

Strategy, Organisation and Market Structure

Day 3

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Mon 20 July	Day 1	The multinational firm: theories, frameworks, entry
Tue 21 July	Day 2	Countries: institutions, political risk, national advantage
Thu 23 July	Day 3	Strategy, organisation and market structure
Fri 24 July	Day 4	Pricing and strategic interaction

Days 1–2 fixed the **firm** and its **environment**. Today: how the firm *competes* — strategy, structure, and the market it sits in.

Tuesday's Porter diamond was the *country* level. Today's five forces is the *industry* level — same author, different unit.

Textbooks

- Chapter 8, 9, 10 Simon Collinson, Rajneesh Narula, Alan M. Rugman and Amir Qamar, *International Business*, 9th Edition, Pearson Education, 2024

Optional reading:

- Chapter 12, John D. Daniels, Lee H. Radebaugh and Daniel Sullivan, *International Business, Global Edition*, 17th Edition, Pearson Education, 2021

- **Part I — Strategy and the five forces**

- Strategic orientations; strategy formulation; scanning the environment
- Porter's five forces; three generic strategies and competitive scope
- Entry deterrence; platforms, switching costs and scale as barriers

- **Part II — Organising the multinational**

- Early structures: the export department and the international division
- Six global structures: product, area, functional, matrix, mixed, transnational
- Why matrices creak; subsidiaries competing for mandates; alliances

- **Part III — Corporate strategy and national advantage**

- Integration versus national responsiveness; Ghemawat's AAA
- The diversification discount; the smile curve of global value chains

- **Part IV — Market structure and concentration**

- Product differentiation: Lancaster's characteristics and Hotelling's location
- Measuring competition: the HHI — and first defining the market (SSNIP)

Objectives:

- Define strategic planning and explain key strategic orientations.
- Explain strategy formulation and implementation, including environmental assessment, location, ownership, and functional decisions.
- Discuss how MNEs control and evaluate their strategies.
- Examine organizational structures used by firms at different stages of international expansion, including international division and global structures.
- Analyze key structural variables and organizational processes that ensure effective and efficient international operations.
- Examine Porter's "diamond" model and critique its application; introduce the "double-diamond" model for non-triad countries.
- Define economic integration and national responsiveness and relate them to MNE global strategies.

PART I

Strategy and the five forces

Multinational strategy

Strategic planning: The process of evaluating the enterprise's environment and its internal strengths, identifying long- and short-range objectives, and implementing a plan of action for attaining these goals.

- **Ethnocentric predisposition:** The tendency of a manager or multinational company to rely on the values and interests of the parent company in formulating and implementing the strategic plan.
- **Polycentric predisposition:** The tendency of a multinational to tailor its strategic plan to meet the needs of the local culture.
- **Regiocentric predisposition:** The tendency of a multinational to use a strategy that addresses both local and regional needs.
- **Geocentric predisposition:** The tendency of a multinational to construct its strategic plan with a global view of operations.

Typical strategic orientations of MNEs

MNE orientation	Ethnocentric	Polycentric	Regiocentric	Geocentric
Company's basic mission	Profitability	Public acceptance (legitimacy)	Both profitability and public acceptance	Both profitability and public acceptance
Type of governance	Top down	Bottom up (each local unit sets objectives)	Mutually negotiated between the region and its subsidiaries	Mutually negotiated at all levels of the organisation
Strategy	Global integration	National responsiveness	Regional integration and national responsiveness	Global integration and national responsiveness
Structure	Hierarchical product divisions	Hierarchical area divisions with autonomous national units	Product and regional organisation tied together through a matrix structure	A network of organisations (in some cases this includes stockholders and competitors)
Culture	Host country	Home country	Regional	Global
Technology	Mass production	Batch production	Flexible manufacturing	Flexible manufacturing
Marketing strategy	Product development is determined primarily by the needs of the home-country customers	Local product development based on local needs	Standardised within the region, but not across regions	Global products with local variations
Profit strategy	Profits are brought back to the home country	Profits are kept in the host country	Profits are redistributed within the region	Redistribution is done on a global basis
Human resource management practices	Overseas operations are managed by people from the home country	Local nationals are used in key management positions	Regional people are developed for key managerial positions anywhere in the region	The best people anywhere in the world are developed for key positions everywhere in the world

Source: Adapted from 'Strategic Planning for a Global Business', Columbia Journal of World Business, summer 1985. Copyright © Elsevier Science & Technology

- **Strategy formulation:** The process of evaluating the enterprise's environment (opportunities) and its internal strengths (resources).
- **External environmental assessment:**
 - information gathering;
 - information assessment.
- **Internal environmental assessment:**
 - physical resources and personnel competencies;
 - value chain analysis.

