food retailers only address a few customer segments. In these markets, joint venture activities exist.

The internationalisation of Asian companies – with the exception of Japanese companies – is geared towards other Asian countries. Lotus from Thailand, AEON, Daiei and Ito Yokado from Japan conduct activities in China, Hong Kong, Taiwan etc. with general merchandise stores or hypermarkets. Local suppliers and weekly markets dominate in these countries. In China, local companies benefit from western retail know-how. The central regulations increasingly assist national merchants and further their concentration through mergers. At the same time they are a hindrance to companies that – like Carrefour – set up regional joint ventures and circumvented the central regulations.

Among the incoming retailers, first Western European enterprises like Carrefour, Metro, Auchan, Casino, Tesco or Delhaize operated in Asia and imported modern retailing know-how. In China, Carrefour did pioneer work. In Vietnam and India, the Metro Group is the Western European pioneer. Some firms' plans for growth include ten or more new outlets per year. These plans are barely realisable when considering all Western European home markets together.

#### *North and Latin America*

The top-five's concentration ratio is above 70% in Canada. In US food retail it is lower than 40% and in Latin America often even less. In view of the US market especially, this partially explains the quite low extent of foreign activities of much of the world's largest US firms. They capitalise on the growth options in their home country. Latin American markets suffer from the physical distance, the insufficient capital etc. and do not appear very attractive to western food retailers.

Nevertheless, large American companies such as Wal-Mart, Safeway, Costco or even regional suppliers such as the Lone Star State company HEB operate in their neighbouring countries. Carrefour and Wal-Mart are among the market leaders in South America. Chilean companies, e.g. D+S and Cencosud, as well as Venezuelan companies operate in neighbouring countries.

In South and North America, Japanese companies such as Ito Yokado and Casino are present. In contrast, the activities of European companies e.g. Tengelmann, Delhaize, Aldi, Ahold etc. centre on the US market. Auchan and Makro SV are present in Latin America.

## 2.4 The Present Dynamics as just the Beginning

The question posed at the beginning of his chapter can only be answered globally. Some tendencies offer a lot of evidence to support the view that this is just the beginning of (food) retail internationalisation.

On the one hand, the future development of the driving forces should facilitate an increase in retailers' foreign activities. This occurs through political and legal developments, company internal determining factors and last but not least, the attitude of management.

The concentration rates of retailing are comparatively low especially in non-Western European foreign markets. Companies here face better conditions than in their – in many cases – concentrated home markets but in the future, a settlement process and an increase in crowding out may be expected abroad.

Finally, today's internationalisation level in (food) retailing is comparatively low. It is certainly incomparable to the level of manufacturing companies (table 2). But retailing may learn from the development of industrial companies from the 70s/80s to the 90s/00s.

Characteristics	Industry companies (phases)		Retail companies (phases)
	70s/80s	90s/00s	90s/00s
International situation	pioneers/early starters	international among others	early starters
International competition	low	high	middle
Relevance of international strategy	low	high	middle
Area of orientation	neighbouring countries, Europe	world	neighbouring countries, Europe
Transaction forms of internationalisation	exports, agents, sales subsidiaries	alliances, acquisitions, own companies	acquisitions, own companies
Primary international dimensions	country/sales activities	value chain dimensions/coordination	country/sales activities
Dynamic of international processes	low	high	high

Table 2: Changing characteristics of internationalisation in manufacturing and food retail companies

- Retail companies remain early starters in many markets (considering e.g. Middle/Eastern Europe or Asia) and do not compete with each other greatly, sometimes not in the same countries. For example, Wal-Mart is present in the north and south east of China and competes in only a few cities with Carrefour or the Metro Group. Metro is currently expanding its activities in Central and Western China.
- Indeed, many international retailers have developed competitive strategies concerning the individual markets but not necessarily a corporate strategy taking internationalisation as a whole into account; e.g. for the next five years.
- Questions of global configuration, coordination or integration do not yet prevail in retail companies. The differences between retail and manufacturing companies become quite obvious when one considers the area of orientation (i.e. the neighbouring countries in the retail sector), the primary transaction forms in use and, in particular, the focus of the primary internationalisation dimension. The latter today covers the development of new markets and sales activities, in the rarest cases the cross-border value chain dimensions or the coordination of the entire (cross-border) international activities. The dynamics are still high.

### 3. Research Status and Dynamics: Retail Internationalisation as a Single Decision or Global Advantage?

#### 3.1 Overview of the Perspectives

Dawson (1993) and Sparks (1995) claim retail specific theories of internationalisation. Existing theories, dedicated to the dynamics of internationalisation, can provide links. They can be found in economic theories of international trade, in product life cycle theories, in theories of direct investment, in the industrial economy or in their contributions to different concepts (e.g. Perlmutter 1993; Dunning 1994; Buckley/Casson 1998). In management research, behaviouristic theories have replaced the primarily classical economic rationality assumption, since the work of Aharoni (1966). Behaviouristic approaches partially combined with diffusion, growth, system or decision theories dominated the discussion for years (especially in the form of stage and incremental models Cavusgil/Bilkey/Tesar 1979; Johanson/Vahlne 1977, 1990). Since then, quite a large number of alternative views have been expressed.

From the multitude of possible approaches, four fundamental perspectives can be pointed out:

- The *experiential learning perspective*, represented among other things by the Uppsala-model and also by so-called innovation-related (stage) models.
- The *systematic planning perspective*, which is based (more or less) on the economic rationality assumption.
- The *value added perspective*, which gathers the growing importance of international configuration, coordination and the various transaction forms used (especially cooperations) in cross border value chain activities.
- The *contingency perspective*, which takes most notably contextual factors of international development as a holistic perspective into consideration.

(We are conscious of the fact that approaches like the economic eclectic or OLI paradigm (Dunning 1994), the transnational solution (Bartlett/Ghoshal 1991), the network approach and the evolutionary approach are remarkable. Davies/Fergusson (1995) point out as existing frameworks for retail internationalisation: push and pull factors, stage theories (e.g. Treadgold 1990), the eclectic paradigm, the value chain and networking.)

It is not possible in this paper to go into the details of the approaches; therefore table 3 gives an overview of them (see also Li/Li/Dalgic 2004, Swoboda/Foscht 2005). We subsequently place emphasis on two perspectives in particular, whereas others are taken into account as the case arises:

- A systematic planning perspective (or the single step view).
- An extended perspective, esp. the view of the international value added retail processes.

	Experiential learning perspective	Systematic planning perspective	Value-chain perspective	Contingency perspective
Theoretical base	<ul style="list-style-type: none"> <li>- Behavioural Theory: Bounded rationality and uncertainty</li> <li>- Diffusions-, Growing- and Decision Theories</li> <li>- Internationalisation is embodied in a process of organisation learning and adoption</li> </ul>	<ul style="list-style-type: none"> <li>- Classic economic theory of perfect rationality</li> <li>- Assume perfect information availability; and a firm can evaluate all the opportunities to pursue maximum utility</li> </ul>	<ul style="list-style-type: none"> <li>- Approaches of retailing functions</li> <li>- Industrial economic and competition theories</li> <li>- Integration of resource based view (in modern perspectives)</li> </ul>	<ul style="list-style-type: none"> <li>- Contingency theory</li> <li>- Combination of economic rationality and managerial behaviour</li> </ul>
Time of emergence	Mid 70s and early 80s	Late 80s and early 90s	Early 30s up to late 90s	Early and late 90s
Internationalisation process - explanatory level	<ul style="list-style-type: none"> <li>- The cycle of four self-reinforced components: Market knowledge, commitment decision, current activities and market commitment</li> </ul>	<ul style="list-style-type: none"> <li>- The internationalisation is a systematic „step-by-step“ planning process</li> <li>- Internationalisation as sequence of single steps</li> </ul>	<ul style="list-style-type: none"> <li>- Competitive strategies and industry specific competition (structures)</li> <li>- Value chain activities (outside-inside-view)</li> <li>- Ressources (inside-outside-view)</li> </ul>	<ul style="list-style-type: none"> <li>- Internationalisation depends on various external and internal factors</li> <li>- (Often) Discontinuing, revolutionary developments with no predictable order</li> </ul>
- resulting level	<ul style="list-style-type: none"> <li>- Sequential choice of countries and modes</li> </ul>	<ul style="list-style-type: none"> <li>- Motivies, market selection, choice of a market entry strategy, choice of operations and choice of implementation as sequential steps</li> </ul>	<ul style="list-style-type: none"> <li>- Competitive arrangements and variation of value chain activities</li> <li>- changes in corporate structure, resources and processes</li> </ul>	<ul style="list-style-type: none"> <li>- Strategic management decision</li> <li>- View of efficient/effective environment-structure-processes-culture configurations</li> </ul>
Representative studies	Johanson/Vahlne (1977; 1990) and a lot of studies on the sequences; Vida/Fairhurst (1998); Vida (2000); Palmer/Quinn (2005)	Miller (1993); Root (1994); Johansson/Yip (1994); Yip et al. (2000)	Seyffert (1972); Porter (1989); Zentes/Swoboda/Morschett (2004)	Macharzina/Engelhard (1991); Welch/Welch (1996); Swoboda (2002a; 2002b)
General liability (intended/ empirically tested - mostly for production firms)	<ul style="list-style-type: none"> <li>- Small, less internationalised firms</li> <li>- Initial stages of internationalisation</li> <li>- Non dynamic sectors</li> <li>- Small economies/countries</li> </ul>	<ul style="list-style-type: none"> <li>- Firms of any size but less viable for small and middle-sized firms</li> <li>- Less applicable to turbulent and volatile environment</li> </ul>	<ul style="list-style-type: none"> <li>- Firms of any size, but more viable for highly internationalised firms</li> <li>- Not empirically tested in retailing (framework for different views)</li> </ul>	<ul style="list-style-type: none"> <li>- Change of structure-process/strategy-culture</li> <li>- Studies of development from first export to multinational stages</li> </ul>
Managerial implications	<ul style="list-style-type: none"> <li>- Experiential learning and adoption are important in an international market of high uncertainty</li> <li>- Reduction of „muddling through“</li> </ul>	<ul style="list-style-type: none"> <li>- Systematic strategic planning may be viable for well-established firms</li> <li>- Limited applicability to firms of all sizes</li> </ul>	<ul style="list-style-type: none"> <li>- Explanations of internationalisation on the levels of configuration, coordination and transaction forms</li> <li>- Management of the whole system (e.g. corporate mission, organisational structure, human capital)</li> </ul>	<ul style="list-style-type: none"> <li>- Contextual factors (e.g. initial resources, networking conditions with stakeholders, marketing etc.)</li> <li>- Effects a firm's internationalisation</li> <li>- Firms ignore that at their own peril</li> </ul>

Table 3: Comparison of theoretical internationalisation perspectives – process-oriented approaches

The importance of both can be clarified on a practical level. First of all, a food retail firm without any foreign experience is easy to imagine, as this was applicable to most companies one decade ago. Thus, these firms going abroad for the first-time face a special challenge, e.g. the goals or the choices of the market, the entry and operating strategy or the market operations and the strategy implementation. These challenges are posed whenever a company enters a new market. Thus, in the case of Carrefour or Metro, thirty times. Nevertheless, a difference still exists when considering the particular step by step views of a company which does not have a lot of foreign experience or knowledge. Therefore, less internationalised companies seek competitive advantages (in terms of a focused strategy) in single steps; they use individual foreign countries (steps) as new sales markets. In contrast, more internationalised companies may also seek competitive advantages (in terms of a global advantage strategy) by using foreign countries in a cross-border value added process. For both parties, different theoretical views are useful.

■ To explain the first steps, experiential learning models are useful but they are not suitable for highly internationalised firms. For both types of firms the usefulness seems to be higher if applying systematic planning models. Outside the retail industry plenty of (planning) concepts are to be found. Miller (1993) suggests ten steps, Root (1994) defines six and also the way station model by Yip/Biscarri/Monti (2000) involves six, but six different decision steps. Many authors follow the assumptions of availability and efficient use of market information. Against the background of observable fast internationalisation, tendering market chances and the rushed development of the business environment, the importance of long-term planning is questionable. Furthermore, regarding behavioural models, it must be stated that decisions have to be made simultaneously and not in a sequential manner, and also that they are dependent on the management's attitude. And, in the retailing sector all decision steps depend strongly on the business model, i.e. the format each company provides in home countries. Nevertheless, a consideration of the following steps arising from systematic planning is valuable:

- motives/goals
- market selection
- internationalisation (entry and operating) strategy
- operations and
- implementation

■ The perspective of internationalisation seen as a value added process can – combined with a contingency perspective – explain the dynamics of the development of firms' internationalisation in the course of time (Swoboda 2002a). If so, not only sales activities come to the fore but also value-adding functions such as sales/service/marketing, logistics, operations/processes, procurement and/or management (infrastructure/human resources). They are to be allocated across the individual countries (configuration), to be integrated (coordination) and – concerning the make, buy or

cooperation decision – to be configured (transaction forms). All of the three decisions aim at achieving (global) competitive advantages (Zentes/Swoboda/Morschett 2004).

As indicated, we will address both perspectives and provide an overview of the main research results as well as pose some open questions.

## 3.2 Systematic Planning Perspective

### 3.2.1 Motives/Goals

The interest centred early on the retail companies' motives for going abroad (e.g. Hollander 1970; Kacker 1985; Treadgold 1988; Treadgold/Davies 1988), was often simultaneously accompanied by the observation of driving forces (for the influence of enabling-factors on push/pull motives, see McGoldrick 2002). This view leads us to differentiate between

- the home market-related *push factors* and the host market-related *pull factors* or
- *reactive motives* and *proactive motives*.

In a conceptual manner, it makes sense to distinguish between push (home country-specific) motives, pull (host country-specific) motives and firm-specific motives. Through this, a link to exogenous and endogenous factors of international management arises.

As regards content, many different motives are suggested in surveys. Whereas, according to Zentes (1998) for example, opportunities within the new market and saturation in the home country are seen as the two most important motives for German retailers, according to Alexander (1990, 1995), the most important motives for British retailers are proactive motives. The primary reason for expansion was essentially economic prosperity in a market with the existence of niche opportunities for the retailer's offer. As regards the Eastern European markets, much importance is attached to specific and pull motives from the British retail companies' point of view (table 4). Table 4 also shows selected results from William's (1992) factors solution to motives.

With growing foreign activities, reactive motives lose their relevance. Quinn (1999) shows that UK retailers are influenced more by growth-oriented or proactive motives and that the relevance of motives differs according to the length of time spent operating in international markets:

- New (operating less than six years) and developing (operating six to ten years internationally) retailers mentioned reactive factors (limited opportunities in the home market) as most important.
- Experienced retailers (operating longer internationally) rate the accumulation of in-company expertise as an influential motive. However, for a number of motives no differences can be considered.

The result complies with observations in other industries, whereby foreign experience exerts significant influence on internationalisation processes and therefore on the motives. Retail industry-specific differences also exist. Regarding push and firm-specific motives, food retailers rate the economies of scale and the restrictive regulatory environment significantly higher than fashion retailers. Fashion retailers rate the firm’s ethos higher. Regarding pull motives, many significant differences exist. For food retailers, some environmental factors in the foreign market are more important, most notably market size, economic and population growth, geographic proximity and infrastructural issues (Tatoglu/Demirbag/Kaplan 2003).

All in all, this high focus on motives in international retail does not yet indicate a far-reaching insight when compared to international management literature.

High (5) or low (1) relevance of motives for retail internationalisation in Central/Eastern Europe			
Push (home country-specific) motives	Pull (host country-specific) motives	Firm-specific motives	
1. Maturity of the home market (2.7)	1. Future prospects of host country (3.7)	1. Increase sales (4.1)	
2. Small domestic market (2.2)	2. Large market size (3.5)	2. Become international (3.5)	
3. Format saturation (2.1)	3. High economic growth (3.3)	3. Exploit unique product/ services (3.2)	
4. High operating costs (2.1)	4. Strategic importance of the market (3.0)	4. Company Ethos (2.5)	
5. Hostile competitive environment (2.0)	5. Existence of (niche) market (2.5)	5. Explore foreign knowledge (2.4)	
6. Low population growth (1.8)	6. Geographic proximity (2.4)	6. Economies of scale (2.2)	
7. Low economic growth (1.6)	7. Easy access to countries (2.3)	7. Utilise excess capacity (1.4)	
8. Restrictive regulatory environment (1.6)	8. High population growth (2.1)	8. Third party invitation (1.3)	
Factors of motives of retail internationalisation			
Proactive and growth-oriented	Limited domestic growth opportunities	Internationally appealing/innovative retail offer	Passive motives
<ul style="list-style-type: none"> <li>■ Long-run sales growth.</li> <li>■ Long-run profits.</li> <li>■ Attractive current and future growth prospect of the new market.</li> <li>■ Economies of scale.</li> <li>■ Corporate objectives.</li> <li>■ Knowledge of opportunities.</li> <li>■ Senior management drive and support.</li> </ul>	<ul style="list-style-type: none"> <li>■ Increased competition in home market.</li> <li>■ Saturated home retail sector.</li> <li>■ Mature home retail sector.</li> <li>■ Home country diversification possibilities exhausted.</li> <li>■ Excessive restrictions in home market.</li> <li>■ Exploit technical advantages.</li> <li>■ Foreign government incentives.</li> </ul>	<ul style="list-style-type: none"> <li>■ Retail formula has international appeal.</li> <li>■ Capitalise an innovative retail formula.</li> <li>■ Retail sector conducive to internationalisation.</li> <li>■ Exploit own retail know-how and techniques.</li> <li>■ Possesses unique competitive advantage.</li> </ul>	<ul style="list-style-type: none"> <li>■ Depressed share price favoured retail acquisitions.</li> <li>■ Offers from foreign retailers.</li> <li>■ Competitors expanding abroad.</li> <li>■ Favourable experiences from previous expansion.</li> <li>■ Increased public standing and prestige.</li> <li>■ Surplus organisational resources.</li> </ul>

Table 4: Motives for retail internationalisation (Source: adapted from Williams 1992, p. 270ff.; Tatoglu/Demirbag/Kaplan 2003)

### 3.2.2 Market Selection

As for the evaluation of attractive markets for retail companies, descriptive reviews are common. So it is not surprising that from a Western European company's point of view, European markets are considered the most attractive (Myers/Alexander 1996). Vida (2000), too, supports the early theories of internationalisation, which consider country selection as a function of geographic proximity and psychic/cultural distance. She shows that geographically and culturally close markets (in her case Canada) are considered the most attractive. European markets that can be described as culturally similar but geographically distant followed. Practicable but unrepresentative are surveys by A.T. Kearney (2004), which point out the high attractiveness of Eastern European markets for European companies, followed by Asia and Western European markets. They use the idea of the attractiveness-barriers-portfolio (figure 1).

Research results of market selection or segmentation from other industries are not yet fully applied to the retail sector. We must distinguish between two views:

- The *integral market* (cross-country) *segmentation* is based on the selection of customers, whereby ideally they are classified with the goal of identifying them across countries.
- The *international market segmentation* is based on the selection of country markets and, secondly, eventually on (intranational) customer segmentation in each country.

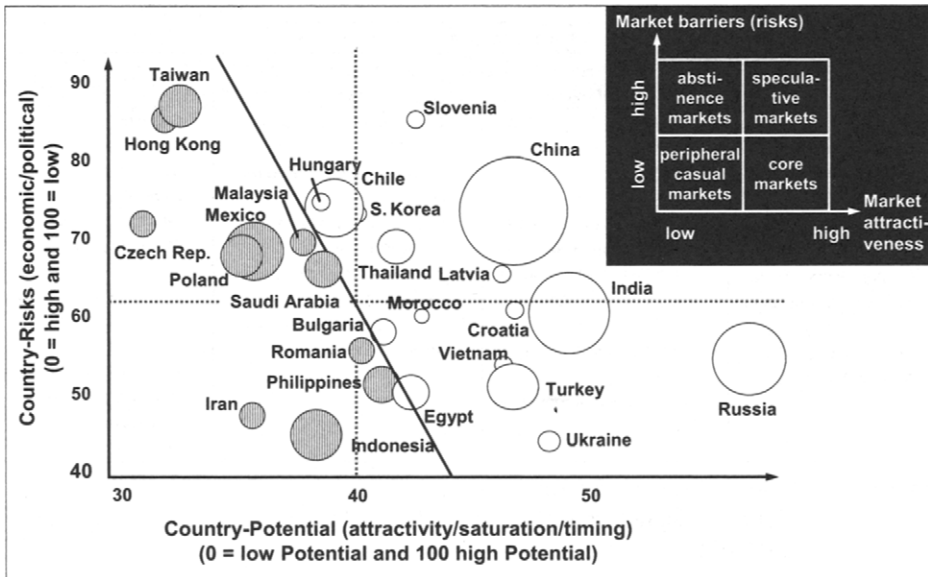


Figure 1: Measurement of country attractiveness as an example  
(Source: LPInternational 15-16/2004)

If we focus on country segmentation, even here the definitions are inconsistent. While Papadopoulos/Denis (1988) restrict the market selection to all stages prior to an intensive evaluation, others deliberate whether the choice (model) should serve as a basis for the application of marketing instruments or not. If yes, markets are clustered according to their similarity with regard to the customers' buying behaviour. If not, companies attempt to select the markets which offer the highest attractiveness for their concepts. Koch (2001) describes this as expansive or restricted and Root (1994) as bottom-up-selection or top-down-selection.

In general we can distinguish between the normative and descriptive approaches of international market selection (see also Andersen/Buvik 2002).

*Normative approaches* consist of *one-stage models*, which screen country secondary data (Papadopoulos/Chen/Thomas 2002). They also consist of *multi-stage models*, which can refer to two fundamental perspectives. Models referring to a market view *outside-inside-perspective* (Root 1994; Brewer 2001; Johansson 2003) essentially distinguish the stages of preliminary screening of country markets (with macro economic criteria e.g. political, economical aspects), in-depth screening (with more precise, industry-specific market aspects) and the final selection (with firm-specific variables). Models referring more to an *inside-outside-perspective* are based on managerial goals, strategies, resources etc. (Koch 2001; Rahman 2003).

*Descriptive approaches* address the way companies act in order to define foreign target markets. Among other aspects, they show on an empirical basis that companies do not only act in a rational way only. This is explained by the limited information-processing capacity of decision makers, by an incremental, rational-bound internationalisation or by the fact that the internationalisation of companies also takes place on a coincidental basis. It is of relevance in retail as well. For example, Clarke/Rimmer (1997) show that the decision to invest in Australia was driven by one senior executive's idea that it would be practicable and advantageous.

Considering the concrete market choice, at least two conclusions must ideally be reached:

- (number of) steps of an evaluation model and
- choice of evaluation criteria for the preliminary screening up to the final selection, supplemented by (operational) methods for the evaluation (profiles, portfolios etc.).

Papadopoulos/Chen/Thomas (2002) developed a preliminary screening model. On a preliminary level there are also a lot of indices available e.g. Country Risk Services, BERI-Index (Zentes/Swoboda/Morschett 2004). In retail, Gable et al. (1995) evaluated seven exogenous and eight endogenous barriers. Hallsworth (1992) considers contingency factors (i.e. the development of the common European market) and context factors (i.e. home market-specific factors) and declares that the different directions of chosen countries by US, UK, and European retailers can be explained by these factors. European re-

tailers use their own (intra-EU) market first to exploit the US market (perceived as open), then the UK markets (perceived as less open). General criteria for the fine selection can be connected with sales potential/attractiveness, market proximity/distance and firm-specific factors. Table 5 summarises selected macro criteria, fine selection criteria and special criteria for transformation markets.

As indicated, retail research often considers firm-specific factors merely as determinants for the choice. Myers/Alexander (1996, 1997) stressed the country of origin as a determinant for country preferences in global regions. Research from the non-retail area identifies differences concerning the market choice, particularly concerning the chosen evaluation criteria dependency on the foreign experience and the particular company's competitive strategy. The latter means that e.g. price-aggressive companies select markets that offer the highest attractiveness for their more standardised concepts (Colla 2003). In contrast, quality-oriented companies adjust to the markets e.g. the buying behaviour.

General criteria	Selected sub-criteria
Macro criteria - Political/legal aspects  - Economic/infrastructural aspects	General: political, legal, socio-economic, infrastructural aspects <ul style="list-style-type: none"> <li>■ Political: situation/stability; capital/investment requirements/risks</li> <li>■ Legal: conditions of foreign trade policy; political country risks</li> <li>■ Market growth: GNP; GDP; income development; economic stability/policy; inflation</li> <li>■ Entry conditions: possibilities for market entry; investment incentives; concessions for foreign companies</li> </ul>
Special: Prospects of transformation (e.g. in Middle/Eastern Europe)	<ul style="list-style-type: none"> <li>■ Speed of market economy reforms; degree of decentralisation and deregulation; conformity of economic legislation with the standards of western countries; degree of equality of foreign to domestic business firms; possibilities of buying real estate etc.</li> </ul>
Micro (industry and firm oriented) criteria  - Sales potential/attractiveness  - Market proximity/distance  - Firms specific factors	General: Sales market potentials; overall attractiveness; market/competitive/structural environment; customer potentials; market proximity/distance; firm-specific factors <ul style="list-style-type: none"> <li>■ Market capacity/volume: population figures; private household incomes/expenditures/equipment; sales volume per industry; customer behaviour; relation to home/other market</li> <li>■ Market structure/processes: forms and intensity of (foreign/domestic) competition; supplier etc.; availability/efficiency of marketing channels; logistic infrastructure</li> <li>■ Distance: affinity to culture/mentality/language; physical market proximity; market knowledge</li> <li>■ Other barriers; utilisation, credit history, financial strength of customers etc.</li> <li>■ Corporate: business mission/philosophy; (portfolio) strategy; managerial principles/rules etc.</li> <li>■ Competitive: strategic advantages; resources; adoptive management; foreign experience etc.</li> <li>■ Behaviouristic: perception of markets (countries, customers etc.); (contract, buyer, payment, credit, distribution, price) risks; managerial attitudes to internationalisation etc.</li> </ul>

Table 5: Selected evaluation criteria for market selection

All in all, this is an interesting research field in retail industry internationalisation. For example, in order to make a decision, a periodical and a long-run evaluation should be

carried out. Here companies, demand, and competitor interdependencies between the country markets are of relevance.

### 3.2.3 Internationalisation Strategy

Foreign market entry and operating modes or, more precisely, transaction forms essentially determine the type of operations in foreign countries (Zentes/Swoboda/Morschett 2004). As regards mergers & acquisitions or joint ventures, standardisations of programmes and processes tend to be more difficult because potentials must be harmonised first; this can take up a lot of time. Franchising and (wholly owned) subsidiaries offer higher standardisation potentials as the multiplication of these concepts is confronted with less antagonism.

Regarding international retail, the options illustrated in table 6 are of primary relevance. However, related empirical results are inconsistent. According to Zentes (1998) companies prefer internal expansion, franchising and acquisitions; according to Vida (2000) acquisitions, followed by joint ventures are preferred – whereas franchise-type agreements dominate. Early work by Alexander (1990) seems interesting; he shows that organic growth by the opening of new units was the most common method (73%), followed by acquisition of local retailers (46%), joint ventures with local retailers (23%) and franchising (15%). He also shows that 54% of companies use only one entry method, 12% use three and no company uses all four. Thus 46% of companies choose between strategies (see Alexander/Lockwood 1996). The study of Gielens/Dekimpe (2001) on the entries into European markets of the top 75 European grocery retailers made from the late 1980s until the end of 1998 also confirms the dominance of entry by organic growth (67% of all entries) and suggest that an entry by organic growth performs, in terms of long-run sales performance, significantly better than acquisitions and joint ventures. Already Barth et al. (1996) claim that this so-called “second wave” of internationalisation in food retailing comprises organic growth and joint ventures, whereas the first wave, which took place in the 1970s and early 1980s, consisted primarily of non-controlled interests, e.g. equity investments, or acquisitions. Research by Burt (1995) based on secondary data over three decades supports a change in the use of entry strategy over time.

Also in retailing, the question – frequently asked in the context of international management – concerning the issues of strategy choice needs to be asked. It would be too simple just to assume that acquisitions or joint ventures are to be considered if financial resources and an adequate take-over candidate/partner are available (Evans 2001). In that case, we would neglect an entire set of factors of influence, e.g. the environmental situation, consequences for operations and management.

In terms of the form of expansion, a choice needs to be made comparable and connected to market selection (see table 7 as an example for two different views). Thus, as it is

common practice in international management, a portfolio with the dimensions market barriers and attractiveness (high/low; see figure 1) could be considered. For example, in the case of high attractiveness and low barriers, internal expansions would be more perceivable; in the case of high barriers, joint ventures or acquisitions would be more perceivable. Markets of low attractiveness could be entered through internal expansions or franchise/license types of agreements. Linking market selection and market entry is also relevant as there are – as is generally known – some countries that only allow e.g. joint ventures as an entry mode.

