



The Nature of Institutional Voids in Emerging Markets

Why Markets Fail and How to Make Them Work

EXCERPTED FROM

*Winning in Emerging Markets:
A Road Map for Strategy and Execution*

BY

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Introduction

THE WORLD IS FOCUSED on emerging markets.¹ The liberalization, growth, and globalization of these still-nascent economies have made them tremendous sources of interest, opportunity, and anxiety over the past twenty years. For households, emerging markets are a source of cheap consumer goods. For frustrated computer users, they are often the location of outsourced technical support. For executives of multinationals, emerging markets are growth drivers amid stagnation and financial crisis in developed economies—and the home turfs of powerful new corporate competitors.

In the first six months of 2009, the FTSE International Emerging Markets Index was up 41.1 percent, whereas the FTSE All World Developed Markets Index was up 7.2 percent. China, India, and Brazil have reported robust and significant growth during this period as the developed world struggled to recover from financial crisis.² For companies drowning in the crisis, these markets have offered life preservers of capital and growth. For upstart entrepreneurs and well-established companies alike, emerging markets are becoming testing grounds and incubators for innovation. For entrepreneurs, business leaders, and citizens in emerging markets, this newfound global standing is a great source of pride.

For some workers in the developed world, however, these markets are a source of job security angst. This anxiety has only increased in the wake

2 | Winning in Emerging Markets

of the financial crisis and recession in developed markets. For others—such as Wall Street investment bankers displaced by the U.S. financial crisis—emerging markets can be havens of new job opportunities. For new university graduates and young professionals in emerging markets, this growth has created tremendous opportunities and recalibrated career aspirations.

For politicians and pundits in the developed world, emerging economies are both derided as the destinations of offshored jobs and pitched as prospective customers for vaunted innovative products and green technologies of the future. For national treasuries in the developed world, the savings held in emerging markets have helped finance government deficits. For politicians from all over the world, emerging markets figure prominently in global trade and multilateral agendas. For environmental and labor rights activists, the rapid industrialization and undeveloped safeguards in these economies are cause for serious concern.

In a small but telling sign of a growing perception that emerging markets were both important and distinctive, the *Economist* in 1994 began including a page of emerging market economic and financial indicators at the back of each weekly issue. The rationale for the feature, the editors noted, rested on a simple premise: “Rich industrial countries dominate the world economy rather less than they used to.”³ In 2007, the *Economist* discontinued the feature, lumping the world’s major economies together in a single table of indicators.⁴ Whether the change was made for substantive reasons or simply to save space, the place of emerging markets in the global economy changed dramatically in that thirteen-year period.

Consider a few items that appeared in that 1994 issue of the *Economist* in which the emerging market indicators debuted. The magazine’s summary of the week’s news included a capsule noting the enactment of the North American Free Trade Agreement (NAFTA), linking emerging market Mexico more closely with its more developed northern neighbors—the United States and Canada.⁵ One article forecast that India would be “a power in its own neighbourhood but its frail economy and its physical isolation between the Himalayas and the sea will almost certainly keep it out

of the global competition” to be among the world’s preeminent powers.⁶ A two-page advertisement touted companies from Taiwan, noting, “Many of the computers crunching numbers and making their reputations on Wall Street are made in Taiwan. That’s right, Taiwan.”⁷

Since then, agreements similar to NAFTA have dismantled trade barriers in many emerging markets. India’s economy has boomed, in part by leveraging global communications technology that renders moot many of the challenges of its “physical isolation.” The promotional advertisement rebutting the incredulity that Taiwan could produce sophisticated computers is now almost laughable: four of every five personal computers now produced by contracted manufacturers are made by Taiwan-based firms.⁸

What Is an Emerging Market?

As economic globalization has brought down trade and investment barriers and has connected far-flung countries in integrated global supply chains—and emerging markets seem to be converging with the world’s “rich industrial countries”—distinguishing these economies from developed markets may seem to matter less than before. We disagree. One fundamental premise of this book is that businesses still need to distinguish emerging markets—collectively from developed markets and individually from each other.

But what, really, is an emerging market? The term *emerging markets* was coined by economists at the International Finance Corporation (IFC) in 1981, when the group was promoting the first mutual fund investments in developing countries.⁹ Since then, references to emerging markets have become ubiquitous in the media, foreign policy and trade debates, investment fund prospectuses, and multinationals’ annual reports, but definitions of the term vary widely (see table I-1).

The term is often reduced to the unhelpful tautology that emerging markets are “emerging” because they have not “emerged.” To understand emerging markets, we need to consider carefully the ways in which they are emerging and the extent to which they are genuine markets.

4 | Winning in Emerging Markets

TABLE I-1

Frequently used criteria for defining emerging markets

Category	Criteria
Poverty	Low- or middle-income country Low average living standards Not industrialized
Capital markets	Low market capitalization relative to GDP Low stock market turnover and few listed stocks Low sovereign debt ratings
Growth potential	Economic liberalization Open to foreign investment Recent economic growth

Source: Standard & Poor's; International Finance Corporation; Trade Association for the Emerging Markets; J. Mark Mobius, *Mobius on Emerging Markets* (London: Pitman Publishing, 1996), 6–23.