Conducting an environmental scan

- Four of the most common methods for conducting an environmental scan are as follows:
 - **Asking experts in the industry to discuss industry trends and to make projections about the future.**
 - **Using historical industry trends to forecast future developments.**
 - **Asking knowledgeable managers to write scenarios describing what they foresee for the industry over the next two to three years.**
 - **Using computers to simulate the industry environment and to generate likely future developments.**

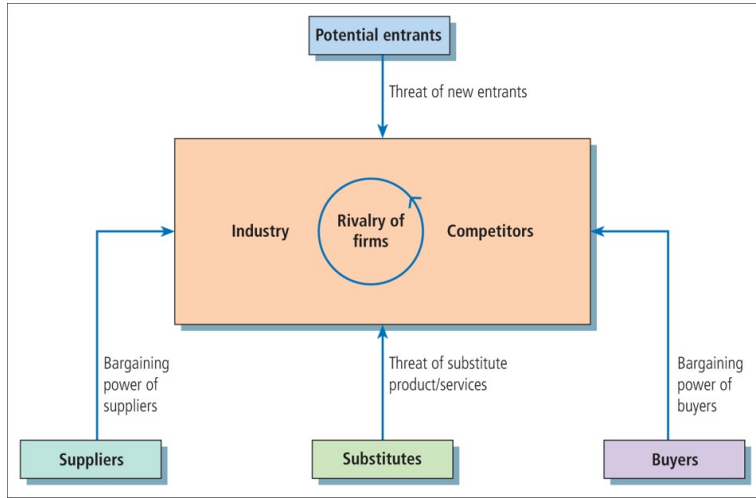
In order to understand the competitive constraints placed on firms in terms of the micro-economic environment in which they operate it is essential to **understand the way firms interact with other firms.**

Interactions are characterized in two ways:

- **Horizontal:** Interactions with firms at the same stage in the production process. Typical concerns include the level of competition and the way firms compete with each other.
- **Vertical:** these are interactions with firms 'upstream' or 'downstream' in the 'supply chain' – concerns here typically concern the distribution of bargaining power in any relationship.

Porter's five forces model

One of the most common approaches to make an overall evaluation is based on the five forces that determine industry competitiveness:



Source: Adapted from The Free Press, an imprint of Simon & Schuster Adult Publishing Group, from *Competitive Advantage: Creating and Sustaining Superior Performance* by Michael E. Porter

Porter's Five Forces: Rivalry (horizontal)

- How do the firms present in the market compete against each other? How can we draw differences over the nature of competition?
- Market shares and concentration
- Degree of innovation
- Attempts at product differentiation
- Industry growth
- Presence of exit barriers (why?)



Porter's Five Forces: Potential entrants (horizontal)

- The market entry by additional competitors poses a threat to profitability of incumbent firms.
- The threat of entry is determined by potential barriers to entry.
- Economies of scale
- Product differentiation
- Capital requirements
- Cost advantage of incumbents
- Access to distribution channels

Porter's Five Forces: Substitutes (horizontal)

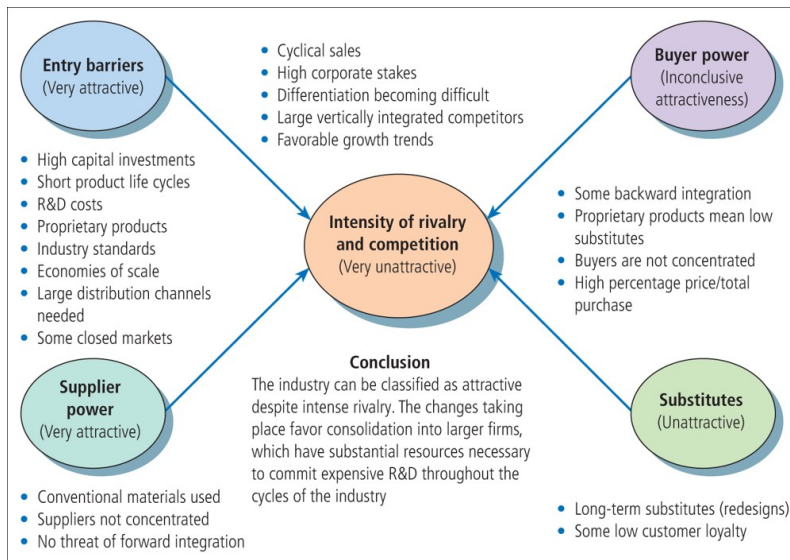
- Substitute products can affect the demand for a given good and may even render entire industries redundant.
- Understanding the degree of substitutability for the products of an industry helps understand the threat by potential substitutes.
- The threat of substitutes can be minimised by:
 - Ensuring cost advantage in the core product
 - Continued product innovation and differentiation

