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Making Sense of Globalization

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BY PANKAJ GHEMAWAT AND STEVEN A. ALTMAN

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Time was, the forward march of globalization was received as a law of nature. Trade would always grow twice as fast as GDP, financial markets would continually become more integrated, foreign direct investment (FDI) would proliferate freely, and information and people would move around the world more easily. Borders and distance might cease to matter at all. But then came 2008, the global financial crisis, and the first global recession since 1944. It hit trade and capital flows hard, and many questioned whether globalization had stalled or even gone into reverse. Although globalization increased slightly between 2012 and 2013, it remains below its precrisis peak.

Understanding the patterns of economic linkage, and how they are changing, is the purpose of the index we produce at New York University's Center for the Globalization of Education and Management and at IESE Business School. The Global Connectedness Index, which has been sponsored by the international shipping company DHL since 2011, enables comparisons of the relevant data for all the years since 2005. We released the third edition in November 2014. For 140 countries, the index measures and analyzes flows of trade, capital, people, and information. It then aggregates them by country and by region, to get a sense of the changes in these patterns year by year.

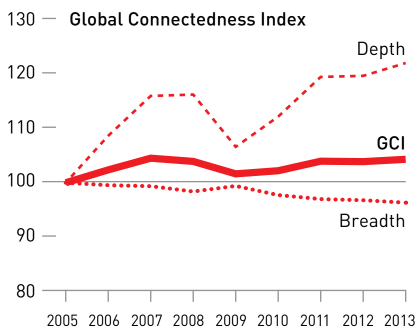
The results are unequivocal: The challenges of doing business abroad are daunting and will remain so. But large untapped opportunities to create value across national borders still exist. In a world of semi-globalization, where markets are only partially integrated, smart strategies can still create big profits by scaling business into new countries and arbitraging across international differences, especially when those efforts are coupled with appropriate adaptation to local and national contexts.

Developing such strategies requires a multidimensional view. A country's degree of connectedness clearly matters. The world's most globally connected countries (such as the Netherlands, Singapore, Switzerland, and the United Kingdom) are many times more connected than the least (which include Burundi, Myanmar, Botswana, and Paraguay). Because the extent of global connectedness is correlated with economic growth, this discrepancy is significant. But it would be unwise to base decisions about which markets to enter on overall connectedness alone. Company leaders need to be able to draw comparisons along three dimensions: depth, or how much of a country's economic activity is taking place across national borders, as opposed to within the country; breadth, or how globally a country's international flows are distributed; and directionality, or the proportion of

Illustration by Andre da Loba

Exhibit: **Two Dimensions of Global Connectedness**

One aspect of global connectedness (depth) is increasing, but another (breadth) is declining. Global strategies should take both factors into account, along with a third aspect, directionality, which measures whether the predominant flow travels into or out of a given country.



Source: DHL Global Connectedness Index, 2014

inward to outward flows for any country (*see Exhibit*).

The data on depth shows how difficult it is to achieve the levels of trade volume that many business leaders expect. The index tracks international flows of trade (merchandise and services), capital (FDI and portfolio equity, such as shares bought on foreign stock markets), information (international Internet bandwidth as a proxy for Internet traffic, phone calls, and printed publications), and people (immigrants, university students, tourists, and business travelers). Internationalization levels exceed 30 percent for only two of these variables—trade and portfolio equity stocks. And when the trade data is adjusted to compensate for products crossing borders multiple times during the manufacturing process, the overall figure drops from 32 percent to about 23 percent. In other words, less than 25 percent of the world's economic output travels across national borders.

Depth varies from one type of flow to the next. It is often relatively easy to make financial investments in foreign firms (portfolio equity) and to ship products from one market to another (trade). It is harder to build and manage operations abroad (FDI), and harder still to build an organization in which your people are as global as your market ambitions (immigration, international education, and business travel).

Trends in the data also vary by activity. The depth of international information flows has risen every year since 2005, powered by expanding telecommunications bandwidth. International capital and people flows grew between 2012 and 2013. But trade depth has been declining since 2011; a smaller proportion of the goods that are produced each year are exported. The latest forecasts imply a continuation of these patterns. More information and more capital are expected to cross national boundaries, while the robust trade recovery that many expect is repeatedly deferred.

The declining breadth of globalization also helps explain why international companies, especially those based in industrialized nations, have had a more difficult time in recent years. In 2005, the majority of the international interactions we tracked on the Global Connectedness Index were from one advanced economy to another. But starting in 2010, the majority of them have involved an emerging economy on one or both sides of the transaction. It is no longer necessary for these emerging economies to interact as much as they used to with the advanced economies on the other side of the world; they can now get much of what they need from one another. In short, the world's economic center of gravity is shifting eastward to emerging markets. And as a result, its geographic flow patterns are becoming more diverse.

Consider, for example, Germany's merchandise exports. Germany is without question one of the world's most successful exporting nations. But its exports to many emerging economies have not grown as fast as those economies' imports from other countries. Had Germany maintained its share of every country's imports from 2005 to 2013, its total merchandise exports in 2013 would have been 17 percent higher. Capturing those opportunities, however, would have required German companies to bridge far greater distances—not just geographically but also in their cultural, political, and economic practices. In fact, Germany did stretch out its exports over greater distances in 2013 than in 2005, but it still sent 70 percent of its exports to markets within Europe. In short, there is a great deal of room to further broaden Germany's export activity—along with that of most other mature economies.

Global companies often experience this world of changing breadth as increased competition with their rivals from emerging economies. Fortunately, they can do a great deal to reduce their sensitivity to cross-country differences and distances. It often makes sense to start with a firm's people—and at the top. Only 15 percent of the top management team members at most Fortune Global 500 companies hail from outside the firm's home country. Location decisions, product designs, and work processes can all be adjusted to help a firm more effectively broaden its international footprint.

Comparing countries' scores on depth and breadth can help them determine likely prospects for expansion. For example, countries with high scores on depth but low scores on breadth (such as Estonia, Barbados, and Brunei) are connected only to a narrow set of partner countries, and may thus be easier to enter via their main trade partners. Countries with relatively high scores on both depth and breadth (such as the Netherlands, Singapore, and the United Arab Emirates) tend to be good candidates for regional hubs.

Directionality—the third dimension studied in the DHL Global Connectedness Index—is also essential to country-level analysis. A firm considering investment in South Korea, for example, may already know that South Korea is a fairly large participant in international capital flows. But it's important to know that this capital flows disproportionately outward: South Korean firms are big abroad, but foreign firms are still relatively small participants in South Korea's domestic economy. Thus, South Korea may not be as easy a place to invest as its aggregate capital flow data might imply.

In general, companies forming a global strategy should first consider the specific aspects of connectedness that matter most to their own success. Those looking to manufacture offshore should consider the country's depth and breadth of merchandise trade, whereas those looking to establish a presence in a country's media sector should take into account the degree and direction of its capital and information flows. Distance, both geographic and cultural, also matters. The relative ease with which a company can operate in foreign countries depends not only on economic connectedness, but also on how familiar or unfamiliar the company is with the culture and political and economic institutions, and whether it has the ability to bridge any gaps.

Finally, comparing the connectedness profiles of rival companies' home countries can suggest the relative strengths and weaknesses each company inherits from its national context. For example, if your company is based in a country with high depth and breadth scores, it's likely to be relatively skilled at adapting to cross-country differences. That sophistication could stand you in good stead in years to come. +

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