If you ask a conference room full of business executives how they would distinguish emerging markets from developed economies, variants of three stories will likely arise. Emerging markets such as Brazil, China, India, and Russia, some will certainly say, are emerging by virtue of their recent fast economic growth. The opening of these large economies to global capital, technology, and talent over the past two decades has fundamentally changed their economic and business environments. As a result, the GDP growth rates of these countries have dramatically outpaced those of more developed economies, lifting millions out of poverty and creating new middle classes—and vast new markets for consumer products and services. Large, low-cost, and increasingly educated labor pools, meanwhile, give these markets tremendous competitive advantage in production, and information technology is enabling companies to exploit labor in these markets in unique ways.¹⁰

Other executives will focus on emerging markets as emerging competitors. On the macro level, a landmark Goldman Sachs report published in 2003 forecast that the economies of Brazil, China, India, and Russia could grow to be collectively larger than the G-6 economies

(United States, Japan, United Kingdom, Germany, France, and Italy) in U.S. dollar terms before the middle of the twenty-first century.¹¹ Commentator Fareed Zakaria sees this “rise of the rest” as a transformative, tectonic shift in the distribution of global power.¹² Companies based in these economies, meanwhile, are already challenging multinationals based in the developed world—and not only in their home emerging markets. China-based Lenovo’s purchase of IBM’s personal computer business in 2004 and the acquisition of Jaguar and Land Rover by India’s Tata Motors in 2008 are only two examples of the increasing global mergers and acquisitions activity by emerging market-based firms. Some observers see the financial crisis of 2008–2009 as an inflection point, accelerating the emergence of these markets as dominant players in the global economy.

A deeper discussion might elicit a list of the persistent headaches of doing business in emerging markets. These markets, the executives might say, are prone to financial crises. Intellectual property rights are insecure. Navigating government bureaucracies can be thorny. Product quality is unreliable. Local talent is insufficient to staff operations. Reliably assessing customer credit is difficult. Overcoming impediments to distribution can be frustrating. Sorting through investment opportunities or performing due diligence on potential partners is often a guessing game. Others might throw up their hands and say that corruption is so endemic in emerging markets that the risks simply outweigh the potential rewards.

Based on many of these signs of emergence, some might say, emerging markets are not distinctly different from other markets; rather, they are simply starting from a lower base and rapidly catching up. Indicators such as the growing numbers of emerging market-based companies listed on the New York Stock Exchange or the growing ranks of billionaires from emerging markets listed annually by *Forbes* illustrate this trend.¹³ Behind those indicators, however, is a more complicated story of why firms based in these economies have sought out overseas listings and how those moguls have amassed fortunes in developing countries that are, by many standards, still quite poor.

6 | Winning in Emerging Markets

All these criteria—the indicators of opportunity and the causes for complaint—are important features of many emerging markets, but they do not delineate the underlying characteristics that predispose an economy to be emerging, nor are they particularly helpful for businesses that seek to address the consequences of emerging market conditions. We see these features of emerging markets as symptoms of underlying market structures that share common, important, and persistent differences from those in developed economies.

A fundamental premise of our work is that emerging markets reflect those transactional arenas where buyers and sellers are not easily or efficiently able to come together.¹⁴ Ideally, every economy would provide a range of institutions to facilitate the functioning of markets, but developing countries fall short in a number of ways.¹⁵ These *institutional voids* make a market “emerging” and are a prime source of the higher transaction costs and operating challenges in these markets. By relying on outcome criteria to assess markets, managers often overlook the ways in which emerging markets operate differently than do developed economies. Ranking the world’s economies by per capita gross domestic product would suggest that the United Arab Emirates, for example, is among the world’s most developed economies, but it is an emerging market nonetheless because of its market structure.

Intuitively, managers know that operating a business in an emerging market is different from doing so in a developed economy. It is tempting to chalk up these differences simply to country context. Indeed, market structures are the products of idiosyncratic historical, political, legal, economic, and cultural forces within any country. All emerging markets feature institutional voids, however, although the particular combination and severity of these voids varies from market to market.

An Actionable Framework

The chapters in this book identify ways in which the uniqueness of emerging markets is shaping the business opportunities and challenges in these economies. We offer a simple actionable framework to help

managers map the institutional context of any emerging market. By developing a granular understanding of the underlying market structure of emerging economies—and not only cataloging symptoms to be incorporated in an overall risk assessment—companies can tailor their strategies and execution in emerging markets to avoid mistakes and outcompete rivals. Familiarity with the framework and toolkits in this book can help organizations address key questions:

- In this particular market, which market institutions are working, and which institutions are missing?
- Which parts of our business model can be adversely affected by these institutional voids?
- How can we build competitive advantage based on our ability to navigate institutional voids?
- How can we profit from the structural reality of emerging markets by identifying opportunities to fill voids, serving as market intermediaries?

In part I of this book, we unpack our structural definition of emerging markets by examining the institutional anatomy of these economies. In part II, we apply this framework to the challenges facing various actors as they manage in these contexts: companies filling voids as intermediaries; multinationals based in developed markets; and domestic companies based in emerging markets, which we call *emerging giants*.

Companies of various stripes face similar strategic choices as they respond to institutional voids in emerging markets.

Replicate or adapt? Institutional voids invariably challenge the execution of business models in emerging markets. Businesses need to determine the extent to which business models can be replicated in emerging markets or adapted to fill institutional voids. Multinationals need to weigh the extent to which they can transfer business models cultivated in developed markets to emerging economies rife with institutional voids or determine how they should adapt. Local companies with global aspirations

8 | Winning in Emerging Markets

can learn from the business models of developed market-based multinationals but also can exploit their local knowledge by developing models based on their intimate understanding of institutional voids in their home markets.