The study of Petersen/Welch (2000) based on secondary industry data of the Danish clothing and footwear industry and two case studies shows that it is a common pattern in this industry to first establish foreign subsidiaries for wholesaling, followed by company-owned retail outlets. Based on this foreign market and retail sector knowledge, companies started using franchising to contribute to growth and a deeper penetration, while emphasising qualities of low investment and low risk. Another field for the use of franchising is divestment: a survey in Italy found that 78% of the companies involved in a divestment process had franchised the divested stores (Petersen/Welch 2000; for divestment see also chapter 3.3.1). However, it would be necessary to consider the companies' resources, which could be opposed to an acquisition. In this context, Ahmed et al. (2002) examine the influence of the perceived international risks on the entry mode (Lessassy/Jolibert 2002). They show that the perceptions of greater international risk are associated with lower levels of resource commitment and vice versa.

Strategy	Advantages	Disadvantages
Franchise type agreements	<ul style="list-style-type: none"> <li>■ Rapid expansion of presence possible.</li> <li>■ Low costs to franchiser.</li> <li>■ Local management may be used and the franchiser gives managerial advice to the franchisee.</li> <li>■ Wide range of forms of agreement available.</li> <li>■ Marginal markets can be addressed and the locally competitive marketing policy can be used.</li> </ul>	<ul style="list-style-type: none"> <li>■ A franchise-suitable concept is needed.</li> <li>■ Possibly complex legal requirements and it is necessary to recruit suitable franchisees.</li> <li>■ Difficult to control foreign franchisees, therefore a strong controlling system is needed.</li> <li>■ May become locked into an unsatisfactory relationship.</li> <li>■ Risks of local operations for the franchisee.</li> </ul>
Joint ventures	<ul style="list-style-type: none"> <li>■ Access to resources, know-how, image; possibly rapid corporate growth.</li> <li>■ Share entry costs and risks with the partner.</li> <li>■ Help available to climb learning curve and to overcome non-tariff (trade) barriers.</li> <li>■ Possible to move later either to exit or make full entry into the market.</li> <li>■ Establishment of barriers to market entry.</li> </ul>	<ul style="list-style-type: none"> <li>■ Relative high costs of market entry and difficulties in finding a suitable partner.</li> <li>■ Necessary to share benefits.</li> <li>■ (Possible) Partial loss of control over foreign operations.</li> <li>■ Difficult to coordinate, e.g. lack adequate procedures for protecting information.</li> </ul>
Internal expansion	<ul style="list-style-type: none"> <li>■ Can be undertaken by any size of firm.</li> <li>■ Experimental openings are possible with modest risk and often modest cost.</li> <li>■ Ability to adapt operation with each subsequent opening; no problems with external decision-making.</li> <li>■ Allows rapid prototyping; exit is easier.</li> <li>■ No undermining of competitive position through transfer of know-how (creation of competitors).</li> </ul>	<ul style="list-style-type: none"> <li>■ Takes long time and high costs to establish a substantial presence.</li> <li>■ May be seen by top management as a minor diversion.</li> <li>■ Requirement to undertake full location assessment.</li> <li>■ More difficult if host market is distant from home market.</li> <li>■ Requires company to become familiar with host country property market.</li> <li>■ Lack of suitable sites in host country.</li> </ul>
Merger or acquisition	<ul style="list-style-type: none"> <li>■ Speed and synergies, e.g. substantial market presence quickly achieved.</li> <li>■ (Possible) Buying of market position/image.</li> <li>■ Management in place and cash flow is immediate.</li> <li>■ Possibility of know-how transfer to home firm.</li> <li>■ May be used as a way to obtain locations quickly for conversion to the chosen format.</li> <li>■ For other modes closed markets can be addressed.</li> </ul>	<ul style="list-style-type: none"> <li>■ High initial capital is necessary.</li> <li>■ High information and search costs, e.g. evaluation of takeover target.</li> <li>■ Suitable firms may not be available and top management commitment is necessary.</li> <li>■ Difficult to exit if mistake is made.</li> <li>■ Management of acquired firm may be unsuited to new operations; coordination in case of different cultures.</li> </ul>
Non-controlled interests	<ul style="list-style-type: none"> <li>■ Finding out about market with minimal risk.</li> <li>■ Allows those who know the market to manage the operation.</li> </ul>	<ul style="list-style-type: none"> <li>■ Passive position.</li> <li>■ Investment made over which little influence.</li> </ul>

Table 6: Transaction strategies in international retailing – advantages and disadvantages  
(Source: Dawson 1994; Burt 1995; Zentes/Swoboda/Morschett 2004)

Elements of an (firm-specific) inside-outside-view	
Issues specific to the firm	<ul style="list-style-type: none"> <li>■ Business mission/philosophy; (portfolio) strategy</li> <li>■ Corporate/managerial principles/rules; available resources</li> </ul>
Assessment of market/position	<ul style="list-style-type: none"> <li>■ Relevant market characteristics (macro environment; legal policy)</li> </ul>
Characteristics of the (industry) market	<ul style="list-style-type: none"> <li>■ Relevant market characteristics (operating environment; intensive evaluation of available information (e.g. target customer segments, benefits))</li> </ul>
Issues specific to the firm and the (product) market	<ul style="list-style-type: none"> <li>■ Competitive strategy; estimated competitive advantages; availability of resources; marketing operations</li> </ul>
Elements of an (environmental) outside-inside-view	
Macro environment	<ul style="list-style-type: none"> <li>■ Economic situation; level of technological development; cultural/political environment; legal policy; trade situation; infrastructure etc.</li> </ul>
Operating environment	<ul style="list-style-type: none"> <li>■ Market volume; control of resources; availability of information; customers (e.g. level of customer service, product usage); competitors (local or foreign); other interest groups</li> </ul>
Internal environment	<ul style="list-style-type: none"> <li>■ Mission/philosophy; corporate/competitive strategy; managerial principles/rules; resources</li> </ul>

Table 7: Selected evaluation criteria for the choice of expansion strategy

Also, in this case the decision perspective in the long run is typically of relevance. Thus, some food retailers enter markets with high barriers with their own outlets early. They expect pioneer advantages e.g. from occupying the most advantageous locations or from an early establishment of relationships with customers, suppliers or stakeholders. As regards the evaluation of possible expansion strategies, questions considering the timing, the change management, the market powers etc. should be taken into account.

### 3.2.4 Operations

Marketing operation-related decisions include a traditional marketing perspective of standardisation vs. differentiation of strategic (concept) and operative (content) marketing activities.

#### *Strategic Marketing (Conceptual) Perspective*

On the conceptual level, in one of few academic papers, Salmon/Tordjman (1989; McGoldrick 2002, p. 572; see also Alexander/Myers 2000) examine this based on case studies in addition to the (financial) investment strategy (without involvement in the day to day operations), a global and a multinational strategy. In addition to a simple multiplication of the home country concept, at least three conceptual options are relevant:

- Global/European concepts provide evidence of *standardisation* in marketing strategy (e.g. formats/channels, in terms of global or European brands), with a high level of marketing mix standardisation, e.g. a uniform location, assortment, service, price, communication, in-store design or management.

- A *differentiation* in marketing strategy results – considering a worldwide/pan-European operating retail firm – in different concepts with manifold national formats/channels, with an assortment, a store design, service, advertising and even a price aiming at the particular given conditions (e.g. purchasing power, lifestyles, competition).
- *Standardised strategies with regional adoption* are characterised by a reproduction of the concept (similarity) but by an adoption of the marketing mix: e.g. similar worldwide definition of store design and price or service position but adjustments of assortment, advertising to take regional issues into consideration while accepting reduced effects of scale.

Salmon/Tordjman (1989) predicted a strong growth in standardisation strategy, as this will benefit more from consumer homogenisation and harmonisation of standards. With regard to food retailers, a more differentiated view is necessary. A comparison of standardised and differentiated channels/assortments as key retail marketing instruments does not result, e.g. branch-wide, in a useful differentiation in food retail (figure 2).

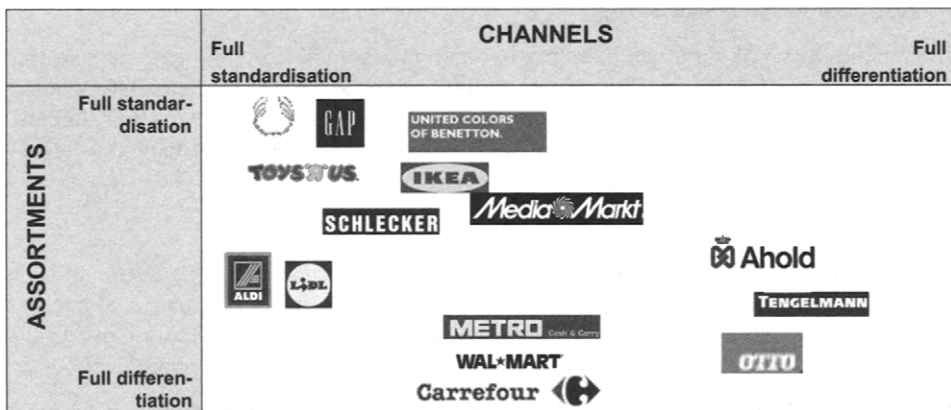


Figure 2: Examples of standardisation and differentiation of formats and assortments

Findings by Goldman (2001) accentuate the need for a differentiated view, too. By analysing the format transfer when entering China, food retailers are simply characterised by extensive or limited format changes. No format changes exist only in the case of companies like Gucci, Dunhill or Escada. Goldman perceives formats as whole strategic concepts (with marketing elements such as assortment, service, location and price, and cultural elements such as retail culture, norms, rules etc.). Channels are lacking. At the same time he is one of the few authors who are currently comparing several format change patterns: no format change, very limited (very few), limited (few) and extensive (very many) format change. Indeed, the boundary between very limited and limited seems smooth. To get a precise idea on the strategic (concept) level, a retail industry-specific view could be suggested. This is where the primary competition takes place.

On the other hand, it is important to deal with the factors which drive the concept or format transfer. Goldman (2001) accentuates that, in accordance with the firm and with the graduation of changes, single or many factors are to be evaluated. We again include these in external/environmental conditions and internal/firms specific conditions.

- External conditions can be distinguished between host and home country conditions:
  - *host country conditions* which may constrain retailers' ability to realise the capabilities embedded in the concept (e.g. consumer, distribution conditions, government policy, retail system) or may create opportunities for retailers to leverage format advantages
  - *home country's level of development*, companies from developed countries in particular have fewer transfer difficulties (especially to China) than companies from highly developed home markets; also technologies and methods are inappropriate in developing countries
- *Advantages generated from global retail operations*, e.g. economies of scale and standardisation advantages, experience and learning advantages, global flexibility or specialisation advantages.

The arising theme of corporate branding in retailing – associated with more standardised approaches – is examined by Burt/Sparks (2002), but their case studies of UK retailers do not provide a clear answer to whether it aids or hinders internationalisation. According to international management literature, the general factors shown in table 8 influence the standardisation vs. differentiation decision.

#### *Operative Marketing (Content) Perspective*

In the case of international or even worldwide operating companies, the question of standardisation vs. differentiation has to be asked, not only on the conceptual level but also on the level of operative (content) marketing mix activities. This is partially – in particular in the case of the differentiation strategy – independent of the conceptual level.

Across country borders, the standardisation option certainly exists in specific instrumental areas, especially for companies with a differentiated strategy. In food retail it appears interesting, particularly with regard to an increasing internationalisation level, as it can be clarified exemplarily: one can remember the scale effects of standardised private labels in such a large market as the USA and compare these with Western Europe. Many languages, decentralised production etc. cause higher costs in Europe. Higher standardisation in two, three etc. countries opens up some potential. Today this becomes apparent when we compare the EBIT between US and European brand manufacturers.

Up to now, empirical insights addressing the international design of the retailing marketing mix instruments are largely lacking. Cross-country comparisons are available, e.g. of marketing programmes (for programmes on small UK and US clothing and shoe retailers, see Brady/Mills/Mendenhall 1989). The decision between more or less differentiation and standardisation should be made taking the instruments such as channel, location, service, assortment, product policy, price, communication and in store management into

account (Liebmann/Zentes 2001). Problems of a standardised marketing mix are examined by Burt/Carralero-Encinas (2000): Their customer survey of the store image of Marks & Spencer in the UK (domestic market) and Spain – Marks & Spencer uses a standardised approach to reach a standardised retail image, which can be seen as a competitive advantage – shows that the customers’ perception in the host country is less positive than in the home country; the pricing policy and the fashionability of merchandise, especially, are the least positively received aspects. So this could be based on the general lack of suitability for the host country but also due to less effort on the part of the company in the host market. A generalisation of these findings seems difficult due their case study character but it shows at least the importance of the marketing mix instruments’ design. Despite the obvious need for a differentiation, especially in communication and assortment, a study of four retailers shows that they try to standardise as much as possible: e.g. Tesco focuses on launching its private textile labels in host countries, Carrefour on its “price leader” line and Metro launched a coordinated European advertising campaign (Swoboda/Foscht/Schwarz 2005).

Advantages of standardisation	Advantages of differentiation
<p>External (environmental) factors:</p> <ul style="list-style-type: none"> <li>■ Standardisation of market positioning</li> <li>■ Image advantages (as a global company)</li> <li>■ Influence or leading the foreign retail system</li> </ul> <p>Internal/firm-specific factors:</p> <ul style="list-style-type: none"> <li>■ Economies of scale and standardisation effects</li> <li>■ Experience and learning effects</li> <li>■ Specialisation (competitive) advantages</li> <li>■ timing effects</li> <li>■ Cross-border coordination advantages</li> <li>■ Use of activity-specific comparative advantages</li> </ul>	<p>External (environmental) factors:</p> <ul style="list-style-type: none"> <li>■ Adaptation to general political/legal aspects (government policy, conditions of foreign trade policy, barriers)</li> <li>■ Adaptation to economic/infrastructural aspects (supply, logistic and distribution conditions, host retail systems)</li> <li>■ Adaptation to host country market conditions (demographical conditions, consumer behaviour, image as domestic company)</li> </ul> <p>Internal/firm-specific factors:</p> <ul style="list-style-type: none"> <li>■ Turnover possibilities because of higher adaptation</li> <li>■ Differentiation (competitive) advantages</li> <li>■ International knowledge and know-how improvement</li> </ul>

Table 8: Factors that influence the standardisation vs. differentiation decision

The factors which influence standardisation vs. differentiation (see table 8) can be used isolated in a cross-country comparison – isolated with regard to each instrument or for combinations of instruments. As regards the operative marketing mix, it differs from the conceptual view in that it attends to multiple and cross-country perspectives:

- on the one hand, the static perspective of entry situation (going international)
- on the other hand, the dynamic perspective in the long run (being international).

As the companies' practices show, standardisation or differentiation considerations relating to the marketing mix instruments are carried out especially during the "being international" stage. They often express a penetration of foreign markets or a reduction of single market commitment. They may even lead to a conceptual strategy change, e.g. to a pan-European standardised strategy.

As is the case for worldwide operating manufacturing firms, in the retail industry, too, interdependencies between different countries should come to the fore by increasing international levels. As suggested, company-, customer- and competitive-based interdependencies are to be taken into consideration. This represents an enormous and interesting need for research in the retail sector.

### 3.2.5 Implementation

The implementation of strategies shows at least two specifications: Concepts to realise the strategy in the market and to put the strategy in place in one's own firm. Focusing on the internal implementation, the following should be noticed:

- the structures (organisation), including the subsystems of organisational structure, the secondary organisation and degree of centralisation vs. decentralisation etc.,
- the systems (processes), with planning systems (e.g. intensity, formalisation, degree of centralisation), information systems (e.g. market research, report systems, controlling tools) etc.,
- the culture, with attitudes, corporate culture, international human resources etc.

In retailing only a few (cultural) country comparisons are available. Greenley/Shiple (1987) focused on country-specific problems in organisations. O'Grady/Lane (1997) found differences between Americans and Canadians in respect of their competitiveness, work ethic, aggressiveness, and attitudes towards risk-taking, individualism, action-orientation and sense of mastery. Baret/Gadrey/Gallouj (1999) contrasted differences in employment practices (in stores in France, Germany and the UK), which influence the organisation and management of labour. Swoboda/Foscht/Morschett (2005) analyse the complete market entry process – that is market selection, modes of entry and operations (see chapters 3.2.2-3.2.4) – within the scope of implementation of two mail order retailers.

The contingency-based dissertation of Anderer (1997) represents one of the few studies that deal with integration. Some results from the survey of 60 European food retailers on the implementation of international activities can be summarised here as follows:

- The chosen organisational structures are different in competitive strategy clusters (quality, cost, outpace), depend on foreign experience or influence the international performance.
  - In the case of low percentages of foreign turnover and low foreign channel diversification, international retailers operate with a differentiated structure or by an

- implicit international organisational form; whereas in the case of high percentages of foreign turnover and high diversification in operating forms, international retailers operate using a matrix, tensor or mixed structure.
- With an increase in the perceived host country uncertainty, the degree of centralisation at a ratio of headquarter to subsidiary is significantly decreasing. The degree of centralisation is significantly higher in the case of cost-leadership strategy.
  - The tendency is that the subsidiaries' degree of self-government decreases with an increase in information and communication technology use for interactions between the headquarters and the subsidiary.
- The evaluation of the implementation of processes shows in some terms tendential results, in particular, specific differences, dependencies and influences.
- Considering early stages of internationalisation, the intensity of reporting systems, as well as the formalising and intensity of planning systems, are lower than in later stages of internationalisation.
  - With an increase in the standardisation of marketing, the degree of planning centralisation is increasing, as is the intensity of communication between the headquarters and the subsidiary, expressed as the intensity in classical and computer aided communication.
- The only briefly evaluated company cultural aspects did not result in significant correlations.
- However, in the case of an increase in the intensity of company culture controlling characteristics there is no decrease in system controlling instruments.
  - The latter supports the opinion declared in general by Anderer of centripetal and centrifugal cultural effects for internationally active retailers.

With a view to company practice, we can ascribe a central implementation and success relevance to the human resources, most notably to the managers employed in each country. Assuming general key success factor examinations, human resources represent the most important key success factor, with priority over even market orientation, also in international retail.

### 3.3 Further Perspectives

#### 3.3.1 Market Failures and Divestments

Retail internationalisation is not only – as supposed by the experiential learning models – self-reinforced nor – as supposed by the systematic planning perspective – does it follow a growing process. In recent years this has become apparent through a series of spectacular failures or divestments, even of internationally successful companies (as they had been described in previous literature) such as Ahold or Marks & Spencer (see table 9).

As is known in international management research, failures or divestments are hardly examined at all any more, or less regularly than growth strategies, but, in recent years, they have begun to attract some attention in their own right (Alexander/Quinn 2002; Burt et al. 2002; Burt/Dawson/Sparks 2003; Wrigley/Currah 2003; see also Swoboda/Foscht/Hälsig 2005). Previously, retail divestment was not considered as a research issue in itself, but it has been remarked on in several studies. Within retail internationalisation most notably Burt (1993), Knee (1993) and Godley/Fletcher (2001) have dealt with failures or divestments and noted divestment activities. Burt (1991) examined 46 market withdrawals and reductions from European grocery companies in the period between 1950 and 1990. Knee (1993) identified 35 cases of market withdrawals in his study of international retail movement in the period between 1991 and 1993. In a more focused approach, Godley/Fletcher (2001) show the increasing levels of divestment activity in the late twentieth century as a result of increased inward investment.

Based on secondary data from the year 1996 Alexander/Quinn (2002) provided evidence of the failure of 42 international activities by UK-based retailers over the past years. They discuss divestment within the framework of broader management literature, examining various dimensions (such as decision, process, effect, and retailers' response to divestment) and argue that withdrawal from an international market may occur due to other strategic reasons than only inherent weaknesses in the international capabilities of the retailer. Only briefly, but nevertheless interesting for further research, they remark that retailers, who experienced failure with organic growth in the past, may adjust their up-coming internationalisation strategy by choosing less capital intensive forms, e.g. franchising.

More recent work by Burt/Dawson/Sparks (2003) and Burt et al. (2002) conceptualise market exit in terms of "failure" by utilising the industrial organisation and organisational studies perspectives. In a case study of Marks & Spencer, divestment is considered in the context of the organisation-wide failure of the company (Burt/Dawson/Sparks 2003). Benito (2005) only considers "divestments" and subsumes "adjustments", "failures" and "results of re-structuring". Furthermore, Burt et al. (2002) conceptualise the various "actions" that are a response to failure in international retailing and offer clues as to whether it is a matter of failures, divestments or only (planned) resource allocations.

- *Failure* is described as an unplanned under-performance that results in operational losses. From a strategic perspective a company is faced with four options: *inertia*, which means to do nothing and accept the losses; *increase* the investment, e.g. develop more stores; *operational restructuring* i.e. change non-store operations such as the buying processes or supply chain systems; and *divestment*.
- *Divestment* means the process of resource allocation that leads to a reduced presence in the market and can be achieved through the closure of trading units, organisational restructuring or an exit.
  - A *closure* takes place at the channel level of the company, involves the closing of one or more retail units. However, the company may continue to trade with a lower intensity in the market.

- *Organisational restructuring* involves changes in the control of resources and relates to activity at the firm level. The firm also continues its activities in the foreign market but through a different organisational form and with reduced resource commitment.
- An *exit* means the total withdrawal of an operational presence from a foreign market.

Burt et al. (2002) propose a four-fold framework of factors for failure in international retailing based on Benito (1997). Failure may occur because the foreign market does not evolve as expected, which means a *market failure*. If failure is due to operational performance compared with the actions of the competition, it means *competitive failure*. *Operational failure* occurs when a company realises that its operating practices or management approaches do not serve well in the foreign market. If retailers make decisions about their international activity due to problems in their home market, it describes a form of *business failure*. But to this reactive perspective, a proactive one should be added: the divestment can also occur as a strategic decision based on changed management evaluations of the external or internal environment.

Palmer (2004) examined the divestment theme within the overall context of corporate restructuring and synthesised four types:

- financial restructuring (e.g. changes in governance structures, companies' relationships with shareholders and the financial markets)
- portfolio restructuring (mergers, acquisitions, alliances and joint ventures)
- organisational restructuring (changes in the company structures, processes or personnel)
- multinational and spatial dimensions of restructuring (changes throughout the company's international operations)

Earlier work, to which Palmer's study refers, considered divestment (only) from the financial restructuring perspective (e.g. Clark/Wrigley 1997; Wrigley 2000; Wood 2001, 2002). The exit process was examined in the context of non-recoverable sunk costs and as part of broad macro regulatory changes (surrounding financial investment instruments and US investment regulations) and this research showed that divestment is sometimes an inevitable part of the internationalisation process for those retailers seeking to develop a major presence through acquisition in another market. Based on the case study of Tesco, Palmer (2004) also examines the role of learning within the context of international retail restructuring and refers to five dimensions (strategic competitive behaviour, relationship between market entry and exit, exit strategy, managerial commitment, marketing communications and reputation). But although retailers may learn from their mistakes, this may not be reflected in overt behaviour due to different situations in the future.

An attempt to build a picture of the scale and dimensions of international retail withdrawal instead of focusing on individual company experience is made by Alexander/Quinn/Cairns (2005). The 153 cases of retail divestments (attributed to a single year) examined during the period 1987-2003 show an increase in divestment activity throughout that period. The majority of them led to complete market exits (in 99 cases), while in 54 cases a presence was maintained. One example of occurring divestment patterns in this sample are that retailers from different markets of origin share similar patterns, except where major economic crises occurred. This suggests that environmental conditions may encourage divestment: if the host market becomes less attractive and, conversely, if the market of origin meets with poor economic conditions. Furthermore, it can be constituted that larger international chains may be somewhat immune to divestment decisions arising from short-term environmental changes (Alexander/Quinn/Cairns 2005; see also Alexander/Quinn 2002).

The numerous divestments in international food retail over the past decade indicate the problems of the dynamic processes. Table 9 shows selected foreign divestments in the form of exits, as it is difficult to collect failures based on secondary data – because divestments may be erased from company history with little reference given to these events in corporate literature (Palmer 2004). In relation to failures, the expected long-term developments of each company should be known. Even a period of up to ten years for a return on investments is not unusual, particularly for retail companies in Eastern Europe.

Table 9 indicates the main reasons for exits: problems in foreign or in home countries, strong competition, losses or weak perspectives (no critical mass, no partner for the future etc.). As in international management literature, they can be summarised in company external and internal reasons (Swoboda/Foscht/Hälsig 2005):

- changes in the internal environment (e.g. strategic changes in the product-market-strategy, resources allocation issues, changing management ideas or attitudes/commitment),
- changes in the external environment (e.g. changing norms/regulations, development of competition, new opportunities) or (poor) performance (in present or future activities).

Company	Country and year	Main influence factors/reasons from ... the internal environment
Ahold (NL)	Argentina, Belgium, Brazil 2005; Spain, Thailand 2004; Chile, Indonesia, Malaysia, Paraguay, Peru 2003; Morocco 2002; China, Singapore 1999	<ul style="list-style-type: none"> <li>■ financial irregularities of the company</li> <li>■ at first reorganisation of resources to Spain, then to core country</li> <li>■ losses; no ROI-Perspective in foreign markets; concentration</li> </ul>
Daimaru (J)	Singapore 2003; Australia 2001	<ul style="list-style-type: none"> <li>■ economic problems of the group and thus reorganisation</li> </ul>
Ihr Platz (D)	Switzerland 2005	<ul style="list-style-type: none"> <li>■ restructuring of the company due to financial problems (losses)</li> </ul>
Kingfisher (UK)	Belgium, Brazil, Canada, Germany 2003; Singapore 2001	<ul style="list-style-type: none"> <li>■ strategic transformation of the group (to a dedicated home improvement retailer)</li> </ul>
KMart (USA)	Czech Republic, Slovakia, Singapore 1996; Mexico 1997	<ul style="list-style-type: none"> <li>■ re-focusing strategy on core businesses</li> </ul>
Marks & Spencer (GB)	France, Spain, Belgium, NL, Germany, Portugal, Luxemburg 2001	<ul style="list-style-type: none"> <li>■ a lot of problems in home country</li> <li>■ concentration of resources in core country</li> </ul>
Sainsbury (GB)	USA 2004; Egypt 2001	<ul style="list-style-type: none"> <li>■ restructuring of the company</li> <li>■ concentration on home market</li> </ul>
		... the external environment
Auchan (F)	Argentina 2005; USA 2003; Mexico 2002; Thailand 2001	<ul style="list-style-type: none"> <li>■ no perspective</li> <li>■ no critical mass</li> </ul>
Carrefour (F)	Japan, Mexico 2005; Chile 2004; Hong Kong 2000; USA 1993	<ul style="list-style-type: none"> <li>■ high competition (market share too low)</li> <li>■ hypermarkets with weak performance</li> </ul>
D & S Group (CL)	Argentina 1999	<ul style="list-style-type: none"> <li>■ losses</li> </ul>
Delhaize Group (B)	Slovakia 2005; Thailand 2004; Singapore 2003	<ul style="list-style-type: none"> <li>■ losses/no perspective (too much financial/human resources required to gain profit)</li> </ul>
Dohle (G)	Poland 2002	<ul style="list-style-type: none"> <li>■ attractive selling opportunity</li> </ul>
Edeka (D)	France, Poland 2003	<ul style="list-style-type: none"> <li>■ strong competition</li> <li>■ no perspective</li> </ul>
GAP (USA)	Germany 2004	<ul style="list-style-type: none"> <li>■ weak perspective</li> <li>■ concentration on higher market growth</li> </ul>
Guangnan (CN)	Hong Kong 2001	<ul style="list-style-type: none"> <li>■ losses</li> </ul>
Home Depot (USA)	Argentina, Chile 2001	<ul style="list-style-type: none"> <li>■ limited markets and economic concerns</li> </ul>
Intermarché (FR)	Italy 2002	<ul style="list-style-type: none"> <li>■ no partner for the future</li> </ul>
Jerónimo Martins (P)	Brazil, UK 2002	<ul style="list-style-type: none"> <li>■ financial problems</li> </ul>
Reitan (NOR)	Poland 2003; Hungary 2002	<ul style="list-style-type: none"> <li>■ strong competition</li> <li>■ weak perspective</li> </ul>
Seiyu (J)	Thailand 2001	<ul style="list-style-type: none"> <li>■ losses</li> <li>■ joint venture partner quit</li> </ul>
Sephora (F)	Germany, Japan 2001	<ul style="list-style-type: none"> <li>■ weak market positions</li> </ul>
SHV Makro (NL)	Taiwan 2003	<ul style="list-style-type: none"> <li>■ economic problems</li> </ul>
Wal-Mart (USA)	Indonesia 1998; Hong Kong 1996	<ul style="list-style-type: none"> <li>■ losses</li> <li>■ problems with joint venture partner</li> </ul>
		... the internal and external environment
Boots (GB)	The Netherlands 2000	<ul style="list-style-type: none"> <li>■ losses</li> <li>■ reappraising business model to less capital intensive alternatives</li> </ul>
Dairy Farm (HK)	New Zealand 2002; Australia 2001; Japan, Spain 1998	<ul style="list-style-type: none"> <li>■ concentration on key competencies</li> <li>■ weak reorganisation</li> <li>■ strong competition and losses</li> </ul>
Douglas Group – Christ (D)	Switzerland 2001	<ul style="list-style-type: none"> <li>■ weak performance</li> <li>■ concentration on other business areas</li> </ul>

Further examples without reasons are C&A/D (GB, IRL 2000); Gresvig/NOR (DK 2001); Lafayette/F (Singapore 1996; USA 1994); La Redoute/F (D 2000); Laura Ashley/UK (A, CH, I 2004; B, D, LUX, NL 2003; USA 1999; J 1998); Macintosh Retail Group/NL (D 2004).