The vertical forces decide who in the chain keeps the margin.

- **Supplier power** rises with: importance of the input, few substitutes, a concentrated upstream market.
- ...and with exclusivity upstream (*input foreclosure*).
- **Buyer power** rises with: importance and substitutability of your product, concentrated buyers.
- ...and with exclusivity downstream (*customer foreclosure*).

Same checklist in both directions: power is symmetry-breaking in the chain.

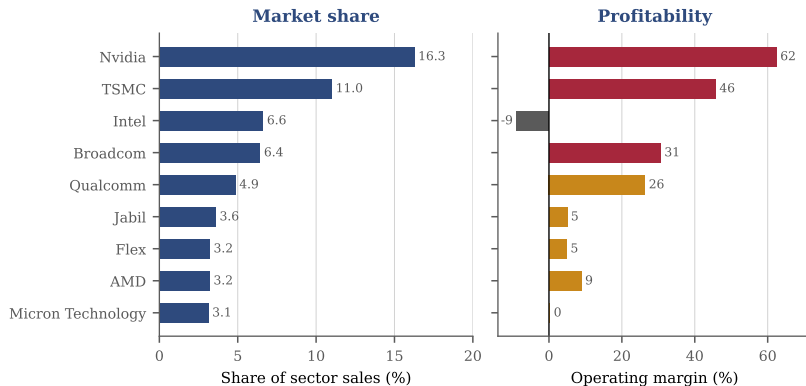
The five-forces model applied to the semiconductor industry



Source: Scott Beardsley and Kinji Sakagami, "Advanced micro devices: poised for chip greatness," unpublished student paper, Sloan School of Management, MIT, 1988. Reported in Arnoldo C. Hax and Nicolas S. Majluf, *The Strategy Concept and Process: A Pragmatic Approach* (Englewood Cliffs, NJ: Prentice Hall, 1991), p. 46

The same five forces, two very different lives

Semiconductors (SIC 367x), 2024: HHI = 591, i.e. "unconcentrated"



The standard concentration index (**HHI** — the sum of squared market shares; defined properly in Part IV) reads 591, officially “unconcentrated” — yet Nvidia sits at a 62% margin and Intel at −9%. Same industry, same forces. Hold that tension for this afternoon.

Own calculations, Compustat, SIC 367x, fiscal 2024.

The five forces redraw an industry: the fabless revolution

One firm's promise split the chip industry in two — and moved the profit.

- **The words first.** A *fab* (fabrication plant) is the multi-billion-dollar factory that physically makes chips. A *foundry* is a fab that manufactures to *other firms'* designs. A *fabless* firm designs chips and owns no factory at all.
- **Before 1987**, design and manufacturing sat inside one firm, because a designer who handed its blueprints to a factory that *also sold its own chips* risked having them copied. Fear of being exploited once you depend on a partner is the **hold-up problem**.
- **TSMC's move (1987)**: sell manufacturing only, with a credible promise — *we will never compete in design*. That removed the fear, so design could safely separate from production.
- **Result**: fabless designers (Nvidia, Qualcomm, Apple) buying from a few giant foundries.
2024 operating margins: TSMC 46%, Nvidia 62%, still-integrated Intel −9%.

Industry structure is a *choice* — the sum of make-or-buy decisions, not something firms are handed.

Analysis of value chains can also help a company determine the type of strategy that will be most effective. In all, there are three generic strategies: cost, differentiation and focus.