Compete alone or collaborate? Developed market-based multinationals and emerging market-based companies each bring inherent advantages to bear in emerging markets, but each might also gain from collaboration with other parties. Multinationals bring brands, capital, talent, and other resources to emerging markets, and yet their track records in these economies have been mixed. Local knowledge is a particularly valuable asset for firms to exploit in navigating institutional voids, and multinationals need to decide whether some form of collaboration with a local player makes sense for their business. Sharing is a two-way street in such collaborations, however, and multinationals need to weigh the benefits of local knowledge against the risk of empowering a partner that could turn into a well-trained and well-informed competitor. Local companies can exploit their inherent advantage in navigating institutional voids as a source of competitive advantage vis-à-vis incoming multinationals, but these firms can gain capabilities and credibility through global partnerships.

Accept or attempt to change market context? Businesses operating in emerging markets can take the institutional contexts of these markets as a given or can work actively to change them by filling institutional voids. Multinationals based in developed markets can either sidestep voids as best they can or strive to fill them in service of their businesses. Given regulatory constraints and other sensitivities, however, it can be difficult for multinationals to fill some voids in emerging markets. Local companies are in some ways better equipped than multinationals to operate amid institutional voids, but they also can exploit their local knowledge to fill voids and create a barrier to entry and expansion by foreign competitors. As we discuss in chapter 3, changing market context can be an entrepreneurial opportunity in its own right for intermediary-based businesses that fill institutional voids.

Enter, wait, or exit? Based on an assessment of institutional voids, companies need to decide whether to enter and operate in an emerging market, to wait and emphasize opportunities elsewhere, or to exit if they are already in the market. Multinationals can bring their global capabilities to bear in an emerging market or say, “Not now” if the challenges posed by institutional voids are too daunting. Exercising the option to wait is relatively easy for multinationals, because they can choose where to compete and have the resources to move to different markets. Although not entering is not an option for local companies based in emerging markets, these firms do have an exit option. Local companies with capabilities unrewarded in their home market contexts can say, “Not here” and exit their markets early in their corporate histories. Exercising this option is difficult for emerging market-based firms, because often they lack the resources needed to go global soon after their founding. Emerging market-based companies operating in different industries might emphasize opportunities elsewhere by waiting to enter a particular industry where institutional voids are more serious obstacles.

Overview of This Book

Part I (chapters 1 and 2) describes the importance of market intermediaries to businesses in all markets and offers a toolkit for companies operating in emerging markets to spot and respond to institutional voids (see figure I-1). Part II begins, in chapter 3, by looking at how companies can see voids as entrepreneurial opportunities and examines the challenges of building intermediary-based businesses in emerging markets. Chapters 4 and 5 then discuss how developed market-based multinationals and emerging giants from a wide range of industries, operating in a wide range of contexts, have wrestled with the strategic choices above to compete in emerging markets. Chapter 6 looks at how the institutional contexts of emerging markets shape the globalization journeys of emerging giants. We conclude the book in chapter 7 by summarizing an agenda for companies to use in developing and deploying strategies that fit emerging markets.

FIGURE I-1

Book structure and organization

Introduction	
Part I: Conceptual Introduction	Chapter 1: The Nature of Institutional Voids in Emerging Markets
	Chapter 2: Spotting and Responding to Institutional Voids
Part II: Applications	Chapter 3: Exploiting Institutional Voids as Business Opportunities
	Chapter 4: Multinationals in Emerging Markets
	Chapter 5: Emerging Giants: Competing at Home
	Chapter 6: Emerging Giants: Going Global
Chapter 7: The Emerging Arena	

One

The Nature of Institutional Voids in Emerging Markets

CONVENTIONAL WISDOM holds that the diffusion of skills, processes, and technologies throughout global markets is resulting in convergence; the gap between emerging economies and their more developed counterparts is quickly closing.¹ This optimism has been bolstered by the development of high-tech global supply chains and the offshoring of professional services, but market transition and emergence often take more time than most decision makers anticipate. What is emerging in emerging markets is not only their forecast potential or liberalizing investment environments but also the institutional infrastructure needed to support their nascent market-oriented economies.

Institutional development is a complex and lengthy process shaped by a country's history, political and social systems, and culture. Dismantling government intervention and reducing barriers to international trade and investment can spark market development, but they do not immediately produce well-functioning markets. The world may be becoming flatter, as columnist Thomas Friedman has argued, but the landscape of emerging markets, in particular, remains deeply striated by institutional legacies.²

Many observers of emerging markets are quick to recognize that, for them to be fully developed, it is important to create physical infrastructure—roads, bridges, telecommunication networks, water and sanitation facilities, and power plants. Without adequate physical infrastructure, it is hard for participants in product, labor, and capital markets to function effectively. However, less recognized is the importance of institutional development that underpins the functioning of mature markets.