Table 9: Selected divestments in the form of exits  
(Source: own research)

Case studies, e.g. from Mellahi/Jackson/Sparks (2002), which consider the organisational failure in the light of the external and internal environment of Marks & Spencer, prove these reasons. So this represents an interesting research area, because there are only sporadic empirical examinations available – also remarked by Alexander/Quinn/Cairns (2005), who propose that the conceptual objective for the de-internationalisation process could be similar to the (attempts at) conceptualisation of the internationalisation process or by Jackson/Mellahi/Sparks (2004), who examine, on the basis of Marks & Spencer, the process of divestment, that is the impact and operationalisation of this decision, especially its managerial dimension. Further research is also needed concerning the relationship between investment and divestment, the different conditions under which divestment is more likely to occur or the financial and human capital dimension that are entwined in the divestment prohibiting the disposal of international operations (Palmer 2004).

### 3.3.2 Value-Added Research as a Future Perspective

Value added research opens up a perspective with a promising future, primarily relating to the international management of highly internationalised retail activities. In a general view, this perspective exceeds the sales activities. It is an essential assumption that all value chain activities (VCA) and processes can be the source of competitive advantages.

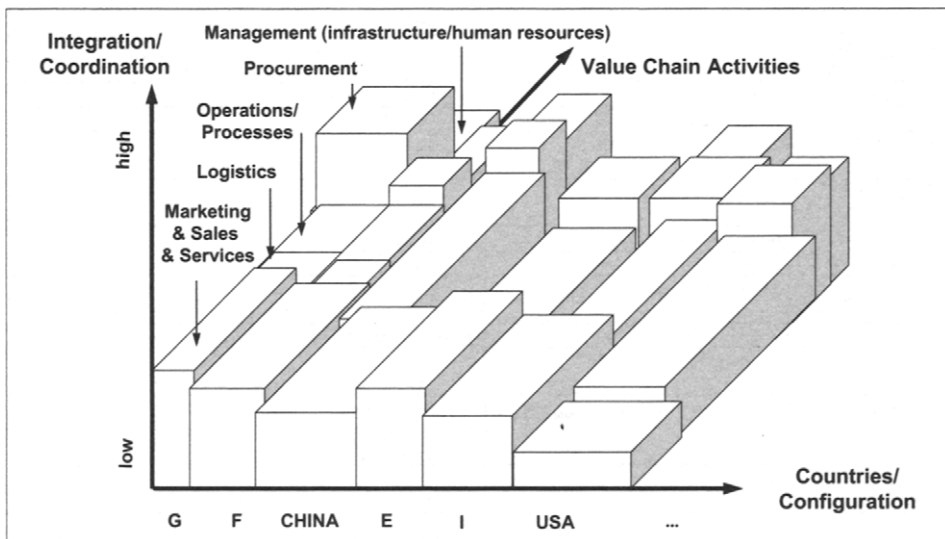


Figure 3: Internationalisation as a value added process – the international mountain (Source: adapted from Kutschker 1994; Swoboda 2002a)

As figure 3 suggests, the perspective of an international mountain comes to the fore. In the case of such a mountain retail specific VCAs are managed in a cross-country man-

ner, in particular their coordination and configuration. Also the figure shows that, for example, procurement activities are mostly located in Germany and China and highly centralised. The perspective can cover the entire value added system, each particular value added activity in an isolated view or the interfaces to the partners' VCA on the supply and demand side. The course of actions' examination may start – as indicated below – at a country level or alternatively at the particular value added activities.

The view of particular foreign activities (or single steps in chapter 3.2) does not come to the fore as much as the the big picture of international management does. A good example is the headquarter's decision to launch a new quality standard or, even more to the point, the closure of several outlets that are doing well in a country, from the local country manager's point of view. Nevertheless, seen from the top management's point of view, they do not fit into the "big picture" of the company's future.

Against this background, recent work adapts the industrial economy fixed basic idea of value chain research and combines it on the one hand with the process-oriented perspective and on the other hand with the resource-based perspective. With the basic decision options and several VCA examples, the perspective can be illustrated briefly.

#### *Basis for decision-making to configure the value chain activities*

In extension of Porters' (1989) well-known concept, Zentes/Swoboda/Morschett (2004) address the options of VCA-configuration, particularly

- configuration (geographic concentration vs. geographic dispersion),
- coordination (low/decentralisation vs. high/centralisation) and
- transaction forms (market, cooperation and hierarchy)

The authors examine particular cross-border VCAs and the combination of supply chain processes and market-oriented processes. As there are no corresponding empirical surveys available in retail, table 10 covers selective bases of decision to configurate the VCA and the processes at a glance. Analogue to the single step view (marketing-oriented view), e.g. the coordination (centralisation or decentralisation), the configuration (geographic concentration and dispersion) and the transaction form are to be analysed with the sales activities. Indeed, for the big picture, we have to regard the system as a whole. This includes the VCA and their process-related connections but above all, the entire system's management is of high relevance. Zentes/Swoboda/Morschett (2004) examine five aspects: the corporate philosophy, vision and mission as a central initial point, the organisational structure, the controlling system, human resources management and information management.

In the following, three examples concerning the VCA's configuration options demonstrate the value chain perspective. The internal cross-border relations between the activities and the big picture remain excluded below.

*Selected examples of particular value chain activities*

As for services, sales and marketing, a geographic dispersion is initially manifest in food retailing. A quite similar picture can be seen in terms of a decentralised coordination. This is also obvious with regard to the sales activities. Concerning marketing, a partial geographic concentration of a concept's development is absolutely conceivable. This does not only apply to the development of new channels. The development of global or regional harmonised standards for customer-oriented processes (e.g. for all Western European countries) can be observed too. The challenge is not so much from frontiers but from the consideration of different cultures (multiculturalism). Furthermore, Greenley/Shipley (1988) and Brady/Mills/Mendenhall (1989) have suggested the different meaning of marketing in different countries. In some international food retail firms, efforts to implement centrally developed standards for customer processes, administration and service within particular regions can be seen today. This applies to pan-European quality control systems or to the harmonisation of customer-oriented international processes.

Configuration Options of VCA	Geographic concentration	Geographical dispersion
<ul style="list-style-type: none"> <li>■ Number of sites and</li> <li>■ Location of sites</li> </ul>	<ul style="list-style-type: none"> <li>■ Economies of scale</li> <li>■ Experience curve effects</li> <li>■ Cost advantages of coordination</li> <li>■ Use of activity-based comparative advantages, e.g. (economic) factor costs, qualifications/competencies, established law, state-run incentives, cultural proximity</li> </ul>	<ul style="list-style-type: none"> <li>■ Improved adaptation to national/local conditions</li> <li>■ Decrease in transportation costs</li> <li>■ Decrease in risk</li> <li>■ Create a national/local company image</li> <li>■ Decrease in international knowledge</li> <li>■ State-run influences (e.g. duties)</li> </ul>
Coordination Options of VCA	Low, decentralisation	High, centralisation
<ul style="list-style-type: none"> <li>■ Structures</li> <li>■ Processes/technocratic (fields of responsibility, level of formalisation/detail in planning etc.)</li> <li>■ Culture/personal</li> </ul>	<ul style="list-style-type: none"> <li>■ Encouragement of motivation of foreign company's management</li> <li>■ Encouragement of entrepreneurial initiative and creativity of foreign company's management</li> </ul>	<ul style="list-style-type: none"> <li>■ Warranty of single decisions' conformity to the overall-strategy in foreign subsidiaries as well as a uniform appearance</li> <li>■ Minimisation of coordination difficulties between the headquarters and the foreign subsidiaries</li> </ul>
Transaction forms of VCA	Market, outsourcing	Hierarchy, insourcing
<ul style="list-style-type: none"> <li>■ Market</li> <li>■ Cooperation (contract free, contract and equity)</li> <li>■ Hierarchy</li> </ul>	<ul style="list-style-type: none"> <li>■ Cost advantages</li> <li>■ Concentration on core business</li> <li>■ Improvement of services/offers</li> <li>■ Financial advantages and risk spreading</li> <li>■ Risks of outsourcing</li> </ul>	<ul style="list-style-type: none"> <li>■ High degree of dependency on external companies (in case of e.g. outsourcing)</li> <li>■ Low degree of synergies with external companies</li> <li>■ Better enforceability of offer's individuality</li> </ul>

Table 10: Selective fields of decision with value chain activities  
(Source: adapted from Zentes/Swoboda/Morschett 2004)

With regard to procurement activities, we can today also see tendencies of centralisation today in some categories of food retailers, particularly non-food, and a concentration in business units such as central group buying or purchasing. Some of the biggest food

companies follow up such efforts initially with private labels and import products. The goal is to increase purchase conditions, where a part of the condition advantages are passed onto the channels or country organisations. Centralisation comes with a stronger geographic concentration of purchasing activities, as in the area of non-food products, e.g. in Asia. Also we can see the growing importance of cooperative arrangements with suppliers. In particular, European-wide value added partnerships between retailers and brand manufacturers are extended. Cooperations are of importance in the area of purchasing volumes being combined within international or national retail companies (e.g. in the form of European buying-groups). The use of traditional alliances and new media, e.g. proprietary extranets or virtual marketplaces, can be taken as further examples of these dynamics.

Even regarding logistics, operations and processes, a geographic dispersion and decentralisation appeared quite popular in food retailing. An opposed example of operations in the area of private labels was mentioned before. Even global or regional logistics appear to stand to reason for instance in the case of worldwide- or regionally-purchased products. Considering other branches such as fashion retail, equivalent centralised concepts are available that meet logistical aims of worldwide product availability and low costs across borders, for example. Similar to relations with brand manufacturers, we also think similarly in the area of logistics regarding service providers and full-service support. Furthermore, efforts relating to international applicable ERP-Systems or controlling systems can be observed. In the future, sources of excellence can be drawn from pan-European or worldwide configured and coordinated data warehouses, free data interchanges, supply chain (or CPFR) systems, category management tools etc. The possibility of a higher coordination of international processes would be a conceivable consequence.

### 3.4 The Present Dynamics as Relation of Single Decisions and Value Chain Advantages

In this section, two perspectives of the internationalisation of food retailing have been dealt with:

- The single step view, which corresponds to newspaper headlines such as “company X goes to Russia with a successful concept” or “the goal is 50 markets in Russia by 2010”
- The value chain, with newspaper headlines such as “company X thrives primarily in foreign countries” or “foreign activities are growing disproportionately and surpassing the firm’s development” or “company X launches European quality control, an ERP-System and combines purchasing volumes”.

An attempt at answering the initial question results in the following modified answer: The present dynamics are regarded as a combination of the marketing-oriented single step view and the value chain-oriented competitive advantages view. Particularly with regard to the dynamics of development, the establishment of a connection between the perspectives appears sensible. Every single step of market entry is of importance. At the same time it has to be brought into agreement with existing activities and embedded, at least in the medium-term, in the big picture. Figure 4 suggests this.

In an overall view, the local competitive advantages in each country or each location are to be linked with a single step view. In contrast, concerning the VCA, the competitive advantages in the world, in Europe or in a specific region come to the fore.

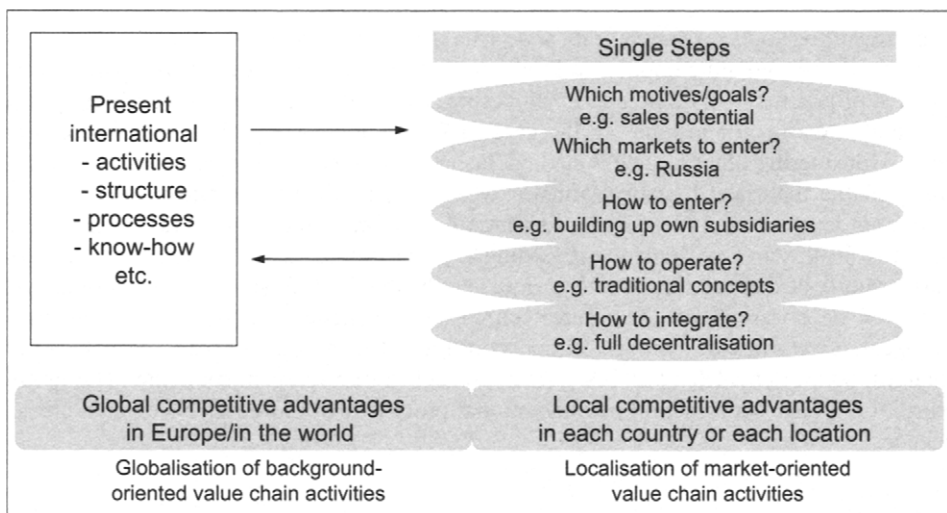


Figure 4: Relationships between single decisions and global advantages

As suggested, this connection will not form the beginning of internationalisation because in this case, single step factors of developing new markets are urgent. At the same time the need for a value chain view is increasing with a proceeding foreign presence due to opening options to realise cross-border VCA advantages. Finally, it seems wise for retailers to combine the global competitive advantages with the local ones. We are convinced that a localisation of market-oriented value chain activities and a globalisation of background-oriented value chain activities will be crowned with success. This is where the challenge is posed for the future internationalisation of food retailers.

## 4. Summary and Outlook

In this paper we have given an overview of the practical dynamics and the research perspectives of retail internationalisation, where the view of European companies followed the present anthology's tenor. The dynamics of development, particularly in food retail, have lasted for a decade. The answer to the practical question was analogous, in that the present dynamics are seen as just a beginning. The research question resulted in the view of retail internationalisation as a relationship between single decisions and global advantages.

During our review, a series of previously unanswered questions were raised. It became apparent that in retail internationalisation, conceptual considerations have been dominant up to now. In contrast, large number-based surveys are lacking, apart from the numerous motive investigations. Upcoming challenges are posed by the empirical level of knowledge extension in retail internationalisation. It is particularly essential if compared with the level of knowledge in international management of manufacturing companies. Two examples illustrate interesting and at the same time unanswered questions.

As regards content, the success factors of retail internationalisation appear particularly interesting. It is quite obvious that international retailers can (more than) compensate for the stagnation of home markets with foreign activities. Today this can be seen particularly in German food retailing. Even general assumptions as regards the success factors of internationalisation are suggested. This includes a stable or successful position in home countries, formats and channels with uniqueness and a high degree of innovation for the new markets or professional management as well as human resources. How the international success by different competitive or value chain strategies is posed today still seems unanswered.

To raise the question of how companies with a more incremental internationalisation compared to companies with a more dynamic internationalisation evolve would be similarly exciting. As initially shown, some companies entered only a few foreign markets and possibly tried to penetrate them more intensively. Others, conversely, entered up to 30 foreign countries. For whom may brighter future prospects be predicted? Maybe the first ones have better prospects because they penetrate markets deeper. Maybe the same companies would have problems with future internationalisation, particularly with future market entrances that are only possible with acquisitions. However, it is just as perceivable that the second companies mentioned may have better prospects for the future due to their early position and know-how in a lot of countries.

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# Changes for Companies: Inside-Outside-Perspective

- European (Virtual) Team-Building: From Optimism to Efficiency
- International Corporate Cultures: From Helpless Global Convergence to Constructive European Divergence
- International Supplier Relationship Management: From Transactional to Relational Purchasing

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# European (Virtual) Team-Building: From Optimism to Efficiency\*

1. The Challenge: Escaping from the All-Is-Simple-Trap
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# 1. The Challenge: Escaping from the All-Is-Simple-Trap

## 1.1 The Need for Cross-National Team-Building in Europe

Statistics on intra-EU trade show that the intra-European interpenetration of national economies continues (Cristallo 2003, p. 2). In a situation of an ongoing process of integration and interconnection of countries, markets, and technologies (Roberts/Kosseck/Ozeki 1998; Barkema/Baum/Mannix 2002), companies face increasing competition with respect to costs and prices, product quality, and time-to-market.

Companies in Europe recognise not only the threats of hypercompetition (D'Aveni 1994) caused by Europeanisation and globalisation. They also realise the opportunities resulting from international presence, such as global sourcing, global product development, global production networks, global marketing, and global distribution. A recent study (KfW Bankengruppe 2004, pp. 3-4) reports that German companies still have their most important export markets in Western Europe and increasingly in the new EU countries of Middle and Eastern Europe, their preferred target region for direct investments – with positive economic effects on the companies and on the whole country.

The subsidiaries, as a result of a Europe-wide and international presence, form international networks (Snow/Miles/Coleman 1992; Sydow 1992). They make it possible to benefit from the market-related advantages in the sense of optimising the overall company performance. The corresponding structure of cross-national collaboration on the team level are cross-national functional teams which receive responsibility for those tasks which are supposed to make synergies work, like, e.g., speed advantages (Simon 1989). Some companies even develop or produce services and goods in an expanded process structure, and therefore pass internationally distributed work forth within Europe and around the globe, following the alternating working hours in their different international locations. Companies are facing the need for cross-national team building, but are also facing the related obstacles: from geographical distances and time differences to national cultural diversity and different work cultures.

The logic of contemporary international teamwork is to transfer the idea of the “lead country concept” (Bartlett/Ghoshal 1989) to team level: Not only should single subsidiaries as a whole take the lead in the transnational network where they have a specific competence advantage, but also should single team units take the lead in the cross-national functional team where they have a specific competence advantage. One of the recently discussed approaches to solve the immense challenges of cross-national teamwork in this sense are International Virtual Teams (IVTs).

## 1.2 The Optimism that Failed

For a long time now, companies have been dealing with cross-national team structures. And for the same length of time, a relatively uncritical optimism has been observed. Except for the rather complicated cultural diversity topic (Moosmüller 1997; Black et al. 1999), international teams were celebrated as a manageable innovation. Managers did not see major problems in transferring local teamwork principles to the international scale. They were optimistic that this kind of company-wide collaboration could strengthen the international interconnectedness of their company and that it might benefit from synergies. Thus, almost over night, international integration teams were set up to handle international mega mergers like DaimlerChrysler in 1998 (Automotive Intelligence w.y.) – and the top managers could examine the poor results of this mechanistic approach seven years later when CEO Schrempp had to resign his post because of the failed international integration of his company (Preuß 2005). International cooperation in teams within companies is obviously not solved by optimism alone, and not everything about cross-national teams is “quite simple”. Substantial conceptual work is needed.

In fact, besides all optimism, corporate management has a far-reaching integration problem with IVTs because of their global range. IVTs should contribute to the corporate value creation, but often fail to concentrate on that task: They are busy with “everlasting” team-building, or they are unwilling to contribute to the corporate objectives because they feel far away from the control and leadership influence. Corporate management can seldom state exactly what their IVTs and the IVT members are doing – whether they are mainly working hard on the (intended) creation of added value for the company or on coping with (unintended) intrateam conflicts during the whole life cycle of the IVT (Furst et al. 2004).

In times of hypercompetition and increasing accounting transparency, however, corporate management can no longer afford to possess “virgin islands”, untouched by strategic embeddedness, monitoring, and controlling. Since in an intrafirm, global competition teams have to compete for the restricted financial resources (Simons 2000), IVTs also have to compete for financial resources. This often even has to happen autonomously without support from subsidiaries, because they perceive IVTs to be out of their reach to some extent, and therefore do not develop any vision for them.

The objective of this contribution is, in the face of the cost pressure for IVTs, to find guidelines for efficient IVT member integration, IVT identity building, and IVT work. This plays a role in all phases of IVTs: During the pre-IVT work phase, the management, which before had decided to establish IVTs, implicitly or explicitly sets up the IVT rules. This initial phase is followed by the IVT work phase where IVTs start to work according to the rules. They combine their core competencies, integrate the international workforce into these flexible, loosely-coupled virtual team structures, and de-

mand the support of multimedia communication – all of that in order to create value. In the post-IVT work phase, this performance is supposed to be controlled and evaluated.

Controlling, especially, is an important step in the IVT management process. It is conceptually based on the IVT objectives which were set up in the pre-IVT work phase and determined the IVT work. Controlling concentrates on the one hand on effectiveness in the sense of “doing the right things”, on the other hand on efficiency in the sense of “doing the things right” (Scholz 1992), using as few resources as possible. Assuming that the effectiveness of IVTs is unquestioned, because the decision in favour of IVTs had been found as part of a long-term strategic logic, the controlling of efficiency is the relevant short-term task and bears the potential for cost optimisation.

The results of post-IVT controlling can be given as feedback input not only into new pre-IVT phases, but also into the IVT work phase. Many companies already inform their employees about the costs they cause. For example, in some production plants of Volkswagen, the work teams receive daily detailed and transparent feedback information on all sorts of costs: material costs, personnel costs, but also lack-of-quality costs and travelling costs. Thus, all IVT members’ target should be to contribute to the reduction of these costs.

## 2. The Background: Focused Research Experience

The IVT-related research background combines research in three relevant fields: virtualisation, globally distant multicultural teams, and international virtual teams. This research is located at the Saarland University in Saarbrücken, Germany. It is based on a broad range of empirical studies, simulations, qualitative analyses, and case studies, performed by the research team led by Professor Scholz.

### *Virtualisation*

Virtualisation has been a management issue for over ten years now (Davidow/Malone 1992; Byrne/Brandt/Port 1993; Coyle/Schnarr 1995). The conceptual frame which is designed to explain organisational virtualisation is the “virt.cube” (Scholz 2000a, pp. 335-342). Based on empirical validation studies (Scholz 2000b), it integrates specific moves along three dimensions which, in combination, help to understand virtualisation both interorganisational (such as grouping of companies to virtual organisations) and intraorganisational (such as grouping of people to virtual teams):

- Core competence differentiation implies the organisation of the task in work modules and the attachment of the modules to employees with appropriate core competencies (Pralhad/Hamel 1990; Byrne/Brandt/Port 1993; Bleecker 1994; Christie/Leveray 1998; Picot/Reichwald/Wigand 1998): The virtualisation partners provide modular capabilities where they really have unique and sustainable competitive advantages.

- Soft integration re-creates a sufficient degree of cooperative interaction and collaboration between partners, resulting in an optimisation across the whole value chain, realising the “one face to the customer”, and avoiding as much bureaucracy as possible by applying soft integration instruments like, e.g., vision, trust, or co-destiny. This interdependence is based on an exchange of materials, information, and reciprocal inputs (Campion/Medsker/Higgs 1993).
- Multimedia communication addresses the point that virtual organisations are strongly linked with modern information technologies and multimedia, and, in particular, with the concepts of virtual reality and cyberspace (Barnatt 1995).

Virtualisation is not seen as a binary construct but as a gradual movement on all three dimensions. By observing the three dimensions, a system's progress of virtuality can be assessed. In the IVT context, the virt.cube can be applied to the progress of IVT-building and implementation: “Ideal” IVTs are far advanced on each of the three dimensions.

#### *Globally Distant Multicultural Teams (GDMT)*

While only few ideal IVTs can be observed in practice, simulations have to model “real life”, illustrating the difficulties that arise with IVTs. The gdmT project ([www.gdmT.net](http://www.gdmT.net)) is a repeatedly performed teaching system initialised by the University of Saarland/Germany (Scholz et al. 2001) together with the University of Tennessee, and the University of Missouri – St. Louis. Since 1999 it has combined several international university institutions annually to provide their students with a challenging learning experience: In a short period of time, i.e. in about one month, students in teams with members from any of the locations are required to complete a joint task. This includes building the teams via internet, finding a topic for the team project, defining the team members' core competencies, distributing the work, collaborating in the process, and finalising the output. The gdmT project is designed as an internet-course, using the broad range of multimedia applications for feedback and information. The gdmT simulation fulfils all definitorial requirements of IVTs: The international and intercultural scope of working teams, challenging tasks under time pressure which can only be solved by bundling competencies, virtual work structures of people in different time zones without face-to-face-contact. Theoretical insights into IVTs are gained by systematic modifications of situational variables and settings from year to year (Osland et al. 2004).

#### *International Virtual Team Research*

Methodologically, this contribution is deeply rooted in the research project on “Building Identity in Global Virtual Organisations”, financed by VolkswagenStiftung, with its concentration on IVTs (Scholz 2005). It assesses IVTs and identity formation in IVTs across the globally spread subsidiaries in the Volkswagen Group as one of Germany's largest multinational companies. Obviously, many structures and processes are conceptualised to reach the objectives of IVTs: global “job families” (Hartz 2001) as clusters of employees who share the same working task, parallelisation and synchronisation of formerly sequential work around the globe, benchmarking within the corporate network,

creation of joint IVT strategies, and standardisation efforts concerning outside IVT appearances. A dominant research question is to identify the conditions for IVT identities which have to exist in addition to the corporate Volkswagen culture and the local subsidiary cultures.

### 3. The Framework: IVTs

Especially in multinational corporations, IVTs (Jarvenpaa/Leidner 1998; Scholz 2001; 2002; Scholz/Stein 2003a) are seen as a new solution to international collaboration (Lipnack/Stamps 1999; Duarte/Snyder 2001). IVTs respond to the need for cross-national team flexibility and cross-national team excellence, for they are supposed to fulfil customer needs effectively, efficiently, and fast, and keep the internal conflicts under control (Montoya-Weiss/Massey/Song 2001). In order to reach above-average performance, the team members, the high potentials, and the top performers should be integrated with the focus on added value creation, using strategically the benefits of communication technologies (Kayworth/Leidner 2000).

It is important to note that IVTs are made up of normal people – not altruistic superhumans – with individual value systems which are primarily oriented towards their individual needs, not the team needs. Therefore, it is understandable that these employees want to work together with other team members only as long as they also gain personal benefits. Thus, IVTs are usually temporary collaboration structures.

The working definition of IVTs is as follows:

IVTs are:

- flexible, organisational forms of close collaboration for cross-national teamwork,
- concentrating on specific and well-defined tasks with a given time limit,
- combining (at least some) highly-skilled top performers from several countries with individual core competence who would otherwise not get the opportunity to cooperate intensively,
- without all members necessarily being physically present or even working at the same time,
- but with a strong technological support of the interaction,
- focusing on effectiveness, value creation, and top performance.

The current relevance of IVTs is increasing, as large multinational corporations explicitly focus on this topic (Jarvenpaa/Knoll/Leidner 1998; Jarvenpaa/Leidner 1999; Maz-

nevski/Chudoba 2000). The related challenge for work organisation, leadership, and HRM is: How can the creation of functioning International Virtual Teams be supported?

Modern management theory and contemporary business practice perceive the creation of successful IVTs as a major problem even on the level of its components: teams (T), virtuality (V), and internationality (I).

### *T – Teams*

It is obvious that even traditional on-site teamwork is difficult to manage because of intrateam social network effects (Das/Teng 1998), group dynamics (Janis 1972), structural holes (Burt 1992), distinct value systems of the employees (van Knippenberg 1984), or demographic heterogeneity (Chatman/Flynn 2001), to name only some of the challenges. Finding “ideal” team members for self-organising team structures who are described as convincing, sensitive, responsible, self-critical, trained in conflict and diversity issues (Caudron 1994, p. 43) seems utopian. A further difficulty in team leadership results from divergent survival interests of companies in market-radical, Darwinian environments on the one hand (Luttwak 1999; Scholz 2003) and the interests of opportunistic individuals (Williamson 1975) as self-optimising team members on the other hand: This conflict translates into teams as economic pressure on teams and team-related management tasks such as team assignment, team remuneration, team process management, and team controlling.

### *V – Virtuality*

Creating virtual teams needs the integration of people in a context where boundaries are eroding (Ohmae 1990; Ashkenas et al. 1995). Intraorganisational and interorganisational boundaries between work units are losing importance. Some of the team members do not even belong to the company but to related business partners. So it is extremely difficult to integrate geographically distributed (Armstrong/Cole 1995) and time-asynchronously working (Carmel 1999; Ballard/Seibold 2000) employees by integration instruments like trust and vision (Byrne/Brandt/Port 1993; Venkatraman/Henderson 1998) or by a distinct support of information technology (Davidow/Malone 1992). Although the virtualisation component is mainly directed towards information and communication technology issues, virtualisation exceeds the rudimentary computer-based exchange of information: Its focus lies on a strategic combination of core competencies (Prahalad/Hamel 1990) and the creation of a unifying identity (Boudreau et al. 1998). This is even more difficult when taking into account the dynamics and member turnover in virtual teams (Arrow/McGrath 1995) caused by the tendency to always combine the best core competence partners. Every new team member again has to share the culture of the existing virtual team to a certain degree, but the whole IVT has to master an ongoing “cultural recomposition” (Hopkins/Hopkins 2002, p. 541) process together.