- **Cost strategy:** A strategy that relies on low price through the pursuit of cost reductions.
- **Differentiation strategy:** A strategy directed toward creating something that is perceived as being unique.
- **Focus strategy:** A strategy that concentrates on a particular buyer group and segments.

Competitive scope

In addition, the firm will determine its competitive scope, **which is the breadth of its target market within the industry.** Figure provides an example of these generic strategies as applied to the worldwide shipbuilding industry.

		Competitive Advantage	
		Cost	Differentiation
Competitive Scope	Broad	Lower cost, volume production, wide range of models/options e.g. S. Korea	Higher cost, higher quality, wide range of models/options e.g. Japan
	Narrow	Low cost, lower quality, volume production, fewer models/options e.g. China	High cost, high quality, specialist and customised models/options e.g. Norway

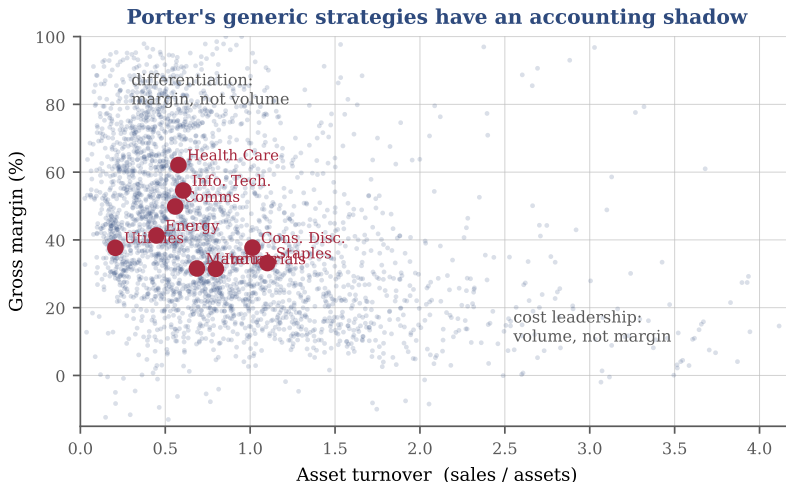
Competitive strategies in global shipbuilding

Value created = (ROIC – WACC) × capital invested.

- **ROIC (Return On Invested Capital)** = operating profit after tax ÷ capital invested. In words: *what each £1 of capital earns*.
- **WACC (Weighted Average Cost of Capital)** = the average return that lenders and shareholders require. In words: *what each £1 of capital costs*.
- **The spread** = ROIC – WACC. If it is positive the firm creates value; if it is zero or negative it destroys value, no matter how large its sales.
- The five forces decide that spread: rivalry and substitutes squeeze its **size**; the threat of entry squeezes how **long** it lasts; buyer and supplier power decide *who along the chain* keeps it.
- A “**moat**” is just the expected *duration* of a positive spread — Monday's data put its half-life at 1–3 years.

A strategy claim is a forecast about the spread — which makes it testable against the accounts.

The strategies have accounting fingerprints



Differentiators live top-left (margin, not volume); cost leaders bottom-right. The corr is -0.37 : the trade-off Porter drew is in the accounts.

Own calculations, Compustat 2024, non-financials with sales > \$50m.

Vevox poll. High margin, or high turnover — which fingerprint is the cost leader?

What type of generic strategy does Vodafone employ?

What type of generic strategy does Vodafone employ?

- **Focus Strategy:** Vodafone targets selected market niches, concentrating on specific customer segments (e.g., mobile customers in key markets).
- **Minority to Majority Ownership:** Initially comfortable with minority stakes (e.g., 35% in Verizon), Vodafone shifted post-2014 to majority control in most European markets.
- **Equity-Funded Acquisitions:** Vodafone paid for acquisitions via equity, insulating itself from financial shocks like the 2000s tech crash.
- **Low-Risk, Innovative Approach:** Vodafone strategically enters markets with lower risk and competes by offering innovative products at competitive prices.

Vevox poll. Cost leadership, differentiation, or focus? Vote before the reveal.