The most important feature of any market is the ease with which buyers and sellers can come together to do business. In developed markets, a range of specialized intermediaries provides the requisite information and contract enforcement needed to consummate transactions. Most developing markets fall short on this count. Investors and companies quickly realize that these regions do not have the infrastructure, both physical and institutional, needed for the smooth functioning of markets. It is difficult for buyers and sellers to access information to find each other and to evaluate the quality of products and services. When disputes arise, there are limited contractual or other means, such as arbitration mechanisms, to resolve these issues. Because of a tremendous backlog of cases, resolving disputes in Indian courts, for example, can take five to fifteen years.³ Some joke that “if you litigate here, your sons and daughters will inherit your dispute.”⁴ Anticipation of these transactional difficulties also hinders contracting. We use the term *institutional voids* to refer to the lacunae created by the absence of such market intermediaries.⁵

To understand institutional voids in more concrete terms, consider the plight of an independent traveler from the United States visiting an emerging market on vacation. Beyond the challenges of operating in an environment having a different language, culture, and currency, the traveler also must navigate a different way of doing business, even as a tourist. Accustomed to booking flights through Expedia, Orbitz, or Travelocity, choosing hotels based on easily accessible and reliable reviews, obtaining travel-planning assistance from the AAA, paying for goods and services with a credit card in virtually any location, purchasing goods that meet enforced regulatory standards and possess enforceable warranties, paying taxi drivers according to standardized rates, receiving flight status updates by

mobile phone text message, and finding restaurant phone numbers by simply dialing 4-1-1, the traveler must adapt to a different environment in the emerging market.

Although they might come in different forms, most other developed markets, such as European countries or Japan, have a comparable tourism market infrastructure to that of the United States. The institutional arrangement of an emerging market's travel and hospitality marketplace, however, differs in fundamental ways. Internet-based airline ticket vendors, published travel reviewers, telephone directory assistance providers, credit card payment systems, and other such intermediaries are businesses, but they are also part of the U.S. market infrastructure. They help bring together buyers and sellers of travel services. (Nonprofit organizations, such as AAA, can also serve as market intermediaries, and governments provide many intermediary functions through regulatory bodies and civic services.)

In developed economies, companies can rely on a variety of similar outside institutions to minimize sources of market failure. Emerging markets have developed some of these institutions, but missing intermediaries are a frequent source of market failures. Informal institutions have developed in many emerging markets to serve intermediary roles. To reach rural consumers in India, for example, many brands rely on traveling salespeople to promote products in villages that have limited television, radio, and newspaper penetration. Salespeople stage live, infomercial-like performances out of the backs of trucks, explaining products while entertaining crowds with skits and banter. One such salesman, profiled in the *Wall Street Journal*, traveled more than five thousand miles per month, moving from village to village pitching products as wide ranging as tooth powder and mobile phones.⁶

Although some informal institutions may look like functional substitutes for the intermediaries found in developed markets, they often exist on an uneven playing field—accessible only to certain local players. A local loan provider might seem like a substitute for a venture capital industry, but only if the loan provider evaluates applicants on their merits or business plan. Seldom are informal market intermediaries truly open to all market participants.

Institutional voids come in many forms and play a defining role in shaping the capital, product, and labor markets in emerging economies. Absent or unreliable sources of market information, an uncertain regulatory environment, and inefficient judicial systems are three main sources of market failure, and they make foreign and domestic consumers, employers, and investors reluctant to do business in emerging markets. When businesses do operate in emerging markets, they often must perform these basic functions themselves.

Institutional voids, however, are not only roadblocks. They are also palpable opportunities for entrepreneurial foreign or domestic companies to build businesses based on filling these voids. To return to the example of the travel industry, Ctrip.com has emerged as China's leading travel booking Web site, offering services similar to those of Expedia, Orbitz, and Travelocity. Established in 1999, Ctrip.com fills voids by aggregating hotel reservation and airline ticket information, providing rates and schedules, and offering a platform for customers to complete transactions—a powerful proposition in a market without a well-developed network of alternative intermediaries, such as travel agents.⁷ Ctrip.com registered \$210.9 million in revenue in the year ending September 30, 2008, with a profit margin of 31.8 percent.⁸ Listed on NASDAQ, the company had a market capitalization of \$1.3 billion as of January 13, 2009.⁹ The significant value that can be created by intermediary-based businesses illustrates the importance of such market institutions—and the cost of their absence. Transaction costs in markets, the role of market institutions in mitigating them, and the challenges of designing market institutions have been analyzed by several Nobel Prize-winning economists: Ronald Coase, Douglass North, George Akerlof, and Oliver Williamson. We draw on this vast literature in institutional economics in the following discussion.

Why Markets Fail and How to Make Them Work

Transactions vary in difficulty. It is generally easier to transact in developed than in developing markets. For example, renting a car in Boston is far easier than it is in Mumbai, São Paulo, or Ankara. Purchasing a home

in London, although increasingly cost prohibitive, is a much easier feat than buying real estate in Moscow, with its infant mortgage market. Even in developed economies, however, there are degrees of transactional difficulty. For instance, U.S. consumers find it far more complex to buy health-care services than to buy groceries or consumer electronics.

Transaction costs, which offer one measure of how well a market works, include all the costs associated with conducting a purchase, sale, or other enterprise-related transaction. Well-functioning markets tend to have relatively low transaction costs and high liquidity, as well as greater degrees of transparency and shorter time periods to complete transactions.