*I – Internationality*

When companies enlarge virtual teams to a European and global range, they have to integrate employees from various countries (Kirkman/Shapiro 1997; Schneider/Barsoux 1997; Black et al. 1999; Welge/Holtbrügge 2003): with diverse cultures (Ting-Toomey 1999) and related cross-cultural differences (Hofstede 1980; 1991; Hampden-Turner/Trompenaars 1993), and with different cultural perceptions of basic assumptions like time and space (Hall/Hall 1990). Psychological phenomena like stereotyping among the cooperating partners (Thomas 1993) play a decisive role in IVT management practice.

The isolated components I, V, and T are well described in theoretical literature so that this discussion need not be replicated here. A large stock of classical and recent literature deals with international issues in management (Porter 1990; Schneider/Barsoux 1997; Adler 2002), with virtuality (Davidow/Malone 1992; Byrne/Brandt/Port 1993; Coyle/Schnarr 1995; Hedberg et al. 1997; Mowshowitz 1997; Venkatraman/Henderson 1998; Fuehrer/Ashkanasy 1999; Scholz 2000a), and with teams (Gladstein 1984; Ancona 1990; Cohen/Bailey 1997; Sundstrom & Associates 1999; Stewart/Manz/Sims 1999; Stewart/Barrick 2000; Keller 2001; Hayes 2002; Druskat/Wheeler 2003).

As to the I/T combination, in international team literature (Winter/Slate 1979; Axel 1996; Kirkman/Shapiro 1997; Salk/Brannen 2000; Govindarajan/Gupta 2001) the intercultural issues still play a significant role. One of the central leadership problems is the local disparity and time-related asynchrony of work (Carmel 1999), another is the cultural diversity in teams (Nemetz/Christensen 1996; Earley/Gibson 2001).

For the combination V/T, approaches on virtual teams (Geber 1995; Hartzler/Henry 1998; Townsend/DeMarie/Hendrickson 1998; Furst/Blackburn/Rosen 1999; Lipnack/Stamps 1999; Duarte/Snyder 2001) mainly present frameworks or tools for implementing virtual teams in practice.

Less literature exists on the I/V combination. Only a few authors like Boudreau et al. (1998) deal with the technical and organisational side of international virtual structures.

As to the combination I/V/T, research focusing on the problem of intercultural virtual teams (Maznevski/Chudoba 2000; van Ryssen/Godar 2000; Montoya-Weiss/Massey/Song 2001; Massey/Montoya-Weiss/Hung 2003; Maznevski/Canney Davison/Barmeyer 2005) mainly points out the difficulties involved in ensuring effectiveness of collaboration in those complex team situations. But there is a general lack of theoretical models explaining the structure of IVT collaboration and their differentiated contingencies in order to create win-win-situations and realise synergies to produce added value.

A negative report has to be given concerning literature on I/V/T/cost efficiency. Although cost efficiency is one of the central management topics (Cooper/Kaplan 1999) and is also discussed for teamwork in general (Hackman 1987; Thompson 2000, pp. 29-33), explicit theoretical links to IVTs can not yet be found.

## 4. The Rule Revision: Toward IVT Efficiency

The meta-rule for IVT evolution reflecting the financial restrictions of companies, is: from optimism to efficiency! The organisation of international virtual teamwork is a secondary activity of the value chain (Porter 1985), supporting the primary activities where the added value is created. It may not absorb the added value, but has to be cost-efficient in respect to production costs and transaction costs. Therefore, some tentative “from – to” movements will be presented. They are the result of the extensive observations made in in-depth interviews in companies, workshops on IVTs, IVT simulations, and empirical data as part of the Saarland University IVT research. The presented “from – to” movements are controversial in IVT discussions, but point to efficiency.

■ *From:*

Any task which is already worked on in more than one internationally located subsidiary could be organised as an IVT.

■ *To:*

IVTs should be chosen for tasks where the joint success depends on heterogeneous, almost non-overlapping competencies of experts and on their related synergies.

In recent IVT practice, multinational corporations have tended to establish IVTs where they perceive similar tasks in several international subsidiaries. This is partly more than a fashion: Their intention is to bundle competencies and to prevent “inventing the wheel twice”.

However, the effects of virtual teamwork are often overestimated where there is no need to work virtually. Often, local team members can deliver average outcomes on-site without international coordination, because in spite of company-wide integration interests, the locally performed levels of results are sufficient to fit the requirements. This holds true, e.g., for internationally distributed tasks without time pressure and internal competition for resources. Refraining from establishing senseless IVTs helps to avoid organisation costs.

But IVTs are a functional solution if international tasks cannot otherwise be performed. This is if critical core competencies are needed. Thus, heterogeneous partners with exclusive and unique core competencies, and not homogeneous partners with the same competencies, have to be combined.

- *From:*  
The IVT members should meet personally as much as possible before and along the IVT work process.
- *To:*  
Personal meetings should be substituted as much as possible by “rich media”.

For IVTs, there is a consensus that personal face-to-face meetings are crucial to ensure IVT success – at least “as need arises” (Steinfeld/Jang/Pfaff 1999), e.g., to renew trust in the mutual comprehension of the team members (DeMeyer 1991). Although international team members often like to increase their individual returns on work by travelling around the globe (“meet & party”-effect), face-to-face meetings are certainly not always the wrong idea – but under cost efficiency restrictions, in multinational corporations employees cannot always meet personally. It is neither practical nor realistic to create special pre-IVT face-to-face-events for every IVT where a bonding of IVT members could take place. The amount of travel costs, time losses and unproductivity often stand in a no-sense-making relationship to the outcome of personal meetings.

However, when employees have to work together because of the task structure, they have to get to know each other – their work attitudes and their work behaviour. Communication on these issues can be realised by “rich” media (Daft/Lengel 1984; 1986), which transport not only information but also emotions and additional interaction support (Manninen 2002). Videoconferencing is an example of such a medium: It allows the participants to see each other, to listen to each other and to make up their minds about each other. It is sufficient to facilitate a “quasi-near” kind of experiencing and getting to know one another. It can be supported by exchanging pictures or biographical information electronically: In literature, this sort of superficial contact which has the psychological effect of having established a relationship with someone is called “schmoozing” (Thompson 2000, p. 250).

An important point has to be added: As Kirkman et al. (2004) show, the number of face-to-face team meetings moderates the relationship between team empowerment and virtual team performance-process improvement. IVTs that rarely meet face-to-face need a collective sense of empowerment in order to learn and make meaningful process improvements. This means that leading IVTs with reduced face-to-face meeting intensity have to focus on IVT member empowerment instead.

In general, the virtual realisation of personal exchange by means of phone, fax, e-mail, application sharing, etc. does not just simply mean transporting communication into the intranet, but supporting the establishment of socio-emotionally “rich” interaction patterns. This drastically reduces the intensity of travelling. The high travel costs are substituted by far lower communication costs.

■ *From:*

IVT means absolute speed orientation, which means that its members are required to concentrate on the solution to their team tasks at all stages of IVT work.

■ *To:*

Before starting IVT work, IVT members should allow themselves some time to deliberate, despite all necessary speed orientation, in order to reach a consensus on the configuration of their team rules.

Many IVT projects do not meet their objectives because the joint work assumptions are not defined at all. Yet there are important assumptions to clarify. Given the virt.cube movements that (a) IVTs combine the best experts available, (b) IVT collaboration should minimise coordination costs and therefore use the means of soft integration, and (c) IVT media support should be optimised, conditions (a) to (c) can each be met empirically in two possible ways (Scholz/Stein 2003b): With respect to (a), an IVT leader can, by virtue of his authority, define who is “the best” – or the IVT as a whole can find out, by means of competition, who would best fit a vacant team role. With respect to (b), the IVT can adopt a given vision of a superior – or the IVT can jointly choose the most broadly shared IVT vision. With respect to (c), the IVT can use media which are pre-defined (like in a Microsoft-monopoly world: the internationally distributed team members follow one standard) – or the IVT accepts open media platforms (like in a Linux-diversity world: the internationally spread team members search for interfaces for their own experienced systems).

The matching of each of the first alternatives tends to be successful – and each of the second alternatives, too. Thus, the combination “authoritarian team building/pre-defined vision/media standards” is a successful team rule configuration, but also the combination “market-like team building/felt vision/open media systems”. The mixing of forms reduces success. Therefore, it is a relevant precondition for IVT success to reflect on these work assumptions in a process of metacommunication before starting work on the IVT task (Furst et al. 2004, p. 15). In spite of any time pressure and speed orientation: Ignoring the fit necessity bears the risk of IVT failure and sunk costs.

■ *From:*

IVT means absolute speed orientation, which means that its members are required to concentrate on the solution to their team tasks at all stages of IVT work.

■ *To:*

Before starting IVT work, IVT members should allow themselves some time to deliberate, despite all necessary speed orientation, in order to reach a consensus on the configuration of their team rules.

The fact that employees work in an IVT does not automatically mean that they like doing so. Employees often feel that working in an IVT is not at all an intrinsic motivator, but even turns out to be demotivating. In comparison to non-IVT work, there are some additional potentials for frustration.

First, due to the international structure, cultural differences between team members can result in collisions within IVT work. The recommended but not always functional solution is to work actively in a team development process that is based on tolerance and appreciation of differences (Earley/Mosakowski 2000). Another solution can be derived from a study of Hambrick et al. (1998) on the effect of cultural differences on the effectiveness of culturally heterogeneous, multinational work groups. Depending on the type of task, different problem-solving strategies are needed: For creative tasks, there is no one-best-way to solve problems, whereas accounting- and calculation-oriented tasks call for clear information and standardisation; coordinating tasks require interaction between team members and have therefore to be based on reliability, speed, and the ability to reach compromises. Thus, a portfolio of different tasks makes it necessary to combine team members with different values, cognition abilities, behaviour patterns, language skills and semantic skills. But this required cultural heterogeneity still implies a lot of problems, e.g., mutual understanding and tolerance, and is still very costly to realise.

Second, IVT work is often introduced to satisfy the needs of headquarters rather than the needs of the locally distributed subsidiaries. Headquarters orders, and the IVTs deliver. The employees involved have to re-allocate their working time, shifting parts of work with local relevance to the IVT work. But they often experience a situation wherein they receive neither appreciation from the subsidiary, nor adequate compensation from headquarters.

Third, like most employees in modern work settings, the existing individual and even opportunistic interests of employees are very dominant and hinder the coordination of joint interests (Scholz 2003). Opportunistic IVT members optimise their own benefits without realising that their own success depends on the further existence of their successful IVT: If the IVT fails, the employee will also fail. Not every employee contributes to the development of the idea of an IVT identity and of a “co-destiny”. While the IVT members tend to avoid this voluntarily, the transaction costs to enforce it are relatively high.

Early anticipation of personal frustration in IVT work and preparation of the employees lead to a reduction in transaction costs: The mental focus on avoiding intra-IVT frictions is activated from the beginning, and this sort of conscious or even unconscious preparation can support stronger task-orientation. Moreover, the more realistic the mutual expectations of the IVT members, the less cognitive dissonances emerge, and the more easily they can be reduced.

■ *From:*

The IVT should be a long-term structure with high decision autonomy.

■ *To:*

The IVT members should keep their distance from each other to avoid collisions during their temporary collaboration.

Multinational companies plan that IVTs as a whole receive long-term decision autonomy in their fields of work. This results in the observable tendency of IVTs to perceive themselves as permanently important, not only temporarily. They try to stabilise themselves by building up their own infrastructures and bureaucracies for their work. In this way they cause a lot of additional costs.

But IVTs resemble a flush or flight of birds (Stein 2003). Their specific rules prevent – as in other flocks, swarms etc. – the individual animals from colliding, but help them to keep their formation and allow them to reach a target together. Such rules can be simulated in computers (Reynolds 1987). For IVTs, the “from – to“ movement is about cost-efficient IVTs not requiring an elaborate administrative structure but only a mental focus on their work task. The objectives of the IVT are reached when the relatively autonomous team members contribute their required expertise in order to reach the solution to the temporary task. However, just as birds keep a minimum distance from their neighbours in order to avoid collisions, in IVTs, team members have to delimitate themselves and their autonomy from their colleagues. Translated into practice, the IVT members ideally provide their core competencies which are well defined, according to their team role, which is clearly communicated throughout the IVT. Moreover, the IVT members keep some mental distance and independence from their potentially volatile team colleagues, because they know that the collaboration is temporarily rather than permanent. Instead of social team-building across Europe and the world, it is more efficient to focus on the targeted results.

- *From:*  
An IVT should tolerate different working styles.
- *To:*  
IVTs should work with synchronised speed and parallelised working styles.

Sometimes, in practice, it is even seen as “charming” when culturally different working styles (Barmeyer 2000) meet and when they are simply united under the umbrella of diversity. However, it can cause intercultural friction when the heterogeneity of working styles is too great.

A combination of the IVT members’ working styles may again function like the coordination of the movement of birds in flight: All birds adjust their speed and orientation to the speed and orientation of the birds closest to them. Accordingly, the pace and the general perception of the local environment can be an important precondition for IVT success. Internal IVT perception also plays an important role because, according to Adams’ (1965) equity theory, people are always observing their work situation and trying to effect a fair input-output-relationship for themselves. If IVT members adapt to their work surroundings in respect of mutual work levels, they reduce the likelihood of perceiving unfair input-output-relationships and in so doing, minimise cognitive dissonances.

Further synchronising efforts are related to the coordination of joint working time and absence slots and to the definition of the level of opportunistic behaviour which is mutually acceptable in the IVT.

- *From:*  
The IVT members should interpret their contributions to IVTs as additions to their regular work and therefore keep their mental work focus on their local unit.
- *To:*  
The IVT members have to orientate themselves towards a single focal IVT point.

IVT members are not usually full-time occupied in the IVT but remain part of the work teams of the local subsidiaries. However, it is not cost-efficient when IVT members continue to work in their local units as if nothing else had happened, simply perceiving their IVT membership as a temporary assignment without any major obligations. As long as an IVT is only seen as an add-on to daily routine work, it will not result in high performance.

By analogy with birds, the employees must keep their own position near the “focal point” as the stable point of convergence for the mutual outcome expectations (Schelling 1960, p. 70) of the IVT. This means that the central vision of the IVT, which is directed at the work results, has to be shared. The question of where exactly the focal point of an IVT is, is a fascinating one to answer: The focal point for the employees is the result of the continuous self-enforcement of an initially emerged focal point. This initially emer-

ged focal point, becoming part of a positive feedback loop, might be the joint vision of the IVT or the IVT objectives. IVT members therefore have to co-formulate it in the IVT building process, or they have to adjust to the existing team vision.

## 5. Conclusion: A New Start

This contribution opens a broad discussion on the challenges of IVT work. As far as the contingencies for IVT work are concerned, this discussion is at its very beginning. Several important questions can be derived from this discussion.

First, why should the IVT members follow these “from – to” movements? In times in which nobody has a guaranteed place (Scholz 2003) – neither the companies a firm place in their markets or as preferred employer of employees, nor the employees a firm place in their companies – it is a permanent struggle to maintain one’s secure areas of retreat. For employees, working successfully in an IVT might be one of the most promising secure areas in the multinational corporations of the future. Although the heuristic validity of these “from – to” movements has been observed in a number of real cases, the corresponding empirical validation of them is still unavailable.

Second, how will these “from – to” movements be monitored? There are two possible ways: Task-related direct control evaluates whether the expected IVT work output has been generated – with respect to content, time, and quality. It is the task of corporate management to evaluate the team task by referring to the framework within which the performance of the IVT had been planned. Process-related meta control evaluates whether the applied IVT rules have been functional for the team process. But this is not applicable for every stage of IVTs: During the intensive IVT work phase, a meta control might lead to a process of self-inspection, moving the focus away from the team task.

Third, how can the “from – to” movements be supported by leadership? The classical answer refers to corporate culture, which, in general, emerges from the behaviour of the IVT members but, conversely, influences the behaviour of the IVT members. An IVT culture could integrate elements such as the willingness to cooperate, tolerance, mutual acceptance of competence roles, high performance orientation, and overt communication of the rules. Other Human Resource Management functions can also contribute to IVT effectiveness, e.g., personnel recruitment by attracting and selecting the employees who fit the requirements of IVTs best, or personnel remuneration by coupling payment with IVT success.

Fourth, do IVTs with the related “from – to” movements bear advantages for the management of cross-cultural teamwork in European companies in particular? The answer is yes. It holds true that because of the limited size of Europe where the employees from the various international subsidiaries of one corporation can visit each other quite sim-

ply, and where the perceptions of cultural differences are sometimes neglected or perceived to be minimal, the temptation is great to fall back on the traditional international teamwork option. But this would mean passing up on the efficiency advantages of IVT work. European companies are facing more and more competition, especially from the Far East (Eurostat 2005). Consequently, the economic pressure on the employees in European companies is increasing so that IVTs would meet the performance requirements – seen as flexible, speed-oriented, temporary work structures, which are explicitly not designed to last but to work on specific tasks on an international level. Moreover, IVTs make it possible to turn one of the hindering factors in European collaboration – the existing differences in working styles and other aspects of nationally diverse workforces – into an advantage, because these differences are strategically combined in IVTs to ensure efficient outputs.

Bearing in mind that a lot of isolated constraints for team work, virtuality, and internationality already exist, the implementation of IVTs is even more difficult. In IVTs, the cross-cultural differences between team members are combined with geographic distance and financial restrictions. The adequate management solution, however, cannot be to completely avoid IVTs or to label any teamwork in the international context an IVT. They promise too many benefits: in particular the possibility to allow people who are separated geographically to work together, people who might then combine their core competencies to really unique synergies and who would gain additional creativity from their cultural diversity. This is a fascinating prospect for IVTs – and worth every effort to design them efficiently.

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Christoph I. Barmeyer and Eric Davoine

# International Corporate Cultures: From Helpless Global Convergence to Constructive European Divergence

1. Overview
2. From Convergence to Divergence: The Context and the Challenge
3. From Monoculture to Multiculture: The Concept of Corporate Culture and International Transfer
4. From Theory to Reality: Case Studies of Corporate Values and Codes of Conduct
  - 4.1 Overview
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References

## 1. Overview

In the process of internationalisation, companies are faced with the challenge of harmonising corporate culture. The widely held idea is that a strong global corporate culture will strengthen the company's identity and image, and reduce costs. This frequently means that the corporate culture of the parent company is transferred to the subsidiary. An overly ethnocentric approach by the company's headquarters often complicates the reception of the new corporate culture in the subsidiaries, and creates misunderstandings and conflicts.

In this article we first present the context of internationalisation, and then show elements of corporate culture and international transfer. We then apply these to company case studies, which illustrate the international reception process of corporate values and codes of conduct transferred by the North American headquarters of a company to the European subsidiaries in France and Germany. In conclusion, the article presents a set of good practices, which can facilitate the successful implementation of corporate values and codes of conduct.

## 2. From Convergence to Divergence: The Context and the Challenge

Since the early 1980s, mergers and acquisitions have increased considerably, both in a European and a worldwide context. After the impressive rise in the number of mergers and acquisitions in the latter part of the 1980s, a rapid progression of cross-border merging, as well as a significant increase in the value of transactions, marked the 1990s and the first years of the new millennium.

For several decades now, research on cross-border merging has focused on the question of convergence or divergence. This is mainly because it is research that, to a large extent, determines strategic alliances (Scholz 2000, Adler 2002). One strategy that has its roots in the convergence hypothesis advocates distribution, and even encourages strong harmonisation between different systems. This view holds that, as the differences between corporations and managers are not very important, they will approach one another via a "common culture" and find a "compromise" so that the newly formed company can function properly. In contrast, the strategic approach based on the concept of divergence takes into consideration cultural plurality and the stability of particular systems. Based on that perspective, the diversity of cultures persists, even if the experience of effective internationalisation deepens. According to this approach, it is therefore essential to manage the different cultures. Table 1 illustrates the two concepts.

	Convergence	Divergence
Contender	The differences will disappear.	The differences remain or increase.
Consequence	Cultural homogeneity.	Cultural heterogeneity.
Risk	The negation of culture may cause misunderstandings and conflicts.	An over-emphasis on culture can become the principal element of conflict.
Management	Management methods are universal and can be transferred and applied in different contexts.	Management methods are principally marked by their culture of origin and encounter resistance in their application in other contexts.
Corporate cultures	Cultures will become entangled and be diffused. Consequently, the stronger culture will have more influence and will therefore be applied.	Cultures resist change. Consequently, adjustments and intercultural compromises need to be made.

Table 1: Convergence and divergence in international management (Barmeyer 2000, p. 38)

The dialectic of convergence vs. divergence in international mergers and acquisitions concerns itself with three areas in particular: organisation, corporate culture, and human resources management. In the following contribution, we will focus on corporate culture aspects, and question the naive belief in a harmonised global culture: How do corporate values and codes of conduct reflect the corporate culture? In which way are they influenced by the national culture of the parent company? Can the corporate values and codes of conduct be useful tools for creating a homogeneous and stable global corporate culture? What distinguishes them from the national culture of the subsidiaries? What are examples of incomprehension and resistance by the local managers concerning these values and the code of conduct? These questions reflect the challenges faced by companies operating on a global scale. How can different corporate cultures be harmonised to secure the identity and cohesion of the organisation without offending the local cultures of the subsidiaries?

### 3. From Monoculture to Multiculture: The Concept of Corporate Culture and International Transfer

Corporate culture, or organisational culture, has been a fashionable topic in management literature since the early 1980s. Corporate culture is understood as a system of shared actions, values, and beliefs that develops within an organisation and guides the behaviour of its members (Schein 1986, Scholz/Hofbauer 1990, Scholz 2000, Hofstede/Hofstede 2005). Corporate culture fulfils an important function in organisations. It promotes a shared identity of its members, *provides orientation* for decision-making and action in general. It is a soft, holistic concept with hard consequences: From the business perspective on performance, it is important that the corporate culture contributes towards the creation of added value (Peters/Waterman 1982). This can be aided by a “strong” corporate culture that is distinguished by a high level of *coherence* in its shared basic assumptions, values, and artefacts (Thévenet 1986, Schreyögg 1990, Scholz 2000). Measures for creating a strong corporate culture include the introduction and “application” of uniform codes of conduct on a visible level, and the introduction and “application” of corporate values on a more intrinsic level. These two elements will be examined in the practical part (3).

According to Schein (1986), organisational culture addresses two important survival issues. On the one hand, there is the aspect of external adaptation: What precisely needs to be accomplished, and how can it be done? It involves reaching goals and dealing with outsiders. On the other hand, there is the aspect of internal integration: How do members resolve the daily problems associated with living and working together? It involves the creation of a collective identity, and finding ways of matching methods of working and living together. Internal adaptation is particularly important for the creation and the transfer of a global corporate culture.

In the process of internationalisation, companies are faced with the challenge of harmonising corporate cultures. Frequently this means that the corporate culture of the parent company is transferred to the subsidiary – in most cases in an ethnocentric way (Perlmutter 1965). This is a somewhat monocultural approach, with the transfer occurring through transfer processes. Transfer processes principally concern the transfer, mediation, and adjustment of cultural artefacts and practices or even the values of one system (e.g. of an organisational culture or a national culture) to another (Weber 1997, Stein 2000). Transfer processes in management occur regularly, for instance when management methods are transferred from one company to another. Frequently, however, there is an asymmetrical transfer of knowledge and know-how, generally from the parent company to the subsidiary (Barmeyer/Davoine 2004).

Various significant systemic elements can be identified in the international transfer processes between parent and subsidiary companies: the actors, the parent company with its subsidiaries and their staff, and the relationships they have to each other. The classic example is the transfer of strategy, information, IT and management methods or reward

systems from the parent to the subsidiaries in other countries, but also the transfer of elements of corporate culture such as basic values or codes of conduct.

Lüsebrink (2001, pp. 215-216) generally distinguishes three processes of culture transfer: selection, mediation, and reception. The reception process is of particular interest for the present research question, namely to what extent the values of the corporate culture of the parent are accepted and adopted by the foreign subsidiaries. Reception processes have received little attention up to now – perhaps because of the ethnocentric strategies of most parent companies (Scholz 2000).

Reception processes are implemented differently and lead to different reactions among the subsidiaries (D'Iribarne 2002; Barmeyer/Davoine 2004). How can the reception of the parent company's corporate culture in foreign subsidiaries be categorised into frequently occurring patterns? Based on our research, we distinguish three typical reaction patterns (figure 1):

- **Resistance:** The employees resist the elements of corporate culture, and do not implement them.
- **Adaptation:** The employees adopt and integrate elements of the corporate culture after modifications in substance or language to take account of the national culture.
- **Acceptance and integration:** The employees adopt and integrate the elements of the corporate culture, such as practices and values, without question or conflict.

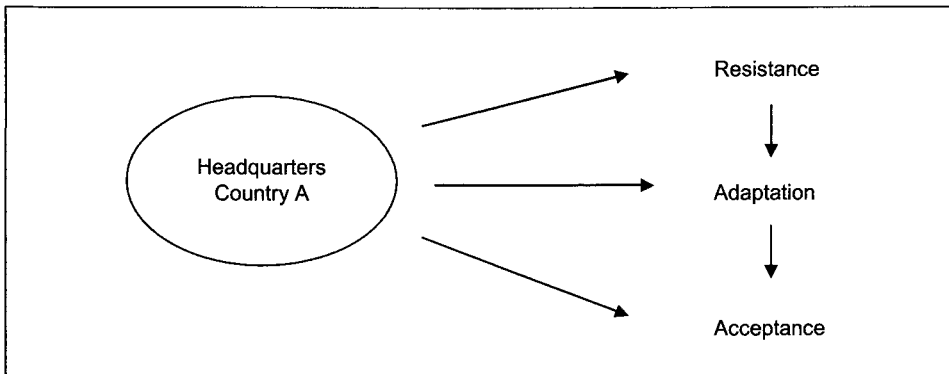


Figure 1: Reception patterns in international transfers

The three patterns described here are not rigid but can represent stages of a development. When the employees of a subsidiary display resistance, this is not necessarily a permanent situation. Depending on the circumstances, resistance can change into adaptation or even into acceptance and integration. Organisational development measures and the involvement of the human resources department can help to facilitate the implementation of headquarters' corporate culture to its subsidiaries, as we will show in the last part (4) of this contribution.

## 4. From Theory to Reality: Case Studies of Corporate Values and Codes of Conduct

### 4.1 Overview

Working on this conceptual basis of international transfer, the following case studies illustrate how the international reception of corporate values and a code of conduct occur in reality, and what consequences result from this.

Our case studies concern the reception of elements of corporate culture transferred from two important North American parent companies to their German and French subsidiaries.

Firstly, we briefly describe the values and codes of conduct concerned. The data was collated from official documents of two companies, one in the USA and the other in Canada. Both companies have had subsidiaries in France and Germany for many decades. For confidentiality reasons, we cannot name the companies. We call the American Company AMY and the Canadian company CANY. In their sector both companies are among the three largest companies in the world and have development, production, and sales operations in more than 40 countries. The companies are known for their innovative quality products. Both were founded at the beginning of the 20th century, but grew in the 1990s through mergers and acquisitions. In Germany and France, they came into being through takeovers but also foundations.

Secondly, we go on to present some results of a survey of managers on the reception of the corporate values and the code of conduct in their subsidiaries. Information about the transfer process was collected through interviews with 30 French and German managers. The managers interviewed come from the areas of corporate and HR development, sales, research and development. They work in France and Germany and have been involved in the implementation of a global corporate culture. In what follows, we have decided to remain on a descriptive level, as an intercultural analysis of the case would clearly go beyond the scope of this article.

### 4.2 Corporate Values

The first element of the global corporate culture consists of corporate values. In general, values are defined as “broad tendencies to prefer certain states of affairs over others” (Hofstede/Hofstede 2005, p. 8). They are acquired unconsciously early in life. Corporate values, however, are “learned” or accepted in a later stage of life, according to the way employees have been socialised by their work organisation. Corporate values fulfil the same function as values in general, but they are much more conscious. What values are supposed to characterise the two companies (tables 2 and 3)?