Typical goals of an MNE (multinational enterprise)

Profitability	Marketing	Production	Finance	Human resource management
Level of products	Total sales volume	Ratio of foreign to domestic production share	Financing of foreign affiliates – retained earnings or local borrowing	Development of managers with global orientation
Return on assets, investment, equity, sales	Market share – worldwide, region, country	Economies of scale via international production integration	Taxation – minimising the burden globally	Management development of host-country nationals
Annual profit growth	Growth in sales volume	Quality and cost control	Optimum capital structure	
Annual earnings per share growth	Integration of country markets for marketing efficiency and effectiveness	Introduction of cost-efficient production methods	Foreign exchange management – minimising losses from foreign fluctuations	

Source: Collinson et al. (2024)

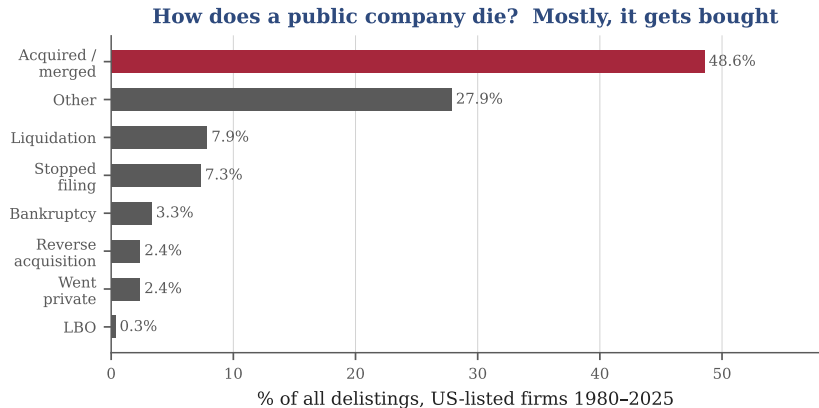
- Goals are set at **two levels**: for the *whole group* (profitability, growth, survival, reputation) and for *each subsidiary* (local market share, cost, quality, staffing).
- The two levels **can conflict**. What suits one country unit — cutting prices, keeping a plant open — need not suit the group.
- Goals must also be **translated** for each host country: the same profit target means very different things where wages, taxes and regulation differ.
- Which is why the *structure* we turn to in Part II matters: it decides whose goal wins when they clash.

The “threat of entry” box is not weather — incumbents spend to change it.

- **Capacity as commitment** (Dixit 1980): the \$20bn fab moves best responses *before* entry.
- **Contracts**: exclusivity, loyalty rebates — raise rivals’ costs, not cut your price.
- **Buy the entrant**: half of all delistings are acquisitions.

Threats must be *sunk* to matter — Friday builds this from the entry game up.

How a public company actually dies



Only about 3% of listed firms end in bankruptcy; roughly half are acquired. So the usual way a public company disappears is that *another firm buys it*, not that it fails. For an incumbent facing a new rival, writing a cheque is often cheaper than fighting a price war — which is why Porter’s “threat of new entrants” and the takeover market (the “market for corporate control”) are really one subject.

Own calculations, Compustat delisting reasons, 1980–2025 (n = 26,051).

A platform serves two groups at once — and that breaks ordinary pricing logic.

- A **two-sided market** is one where a firm sits between two groups who need each other: riders and drivers, shoppers and sellers, readers and advertisers (Rochet–Tirole 2003).
- **Cross-side network effects**: each group becomes more valuable to the *other* as it grows — more drivers make the app better for riders, which attracts more riders, which attracts more drivers.
- **So price by demand, not by cost**: charge the side that is hard to attract little or nothing (free search, free listings) and recover it from the side that will pay. Below-cost pricing here is ordinary business, not predatory.
- **Winner-take-most** is the usual end state, so competition authorities police whether a platform *favours its own products*, rather than reading a concentration index.

Test for international strategy: network effects that are *local* (taxis, food delivery) do not travel; *global* ones (software, social media) travel devastatingly well.

A switching cost is whatever a customer must give up to change supplier — money, effort or time.

- Once customers have paid it they are hard to win back, so a firm has pricing power over *them* even in a crowded market: competition is fierce for *new* customers and mild for existing ones (Klemperer 1995).
- **Contractual**: exit fees, minimum contract terms, loyalty points. **Technological**: devices that only work well together; printers tied to their own cartridges.
- **Learning and data**: staff trained on the system, files stored in it, links to other software, years of history — typical of business software sold by subscription.
- **The resulting strategy**: win the customer cheaply (discounts, free trials), then earn the margin over the years they stay.

It leaves a trace in the accounts: heavy selling costs today, repaid by high margins later.

Unit costs fall 10–30% per doubling of cumulative output (aircraft, chips, batteries, solar).