The World Bank Group's World Development Indicators highlight the variance in market performance between countries. Brazil, China, and India required more than twice the number of start-up procedures to register a business in 2007 than the six procedures required in the United States; Australia required only two. Another transaction cost measure is the time required to build a warehouse. A warehouse could be completed in leading developed countries in fewer than 200 days in 2007—in some cases far fewer—whereas in major developing markets such as Brazil, China, India, and Russia, it took 411, 336, 224, and 704 days, respectively. Other indicators, such as time to enforce a contract, time to register property, and time to start a business, also suggest higher transaction costs in many developing regions (see table 1-1).

All markets, irrespective of development phase, are less than perfectly efficient. Compared with emerging markets, however, developed markets are more likely to approach consistent standards for efficient transactions. Conducting even simple transactions in developing economies can be a time- and resource-intensive process, posing hazards for those expecting the fluidity of developed markets.

The challenge of transacting in the absence of well-developed market infrastructure is best illustrated through the Nobel Prize-winning economist George Akerlof's example of a used car market. Akerlof's work showed the difficulty of creating a well-functioning market when the quality of goods and services being bought and sold is uncertain.¹⁰ After

TABLE 1-1

Comparing transaction costs in emerging and developed markets (2007)

Country	Start-up procedures to register a business (number)	Time required to build a warehouse (days)	Time required to enforce a contract (days)	Time required to register property (days)	Time required to start a business (days)
Emerging markets					
Argentina	14	338	590	65	31
Brazil	18	411	616	45	152
China	13	336	406	29	35
Czech Republic	10	180	820	123	17
India	13	224	1420	62	33
Indonesia	12	196	570	42	105
Israel	5	235	890	144	34
Republic of Korea	10	34	230	11	17
Nigeria	9	350	457	82	34
Pakistan	11	223	880	50	24
Russia	8	704	281	52	29
Turkey	6	188	420	6	6
Developed markets					
Australia	2	221	262	5	2
Canada	2	75	570	17	3
Germany	9	100	394	40	18
Japan	8	177	316	14	23
Norway	6	252	310	3	10
United Kingdom	6	144	404	21	13
United States	6	40	300	12	6

Source: World Bank Group, World Development Indicators, WDI Online.

owning and maintaining a car for five years and driving it for sixty-five thousand miles, the seller knows the condition of the car far better than the buyer. Unfamiliar with the car and its seller, the buyer will therefore approach the transaction with a degree of apprehension and mistrust. Is the seller selling a used car in decent working condition, or is he peddling a car with inferior quality relative to its price—a lemon? Is the car worth the price being asked?

The difference in knowledge about the car between buyer and seller—what economists call *information asymmetry*—and lack of trust make the buyer wary of taking the seller's claims of quality at face value. As a result, a prudent buyer generally is reluctant to pay the price asked by the seller. Given these conditions, how can the buyer and seller consummate the transaction to their mutual satisfaction?

One obvious solution, practiced in ancient bazaars for centuries, is price bargaining. Suppose the seller is asking \$10,000 for the car. The buyer can respond by offering a lower price—say, \$6,000—to compensate for the variety of unknowns. If the seller finds the price acceptable, the transaction will take place; otherwise, the seller will walk away.

But simple bargaining leaves most market participants unsatisfied. Why? The seller has a pretty good idea of the true value of the car, so he will be happy with the \$6,000 offer from the buyer only when it exceeds the car's true intrinsic value. This, of course, means that the buyer would have overpaid for the car even though the bid price is substantially lower than the asking price. In contrast, if the seller were honestly representing the facts of the car's quality and asking a reasonable price given its true value, he would find the \$6,000 bid from the buyer unattractive, prompting him to walk away from the deal. Thus, with a strategy of bargaining for a price lower than the asking price, the buyer will consummate only deals that are systematically adverse to his interests.¹¹

This type of used car market leaves buyers unhappy, because they systematically overpay for any given level of quality. Sellers of genuinely high-quality cars will find no takers, because the market-clearing prices are always lower than sellers' assessment of fair prices. The only participants who will be happy are sellers who sell lemons at an inflated price. Clearly, this type of market will not last very long because sellers of genuinely high-quality cars will learn not to use it, and buyers will regret their purchase decisions and will learn to avoid it for future transactions.

There is, fortunately, a simple way to fix the problem in the used car market. The buyer and seller can agree to take the car to an independent expert mechanic who tests the car for its quality and provides an assessment of

its intrinsic value. Based on this independent expert opinion, the buyer and seller can agree on a price.

How does the independent expert alter the situation? The expert opinion reduces information asymmetry between the buyer and seller and creates a basis for agreeing to a price based on common information. As a result, genuinely good-quality cars are likely to receive a fair price, so sellers and buyers of those cars will be happy with the transactions. Moreover, lemons will be exposed for what they are and accordingly will be priced lower. So buyers will either avoid them or, if they choose to buy them, will not overpay. The only players who will be unhappy with the introduction of the independent expert mechanic will be potential sellers of lemons. Because the used car market with the independent expert functions far more reliably than the one without such an expert, both the buyers and the sellers of good cars will be happy to pay for the services of such an expert.

All purchase and sale transactions in product markets for goods, in labor markets for talent, and in financial markets for capital and securities involve information problems and incentive conflicts. As a result, there are plenty of ways in which these markets in any economy may fail to work efficiently and effectively.