AMY in the US	AMY in Germany	AMY in France
<p><i>Respect for people</i> that includes our concern for the interests of all people who touch – or are touched by – our company: customers, employees, shareholders, partners, suppliers, and communities.</p>	<p><i>Respektvoller Umgang</i> mit allen Menschen, insbesondere mit denen, die weltweit direkt oder indirekt von unserem Unternehmen berührt werden: Patienten, Ärzte, Kunden, Mitarbeiter, Aktionäre, Partner, Lieferanten und Einwohner unserer Standortgemeinden.</p>	<p><i>Le respect d'autrui</i>, qui comprend le souci que l'on a pour intérêt de tous ceux qui, dans le monde entier, sont touchés d'une manière ou d'autre par notre société: les clients, collaborateurs, actionnaires, partenaires, fournisseurs et communautés.</p>
<p><i>Integrity</i> that embraces the very highest standards of honesty and ethical behaviour.</p>	<p><i>Integrität</i>, die durch Ehrlichkeit, ethisch korrektes Verhalten und beispielhaften Charakter gekennzeichnet ist.</p>	<p><i>L'intégrité</i>, qui englobe les principes les plus strictes sur l'honnêteté, le comportement éthique et le caractère moral.</p>
<p><i>Excellence</i> that is reflected in our unsurpassed focus on quality and a continuous search for new ways to improve everything we do.</p>	<p><i>Hervorragende Leistung</i>, verbunden mit der ständigen Suche nach noch besseren Ergebnissen.</p>	<p><i>L'excellence</i>, qui est reflétée dans notre recherche constante de nouveaux moyens d'améliorer la performance de notre société afin de devenir le chef de file dans notre domaine.</p>

Table 2: Corporate values of AMY

CANY in Canada	CANY in Germany	CANY in France
<p><i>Integrity:</i> We believe in operating with integrity in all our business dealings. We conduct ourselves in a responsible fashion as outlined in our Worldwide Code of Employee and Business Conduct, which also applies to our contractors, consultants, and suppliers.</p> <p><i>Accountability:</i> We also strive to be openly accountable and willing to align decision-making power with responsibilities at all levels of our organization. For CANY employees, accountability entails honouring commitments and accepting responsibility for our actions and behaviour.</p> <p><i>Trust and transparency:</i> At the core of all ethical business dealings, there must be trust. Trust that others will do as they say, and trust that we will live up to our commitments. To accomplish this, we must also be transparent in the way we communicate with others, providing timely and accurate information.</p> <p><i>Teamwork:</i> We believe in leveraging the abilities of our employees, suppliers, contractors, and customers – our many stakeholders – through a cooperative team approach to problem solving and project implementation. Interaction with other group and team members is a vital part of everyone's job.</p>	<p><i>Integrität:</i> Integrität ist unabdingbar bei der Ausübung sämtlicher Geschäftsaktivitäten. Die Verpflichtung zu verantwortlichem Handeln ist ausführlich dargelegt im Weltweiten Verhaltenskodex für Mitarbeiter- und allgemeine Unternehmensangelegenheiten von CANY, der auch für unsere Auftragnehmer, Berater und Zulieferer verbindlich ist.</p> <p><i>Verantwortungsbewusstsein:</i> CANY ist bereit, auf allen Ebenen unseres Unternehmens die Übertragung von Verantwortung mit den entsprechenden Entscheidungskompetenzen zu verbinden. Wer Verantwortung übernimmt, muss seine Verpflichtungen erfüllen und über sein Handeln und Verhalten Rechenschaft ablegen.</p> <p><i>Vertrauen und Transparenz:</i> Vertrauen ist das Kernelement ethischer Geschäftsführung. Dazu gehört, dass Geschäftspartner ihren Verpflichtungen gegenseitig nachkommen. Eine wesentliche Voraussetzung für gegenseitiges Vertrauen besteht zudem in der Transparenz des eigenen Verhaltens und in offener Kommunikation.</p> <p><i>Teamwork:</i> Wir müssen die besonderen Fähigkeiten unserer Mitarbeiter, Zulieferer, Auftragnehmer, Kunden – also unserer verschiedenen Anspruchsgruppen – gezielt einsetzen, um im Team Probleme zu lösen und Projekte zum Erfolg zu führen. Der Dialog mit Kollegen aus anderen Unternehmensbereichen oder Mitgliedern anderer Teams gehört zu den Aufgaben jedes Mitarbeiters.</p>	<p><i>Intégrité:</i> Nous croyons fermement que l'intégrité doit marquer toutes nos opérations commerciales. Nous nous conduisons de façon responsable, conformément à notre code de conduite mondial des employés et de l'entreprise, qui s'applique également à nos sous-traitants, à nos consultants et à nos fournisseurs.</p> <p><i>Responsabilité:</i> Nous nous efforçons aussi d'assumer ouvertement la responsabilité de nos actes et nous voulons aligner le pouvoir décisionnel sur les responsabilités à tous les paliers de notre organisation. Pour chaque employé de CANY, il s'agit d'honorer ses engagements et d'assumer la responsabilité de ses actes et comportements.</p> <p><i>Confiance et transparence:</i> Toutes nos relations d'affaires doivent être fondées sur la confiance, soit l'assurance que les autres respecteront leur parole et que nous en ferons autant. Pour parvenir à établir un climat de confiance, nous devons communiquer de façon transparente avec les autres et leur fournir des renseignements exacts et opportuns.</p> <p><i>Travail d'équipe:</i> Nous croyons que nous devons miser sur les compétences de nos différents partenaires – employés, fournisseurs, sous-traitants et clients – en adoptant des méthodes de résolution de problèmes et de réalisation de projets fondées sur la coopération et le travail d'équipe.</p>

Table 3: Corporate values of CANY

What are the opinions and reactions of European managers concerning the corporate values? As an example, we would like to quote some statements here:

“In order to understand the corporate culture of AMY, it is necessary to know the historical and cultural context of the company. AMY was founded in the 18th century in the Midwest of the USA. To the present day, values like pragmatism, tradition, and honesty, as well as a high work ethic prevail there. These values have been upheld to this day, and have strongly influenced the corporate culture of AMY.” (G)

“The corporate values are truly lived here, albeit in different forms. The corporate culture is the unifying element of the global company. This similarity can be sensed in other subsidiaries all over the world.” (G)

“Employees identify themselves strongly with their company. The corporate culture attracts employees with particular kinds of values and recruits employees with particular kinds of values. The corporate culture influences strategy and interaction within the company.” (F)

The European AMY managers commented that the corporate values appeared to be followed almost like a religion in the US parent company. For both groups, the values are an important reference and orientation system in day-to-day dealings on important decisions with all stakeholders. They are found on posters in almost every office in the company's headquarters. As the corporate values are relatively universal, most French and German managers generally accept them. Some managers indicated, however, that these written corporate values, “approved” by the company's headquarters, influence their actions less than their own “natural” national values.

Both the French and the German managers repeatedly described the problems connected with the translation of company documents, which frequently lead to misunderstandings and misinterpretations. American texts are translated into French and German at the company's headquarters. Headquarters has decided that this is the best way to guarantee coherence and to keep interpretation to a minimum. However, the documents are sometimes translated and formulated in such a way that they are scarcely comprehensible and make little sense. Every year when new strategies, missions, and visions are generated by headquarters, problems are inevitable. The German and the French HR departments revise the documents and send them back to headquarters. The parent company frequently reacts with confusion and anger because such behaviour is regarded as disloyal and rebellious. There is little understanding in the parent company about why the first version was not accepted. One French HR department has now started to make modifications without informing the parent company. A literal translation into the local language appears senseless or even ridiculous, as the following example demonstrates.

### 4.3 Codes of Conduct

The second element of the global corporate culture is the code of conduct. “A code of conduct is a statement that lays out corporate principles, ethics, rules of conduct, codes of practice or company philosophy concerning responsibility to employees, shareholders, consumers, the environment or any other aspects of society external to the company” (Schneider/Barsoux 1997, p. 247). It stipulates the rights and the obligations both of the company and the employee in many areas of activity and daily work, such as dealing with conflicts of interest, corruption, confidential information, health and safety, colleagues, etc.

AMY	CANY
<p>The Code of Business Conduct provides standards for conducting business consistent with the company's legal obligations, global policies, and core values.</p> <p>Each section discusses the basic principles of our global policies and includes examples to assist you in applying the policies to your job. You must read and comply with The Code of Business Conduct. The Code of Business Conduct often reflects a blend of U.S. legal requirements and those of other countries in which the company operates. If your local country laws are more restrictive than The Code of Business Conduct provisions or global company policies, you must conduct your activities in accordance with those more restrictive local requirements.</p> <p>Beginning with this edition of The Code of Business Conduct, you must participate in Code of Business Conduct training to ensure understanding of The Code of Business Conduct obligations. At the completion of your training, you will be asked to certify that you agree to comply with the principles contained in Code of Business Conduct.</p> <p>Failure to complete the training and certification may result in disciplinary action.</p>	<p>At CANY, we have always understood that our success is possible because of our values, which include integrity, accountability, trust and transparency, and teamwork.</p> <p>CANY updated a <i>Worldwide Code of Employee and Business Conduct</i>, which supports and reinforces these values.</p> <p>The Code requires that we exercise the highest degree of ethical conduct in all our dealings with or on behalf of CANY.</p> <p>Despite the fact that this principle is entrenched in our culture, it is understood that in our working lives we often experience situations where the “right thing to do” is not immediately apparent. The interests of CANY and those of fellow employees, customers, suppliers, families, communities and ourselves may seem to conflict at times. When we are faced with such complex situations, it can be difficult to decide just where the ethical path lies.</p> <p>I encourage you to take time to read this important document. The principles that it contains are intended as a guide to making the “right choice”. When in doubt about any matter that may have ethical implications, you should seek guidance. This Code identifies the channels and procedures that we have established to help answer your questions or address your concerns.</p> <p>Compliance with the Code is essential to preserving and enhancing CANY's reputation as a responsible corporate citizen and ultimately to maximizing shareholder value. Violation of the Code is a serious matter that could subject you or CANY to legal liability. To me, it is all a part of “doing the right thing”!</p>

Table 4: Letter from the CEO on the code of conduct

The code of conduct serves as the basis for decisions and behaviour of managers and employees. It is provided for all employees in the form of a booklet of about 40 pages which has to be signed on the last page by everybody. It starts with a letter from the CEO and then treats various aspects of ethical behaviour (social responsibility) and making profit (table 4). Over and above the employment contract, it represents an additional “moral” contract. In this way, it exemplifies the stated corporate values.

As stressed in the letter of the CEO, compliance with the code of conduct is an important element. It is measured by audits, which include a review of reporting procedures and training programmes. What are the main aspects of a code of conduct? Table 5 shows a list of aspects. In general, they are quite similar, independent of the industry or the corporate culture.

AMY	CANY
<ul style="list-style-type: none"> <li>■ Integrity</li> <li>■ Fair dealing with suppliers</li> <li>■ Fair and open competition</li> <li>■ Dealing with government officials and political parties</li> <li>■ Conflicts of interest</li> <li>■ International trade controls insider trading</li> <li>■ Excellence</li> <li>■ Drug, device, and biological laws and regulations</li> <li>■ Product promotion and ethical interactions with providers</li> <li>■ Communications with the public</li> <li>■ Asset protection</li> <li>■ Books and records</li> <li>■ Records management</li> <li>■ Respect for people</li> <li>■ Privacy</li> <li>■ Fair employment practices</li> <li>■ Health, safety, and the environment</li> </ul>	<ul style="list-style-type: none"> <li>■ Application of the code to non-employees</li> <li>■ Books and records</li> <li>■ Competition issues</li> <li>■ Confidential information and intellectual property</li> <li>■ Conflicts of interest</li> <li>■ Drugs, alcohol impairment, and firearms</li> <li>■ E-mail and Internet usage</li> <li>■ Employee use of company property</li> <li>■ Environment, health, and safety</li> <li>■ Government relations</li> <li>■ Human rights and the workplace</li> <li>■ Improper payments to officials</li> <li>■ International business</li> <li>■ Marketing and sales</li> <li>■ Political activity</li> <li>■ Securities law and insider trading</li> <li>■ Sexual harassment, workplace harassment, and violence</li> <li>■ Shareholder, media, and community relations</li> <li>■ Workplace security</li> <li>■ Compliance with the code</li> </ul>

Table 5: Subjects and content of code of conduct

## 4.4 Findings and Reactions

We now present some empirical findings: The reception of the code of conduct by the European managers in France and the reactions of European managers concerning the code of conduct are diverse. In our enquiry, the French managers were much more critical towards the formulations than the German managers:

“The code of conduct and the corporate values form the basis for important decisions. And they are abided by. This means that in many cases employees no longer need to consult their superiors. It makes day-to-day business easier.” (G)

“I constantly review my behaviour on the basis of the code of conduct. It gives me a sense of security and orientation. It also creates awareness of one’s actions. It should not, however, be an instrument for controlling behaviour.” (G)

“I don’t agree with everything. There are so many romantic ideas about an ‘ideal world’. I find it unrealistic not to allow contact with colleagues from the competition. Just as I find it unrealistic that we should not accept gifts. We sometimes seem more Catholic than the Pope.” (F)

“There are too many American examples. And all these obligations and the checking to ensure that everyone is complying: That almost seems a little totalitarian to me.” (F)

What especially struck the French and German managers about the code of conduct was its explicit and binding nature – which almost reminded the reader of the “Ten Commandments” contained in the Old Testament – expressed by the frequent use of “you should ...” or “you should not ...” Generally, acceptance of the code of conduct was less problematic in Germany than in France. However, many German and French employees sign the declaration without reading it in detail. (Implicitly, the concept of values, rules, and behaviours which are shared by a given community and which represent shared ethics have a religious element. It is even a sign of the Protestant work ethic, which encourages a person to achieve set goals using an instrumental approach and the hard work of the individual (Weber 1905). Work is considered in the Protestant work ethic to be the means to redemption, whereas in the Catholic church, other people mediate between the individual and God.) In contrast to the relatively neutral and universal corporate values, the code of conduct consistently displays limitations. In reality, the code of conduct is “interpreted” by individual managers, a case in point being the prohibition of payments (“bribes”) to clients in order to obtain large orders (table 6).

AMY	CANY
<p>"Conduct business fairly, relying on the merits of products, services, and people. [...] Do not accept gifts, entertainment, or payments from parties doing or seeking to do business with AMY (see Conflicts of Interest). Do not make a bribe or offer a payment or gift directly or indirectly to an employee of a supplier." (12)</p>	<p>"It is our policy to demonstrate the highest standards of integrity in all aspects of CANY's business and to do business fairly and equitably. In marketing and sales, we must: [...] never give or receive improper payments or gifts to or from anyone in connection with the sale or purchase of products or services even at the cost of foregoing business opportunities [...]" (8)</p>

Table 6: Prohibition of bribes

The European managers interviewed said that deals in certain countries were mainly won through gift-giving or bribes. Sales managers are obliged to generate turnover and profit. If they strictly followed the code of conduct, a lot of business would be lost, which could endanger the continued existence of the company. "Are we now supposed to be 'excellent' and create value or to show 'integrity'?", one French manager quipped. The dilemma between value creation and ethical behaviour becomes evident.

A further problem is that of the individual employee taking on responsibility for the aims of the company, something which the code of conduct stipulates as a written and binding obligation. As is usual in many American companies, the employees of the company's headquarters are expected to report misbehaviour, irregularities, and infringements of the code of conduct to a superior or even via an anonymous telephone number in the USA and in Canada. Both the German and the French employees are very surprised by this. Who would dream of ringing up a stranger in the company headquarters far away, and in English? Particularly amongst the French managers, resistance is great. In France, it is unthinkable to denounce somebody in this way. The reactions of the French staff on this point were very emotional and the rejection very strong. This regulation was regarded as an attack on one's personal freedom, and a conflict of values. How could one denounce a colleague and thereby endanger personal relationships in order to serve the anonymous organisation? The American managers of the company's headquarters concerned with ensuring adherence to the code of conduct cannot understand this behaviour and are annoyed. After all, the point of the anonymous telephone number is precisely to protect the employee who makes a complaint.

What is particularly striking about the reception process in France is the search for the apparent point of implementing the corporate values and the code of conduct. French employees resist having to uncritically follow standards and regulations set by the American parent company without understanding their sense. To many employees, some aspects of the code of conduct concerning employees' behaviour appear naïve, almost childish. They are sometimes not all adapted to the European context, as the following rule in the code of conduct of the Canadian company CANY shows: "Firearms are permitted only in those areas and circumstances expressly authorised by management"

(CANY, p. 8). For that reason, these rules are received with a great deal of irony, and are freely adjusted and “interpreted”.

The co-existence and concurrence of national law and the “company’s law” (code of conduct) is of special interest. A long tradition of more than 2000 years of Roman Law in Europe has shaped the legal context there into something completely different from the North American system, based on Common Law. Owing to the principle of subsidiarity, national law is still more important than private (company) law in Europe, as shown in the following case, which also refers to an important element of French culture: food and quality of life. Shortly after the Canadian company CANY bought a big French competitor, they introduced the international code of conduct to the French headquarters and its 30 subsidiaries in France. The code of conduct states that the consumption of drugs and alcohol is not allowed at the workplace:

“It is forbidden to possess or consume illegal drugs while working on CANY premises. To remain competitive in today’s business environment, it is essential that we make the best decisions; therefore, we expect that all our judgments be clear and unimpaired by drugs or alcohol. These restrictions are established for the well-being and productivity of our employees and our company.” (CANY, p. 8)

As is common in France and other Latin European countries, French employees and managers are used to enjoying a glass of red wine with their lunch. Canadian managers on a visit to the French subsidiaries were quite astonished and puzzled to observe how many of their French colleagues drank alcohol during the meal, and then returned to work. Initially, the Canadians demanded that the company managers apply the code of conduct fully and forbid serving alcohol in the restaurant. The French employees were not amused and threatened to go on strike. The Canadians then made a complaint to headquarters, clearly challenging the behaviour of their French colleagues. The French human resource department was asked to mediate between headquarters and the French subsidiaries. The outcome of this dispute was that the French employees continue to drink wine – in fact, they have every legal right to do so: An article of the influential *Code du Travail* (labour law) of 1973 prohibits the consumption of alcohol during work hours, *apart from* wine, beer, and cider! (Code du Travail: Loi L232-2 (Inséré par la Loi n°73-4 du 2 janvier 1973 Journal Officiel du 3 janvier en vigueur le 23 novembre 1973): “Il est interdit à toute personne d’introduire ou de distribuer et à tout chef d’établissement, directeur, gérant, préposé, contremaître, chef de chantier et, en général, à toute personne ayant autorité sur les ouvriers et employés, de laisser introduire ou de laisser distribuer dans les établissements et locaux mentionnés à l’article L.232-1, pour être consommées par le personnel, toutes boissons alcooliques autres que le vin, la bière, le cidre, le poiré, l’hydromel non additionnés d’alcool.”)

Another aspect concerns diversity and respect, which are important elements of the company’s social responsibility. They are covered in the chapter “Fair employment practices” at AMY:

“In your daily work activities, observe normal standards of courtesy and consideration when interacting with other employees and people with whom the company has business dealings. Do not harass another employee or person who has business dealings with our company. Some examples of harassment are:

- racial or religious slurs,
- racial or religious stereotyping, intimidating or aggressive acts or words based on gender,
- unwelcome physical or verbal conduct (such as negative comments or humor) of a sexual or racial nature - derogatory jokes, gestures, or stereotyping related to sexual orientation.” (AMY, p. 26)

For purposes of illustration, the problem is further analysed – like many subjects – with the help of a little question, posed by the employees and answered by the code of conduct. In this case, concerned employees who need help can also call a “Compliance and Ethics Helpline” in the United States:

Example of Question/Answers of the code of conduct (AMY, p. 26)

*Question:* “My boss frequently comments on the way that I look or dress and tells me that I look ‘hot’. I’m very uncomfortable with this. Is this sexual harassment? What should I do?”

*Answer:* “Sexual harassment may include unwelcome verbal or physical conduct that creates a hostile or offensive working environment, requests or demands for sexual favors, sexual advances, sexually explicit jokes or pictures, or unwelcome touching. Contact your human resources representative or a member of supervision. If you wish, you may call the Compliance and Ethics Helpline at 800.815.2481.”

Many of the French managers that were interviewed (both male and female) think that this passage is extremely exaggerated, even ridiculous. Day-to-day business life is based on interpersonal communication and relationships. Especially in Latin cultures like in France, the emotional level of interaction – even at work – is very important. It is much less formal than in northern European cultures. The emotional level concerns the expression of feelings such as anger, but also humour, jokes, comments, and compliments, etc. The assumption is that human beings are not robots and have a right to show their feelings. It is common for both men and women to comment on clothing, and this is still considered “normal” and even a sign of consideration and esteem in most cases. (In the French version, the word hot is translated as ‘sexy’, which is frequently used not only for persons but also for projects, stressing the interesting and challenging aspect: “C’est un projet sexy”.)

Another point of confusion was frequently mentioned. The code of conduct has to be signed by every member of staff, and then has to be sent to the parent company. We

learned in the course of our survey that many French and some German senior managers refused to sign the code of conduct after the takeover of their companies by the American parent. Some of the recurring statements were: “I can’t sign that sort of thing”, “We have more important problems”, “This is a private matter and does not belong in the work-place”. A few weeks later, the managers who had not signed the code received a personal e-mail from the CEO. This surprised the managers and made a considerable impression on them. The CEO wrote that he was surprised and angered that the code of conduct had not been signed. Everybody who belonged to the “company family” had to accept these values and obligations because the attitudes and behaviour of the managers had to be in accord with the company’s values and code of conduct. The document had to be signed, or sanctions would follow. The e-mail proved effective. Most of the German and French senior managers signed disapprovingly, but a few left the company.

These examples illustrate that the foreign subsidiaries display a pattern of resistance to the new code, which occasionally develops into acceptance (see Figure 1). North American parent companies frequently fail to achieve their objective of creating a coherent, homogeneous and harmonised corporate culture for the purpose of achieving the company’s goals more efficiently. This can be attributed to the fact that their strong ethnocentric approach does not take sufficient account of the prevailing cultures in the foreign subsidiaries.

## 5. From Bad Practices to Good Practice

The reactions of managers in the French and German subsidiaries clearly show that cultural harmonisation with the help of corporate culture, as desirable as this may be from a management point of view, is far from being achieved. The thought and behaviour patterns of the employees and managers in Europe still seem to be marked more strongly by their national culture internalised during their *primary* socialisation than by the American corporate culture “acquired” in their *professional* socialisation.

Corporate culture is intended to create coherence, also internationally, but the generally hesitant and problematic reception process indicates that precisely the attempt at homogenisation is the cause of fresh disagreement. Again, it seems important to adapt global strategies to local contexts.

Our empirical research has led us to identify the following factors, which may serve as the basis for formulating problem-oriented research questions and for establishing solution-oriented *good practices*:

- It is important to bear in mind the history and the context of the companies involved. This is particularly relevant with regard to the respective local subsidiaries: Are we dealing with a newly founded subsidiary or with the takeover of a company within the framework of a merger? The transfer is smoother in the case of internal company

formations. In contrast, takeovers often see a clash of not only different national cultures, but also different corporate cultures. Conflicts of interest and power struggles may also arise.

- In the case of a takeover, it is necessary to investigate the strength or weakness of the particular local corporate culture, i.e. the subtle coherence and identity between the organisations: A strong corporate culture that differs from the corporate culture of the foreign parent company will invariably hinder the implementation.
- What can be said about the duration and the intensity of the transfer from parent to subsidiary so far? How long has this relationship already existed? This is particularly important with regard to familiarisation and acceptance of the transfer. By the same token, it takes time to assume the corporate culture of the parent company. After all, it is clearly an instance of a change management process.
- What is the quality of the relationship between the parent company and the subsidiary? Is the subsidiary seen merely as a (possible) “cash cow”? Does it present a financial burden for the parent company, or is it a driver of change that creates added value for the entire company?
- What can be said about the cultural proximity as opposed to the distance of the affected national cultures of the parent company and subsidiary? Studies on the subject up until now have referred to a – historically founded – mutual cultural proximity of Anglo-Saxon/German-speaking countries or countries that speak one of the Romance languages. Thus, for example, there are more cases of “opposition” to cultural transfer from the USA to France than from the USA to Germany. The concept of cultural coherence, “cultural fitness”, becomes important here.
- How great is the understanding and the knowledge of the cultural characteristics between the parent company and the subsidiary? What philosophy dominates, ethnocentrism or cultural relativism, i.e. is the foreign culture seen as a threat to one’s own culture or as an opportunity to learn?
- As with all intercultural processes, interfaces and intermediaries who act as “cultural translators” (by interpreting and adapting cultures) play an important role in minimising conflicts and misunderstandings that result from different ways of thinking, communicating, and working. A number of American parent organisations have called non-American, e.g. European or East Asian, managers to the head office and have given them strategically important roles. For example, a French manager, acting as an interface, might be put in charge of more and more projects that concern the subsidiary in France. In this way, the classic misunderstandings and problems between the Americans in the parent company and the French in the subsidiary can be reduced.
- To what extent are managers and employees actively involved worldwide in formulating the company values and codes of conduct? The objective must be to involve

employees from many different cultures in order to take account of the cultural diversity of international companies, and to achieve as great an acceptance as possible among the foreign subsidiaries.

- Are local managers and employees involved in implementing the corporate culture? Is the chosen approach defined by cultural relativism, rather than by ethnocentrism? Do the subsidiaries conduct social audits to obtain information about how local employees accept and apply new tools?
- In the end, human resources development, especially professional training, plays a crucial role. A particularly effective method during training aimed at informing and implementing the corporate culture is the integration of an intercultural approach. It is not enough to present and train the elements of corporate culture as a “simple” directive from the parent company. Rather, participants taking part in such a training measure should first be familiarised with the fundamental assumptions of the national culture of the parent company. These should then be placed into relation with the fundamental assumptions of the national culture of the subsidiary. The three cultural levels described by Schein (1986) should be used as a basis for this type of training. Then the national cultural values as well as the corporate cultural values can be put into perspective. Only then can the practical issues such as the code of conduct be dealt with. Therefore, we are concerned here with an intercultural approach that creates an understanding for diverging values, differing ideas, different ways of thinking and behaving, and misinterpretations, all of which regularly lead to conflict and misunderstanding. This intercultural approach forms the basis for a successful implementation.

Both on the practical and empirical level, but also on the academic and conceptual level, research into the international transfer of corporate cultures has not progressed very far. Implementing corporate cultures successfully on an international level can be achieved through an intercultural approach. Companies’ attitudes and strategies concerning corporate cultures will then move from helpless global convergence to achieving constructive European divergence.

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Hanna Schramm-Klein and Dirk Morschett

# International Supplier Relationship Management: From Transactional to Relational Purchasing

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## 1. Introduction

The already high and still growing importance of international strategic procurement in the sense of global sourcing means that firms are concentrating on supply concepts with a more international orientation. International procurement relationships when compared to national procurement relationships are characterised by more complex buying markets, a larger number and more heterogeneous buying markets, higher risk and greater uncertainty in the buying relationship and buying terms. It is more difficult to forge an international relationship since there are often the hurdles of greater geographical distance, language and cultural disparities between the actors and less frequent personal contact to overcome. The likelihood of conflict between the parties is greater and a breakdown in the supplier relationship more likely in the international context than in the national context (Dominguez/Zinn 1994, pp. 65-66).

The more strategic orientation of international purchasing as well as the need to increasingly integrate supply chains on an international scale lead therefore to a fundamental shift in the supply management. The change of the paradigm is especially apparent in the international supplier relationship management, which above all focuses on the management of a company's most important suppliers (key suppliers) (Mühlmeier/Belz 2001, p. 20). Supplier management systems are used to minimise risk and uncertainty in international procurement relationships, thereby maintaining and developing strategically important supplier relationships.

## 2. Relational vs. Transactional Supplier Interaction

Supplier Relationship Management (SRM) is the systematic coordination, maintenance and development of supplier relationships. International supplier relationship management focuses on international customer-supplier relationships, that is, relationships between import and export firms. For the buying firm it encompasses the cross-border supply to a firm from external sources, e.g. classic import (Kaufmann 2001, p. 44).

In international relationships, the supplier relationship management works to form partnerships which are long-term and strategically orientated. Procurement no longer merely targets cost effectiveness. There is a wider mandate to enhance revenue through a supportive supplier relationship, e.g. by improving product quality and performance. Cooperative supplier relationships result in more extensive acquisition of innovative advances from supplier markets and supplier involvement in developing innovative concepts for supply chain management (Wagner/Locker 2003).

The increasing focus on relationship building with suppliers makes it plausible to view international supplier relationships in terms of general relationship management models. The strategic long-term relationships a firm has with its stakeholders (e.g. customers,

employees, capital investors, public, etc.) are paramount to this perspective (Eller/Jung/Speiser 2003, p. 39). Focus on supplier relationships implies a holistic examination of the whole relationship, in particular the aims, benefits and needs of each partner in the relationship. The future development of the relationship is more important than a short-term optimisation. Strengthening relationship ties between the partnering institutions is a crucial aspect of relationship management (Bruhn 2001).