We can draw three important lessons from the used car market example. First, information asymmetries and incentive conflicts between buyers and sellers create significant problems in markets. If these issues are not addressed properly, they will lead to a loss of confidence among market participants and potentially to the breakdown of the market. Second, it is possible to devise institutional arrangements—such as the independent mechanic's expert evaluation in a used car market, or passive intermediaries such as Kelley Blue Book and Autobytel—to mitigate these problems and make the markets work significantly better than they would otherwise. Developed economies have devised many such institutions to make their markets work well.

Third, even though such institutional arrangements make many market participants better off, their emergence will adversely affect those benefiting from institutional voids, such as those who sell faulty cars. The

creation of market institutions will be resisted by such groups. Building market infrastructure is thus a matter of both economics and politics.

How Developed Markets Work

Developed markets for products, talent, and capital are full of institutions that are the equivalents of the independent car mechanic in the used car market. To reduce the transaction costs that arise from the differential information between buyers and sellers and to limit potential conflicts of interest, markets need institutions to intermediate between buyers and sellers of goods, services, and capital. High transaction costs make an economy inefficient, leading to higher cost of capital, less labor mobility, and increased cost of trading. Beyond transaction costs, absent market institutions are critical sources of operating challenges.

From protecting intellectual property to reaching customers, businesses need market institutions. Developed economies, in their quest to mitigate transaction costs and facilitate commerce, have developed several complementary solutions that together make information disclosure credible, enforce constraints reliably, and regulate markets fairly. Disclosure of high-quality, credible information reduces information asymmetries. Enforceable contracts ensure that buyers can be confident that sellers will not behave opportunistically. By providing aggregation, certification, analysis, and advice, market intermediaries help buyers and sellers come together to conduct transactions efficiently. Finally, market regulation ensures fair play by all parties by defining and enforcing a clear set of rules.¹² Consider the important roles played by market intermediaries in product, capital, and labor markets.

Product Markets

In developed product markets, consumers are able to search for their desired products based on information provided by companies through advertising in newspapers and magazines, direct mail marketing, telemarketing, Web sites, and other forms of communication. Further, consumers have access to third-party information providers, such as the

Consumer Reports magazine and CNET, which produce extensive independent rating information on the quality and efficacy of a variety of products and services.

Retail chains also perform several valuable intermediary functions. They analyze consumer preferences; screen producers that seek to meet these preferences based on attributes such as quality, price, and delivery; stock and display goods so that consumers can see and evaluate them; advise consumers who visit the stores about product attributes; and allow consumers to return goods if they are dissatisfied.

Contracts between manufacturers and retailers, retailers and credit card issuers, card issuers and consumers, and manufacturers and consumers all play a critical role in ensuring that each performs its part of the obligation. Credit card issuers facilitate transactions by providing credit verification, financing, and collection of cash. Courts and consumer groups ensure that these contracts are enforced and that defaulters are penalized. If a manufacturer produces a low-quality product that fails to work as promised, for example, consumers have the right to return the product and recover their outlay. Similarly, if the consumer fails to pay the credit card company, the card company has recourse to collect the payment. Logistics suppliers such as delivery services meet the needs of transporting purchased goods from seller to buyer. Packaging contractors, shipping companies, and insurance agencies provide valuable services between seller and buyer to facilitate safe, timely, and guaranteed movement of products.

All the parties in the consumer product market are subject to a set of clearly laid-out regulations. For example, companies are prohibited from misleading potential customers through false advertising or promotion. Similarly, credit card companies are prohibited from sharing consumer information that violates customers' privacy. Retailers are required to offer well-defined return policies. Logistics providers must be accredited and are held accountable by both transacting parties to deliver products on time and intact. All sales are accompanied by a certain implied warranty by the manufacturer that the consumer is entitled to expect. Manufacturers are prohibited from taking certain actions, such as resale price

maintenance, which can reduce retail competition. Consumers can sue companies for selling goods that cause damage or injury.

All these mechanisms in a developed consumer products market rely on a comprehensive network of soft and hard infrastructure. *Soft infrastructure* includes advertising agencies and media outlets that facilitate corporate communication, market research companies and logistics consultants that assist retailers, and credit rating agencies that collect consumer credit information to assist credit card companies. *Hard infrastructure*, such as roads and bridges, is also essential for low-cost movement of goods from producers to retailers. Public institutions such as national, state, and local governments that promulgate rules, consumer unions that lobby for such rules, and courts that enforce these rules, all play an important role.

Capital Markets

Similarly complicated sets of mechanisms underpin the functioning of capital markets in well-developed economies. Financial reporting facilitates investor communication. Accounting standards and independent auditors enhance the credibility of financial reports. Information intermediaries such as analysts, rating agencies, and the financial press provide analysis. Financial intermediaries such as venture capitalists, commercial banks, insurance companies, and mutual funds help investors channel their funds to attractive investment opportunities and facilitate access to capital for entrepreneurs and established companies. Stock exchanges create liquidity by enabling investors to trade with each other at a low cost.

These markets are strictly regulated. The central bank, securities regulators, and stock exchanges enforce these rules. Courts act as arbiters of disputes between various parties. In developed markets, investors can hold corporate managers and directors accountable through the threat of securities litigation, proxy fights, and hostile takeovers. By reducing risks to investors, these institutions make it possible for new enterprises to raise capital on approximately equal terms as big, established companies.

Labor Markets

In the labor market, educational institutions not only help develop human capital but also certify its quality through graduation requirements. Placement agencies and headhunters help employers find talent. Employment contracts and numerous regulations allow both the employers and the employees to protect their interests. Unions act as intermediaries between rank-and-file labor and big corporations that have substantially more power and resources. Unemployment insurance gives companies the flexibility to hire and fire based on their needs and yet provides employees with a safety net.

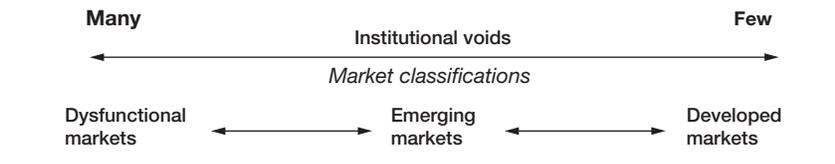
In developed economies such as the United States, Canada, Western Europe, Japan, and Australia, dozens of market institutions facilitate the smooth functioning of capital, product, and labor markets. In emerging markets, by contrast, many of these intermediary institutions are either underdeveloped or absent. Chapter 2 describes a framework to help spot these institutional voids in emerging markets. Chapter 3 examines the institutional anatomy of markets in more detail as we consider opportunities for businesses to serve as intermediaries in emerging markets.

Structural Definition of Emerging Markets

This chapter highlights the myriad institutions required in product, labor, and capital markets to support simple or complex transactions between buyers and sellers of goods and services. We define emerging markets as those where these specialized intermediaries are absent or poorly functioning. That is, these markets are emerging as market participants work to find ways to bring buyers and sellers of all sorts together for productive exchange. This structural definition arrays markets along a continuum, from entirely dysfunctional—with a plethora of institutional voids—to highly developed (see figure 1-1).

This definition implies that every market, including those of the United States and other developed economies, has some degree of “emergingness” built in. For example, the subprime mortgage market in

FIGURE 1-1

Continuum of institutional voids and market definitions

the United States, a key contributor to the financial crisis of 2008–2009, was an emerging market. Although the subprime lending market was serviced by a range of intermediaries—mortgage brokers, credit scorers, rating agencies, investment bankers, credit insurers, and regulators—these intermediaries did not effectively mitigate the information and contracting problems of a market in which the origination and financing of loans were so separated and incentives—such as credit-rating agencies being compensated by the entities whose securities they rated—were misaligned. The fast growth and increasing sophistication of transactions—the bundling and selling of mortgages in complex derivatives—outpaced the capacity of market intermediaries to handle them. More than the absolute growth or potential of a market, it is this gap in market infrastructure that defines an emerging market. The resulting financial crisis—the worst since the Great Depression—shows that institutional weaknesses can lead a market completely astray.

Working with this structural definition, chapter 2 focuses on how to evaluate emerging markets to spot these voids and introduces a general approach for companies to use in responding to institutional voids. Markets do not emerge overnight. Product, labor, and capital markets that are missing critical intermediaries tend to be imperfect for long periods. Even when governments of developing countries establish new intermediaries to fill these voids, they do not immediately function along the same lines as those in developed economies. The existence of intermediaries does not guarantee that they will execute their roles effectively, efficiently, or even-handedly, as the U.S. subprime mortgage market example illustrates.

24 | Winning in Emerging Markets

Institutional voids cannot be mandated away through deregulation and liberalization; it takes both significant time and substantial expertise to eliminate these voids. Indeed, the most predictable feature of an emerging market is the persistence of institutional gaps over the short and medium term. Thus, scanning emerging markets for institutional voids provides an anchor for business analysis, opportunity assessment, and strategic decision making in these markets.

Notes

Introduction

1. Portions of this introduction have been adapted from Tarun Khanna, Krishna Palepu, and Kjell Carlsson, "Why Study Emerging Markets," Note 5-706-422 (Boston: Harvard Business School, 2007).

2. David Oakley, "Emerging Market Equities Outperform West," *Financial Times* (FT.com), June 7, 2009.

3. "Emerging-Market Indicators," *The Economist*, January 8, 1994, 102.

4. "Economic and Financial Indicators," *The Economist*, January 6, 2007, 81.

5. "The World This Week," *The Economist*, January 8, 1994, 5.

6. "The New World Order: Back to the Future," *The Economist*, January 8, 1994, 21.

7. *The Economist*, January 8, 1994, 52.

8. *Standard & Poor's Global Industry Surveys*, "Computers: Hardware: Asia," October 2006, 20.

9. Antoine van Agtmael coined the term. See Antoine van Agtmael, *The Emerging Markets Century: How a New Breed of World-Class Companies Is Overtaking the World* (New York: Free Press, 2007), 1–6. Mark Mobius of Franklin Templeton Investments pioneered equity investing in emerging markets.

10. International outsourcing, or offshoring, has not and may not result in widespread unemployment in the United States and other developed markets compared with the normal churn of jobs in the hurly-burly of competitive, technologically dynamic market economies. It may nonetheless have a transformative impact on the labor markets of developed economies, as Alan Blinder has argued. The accessibility of labor in emerging markets is likely to reshape different service industries in different ways in developed economies, because some highly skilled workers will be vulnerable to emerging market competition while some low-skilled workers in personal services will be less vulnerable. Offshoring to emerging markets could have a profound impact on the educational systems and social safety nets of developed economies as these countries come to terms with preparing their youth to compete in this new landscape and support those who lose out to labor competition based overseas. See Alan S. Blinder, "Offshoring: The Next Industrial Revolution?" *Foreign Affairs*, March/April 2006, <http://www.foreignaffairs.org/20060301faessay85209/alan-s-blinder/offshoring-the-next-industrial-revolution.html>.