International supplier relationship management therefore puts particular emphasis on an integrative approach to the entire relationship of the firm to an individual supplier. When the focus is on relationships, rather than discrete isolated transactions, all levels of contact and transactions are embraced (EBig 2001, p. 71). This means thinking about all transactions taking place over several transaction episodes, i.e. all past, current, potential and future transactions (Diller 1997, p. 573), it also explicitly includes all partner interaction (Stölzle/Heusler 2003b, p. 172).

In this paper, first the differences between transactional and relational supplier management in international supplier relationships are singled out. To do this, the terms transactional and relational interaction need first of all to be defined. Business relations management literature is very useful for this as it contains a wealth of concepts about relationships. A selection from the broadband of transaction form descriptions is presented below (table 1). The authors' terms should be interpreted as a continuum, they are not discrete choices.

Author(s)	Governance Modes
MacNeil 1978	Discrete exchange – relational exchange
Hakansson 1982 (IMP group)	Exchange episodes – relationships
Williamson 1985	Markets – relational contracting
Shapiro 1985	Traditional adversarial approach – new adversarial approach – buyer-supplier partnership – “conduit for innovation”
Heide 1994	Market governance – non-market governance (unilateral/hierarchical vs. bilateral)
McIvor/Humphreys/McAller 1998	Adversarial – collaborative
Spekman/Kamauff/Myhr 1998	Open market negotiations – co-operation – co-ordination – collaboration

Table 1: Different terms for the continuum of (non-hierarchical) governance modes (Source: adapted from Bartsch 2004, p. 162)

### 3. Objectives and Effects of International Supplier Relationship Management

#### 3.1 Theoretical Foundation

There are several different theoretical streams, which can be used to examine the benefits and effects of international supplier relationship management. The most important are information economics, transaction cost theory, resource-focused approaches and interaction theories.

##### *Information Economics*

Information economics is primarily concerned with the role of uncertainty in judging objects or situations. It differentiates between exogenous uncertainty and internal uncertainty. Internal uncertainty (market uncertainty) implies the asymmetric distribution of information between the customer and supplier with the consequence that the customer is usually not fully informed about the market conditions (Weiber/Adler 1995, p. 64). It is assumed that the actors assume a potentially opportunistic behaviour pattern, taking advantage of any competitively beneficial information asymmetry (Kaas 1995a, p. 25).

Information economics approaches highlight the relevance of international supplier relationship management. Market and environment uncertainty is greater in an international field than it is in a national field, which multiplies the significance of information asymmetry. If the danger of opportunistic behaviour is reduced by a long-term supplier buyer relationship, then uncertainty may be dispelled (Kaas 1995b).

##### *Transaction Cost Theory*

Choice of governance mode (used for the coordination of business transactions) depends on the relative transaction costs associated with that mode. Transaction costs include the ex-ante and ex-post costs of searching for information on potential business partners, selection of partners and contract negotiations; the cost of monitoring the performance of the contractee, ensuring his adherence to the contract and, if necessary, subsequent contract amendment (Williamson 1985; Richter/Furubotn 2003, p. 61).

The main factors of influence on transaction costs are the transaction frequency, asset specificity (particularly necessary transaction specific investments, e.g. physical assets and human resources) and uncertainty (Williamson 1981). In the international context, uncertainty is greater; particularly demand and supply, market and transaction uncertainty. As specificity, uncertainty and the frequency of transactions increase, so do transaction costs. Transactional cost theory is therefore useful in illustrating cooperative long-term business relations. Cooperative long-term relationships are more advantageous to the partners in consideration of transaction costs, when the specificity, frequency and uncertainty associated with transactions are high (Bruhn 2001, p. 27). This is particularly true in the international context (figure 1).

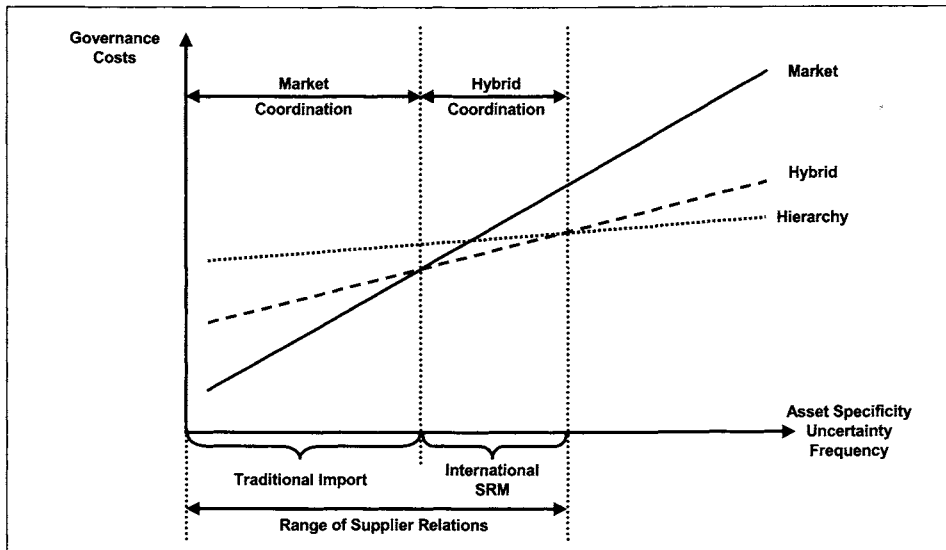


Figure 1: Relative advantage of different governance modes dependent on asset specificity, uncertainty and transaction frequency (Source: adapted from Homburg/Werner 1998, p. 985)

### *Resource and Resource-Dependency Approaches*

Whereas transaction cost theory is particularly concerned with costs, the resource-based view focuses on the benefit side of coordination forms (Das/Teng 2000). This approach sees the benefits of cooperation in the access to resources (e.g. expertise, assets, financial resources) (Oelsnitz 2005). International cooperation means firms potentially gain access to resources which are rare, valuable, difficult to imitate or difficult to substitute (Dyer/Singh 1998). International supplier relationship management systems may thus result in greater competitive advantage than interaction relationships which are based on the “bid-buy system” (Hoyt/Huq 2000).

Resource-dependency theory or the resource-dependency perspective is an environmental interaction approach rooted in the research done by Pfeffer/Salancik and others (Pfeffer/Salancik 1978, p. XI; see an overview from Bartsch 2004). The starting point for all aspects addressed by this approach is the question of how firms can best ensure their survival regarding the resources on which they depend. The resource-dependency theory attempts to explain differences in structure and behaviour-styles of organisations, the way their international relations were determined and their choice of transaction form in relation to the restricted availability of resources (Homburg/Werner 1998, pp. 982-983). The resource-dependency theory is highly relevant to transactional versus relational interactions as it highlights avoidance, exploitation and development of dependencies as central determinants and driving forces in long-term inter-organisational relations. This

in turn enables organisations to plan their relationships with suppliers according to the resource-dependency criteria for that particular environment (Swoboda 2003, p. 53). Resource-dependency theory can therefore be used to illustrate the necessity of interaction with and bonding of suppliers by the buying company (Rieker 1995, p. 5).

*Interaction Theories*

Interaction theory approaches to modelling the establishment of cooperation use the way internal relationship factors themselves contribute to cooperation formation between partners. The interaction approach is based on analysis of social and interpersonal exchange processes within the framework of inter-organisational exchange relations (Kern 1990). Its most relevant streams are the social exchange theory, Kirsch/Kutschker’s interaction approach and the IMP group interaction approach. Whereas the social exchange theory addresses interaction behaviour on the assumption that an individual’s interaction behaviour is molded by cost/reward considerations (Kern 1990, p. 8), Kirsch/Kutschker (1978) focus actors’ risk considerations. From this perspective, transaction strategy is guided by risk minimisation. The formation of long-term relationships between participating organisations is seen as a risk immunisation tactic, whereby experience gathered by the partners from previous contact plays a crucial role.

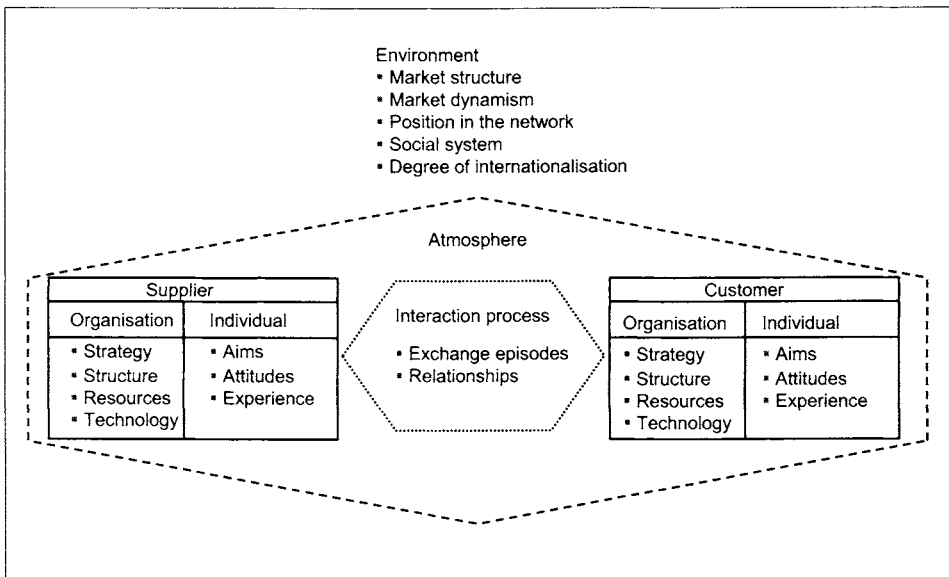


Figure 2: The IMP group’s interaction model (Source: Cunningham 1980, p. 326)

The focus of the IMP group’s interaction approach (figure 2) is the interaction process between supplier and buyer. The term “exchange episodes” refers to the exchange of products and/or services, information and/or money as well as “social exchange”, i.e. the relationships between members of buying and selling companies (Cunningham 1980,

pp. 326-327). Over time, as representatives of both organisations interact in repeated exchange episodes, learned roles and the scope of the cooperation as well as a network of personal relationships develop. This arrangement and net of relationships and roles is referred to as “atmosphere” by the IMP group (Hakansson 1982). The individual phases of a developing business relationship are identified by increasing mutual adaptation, commitment and distance minimisation between the interaction parties (Turnbull/Ford/Cunningham 1996, p. 45, p. 49). Characteristics of the interaction parties considered as important in this approach are the technology they use, the size and structure of their companies and the business strategies they implement and of course the individual experience, attitudes and aims the interaction party representatives bring to the interaction progression (Cunningham 1980, p. 327). The relationship between the two interaction parties is characterised by the power and dependency balance. By cooperative behaviour, a trusting atmosphere can be developed, which leads to the establishment of a long-term business relationship (Hakansson 1982, p. 18). The interaction approach of the IMP group is understood as a basis relevant to the present discussion in so much as it is not concerned with discrete exchanges but instead has its focus on long-term business relationships, in which, in turn, individual transactions are embedded.

Interaction theories emphasise that the formation and quality of international supplier relationship management systems are extensively influenced by internal relationship factors such as previous experience, commitment, and trust. In fact, these could be said to be the prerequisites for a successful international supplier relationship management system.

### 3.2 Objectives of International Supplier Relationship Management

The difference between traditional international purchase and international supplier relationship management can be illustrated following the 4C-model in figure 3.

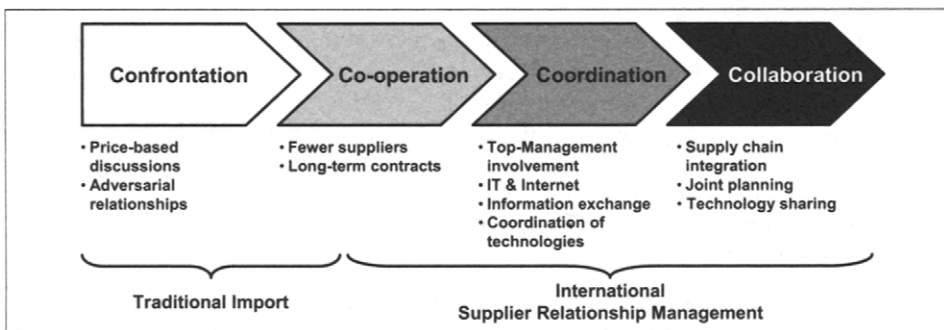


Figure 3: 4C model

(Source: Spekman/Kamauff/Myhr 1998, p. 634; Fitzek/Gaso/Voelz 2002, p. 2)

Traditional import is geared above all towards single transactions and price optimisation. Consequently, a relationship with a supplier tends to be adversarial. Interaction is primarily directed towards arm's-length negotiation of conditions. The aims of the participants are naturally quite at odds with one another. The exporter is interested in getting a good price. The importer is looking for optimum buying conditions. Cooperative elements which redirect the focus from pure price or condition considerations are only apparent in a rudimentary form in traditional international customer supplier relations. In contrast, international supplier relationship management is informed by cooperation, coordination and team work, unlike the more antagonistic relationships of traditional import (Fitzek/Gaso/Voelz 2002, pp. 2-3).

If international supplier relationship management is seen as a transaction form, its cooperative elements in terms of its relationship structure allow it to be classified as a cooperative form or hybrid form in the transaction form type continuum. It can thereby be viewed as a long-term focused vertical relationship initiated by the importing company (Hoyt/Huq 2000).

From the theoretical effects described above the main aims of international supplier relationship management can be derived. These can be grouped systematically into the following four categories:

- *Cost reduction*: in international supplier management systems, once a relationship has been forged with a specific supplier, a reduction in direct costs (especially purchase costs) as well as transaction and process costs is sought from inter-organisational adaptation of the operating processes and systems. Optimisation of production costs is also expected to result from better coordination with the supplier (e.g. specialised product specifications) (Hoyt/Huq 2000, p. 758). The backdrop of cooperation and all that cooperation implies, may then even make it worthwhile to accept higher purchase prices (Riemer/Klein 2002, p. 10).
- *Process and quality optimisation*: if further cooperative bonds are formed as part of an international supplier relationship management system, resulting, for example, in a relatively free flow of information or interconnection of the value-added processes of the partners, then these bonds will contribute to process optimisation and influence output positively (Choy/Fan/Lo 2003, p. 263). The integration of suppliers into the value-added processes of a company can also lead to process and product improvement suggestions being made (Tang 1999, p. 41) or an improvement in order fulfilment by the supplier. This, in turn, has a positive effect on performance quality (Frazier/Spekman/O'Neal 1988).
- *Innovation capability and flexibility*: through a close connection with suppliers, changes to an intermediate product can be made more quickly and more efficiently (for example, changes in response to the end customers' requirements). Good connection to a supplier means that more sophisticated product modifications or customisation can be implemented, resulting in shorter product life cycles and an enhancement of new product launches. This increases the nimbleness of a firm in its reactions to customer requirements (Hoyt/Huq 2000, p. 758; Choy/Fan/Lo 2003, p. 263).

- *Risk reduction*: the risks faced in international exchange relationships are far greater than those encountered in national relationships and the complexity of the procurement scenario is greater. A system based on supplier cooperation can reduce procurement complexity and reduce perceived risks. Long-term relationships contribute to risk reduction by building trust between the supplier and buyer (Hoyt/Huq 2000).

### 3.3 Optimal Transaction Mode in International Supplier Interactions

There is a strategic decision to be made regarding the relationships formed with suppliers, namely the decision about which transaction form is to be chosen (Stölzle/Heusler 2003a). “Collaboration” in the sense of international supplier relationship management is often put forward as best practice. This is, however, not always appropriate. A more sophisticated view of suppliers is required (Cox et al. 2003, p. 136), analysing contingency variables.

The establishment of an international supplier management system made with a particular supplier is only expedient if the anticipated strategic, operative or financial gains are greater than the costs entailed in constructing the international supplier management system. This perspective corresponds to the concept of supplier lifetime value. This is the total, future-orientated value a supplier relationship can realise, including competitive advantage in the sales market being reached through this supplier (Eßig 2003). In this concept, it is therefore essential to select suppliers with a high supplier lifetime value and to invest in this relationship by development of the international supplier relationship management system (figure 4).

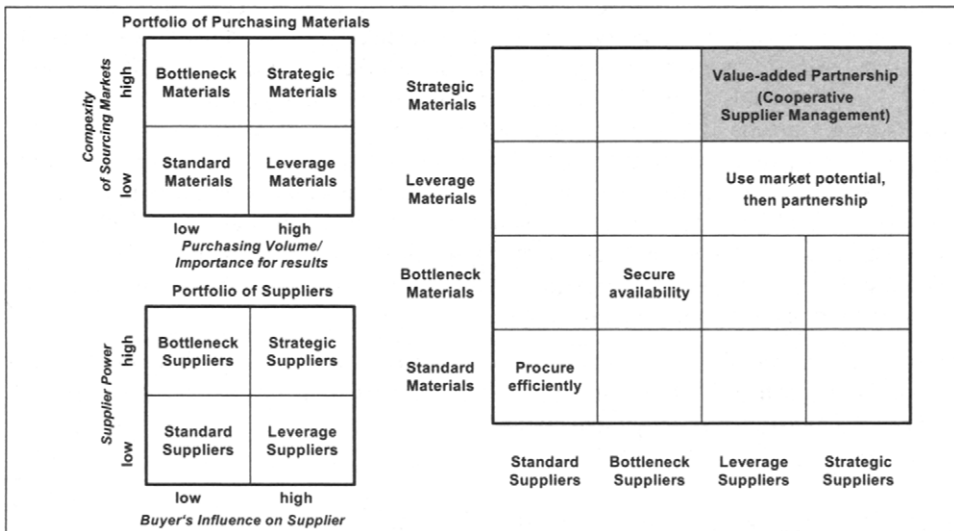


Figure 4: Supplier management norm strategies (Source: adapted from Eyholzer/Kuhlmann/Münger 2002, p. 69)

It needs to be borne in mind that the construction of a supplier relationship management system is not a one-sided process, it does require the involvement of the supplier and not all suppliers are willing to enter cooperative relationships (Cox et al. 2003).

The optimum reciprocal relationship depends on the particular product and supplier (among other things). Consideration should therefore be given to whether the supplier is a standard or strategic supplier and whether the product is a standard or strategic product (see figure 4). Supplier competition can be beneficial in a standard product scenario. Ties to a supplier would be counter-productive in this case and market transaction forms in which suppliers are in competition could make more sense. Strategically relevant products, e.g. complex, specialised products or service packages, may be more promising for cooperation between supplier and customer. Customer input and expertise from both partners are important for the quality of performance, in which case international supplier relationship management systems may be more beneficial (Arnold 2000; Stölzle/Heusler 2003a, p. 12).

## 4. Features of International Supplier Relations

### 4.1 Overview

The differences between national and international supplier relations are particularly apparent in situational disparities such as the geographical distance between partners, cultural differences and exchange rate or currency calculation difficulties. These not only affect procurement terms but also affect evaluation of the supplier value (Zentes/Swoboda/Morschett 2004, pp. 321ff.). The complexity of international supplier relationships is a reflection of this situation and is a key issue in international supplier management systems. The peculiarities of international exchange relations influence attainment of the aims of supplier management systems (see 3.2). There are four main areas important to the design and efficacy of international supplier relationship management which emerge from the myriad of theoretical considerations of the international supplier relationship. They are the specifics of supplier/region, product specifics, relationship attributes, and the particularities of international relations.

The four areas cannot be viewed independently of one another, they are interdependent in that the effect they have on international supplier relationships is interwoven as well as the characteristics are partly interdependent.

### 4.2 Attributes of the Supplier and Region

One set of criteria which has a significant effect on the relationship between the buyer and supplier comprise the location factors which in general terms determine the relative

economic attraction of procurement markets (Levy 1995, p. 343). (For the choice of procurement markets, see also Bogaschewsky 2004.) These criteria are frequently used to select a procurement market. The most important attributes can be grouped as follows (see detailed Koppelman 2000, Zentes/Swoboda/Morschett 2004, pp. 321-323, and other classification systems of relevant factors of influence in international supplier relationships, e.g. Liu/McGoldrick 1996):

- Performance attributes (e.g. work productivity and quality; communication, logistics and technology standards; capital availability, etc.)
- Cost attributes (product and production materials costs, e.g. manpower, logistics and capital costs; taxes, duties, etc.)
- Risk attributes (e.g. political risks, economic instability, danger of strikes, resource availability/accessibility, import dependency, etc.)

Other criteria relevant to the relationship between the firm and its foreign supplier which could be taken into consideration are procurement market attractiveness and relative procurement competitiveness, including procurement market size, competitor structures, supply risks, performance, technological and flexibility potential (Zentes/Swoboda/Morschett 2004, p. 323).

The general economic attraction of a region is intrinsic to supplier relations as it affects the attraction of a supplier compared to the attraction of a supplier's competitors from other foreign markets and in so doing affects the supplier's position regarding the buying firm. In addition, these factors are directly relevant to a relationship in so much that, as general factors of influence they can ameliorate or hinder the formation of a relationship between a firm and supplier. For example, customs duties and other trade barriers affect procurement costs and administrative development of procurement relationships (Arnold 1990, p. 61). General economic conditions (such as strike hazard or pollution control measures) as external relationship factors of influence affect the risk of uninterrupted supply, production conditions and the options to structure the supplier relationship (Zentes/Swoboda/Morschett 2004, p. 325).

As general external conditions, these macro conditions above all affect the configuration of procurement activities. If the macro conditions are broken down at supplier level, the specifics influencing the attraction of the supplier in the micro perspective can accordingly be grouped into performance criteria (e.g. product quality, logistics quality, flexibility concerning product adaptation, innovation potential, etc.), cost criteria (e.g. price and conditions, logistics costs, etc.) and risk criteria (e.g. supply guarantee/capacity, susceptibility, financial risks, etc.) (Tan/Kannan/Handfield 1998).

These characteristics directly affect the supplier relationship in that they influence negotiation arguments, progression of the relationship and importantly, susceptibility to conflict. Furthermore, they affect an additional category of supplier attributes. Beyond performance, cost and risk aspects, the relationship climate and the connection between cus-

tomers and providers are of key importance to the supplier relationship. Pertinent factors include:

- supplier size (e.g. regarding his market importance in the procurement market),
- the relative importance of this supplier to the firm (e.g. as provider of a certain brand product),
- the relative importance of the firm to the supplier (e.g. regarding revenue share he obtains from the firm),
- supplier resource availability (e.g. control over key resources) or
- availability of alternative suppliers.

All these factors exert influence on the power relations between a firm and specific supplier, particularly negotiating power and assertiveness. They therefore determine the negotiating positions of the partners in the relationship and can affect relationship dependency, i.e. determine whether a firm/supplier relationship is based on a one-sided or a balanced dependency.

### 4.3 Attributes of the Product

The influence of product specifics on the supplier relationship refers to product characteristics related to its manufacture, availability and (relative) importance (Cox/Sanderson/Watson 2000). (Product attributes which mark out specific product characteristics such as the quality of the product are factored out at this point. They are viewed as being closely connected to supplier attributes as they are more closely related to the performance characteristics of the supplier (see section 4.2).) Differentiation is made between standard products (which can be manufactured by any number of potential suppliers) and complete product and service bundles (modules and systems). Such bundles refer to goods and service packages of high complexity for which specialised investment, resources, expertise or licenses are required for their production (Arnold 2000).

Closely related, but not congruent to this, is the dimension of the availability of the product. This dimension is governed by the question of whether there are a large number of potential suppliers providing the product or the product is exclusively available from one or only a few suppliers.

The relative importance and the substitutability of the product affect the dependency relationship between firms and more or less determine supply risk for the buyer. If a product is particularly important, the supplier is in a strategically advantageous position (Bensaou 1999, pp. 40-41). The relationship of the supplier to the buyer (in terms of vertical international relationships) is given greater or lower significance according to whether the product is viewed by the supplier as having revenue leverage, strategic leverage or whether it is simply an auxiliary product (Cox et al. 2003, p. 139). The relative importance of a product particularly affects interest in maintaining a relationship, the mutual

dependency of the partnership partners, their negotiating positions or negotiating power and therefore the opportunity they have to have their interests included in the international vertical relationship (Cox et al. 2003, pp. 140-141).

#### 4.4 Attributes of the Relationship

The specific attributes of the relationship between the partners are pivotal in partnership relationship balance in international supplier relations. Commitment and trust are factors which have been found to be particularly crucial to the quality of a relationship (see e.g. Morgan/Hunt 1994; Campbell 1998).

Commitment is seen as an emotion connected to the bond and the desire to sustain a (vertical) relationship (Morgan/Hunt 1994, pp. 29-31; Andaleeb 1996, p. 81). Consequently, maximum effort is put into promoting and strengthening the relationship (Moorman/Zaltman/Deshpande 1992, p. 316). Commitment in an international supplier relationship can result in specific investment in the relationship ties between firms, e.g. information, physical value-added process, and financial ties (Levy 1995).

Trust relates to how the motives and intentions of other institutions are perceived. It is defined as the expectation or strength of belief in the opposite party's credibility and honesty. It is associated with attributes such as consistency, competence, honesty, fairness, sense of responsibility, helpfulness, goodwill, etc. (Morgan/Hunt 1994, p. 23).

Due to the particular attributes of international relationships, commitment and trust building in international vertical relationships is considered much more complex and difficult than in national relationships (see especially 4.5). If other relationship attributes are taken into consideration, the factors relevant to commitment and trust building may be categorised as follows (Geyskens/Steenkamp/Kumar 1998):

- *Uncertainty concerning environment*: uncertainty (e.g. heterogeneity of performance, environment volatility) exerts a negative influence on trust. This is particularly true in the international context.
- *Decision structures in the marketing channel and instruments to influence decisions*: when negative means of influence such as "threats", penalties or similar are used, trust is negatively affected. Positive strategies such as bonus and reward systems (in the sense of an international supplier relationship management system) on the other hand, are considered to have a positive effect (Andaleeb 1996).
- *Power and dependence*: mutual dependency in vertical relationships that exists generally or as a result of specific investments by the parties usually correlates positively to trust (Ganesan 1994), whereas asymmetry in interdependency situations is likely to have a negative effect (Anderson/Narus 1990).

- *Behaviour*: support of the opposite party, cooperative behaviour or specific investment related to the relationship have a positive effect, whereas conflicting behaviour or opportunistic behaviour have a negative effect on trust (Anderson/Weitz 1989).
- *Performance*: good past performance or task fulfilment by the opposite party positively effects trust. In addition to economic results, contentment is highly relevant in this connection. Past performance is used by the opposite party to assess levels of performance and the likelihood of promises being fulfilled by the other party (Ganesan 1994). This also illustrates the importance of the duration or permanence of a partnership in building trust.

When international supplier relationship management systems are established, trust and commitment are boosted and lay the path to a reduction in the complexities in the international supplier relationship. A large number of detailed regulations can be relinquished and a more informal relationship formed with less complexity and fewer regulatory formalities (open contracts). The positive effects on the length of involvement (permanence) of the relationship, relationship quality and its stability confirm that establishment of an international supplier relationship system works positively for the relationship between firm and supplier.

#### 4.5 Attributes of the International Dimension of the Relationship

International relationships are characterised by the supplier and buying firm being resident in different countries. There are many factors influencing a relationship in the international context, the most relevant being (Dominguez/Zinn 1994, p. 65; Homburg et al. 2002):

- *Geographical distance*: transport costs and transport times, for example, are adversely affected when the supplier and firm are domiciled in different countries. Information and communication flows are made more difficult by geographical distance. Even though new information and communication technology has produced a significant easing of the information and communication processes, personal communication in particular (especially important to build trust) is hampered by spatial distance (Sirdeshmukh/Singh/Sabol 2002). Geographical distance also impairs the transfer of certain types of information (e.g. tacit knowledge) between partners (Ambler/Styles 2000, pp. 500-501).
- *Cultural distance*: when there are diverging cultural expectations, values and standards between the business partners; a modified negotiating style may be required and it is likely that information and communication exchange processes are affected (Simintiras/Thomas 1998). The importance and assessment of quality may be different in different cultures (Homburg et al. 2002). In addition, cultural divergences can increase the potential for conflict when the partners have different standard business routines and norms and these differences are given insufficient attention (Anderson/Weitz 1989).

- *Language differences*: language differences aggravate communication processes and can result in misunderstandings or misinterpretations (Liu/McGoldrick 1996).
- *Technological distance*: business relationships may also be adversely affected when there is a technology gap between the participating firms. Differing international standards have frequently meant that technological standards of suppliers and buyers are incompatible with one another and the information flow and data exchange between firms hampered (Schramm-Klein/Morschett 2004).

The differences or distance between a firm and supplier in the international context mean that establishing an international supplier relations management system demands greater management capacity than for nationally focused supplier relationship management and that international supplier relationships are usually associated with greater administrative expenses. The expenditure required for the establishment, sustenance and maintenance of international relationships is greater and increases with increasing distance/dissimilarity between partners (Homburg et al. 2002, p. 10).

## 5. Stages of an International Supplier Relationship Management

### 5.1 Selection and Acquisition of Suppliers

The development of an international supplier relationship management system can be divided into several phases. The important initial stages are represented by the evaluation and selection of potential suppliers (Stölzle/Heusler 2003a, pp. 12-13). It only makes sense to invest in investment-worthy supplier relationships (see 3.3). Supplier selection is therefore of key importance to international supplier relationship management. Careful selection of a suitable supplier has a significant influence on costs reductions and process optimisation and should help reduce lost investments wasted on inappropriate suppliers (Choy/Fan/Lo 2003, p. 263).

A wide variety of procedures can be applied in the assessment and evaluation of suppliers, e.g. ABC-analyses, supplier profit contribution analyses, portfolio analyses, scoring models or supplier lifetime value concepts. (For a description of various procedures and methods applied in supplier evaluation, see e.g. Hoffmann/Lumbe 2000, Eßig 2003 and Stölzle/Heusler 2003a.)

Evaluation procedures such as these are used to select suppliers suitable for supplier relationship management engagement. In the international context, evaluation of a supplier may be exasperated by heterogeneous environmental conditions, exchange rate and currency fluctuations or divergences in calculation practices or international risks, which make a comparison of suppliers difficult. In addition, information sourcing in an interna-

tional environment is difficult, expensive and afflicted with a greater degree of data and information uncertainty (Zentes/Swoboda/Morschett 2004, pp. 803-804).

Once potential suppliers have been selected, the phase of supplier recruitment begins, i.e. the phase when a supplier suitable for a cooperatively-focused supplier system is won for such a partnership. The supplier has to be open to bonding with the firm as defined by the international supplier management system (Cox et al. 2003). Signalling methods may be implemented, e.g. self-bonding (through long-term contracts, for instance, or own specific investments) or by focusing on their own reputation as a reference for the supplier (Stölzle/Heusler 2003a, pp. 12-13).

## 5.2 Establishment and Development of Supplier Relations

The preliminary phases are followed by the operational phase of supplier relationship management. Here the focus is on the stabilisation and further development of relationships, particularly strategies on supplier care, supplier education, supplier advancement and supplier development (Stölzle/Heusler 2003a, p. 13):

- *Supplier care* encompasses strategies to build and maintain a trusting relationship with the supplier, e.g. supplier workshops, events, etc. (Arnold 1997, p. 193).
- *Supplier education* is aimed at an “education strategy” to prevent performance errors or shortcomings by implementing mutual quality programmes (Stölzle/Heusler 2003b, p. 189).
- *Supplier advancement* is aimed at the transfer of expertise between supplier and buyer to optimise performance processes, e.g. on technical, product-related, outlet market and logistics issues (Dominguez/Zinn 1994, p. 66).
- *Supplier development* is concerned with developing a new “procurement source” by transferring expertise and skills to the new supplier (Arnold 1997, pp. 190-192).

Information and communication technologies allow international supplier relationship management to be more efficiently structured. E-procurement tools or specialised SRM software used in connection with a firm’s ERP system can be significantly beneficial. Transfer of information between businesses (e.g. for planning and value-added processes) requires EDI, Intranet, Extranet or Internet for realtime data transfer to take place and redundancy of data exchange processes avoided (Bogaschewsky 2000). There is often a problem in the international context, when the system and data standards of the collaborating firms are incompatible (Morschett/Schramm-Klein 2003), making interface and data converting solutions imperative (see 4.3).

### 5.3 Attributes of International Supplier Relations: A Stages Model

Attributes of relational supplier management (see 4.4) are not generated simultaneously, but develop as the business relationship progresses through different stages (see in detail Bartsch 2004, pp. 175-177). This reflection forms the backbone of the IMP group's interaction approach, which sees relationship progression as a series of exchange episodes during which partners jostle and in time a business relationship is precipitated whereby adaptations will probably have been undertaken regarding products, financial matters, communication routines and social exchange relations. Business relationships of this type are usually planned as long-term ventures and involve complex interaction patterns between and within the cooperating firms (Hakansson 1982, pp. 17-18). Following the interaction approach of the IMP group, Mandják/Durrieu (2000, pp. 1-2) also emphasise that business relationships need to be interpreted as a process of interconnected exchange episodes between the interaction parties. In their view, relational supplier management requires a range of investments (money, time, training, etc.), adaptation, coordination, commitment and trust by both business partners if their mutual aims are to be attained.

Attribute	Stage	Partner Selection	Defining Purpose	Setting Relationship Boundaries	Creating Relationship Value	Relationship Maintenance
Reputation		██████████				
Performance Satisfaction		████████████████████				
Trust		████████████████				
Social Bonds		████████████████████████████████				
Comparison Level		████████████████				
Mutual Goals		██				
Power/Dependence		████████████████████████████				
Technology		████████████████████████████████				
Investments				████████████████████████████		
Adaptions				████████████████████████████		
Structural Bonds					████████████████████	
Cooperation					████████████████████████████	
Commitment					████████████████████████████	

Figure 5: Stages in relationship development (Source: Wilson 1995, p. 15)

Relational supplier management is therefore characterised by various, sequential development stadia. Wilson (1995) distinguishes, in more detail than in the previous sections of this text, five stages:

- Partner search and selection
- Defining purpose, e.g. finding the right balance between shared goals and individual goals, defining the breadth of purpose or scope of the goals.
- Boundary definition, i.e. answering where each partner's organisation ends and where the hybrid begins as well as what the hybrid's legitimate claim upon the resources of the partners is.
- Creating relationship value, i.e. the process step by which the competitive abilities of the hybrid and the partners are enhanced by being in the relationship.
- Relationship maintenance refers to the stability of the hybrid over time. This strongly depends on the success the partners have in creating positive outcomes.

Different relationship attributes are of central importance in different stages of the relationship. Each attribute has an active phase, which is at the centre of the relationship development process, and a latent phase, where the attribute is still important but not under active consideration in relationship interaction (figure 5). For example, trust may be very active in the early stages of the process but become latent in later phases. Changes in the environmental forces or relationship partners may re-activate an attribute. For instance, a change in management at the partner companies could re-enhance the importance of trust. In the first phases, social bonds are established, which later remain important, but are not in the focus any more. Only in later phases, when the business relationship is in its operating phase (i.e. really creating the relationship value), commitment to the relationship develops, especially if every partner gets his "fair share" of the value being created (as the social exchange theories would also predict).

## 6. Summary and Conclusion

In the international context, supplier relationship management facilitates the reduction or exclusion of risk and areas of difficulty arising from geographical and cultural distance, differing business routines and norms and the more complex international procurement processes, etc. which may occur between an importing business and its supplier domiciled abroad.

The main differences between transactional and relational interactions have been discussed above and are tabulated below in a comparative analysis (table 2).

Commitment and trust are required from both partners for international supplier relationship management systems to produce cost and optimisation benefits. A firm has to pro-

vide support and encouragement to its supplier in the sense of commensurate dedication and involvement if information and knowledge are going to be exchanged openly between the two parties and to a sufficient extent. This in turn is the prerequisite for meeting the expected cost reductions, optimising processes and realising competitive advantages and it forms the basis for production flexibility in order to modify product design and meet buyer specification modifications.

Attribute	Transactional interaction	Relational interaction
Contract type	formal, multiple short-term contracts	tendency towards open contracts
	mainly one-off transfer of ownership	repetitive transfer of ownership
Time horizon for exchange relation/supply frequency	short-term	medium to long-term
	rather less frequent procurement	more frequent procurement
	few and irregular deliveries	more frequent and regular deliveries
Supplier basis/costs	large supplier base	tendency towards small supplier base
	low transaction costs and supplier switching costs	rather high transaction costs and supplier switching costs
Participants in partner firm	few employees and business functions involved in exchange	usually more employees and business functions involved
Focus of exchange	focus on transaction and goods	focus on the process of exchange and future activities
	price and transaction in focus	increasing importance given to technology, quality, (process) costs and other services
Specific investment/risk	negligible specific investment	usually rather high specific investment
	minimum risk (resp. dependency)	high risk (resp. dependency)
Inter-organisational communication	ad hoc information exchange	regular information exchange
	minimum personal commitment and relationships	often informal communication and personal relationships
Collaborative/problem-solving behaviour	rather little cooperation	higher degree of cooperation
	re-active conflict-solving behaviour	pro-active avoidance of conflict

Table 2: Differences between transactional and relational interactions  
(Source: Bartsch 2004, p. 181)

At the same time, a supplier relationship management system initiated by the buyer means the buyer is entering into a dependency relationship with the supplier. The buyer makes a number of specific investments in the relationship, which are usually greater for international relationships than for national exchange relationships. The careful selection of suitable suppliers, i.e. strategically relevant key suppliers, is therefore crucial to avoid misdirected investments.

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# Consequences for Germany

- A Strategy Map for Germany: From Passive Self-Pity to Offensive Self-Renewal

# A Strategy Map for Germany: From Passive Self-Pity to Offensive Self-Renewal

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## 5. Summary and Conclusions

## References

## 1. The Challenge: Germany and Old Europe

Europe viewed from the outside – a complete mystery? It certainly seems difficult and cumbersome to obtain a differentiated image of Europe. The evaluation of American Minister of Defence, Donald Rumsfeld, in early 2003 is legendary: “Now, you’re thinking of Europe as Germany and France. I don’t. I think that’s old Europe.” This perspective that associates Europe with being backward is particularly prevalent in the economic context. Writing in the *Financial Times*, Wolf (2005) stressed this negative vision with the following headline: “Outpaced: why are the big eurozone countries and Japan doing worse than English-speaking nations?”

Indeed, the “geostrategic map” of value-added management is changing radically and Europe finds itself in the middle of this development. This is exemplified by the expansion of the European Union with ten Central and Eastern European states on 1 May 2004 and the pending integration of yet more (e.g. Bulgaria, Croatia, Romania) over the next few years (Woyke 2002). Furthermore, there is the intensification of economic exchange between the booming sales, procurement, production and value-added locations such as India, China and Taiwan, as well as the dynamically developing South East Asian developing nations such as Malaysia, Vietnam and Cambodia, to name just a few.

These changes in the global competitive arena necessitate fundamental change in Old Europe, not only from enterprises, but also from all political, state and other institutions. They are confronted by major changes in the rules of the game of competition, which apply not only to the whole of Old Europe, but also to Germany, which was once the growth engine of Europe. Germany in particular has the opportunity to refocus on a number of rules independently of the rest of Europe.

This paper will commence with a clarification of the current situation and selected inappropriate developments and threats facing Germany as an economic region. This will form the basis for a positive vision within the context of new rules of the game.

Even American writers indicate that a positive view of Old Europe and Germany is not unrealistic. Most recently, Rifkin (2004) describes the emerging “European Dream”, which he believes could replace the corresponding American Dream. Despite the various prevailing problems in the European economy and society, he stresses the sustainable economic power, social stability, high quality of life and work, and above all, the ability to cope with the future through bold visions. Particularly for Germany, Nees (2000, p. 169) draws attention to the repeated “phoenix-like arising” of this central nation in Europe and is confident that remarkable solutions will emerge.

## 2. Playing by Old Rules: Inappropriate Developments and a Negative Scenario

### 2.1 Endangered: Germany as the World's Export Champion

If the current developments in Europe and particularly Germany are considered, three trends can be identified, which, in unison, create a threatening scenario.

At first glance, the current list of top global exporters (figure 1) shows the unchanged strength of the EU countries – Germany, France, Great Britain, the Netherlands, Italy and Belgium. They account for approximately 30% of world exports, including intra-EU trade.

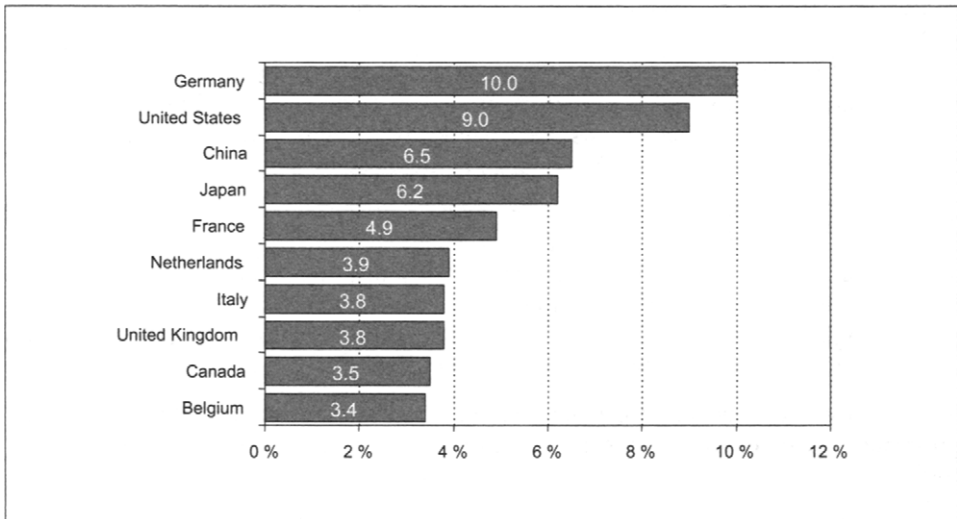


Figure 1: Hit list of world exporters in 2004  
(Source: WTO 2005)

However, more and more firms are transferring substantial portions of their production to foreign locations in Eastern Europe and (South East) Asia in order to exploit comparative advantages (Zentes/Swoboda/Morschett 2004) so as to retain or even improve their international competitiveness (table 1). According to a new study by the DIHK (German Chamber of Commerce and Industry), this applies increasingly also to medium-sized enterprises. Presently, 36% of all industrial SMEs (enterprises with up to 499 employees) are planning foreign investment. This is six percentage points more than in the previous survey that was conducted in 2003.

Statistically speaking, the intermediate products/components/modules produced in the foreign facilities lead to an increase in both (German) imports and (German) exports, because a substantial proportion are used in products that are finished in Germany and then exported as final products.

1999	2001	2003	2004
30%	34%	38%	43%

Table 1: Planned investment outside Germany by German industrial enterprises (Source: DIHK 2004, p. 1)

After such an associated rise in imports, a rise in the importance of end product imports is to be expected. This development is instigated by political factors such as the increasing opening of markets of the WTO members to products from China and vice versa. This applies particularly to textile products.

As early as in 2003, China demonstrated remarkable export dynamics. In 2004, for the first time, China reached third place in the list of top exporting nations, overtaking Japan. Considering the massive direct investment of American and European enterprises in China, such as the automobile and components industry, it can also be assumed that China will become the world's largest exporter over the medium term. All in all, Germany's position as export champion is in jeopardy.

## 2.2 Endangered: Germany as an Industrial Location

A closer analysis of the current economic data for Germany reveals a widening gap between export performance and domestic value added. Accordingly, the share of value added of foreign production locations in German exports in 1991 was just 27%. By 1995, this had risen to just over 30% and by 2002, to 39% (DIHK 2004, p. 2). In a similar manner, industrial production and value added in Germany are also drifting apart (figure 2). This creates the danger of degenerating to a "bazaar economy". According to the theory of ifo President Hans-Werner Sinn, German enterprises are relocating valuable elements of production and jobs out of the country. Therefore, Germany will gradually become a trading location from which goods manufactured beyond its borders are sold with a German label. In statistical terms, German production will be inflated because statisticians count foreign-produced intermediate goods. Yet real value added in Germany will not rise correspondingly (Anonymous 2004a, p. 13).

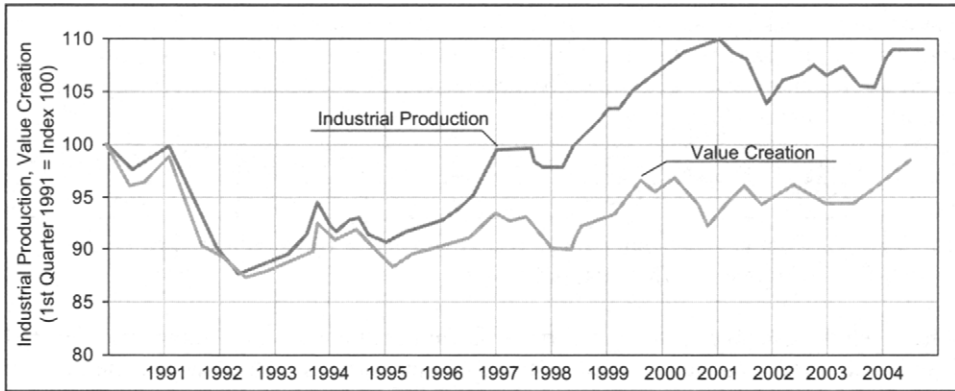


Figure 2: Gap between production and value added in Germany  
(Source: Deutsche Bundesbank 2004)

### 2.3 Endangered: Germany as an Innovation Engine

It is true that the “spirit of discovery” in Old Europe remains intact, in Germany, for example. In 2003, the German Patent and Brand Office (DPMA) registered 64,518 patents, an increase of 1.7% in the course of 2002. However, the actual performance, i.e., success in the market, is declining progressively. There are countless examples of ideas that originate in Germany, creating jobs elsewhere. In his inaugural address, Federal President Köhler (2004) cited the first computer of Konrad Zuse and the MP3 technology.

Apart from this implementation deficit, Germany is confronted by another serious danger. While in the past, ideas that are relevant to the global market have been copied by Japan, Korea or China, in several fields of the future such as biotechnology or genetic technology, a new development is emerging. New knowledge, and thus innovations, originate in these countries, while such developments in Old Europe lag behind due to legal restrictions and ethical misgivings. Given the impressive competence in implementation of these Asian countries – and of the USA – combined with the comparative cost advantages of these regions, Old Europe is hardly in a position to pursue a strategy of imitation.

## 3. Playing by New Rules: Searching for New Ways

If Old Europe is to prevent such bleak scenarios from materialising with almost apocalyptic potential, not only do the socio-economic systems need radical reform, but strategic orientations need radical reformulation along with management principles in enter-

prises. In short, the “rules of the game” need to be changed completely. These are discussed below, without being exhaustive.

Figure 3 provides an orientation framework with a new strategy map which differentiates between the two dimensions of

- visibility and
- desirability.

“Visibility” has an empirical-descriptive orientation. It describes whether a particular (strategic) reorientation or new orientation is already visible or cannot yet be discerned at the political, macroeconomic or entrepreneurial levels. The dimension of “desirability” is prescriptive in nature. It relates to whether manifest or non-manifest orientations or behavioural patterns or principles can contribute towards preventing apocalyptic scenarios and thus secure or restore the international competitiveness of Germany or Old Europe.

<b>Visibility</b>	Manifest	<b>Turnaround</b>	<b>Carrying On</b>
	Non-manifest	<b>Letting It Be</b>	<b>Getting Going</b>
		Negative (no)	Positive (yes)
		<b>Desirability</b>	

Figure 3: New strategy map

This new strategy map contains four fields, each with specific implications for the management of society and the economic future of Germany and Old Europe. These must be followed in the sense of normative strategies:

- If new strategies are already manifest and have proven to be positive, “carrying on” is recommended.
- If there are no new orientations yet, but these are clearly necessary or desirable, the formula can only be “getting going” as soon as possible.
- If there are new orientations, but they seem to be in the wrong direction, a “turn-around” is essential.
- If new orientations are neither evident nor desirable, one should “letting it be”.

These normative strategies allow for the derivation of individual “rules of the game”, behavioural guidelines which should be taken into account by the various actors with respect to creating a sustainable, competitive positioning of the economic area.

In the next section, within the context of Germany as a central economic area in Old Europe, there are such political and social orientations presented on the one hand, as well as (competitive) strategic orientations on the other hand that can be assigned to the four fields of the New Strategy Map.

## 4. Strategic Management Options: The New Strategy Map

### 4.1 Carrying On

#### 4.1.1 From a Leisure Society to a Work Society: New Work-Life-Balance

The highly unsatisfactory labour-market situation with rising unemployment that has prevailed in Old Europe and particularly in Germany for many years, is now leading to the first signs of a turnaround in people’s values and ways of thinking, and this applies particularly to employees. While, over the past few years, efforts to reduce working times to 35 hours per week (and less), as is already the case in France, formed the focus of discussion, the work-life-balance pendulum is currently swinging in the direction of more work. This has been triggered not least by declining birth rates and a rising average lifespan. A new equilibrium is developing, and, according to Opaschowski (1997, p. 34), the century of reduced working time is over.

According to the current study “Perspectives for Germany” (McKinsey et al. 2005), 75% of responding employees are willing to accept a flexibilisation of weekly working time and 38% are prepared to give up three days of holiday. If a differentiation is made according to membership in trade unions, the figure rises to 40% for non-union members.



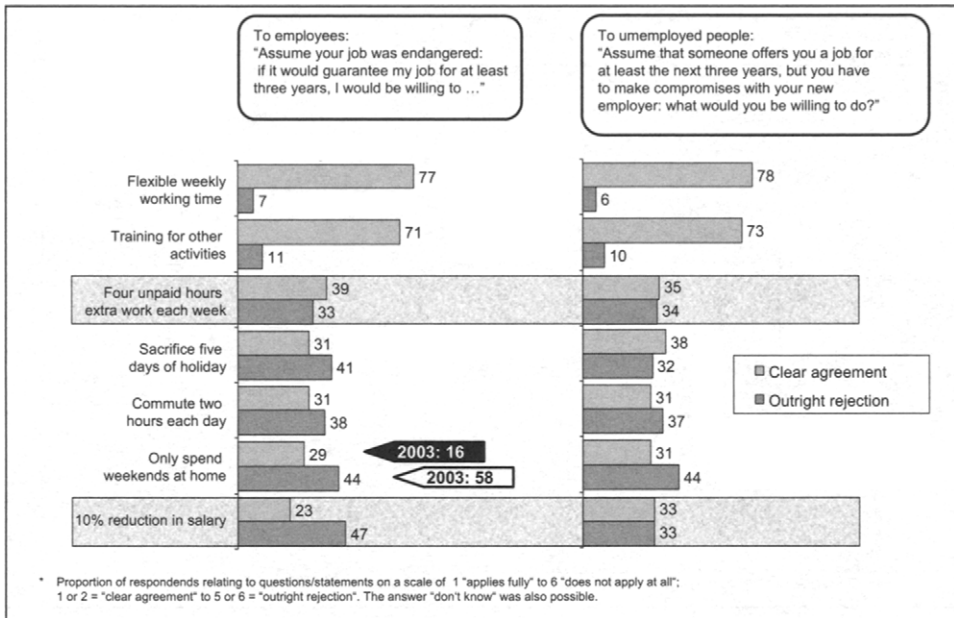


Figure 5: Individual contribution to securing one's own job (Source: McKinsey et al. 2005, p. 58)

#### 4.1.2 From Regulation to Deregulation: New Flexibility

Within the European Union, a trend towards sectoral deregulation has been evident since the beginning of the 90s. The following are examples of deregulation:

- goods traffic (air, road, rail),
- capital markets (stock exchanges, banks, insurances),
- telecommunication (landline telephony, mobile radio),
- pipeline/networked energy (electricity, gas).

Similar developments are evident in additional sectors such as health. The deregulation of former state monopoly sectors or areas with governmental regulation have evolved into dynamic new markets and to increased cross-border trade and cross-direct investments within the EU. Not only enterprises within and beyond the EU have benefited from the new flexibility as new market players, but also private and industrial consumers.

In addition to this sectoral deregulation which will not be considered in greater detail here, fundamental change, or at least the initial signs of such change, are evident at all relevant political and administrative levels, that is, at the level of the EU, the level of

Member States and their provinces or (internal) states, as well as departments and the level of communal institutions. There is thus widespread deregulation in the sense of eliminated or reduced bureaucracy. This statement does not contradict the danger that the expansion of the EU to the East could be associated with a clumsier “Brussels apparatus”.

The German state “Saarland” is an excellent example. In 2003, it was awarded the highest “Federal Dynamic Ranking” within the “Initiative for a New Social Market Economy” as the state with the greatest reform dynamics. The Economic Minister of the Saarland stressed that the reasons for this included the privatisation and deregulation as well as the streamlining of approval procedures as an expression of reduced bureaucracy. As Minister Georgi (2003) pointed out, the entire approval process was put to the test, temporarily limited administrative regulations and a reduced burden of proof were introduced, 2,300 regulations were eliminated and many procedures simplified. E-government was promoted through a major initiative and the working times of government officials were made more flexible so that they became more customer and service-oriented.

#### 4.1.3 From Rigid to Flexible Labour Markets: New Employment Capacity

A particularly important variant of flexibilisation, and thus one that should be treated in isolation, has an impact on the labour market and particularly in Germany. Even if there are those who doubt that the unemployment in Europe is largely the result of rigid labour markets and high real wages (Stockhammer 2004), these factors most certainly constitute important influence factors at least (Oschmiansky/Kull/Schmid 2001, pp. 18-21). For this reason, the trends towards a new work-life balance and new flexibility are gaining in importance as part of the trend towards “new employment capacity”.

The willingness to work more and the change in basic attitudes that find expression in a new work-life balance are articulated not only in demoscopic surveys (“first level of visibility”), but are also manifest in actual wage negotiations. This is evident, for example, in the results from the agreements made in 2004 by Opel, Volkswagen and KarstadtQuelle in Germany (figure 6). In order to avert redundancies or even the complete closure of factories or sales subsidiaries (branches), the employees of Opel and KarstadtQuelle, and also the trade unions, were willing to make wide-ranging concessions. This applies similarly to the agreements of the Volkswagen concern (Zentes/Schramm-Klein/Neidhart 2005).

Ensuring employment until 2011, thus associated with securing the location of the West German VW factory
One-off payment of € 1000
No wage rises until the beginning of 2007, a zero wage round for both employees and top management
Low salary for new employees
Appeal clause containing a short-term dismissal clause
<b>Objective: Reducing Personnel Costs by one billion Euros</b>

Figure 6: Wage agreement for the future for VW in 2004  
(Source: Zentes/Schramm-Klein/Neidhart 2005, p. 22)

The empirical results presented in figure 5 can also be interpreted as an expression of a new flexibility and movement in the labour market. (In this context, refer to the contribution of Broll/Hansen in this volume.) Accordingly

- 71% of the responding employees were willing to train for an alternative work activity,
- 77% of the responding employees were willing to accept flexible weekly working times,
- 29% of the responding employees were willing to be at home only on the weekends in order to secure their jobs for at least three years.

The flexibility of labour markets affects not only regulation, but also people's increasingly mobile careers and the associated real mobility. The concept of "virtual regions" (Hartz 2005, pp. 82-83) relates to this mobility and attempts to convert it into real and new employment capacity for regions of Germany. The focus is on networks of economically active people whose commonality lies in their regional origin, so that, despite spatial and geographic distance, they can apply their current knowledge context in their home region and link up with the value added activities that are occurring there.

#### 4.1.4 From Transactional to Relational Economic Activity: New Models of Buying and Selling

While the new rules of the game that were discussed above can, in summary, be interpreted as a visible recognition of intensified market control or at least an increased mar-

ket orientation, at the entrepreneurial level, a change in dealing with actors in the procurement markets is evident. This refers to suppliers, actors in the sales markets and customers: from transactional to relational interaction. (In this context, refer to the contribution of Schramm-Klein/Morschett and Terlutter/Weinberg in this volume.)

These developments are also characterised as new forms of relationship management, as “supplier/customer relationship management” (Sexauer 2004) or as “relationship marketing” (Bruhn 2001). The concepts are often limited to the most important suppliers or customers as “key supplier management” or “key account management”.

Procurement and sales-market-oriented forms of relationship management are associated with this, so that the procurement or marketing activities do not aim at individual (discrete) exchange processes, but rather at long-term and increasingly cooperative business relationships in which the suppliers or customers are regarded as partners. Relational business contacts are characterised by a variety of variables or attributes in terms of their origin and nature (Bartsch 2004, pp. 173-175). These are:

- Commitment as the most common independent variable, that is, the mutual and ongoing desire to continue with the business relationship and to ensure that it lasts over time.
- Confidence as the fundament of the business relationship, that is, the belief that one business partner will act in the interests of the others.
- Cooperation, meaning similar or complimentary actions from relationship partners in order to achieve common objectives.
- Mutual dependence in order to reduce the danger that unilateral power and the corresponding dependence of the powerful partner will compel the less powerful into unwelcome and unwanted activities.
- Striving towards satisfaction with performance, which corresponds with high demands on suppliers.
- Mutual adaptation through process or product change.
- Commonly used technologies with a networking of IT activities in order to strengthen functionality.
- Structural correspondence or commonalities which develop over time with the intensity of specific investments, adaptations and common technologies.
- Social agreements or commonalities in the sense of personal actions by employees or business partners as representing the degree of mutual personal friendship.

The aim of procurement or sales-market-oriented relationship management is ultimately to achieve win-win situations. Particularly because of this new form of goal-orientation, this new set of game rules can also be regarded as a paradigm shift.