11. Dominic Wilson and Roopa Purushothaman, *Dreaming with BRICs: The Path to 2050*, Goldman Sachs Economics Paper No. 99, October 1, 2003.

12. Fareed Zakaria, *The Post-American World* (New York: W.W. Norton & Company, 2008).

13. As of April 2009, 168 listings on the New York Stock Exchange were based in countries included in the Morgan Stanley Capital International (MSCI) Emerging Markets

Index; New York Stock Exchange, http://www.nyse.com/about/listed/lc_ny_region.html. The MSCI Emerging Markets Index included 24 countries as of January 2009: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey. In 2008, 300 of the 1,125 billionaires identified by *Forbes* on its annual list resided in countries included in this index. *Forbes* identified only 83 billionaires from those countries in 2001 (out of 538) and only 13 in 1987 (out of 141); Luisa Kroll, ed., “The World’s Billionaires,” *Forbes*, March 5, 2008, http://www.forbes.com/2008/03/05/richest-people-billionaires-billionaires08-cx_lk_0305billie_land.html. See also “The World’s Richest People,” *Forbes*, July 9, 2001, 110–124; and Harold Seneker, “The World’s Billionaires,” *Forbes*, October 5, 1987, 82.

14. Adapted from Tarun Khanna and Krishna Palepu, “Why Focused Strategies May Be Wrong for Emerging Markets,” *Harvard Business Review*, July–August 1997, 41–51.

15. We use the terms *emerging* and *developing* interchangeably throughout this book to refer to economies having a variety of transactional challenges or institutional voids.

Chapter 1

1. Portions of this chapter have been adapted from Tarun Khanna and Krishna Palepu, “Spotting Institutional Voids in Emerging Markets,” Note 106-014 (Boston: Harvard Business School Publishing, 2005); and Tarun Khanna, Krishna Palepu, and Kjell Carlsson, “Why Study Emerging Markets,” Note 706-422 (Boston: Harvard Business School Publishing, 2007).

2. Thomas L. Friedman, *The World Is Flat: A Brief History of the Twenty-First Century* (New York: Farrar, Strauss & Giroux, 2005).

3. Amarchand & Mangaldas & Suresh A. Shroff & Co., quoted in Kian Ganz, “India Special Report: Hard Court Battle,” *The Lawyer*, June 8, 2009, <http://www.thelawyer.com/india-special-report-hard-court-battle/1000999.article>.

4. Ibid.

5. Tarun Khanna and Krishna Palepu, “Why Focused Strategies May Be Wrong for Emerging Markets,” *Harvard Business Review*, July–August 1997, 41–51.

6. Eric Bellman, “The Infomercial Comes to Life in India’s Remotest Villages: Traveling Salesman Mr. Sharma Sings, Jokes to Spread Gospel of Global Consumerism,” *Wall Street Journal*, June 10, 2009, A1.

7. “Company profile,” Ctrip.com, <http://pages.english.ctrip.com/webhome/purehtml/en/footer/CompanyProfile.html>.

8. Capital IQ, <https://www.capitaliq.com/main.asp>.

9. Ibid.

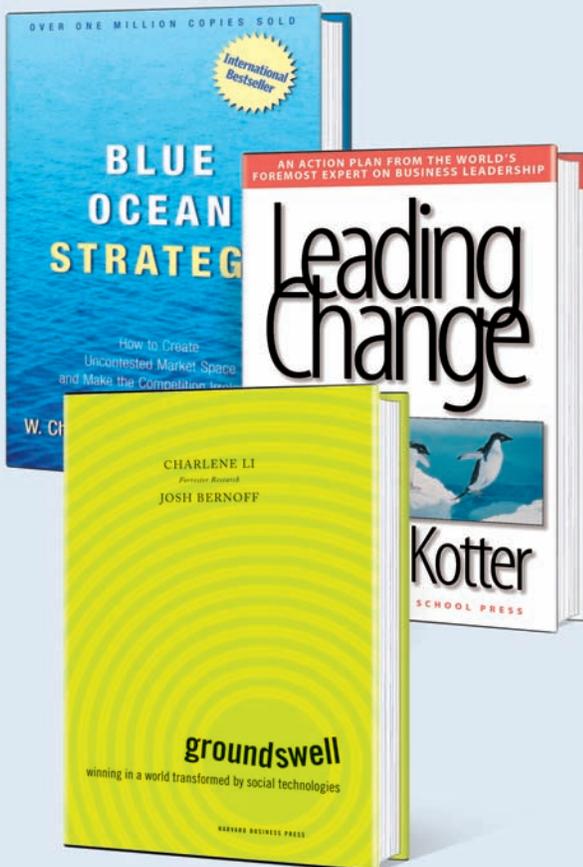
10. George A. Akerlof, “The Market for ‘Lemons’: Quality Uncertainty and the Market Mechanism,” *Quarterly Journal of Economics* 84, no. 3 (August 1970): 488–500.

11. Economists call this an *adverse selection problem*.

12. Khanna and Palepu, “Why Focused Strategies May Be Wrong for Emerging Markets.”

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