## 4.2 Getting Going

### 4.2.1 From Collective Depression to Entrepreneurial Renewal: New Entrepreneurial Spirit

A look at the societal and economic climate in Old Europe reveals what can fairly be described as an episode of collective depression. After the growth phase which commenced at the end of the Second World War and continued into the 1960s and after the almost euphoric period in which the European common market was expanded vastly (Scholz/Zentes 1995) especially in the 1980s, after the phase of German reunification and after the peaceful and promising revolution in Central and Eastern Europe (Scholz/Zentes 1998), since the end of the 1990s, a mood of scepticism about the future has dominated (Scholz/Zentes 2002). The dynamic technological change, and fear of being unable to cope with this change, which has been caused by increasing globalisation or the associated fear of job losses and anticipated increasing financial burdens through inevitable winding back of social systems are just some of the sources of the distinct “crisis mentality” (Siebert 2003).

If one considers the expectations of the future for Germany from the perspective of Germans, a distinctly sceptical evaluation is evident (figure 7):

- 55% of the respondents expect the labour market situation to deteriorate.
- 40% of the respondents expect the quality of life for families and children to deteriorate.
- 28% of the respondents expect the educational situation to deteriorate.

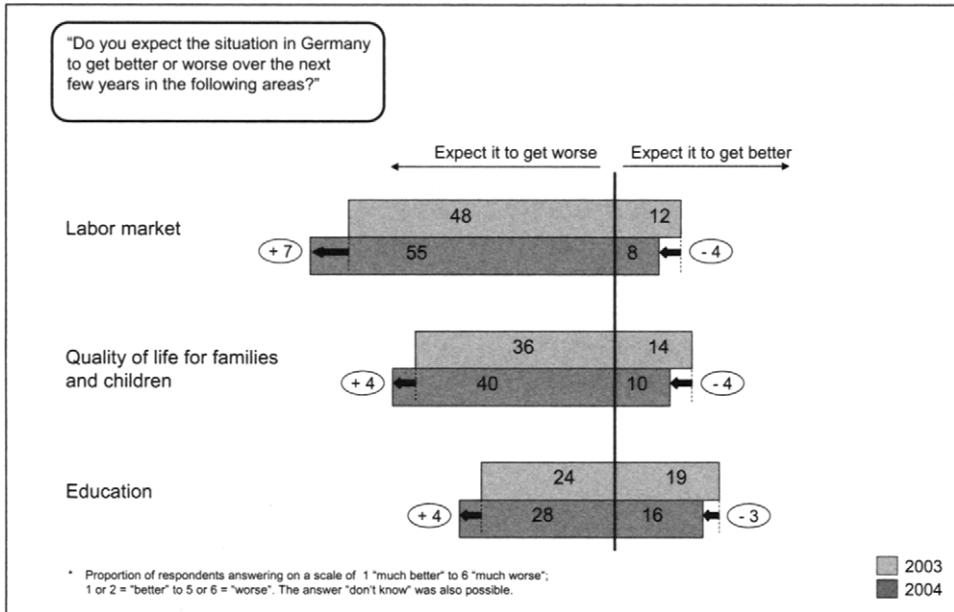


Figure 7: Future expectations for individual aspects of life in Germany (Source: McKinsey et al. 2005, p. 44)

While in Germany – as demonstrated in Sections 2.2.1 and 2.2.2 – willingness to make sacrifices in order to secure one’s own job and to create new jobs, is the result of scepticism about the future, this is not “fertile ground” for establishing new business and for a new independence, new entrepreneurship, all of which are desperately needed. Accordingly, in the study “Perspectives for Germany 2003/2004”, only 23% of the responding Germans were willing to establish their own business if they were sure that this would create new jobs (McKinsey et al. 2004 p. 57). However, this statistic should not be interpreted as a general willingness to be entrepreneurially independent. Such a willingness to the extent of 23% would be an expression of a new entrepreneurial spirit, from which, regrettably, Germany and Old Europe are far removed.

There needs to be a mood of “get up and go” in existing enterprises. The opportunities presented by the globalised world, of technological change and the courage to meet the challenge of fundamental and constant change are clearly recognised. Entrepreneurship has always meant: action and dynamism, creativity and imagination, a willingness to experiment, the courage to take risks and an openness to change. (In this respect, see also the contribution of Velamuri/Sosna in this volume.) The need for a changed awareness, not only in society, but also in many enterprises or on the part of their managers and leaders, is widely recognised. However, the much-invoked “jolt into action” just has not occurred; and this one has to be instigated.

#### 4.2.2 From Administration to Management: New Managerial Models

The creation of a dynamic mood and spirit entails more than mastering the various conventional instruments of management. Modern controlling, modern marketing and IT-networks and much more are indispensable conditions for successful business administration and management. If management is limited to the (further) development and application of such supporting processes and methods, it degenerates into little more than a trade.

Successful management inevitably requires employee motivation and integration. In this respect, in contrast to America, for example, Old Europe has traditionally considered industrial relations as a fundamental element of its approach to management (Schreyögg/Oechsler/Wächter 1995, pp. 212-224). However, what is more important is that, beyond methodological competence, there must be managerial and leadership competence which is quite passionate. "People management" must ultimately form the focus of business activity.

This entails, in particular, a professional handling of corporate human resources. An example of a long overdue strategy change is the current movement in the debate on business administration away from a personnel-cost approach (negative monetary), towards a human-capital approach (monetary positive). This human-capital debate (Scholz/Stein/Bechtel 2004) specifically treats people in enterprises not as an economically onerous and cost-generating mass, but as carriers of value. Accordingly, it would be nonsensical if, in the awareness and acknowledgement on the part of enterprises that "employees are our most important capital", no one really appreciated this fact. No one would then take the approach seriously. Recognition of the economic significance of human capital and its strategic value for optimisation enables enterprises to stress internally the relative significance of personnel management activities and their comparison with other business administration functions. This extends to external reporting on personnel practice. The very orientation towards human capital management creates a variety of opportunities for all participants and with minimal associated risks. Germany and Old Europe could be pre-eminent in this area.

If one pursues the postulate of new leadership-oriented management models, this entails a fundamental reorientation of educational and in particular further-education opportunities. In the university sector, the purely technical components of management continue to dominate. What is required is a concerted linking with "live" managerial experience and responsibility.

#### 4.2.3 From (Pure) Egoism to Social Responsibility (too): New Corporate Culture

A new understanding of management also includes responsible behaviour in enterprises. In the sense of Corporate Social Responsibility (CSR), which is a familiar concept but

one that is difficult to implement (Farmer/Hogue 1973), several issues are significant. These relate to sustainable production which is economically viable, socially just and ecologically compatible. The point is that enterprises influence economic, ecological and social circumstances throughout the world just as much as politics and politicians.

CSR is therefore not a supplementary corporate activity, but a way of handling the very core of business activity. As an example of CSR in Germany, Bergius (2004, p. 2) explains that with environmentally friendly tourism offers, the firm TUI appeals to customers who would not otherwise book packaged tours at all. With its “eco-food”, the baby food manufacturer Hipp has, de facto, set a new standard by which the competition is measured and compared. The school and office equipment manufacturer Herlitz, has committed itself to the field of training as a means of helping themselves out of the recent crisis. Because of the lack of funds for marketing, Herlitz assisted in school projects, so that teachers and pupils spoke positively of the company.

From the perspective of the EU, “CSR can therefore make a contribution to achieving the strategic goal of becoming, by 2010, the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion” (European Commission 2002, p. 4).

This hope, or even certainty, is based on investigations which demonstrate that enterprises which operate responsibly, obtain more profits and even achieve higher corporate worth (figure 8).

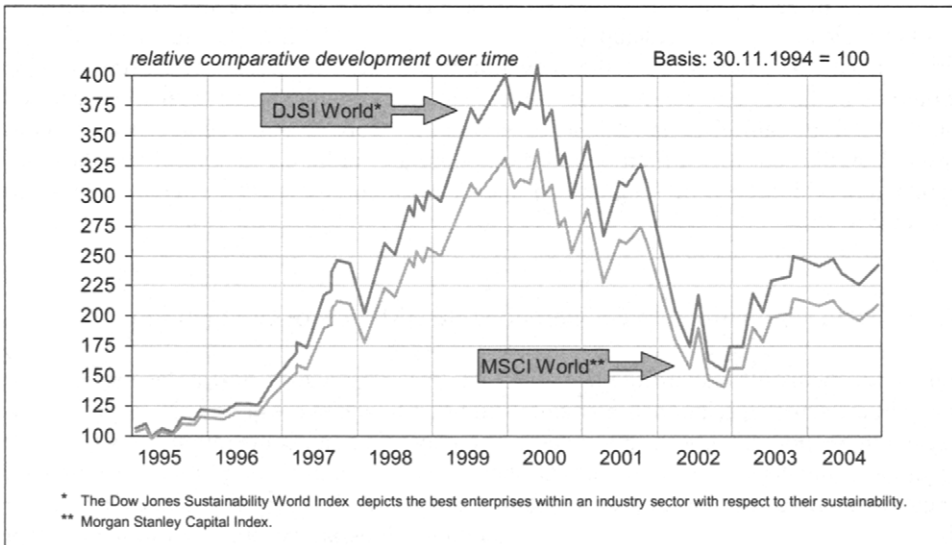


Figure 8: Dow Jones Sustainability Index  
 (Source: SAM-Indexes GmbH 2004 (cited by Bergius 2004, p. 2))

Also within enterprises, an increased orientation towards open and transparent interpersonal interaction is evident. The concept of “Darwiportunism” (Scholz 2003a) indicates that, as complex social networks of actors, enterprises only function effectively where there is simultaneous collective competition combined with an orientation towards individual benefit:

- Darwinism is regarded as an economic principle according to which, irrespective of whether or not one approves of it, economic activity and life proceeds according to the notion of “only the few survive”. Darwinism occurs not only between enterprises, but also between departments and even employees. People seldom admit that they are being Darwinist, but progressively more systems revolve implicitly around this logic.
- Opportunism is based on the drive for individual survival. At the latest since the New Economy, the clever opportunist is familiar as the type of employee who instrumentalises his environment in order to promote his own welfare. However, opportunism is also found when employees attempt to survive within rationalisation processes and place their own interests over those of the enterprise. Despite its negative aura, opportunism means nothing other than to “do like everyone else – find your opportunity and grab it”.

With respect to the meeting of Darwinism (collective mechanisms for optimising enterprises, business areas or employees) and opportunism (individual drives, seizing opportunities without consideration of others), a warning against drawing a false conclusion is called for: Believing in “the goodness in people” and promoting the “elimination of market radicalism” is understandable, but a realistic approach to management in enterprises must take into account the inevitability of Darwinism and opportunism. This would be in the hope of creating more stable enterprises in the long run than those based on the myth of “altruistic angels”, a naivety that is likely to lead to collapse when confronted by the first real difficulty and disappointment in human nature. Thus, these insights, too, with their wide-ranging consequences for corporate culture, contribute to social responsibility.

#### 4.2.4 From Competition to Cooperation: New Models of Competition

Ethical demands for responsible behaviour and the conspicuous shift to lasting relationships in the sense of relational interactions in order to achieve win-win situations, as discussed in Section 2.2.4, lead to a linkage of competition and cooperation. This tendency is already noticeable as a trend, but there is considerable room for intensification (Schmidtchen 2005). This can even occur if cooperation is limited to selected fields of activity, and in other respects, competitive relationships are accepted, as in the concept of “co-opetition” (Brandenburger/Nalebuff 1996) and/or “transcompetition” (Robbins/Finley 1998).

Accordingly, it is possible to achieve efficiency and effectiveness advantages for the participating actors without constraining competitive relationships in sales markets through

cooperative activities with competitors. Such relationships are often referred to as cooperative, often known as collaborative commitments of companies in “pre-competitive” segments of the value chain, and these can be both up-stream and down-stream in orientation:

- Common research and development plans (such as in the semiconductor industry, biotechnology, genetic and nanotechnology),
- Common use of production capacity (such as in the broader electronics and entertainment electronics industries),
- Logistical joint ventures, such as common storage and distribution (as in the food and DIY industries).

Value added models of this kind can also be interpreted as a (further) form of relationship management. “Relational competition management” is thus added to the prevailing supplier and customer management. As already indicated, this is not a new business model, but rather an innovative model of value added activities and structuring. The business models of the participating actors continue unchanged.

The model of cooperative or collaborative value added “transfers” an enterprise from essentially closed structures into networks (Zentes/Swoboda/Morschett 2005). Successful activity within such networks requires not only an adaptation of processes and their supporting systems such as in the IT area, but also a mental openness and adaptability. Besides a strategic fit and a technical and organisational fit, the corporate-culture fit of the cooperation partners proves to be an important factor in “cooperative” value added.

## 4.3 Turnaround

### 4.3.1 From Convergence to Divergence: New Awareness of Difference

The much-cited internationalisation or globalisation tendencies extend not only to value-added areas such as purchasing, research & development and production, but also, as is widely known, to a large degree also to marketing and thus to sales markets. Since Levitt (1983), at the latest, in this context the issue has arisen of the potential of standardised marketing against the background of internationally observed increasingly converging consumer behaviour. Even if this thesis leads to controversy and debate in the future, and some empirical studies will support it while others do the opposite, intercultural groups can increasingly be identified in all industrialised and industrialising countries (consider, for example, the Euro-Socio-Styles). The existence of such cross-border target groups facilitates a segment-specific operation with standardised concepts.

This does not contradict the increasing awareness of cultural diversity in Old Europe that needs to be promoted. The new understanding of a “Europe of regions” is also the political expression of this orientation. In terms of marketing, this means the opportunity for a

renaissance of regional products or services which have high sales potential in several respects. There are, therefore, potential market niches which provide profiling opportunities for medium-sized firms and thus the potential for growth. Regional diversity is, at the same time, a starting point for export potentials. Products with a regional character are finding increasing acceptance in regions other than the original ones, which provides the basis for “ethnomarketing” (Wilken 2004). This “converging” acceptance is in fact grounded in divergence.

The cultural diversity of Old Europe remains one of its main attractions, and not only from the perspective of tourism. Maintaining this differentiation is a virtually indispensable element of regional macro-marketing. From the managerial perspective as well, the cultural domain of Old Europe opens up potential which can be exploited through a synthesis of differing core competencies and basic behavioural patterns. This calls to mind such potential synergies as the linkage of Italian design skills with German technology and organisational competence. The synthesis of cultural, political/historical and linguistic dimensions also offers enormous competitive advantages for Old Europe, which have not been previously unknown, but which have certainly not been “played out” in full. Accordingly, due to its geographic location and cultural affinity to Eastern Europe, Austria is the ideal bridgehead for capturing these markets. This applies similarly to the Scandinavian countries and particularly Finland in terms of entry into the Baltic region and Russia. France provides a natural entry point for entry into the Francophone countries of Northern Africa, and Great Britain for the Indian subcontinent. The relatively high ranking of Germany in Asia and particularly in Japan and China, could form the basis for entering these growth markets. The traditional multi-lingual approach and orientation of the Benelux area provides the basis for monitoring and guiding global activities.

#### 4.3.2 From Network to Hierarchy: New Organisational Models

The already noticeable or desirable orientations for forming intra- and inter-enterprise networks for linking competition and cooperation as well as transforming transactional to relational exchange, simultaneously entails the danger of following the wrong path which enterprises have already partly followed. After all, the “cultural synthesis” discussed in the previous section is also attainable through corporate networks.

Network thinking is often accompanied by the notion of an absence of hierarchies. Models of self-control, equal-ranking coordination and other similar processes have been propagated. From a current perspective, however, a turnaround in this respect seems urgently necessary. It is precisely the enormous effectiveness and efficiency potential of these intra- and inter-enterprise networks that require tight network coordination.

Nonetheless, this requirement should not be interpreted as a call for the reinstatement of traditional centralised hierarchies which focus on the enterprise itself. Networks need focal organisational units with network-wide implementation power that is related to the

relevant field of expertise and competence. Both headquarters and subsidiaries, branches or joint ventures can serve as focal organisational units in the sense of competence centres according to the lead-country model of Bartlett and Ghoshal (1990). The utopia of freedom from hierarchies should, however, be relegated to the past.

Demands for stronger hierarchy do not conflict with notions of increased participation along the lines of the “people management” that was discussed earlier, either. The competitive strength of enterprises derives from situationally varied managerial models which are oriented towards the particular phase of management process, that is, the development and implementation phases.

In the development phase, new concepts and decision-making processes should be as participative as possible, so as to utilise the competencies and know-how of a variety of employees and to create commitment, and this should not be mistaken for some romantic and unrealistic notion of consensus. Conversely, during the implementation phase, the decisions that have previously been made must be implemented rigorously and authoritatively. Nonetheless, this does not prevent decisions relating, for example, to research, production and marketing, from being subjected to periodic audits and, where necessary, adapting them once again through participative processes.

It is particularly this synthesis of participative and autocratic elements that also entails a lineage of traditional cultural dimensions of Old Europe.

#### 4.3.3 From Central Planning to Confidence in the Market: New Market Economy

If one considers the entire economic discussion in Germany, and in this respect, Germany is different from the rest of Old Europe, one soon gains the impression that the flood of regulation stifles any dynamics that would otherwise prevail. Only recently has it become fashionable, as mentioned in Section 4.1.2, for newly elected local or state governments to eradicate old laws and regulations. Nonetheless, from wage negotiations to education policy to taxation legislation, the view still prevails that free competition can only occur subject to regulation, so that it is no longer really free.

Over-regulation is also a traditional remnant in German enterprises that, in previous up-swings, have developed an elaborate planning mechanism. In Germany, the guiding principle of organising each and every aspect of corporate life has dominated up to the present. From planning to controlling, all aspects are described and evaluated in minutest detail.

Meanwhile, pressure is mounting in all sectors of industry for both financial and non-financial resources to be used more efficiently and effectively. In the context of corporate management, attempts are made to make statements as to which corporate areas are “good” and which are “bad” in terms of performance, for example. However, so far it

has not been possible to develop a system which helps to provide an accurate comparison of all corporate areas. Despite the wide range and disparity of the various approaches, the only thing they really have in common is their inability to provide a viable solution to the problem.

Yet, it is possible within an enterprise to allow the “market” to decide which areas or employees are good. The methods range from transfer prices between profit centres and price-related guidance (Schmalenbach 1948). Market mechanisms do not only entail such (sometimes controversial) monetary systems – markets also develop in the context of structural or other organisational solutions aimed at creating transparency to make information freely available to all internal parties who supply and require information and are not controlled hierarchically by anyone.

This field of internal organisational market systems has not yet been pursued intensively in Germany. Yet, it offers many bases and considerable innovative potential for a conscious selection of market solutions for managing and guiding the performance of sectors of enterprises (Scholz 2003b). This includes, for example, the evaluation and value-oriented optimisation of human capital (Scholz/Stein/Bechtel 2004).

Particularly with respect to the debate on “central control versus the market”, a comprehensive reversal is required. The problem is that whenever “more market” is called for, all systems develop in the opposite direction. The university landscape provides a macabre example. An opening to the market is propagated constantly and this myth is also used as a “stick-on label”. Nevertheless, the German university system is subject to ever increasing planning and central control and ever decreasing decentralisation and autonomy for the organisational units which are ultimately responsible for performance. This fatal trend must be stopped and reversed if the ongoing damage to Germany as a location is to be terminated.

#### 4.3.4 From a Politicians’ State to a Civil Society: A New Understanding of Democracy

At present, we are experiencing an ever stronger and indeed excessive predominance of politicians, where real value-added processes evidently no longer play a role. The media are not influenced by real occurrences, but exclusively by the perceptions articulated by politicians in the context of their power plays in front of the cameras and notepads. When politicians are celebrated as “media chancellor(s)” (Meng 2002), political substance recedes into the background.

It would appear to be the case that no professional group in Germany is so thoroughly unaffected by job destruction and pay cuts as that of politicians. If one included the newly created positions at a European level, it would become immediately evident that real processes retreat ever more into the background and that political rhetoric is becoming an end in itself. This process has currently reached a level that politicians no longer even think in terms of their much vaunted simplifications, but, in order to legitimise their

significance, intensify the localisation of new fields of regulation. A good example is the much discussed implementation of guidelines for the European Union in the form of an anti-discrimination law, the originally planned German intensification would have discriminated against Germany as an industrial location.

If one political scandal after another takes place, each relating to a politician and his self-seeking activities, it is quite clear that Germans will inevitably become very disgruntled with their politicians.

Even if it is not clear who can prevent the tendency of politicians to expand their power, this trend can indeed be prevented and replaced by a movement to the contrary. Such a movement could possibly arise from the notion of a civil society. In this context, the decentralised self-organisation of individuals, groups, and interest organisations would assume a greater role, also, and indeed particularly, in the state and the economy (Steger 1999, pp. 86-106). Citizens and employees undertake activities in order to contribute to networks for the common good. This is more than an altruistic hobby. Even now, lobby groups, collective bargainers, stakeholders, non-profit organisations and other non-governmental organisations assume an important guiding function and relieve the burden devolving on the state and economy in some sectors. Also, in terms of decision-making processes, through civil-society procedures such as round tables or concerted actions, the range of actions implemented by citizens and employees is expanding, which in turn leads to a more intensive monitoring of the political process.

## 4.4 Letting It Be

### 4.4.1 No (Renewed) Expansion of Co-Determination

The combination of dimensions *visibility not given* and *desirability not known* leads logically to the field “letting it be” of the New Strategy Map (figure 3). In this quadrant, virtually a universe of possible errors is conceivable. Fortunately, strategic orientations which (could) ultimately lead to negative consequences are seldom evident.

Only a few years ago, in Germany, very serious thought was given to extending the system of co-determination. This trend has been stopped and seems quite dormant. In this respect, a “position paper” from the Federation of German Industry (BDI 2004, pp. 17-18) on the challenges facing European policy on medium-sized firms, has made it abundantly clear why a movement in the direction of more co-determination is not appropriate for Germany. Even now, the German model of parity is not understood or accepted by foreign investors and is regarded as a serious obstacle to investment. At most, a reform of the system of co-determination could allow enterprises themselves to decide on the nature and extent of co-determination. However, quite independently of that, certainly co-determination in enterprises has a limited future in a globalised world, as the

relatively harmless strike threats at Opel, Lufthansa und DaimlerChrysler in 2004 and 2005 have demonstrated.

Because there is no general tendency towards more co-determination, there is no need for action in this respect. This also applies to the role of trade unions, where stagnation seems to equate to an increasing lack of significance. An indicator of this trend is the rather harmless reaction to the position paper from the BDI, which, for example, Hexel (2004), the Chairman of the German Federation of Trade Unions, argued was associated with threats of a decline in the influence of trade unions. He stressed that an enterprise is "not only an economic accounting entity, but in the first instance, a social organisation with its 'own mind'". He recommended that employers decide between participation in supervisory boards of companies, which is attractive to trade unions, or strikes: "I know from my own experience that organising a strike is easier than ongoing work in a supervisory board". The situation with respect to co-determination looks somewhat different, to the extent that this does not deal with institutionalised and ideological trade union interests, but rather with the on-the-spot resolution of specific problems. The latter could play an important role in the future and without requiring any change in the framework of rules.

#### 4.4.2 No (Renewed) Reduction of Pension Age Limits

Over a period of many years, personnel costs and unemployment statistics have been presented as an optimisation through an ongoing reduction of the pension age limits. While in 1963 the average duration of pension payments was still 10.5 years, by 1983 this was already 12.8 years and by 2003, 16.7 (VDR 2005). The result of ever earlier retirement is that by the end of 2004, roughly one million concealed unemployed really need to be added to the official figures: "This year, the largest share of all concealed unemployment lies in early retirement (1,015,000)" (Anonymous 2004b, p. 15). However, this trend has come to an end, because it no longer seems possible to finance a continuously declining retirement age. On the other hand, a shifting of the retirement age in the other direction does seem meaningful in terms of an increased employment capacity, but is simply not realistic, because of the prevailing unemployment statistics. Therefore, in this respect, at least in the short term, there is no need for action.

#### 4.4.3 No (Renewed) National Protectionism

The liberalisation of the domestic, common market can be regarded as one of the major achievements of European unification. This success model has contributed to a safeguarded labour situation and growth throughout Europe (Zentes/Morschett/Schramm-Klein 2004). However, the current discussion (April 2005) on implementing the EU services regulation only to a limited extent, or in a more modified form is an attempt at neo-protectionism. This planned EU guideline on liberalising the service industry in the EU

is intended, *inter alia*, to be introduced into core service sectors as the “country of origin principle”. This principle could enable service providers and employees to offer their services across borders according to their own standards back home, and these may be considerably lower. Fears of an implementation of this guideline in terms of German law relate to dumping wages for services and massive circumvention of local practices such as worker protection or quality standards through relocating a firm (as a “letter box”) to an EU country with more favourable conditions.

Although this, in particular, is a liberalisation that, in the initial stage, could have a negative impact on the German labour market, the undoubted advantages of liberalisation must not be jeopardised by national protectionism. An opening of the European market for services can certainly increase the potential for selling German services within Europe, provided Germany succeeds in realising international competitiveness also in this sector. Finally, it is evident that the overall effect of the various risks and opportunities cannot yet be predicted. Nonetheless, new protectionist barriers should not be raised. Here too, to a large extent, a policy of “letting it be” is the appropriate one.

#### 4.4.4 No (Renewed) Ideological Resistance to Globalisation

For decades, the theoretical debate has revolved around whether the net effect for a country is positive if it opens its borders to free trade. A current controversy demonstrates that the economic arguments can lead to divided views. That is, the continued widespread dissemination of technical knowledge in the developing nations could cost America and the European Union a degree of competitive advantage (Samuelson 2004). However, this statistical scenario is contradicted by the dynamic adaptation potential of economies (Bhagwati/Panagariya/Srinivasan 2004), which has not yet been integrated into Samuelson’s argument. Nonetheless, the dominant view of business theoreticians remains that globalisation is generally economically beneficial.

On the other hand, the globalisation of the economy is often regarded critically from societal, social-policy and ecological perspectives. It is clear that the political, social and ecological impacts (beyond the home country as well) of international value added activities and the activities of enterprises must all be considered and analysed in order to achieve sustainable results over time. At the same time, there is a need to inform the public adequately in order to prevent the welfare-promoting effects of globalisation from being jeopardised by the slogans of naïve social utopians or, even worse, through “big bang” ideologists.

Fortunately, such “globalisation protests” have so far been rare in Germany. This is likely to continue to be the case, although this does not mean the end of continuous critical observation of economic developments.

## 5. Summary and Conclusions

If Germany implements the changes that seem necessary (figure 9), the rules of the game to end the process of attrition that is wearing away the substance of Germany as an industrial location will be established. If the process succeeds, the country could set benchmarks for international competition. The chances of establishing viable competitive advantages in this way are not bad. Provided Germany avoids taking the wrong paths into the future, this reformation process could not only resurrect its former strength, but extend its competitive position in international markets. This will in turn have broader impacts on the entire European economic and societal system:

From Old Europe to New Old Europe!

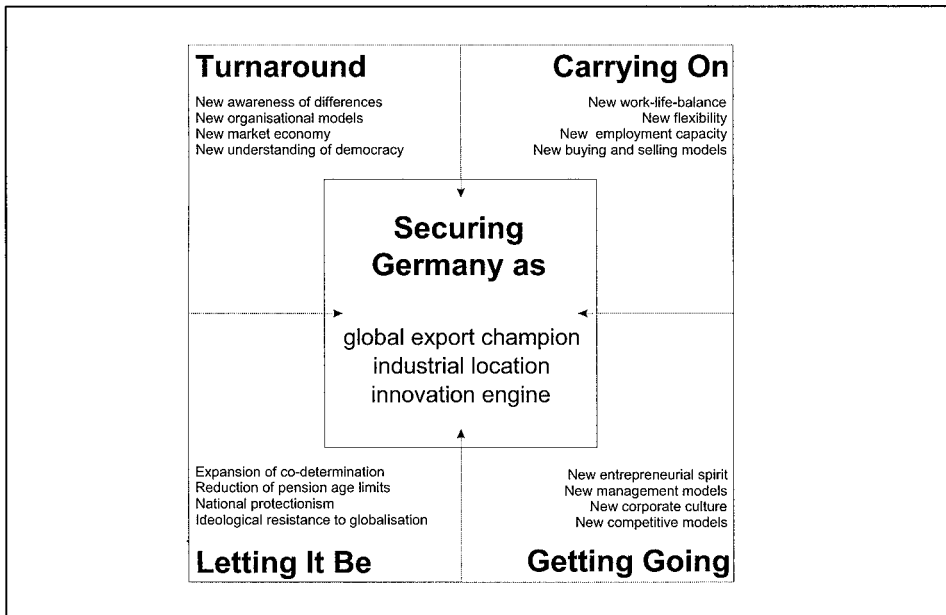


Figure 9: Necessary change in Germany

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