- Cumulative volume is itself an asset: pricing *down the curve* invests and deters at once.
- **MES** is the static twin: large MES / small market $\Rightarrow$ few firms by technology, not conduct (Demsetz).
- Caution: learning, scale and technical progress are hard to separate — Wednesday's identification problem in cost form.

The entrant must fund the same ride with none of the volume.

Intangible scale: why the winners got so big



- Haskel & Westlake: intangibles are **scalable** (software serves the marginal customer at ~zero cost), **sunk**, and full of **spillovers** — so intangible-heavy leaders can serve whole markets, and concentration rises through *efficiency* (Autor et al.'s superstar mechanism, one of the two readings of Wednesday's HHI trend).
- Measurement trap from the data: internally built intangibles are **expensed, not capitalised** — the balance sheet understates exactly the assets doing the work.

Own calculations, Compustat: net PP&E share of total assets, US-listed non-financials.

PART II

Organising the multinational

Structure follows the internationalisation stage.

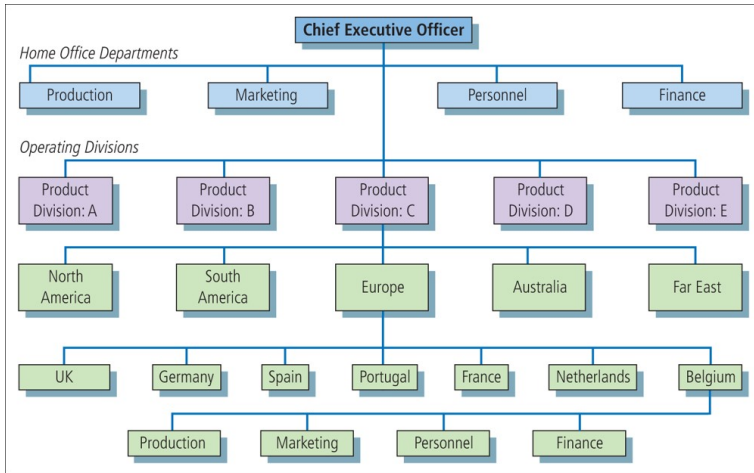
- **Start:** extend domestic operations; a third party handles foreign sales.
- **Growth:** an export department, then an overseas subsidiary; focus still the home market.
- **Maturity:** IBM-, GM-, Mitsubishi-style structures with globally integrated affiliates.

The org chart is a lagging indicator of Monday's entry-mode ladder.

- As MNEs generate more and more revenues from their overseas operations, their strategies and the structures used to implement these strategies become more global in focus.
- There are six basic types of global structures.
 - (1) global product;
 - (2) global area;
 - (3) global functional;
 - (4) matrix;
 - (5) mixed;
 - (6) transnational network

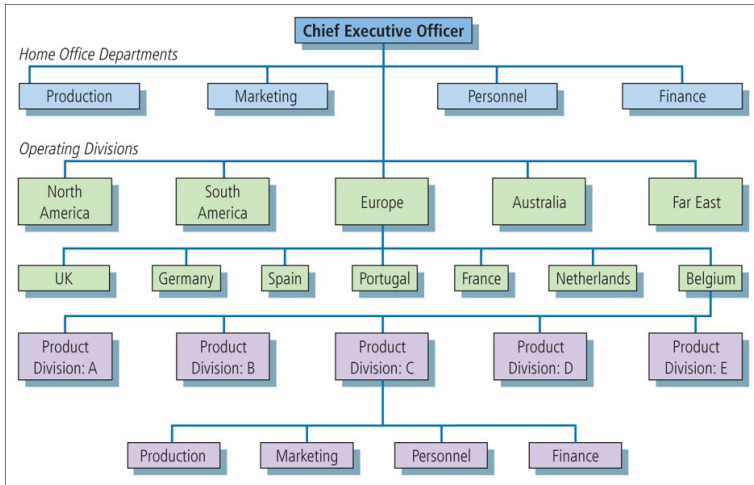
1. Global product structure

- An arrangement in which divisions are given worldwide responsibility for a product group — each division runs its product everywhere. Eg. **Sony** (global divisions for Gaming, Music, Pictures, Imaging); **Siemens** (Digital Industries, Mobility, Healthineers); **Procter & Gamble** (Fabric Care, Baby Care, Grooming).



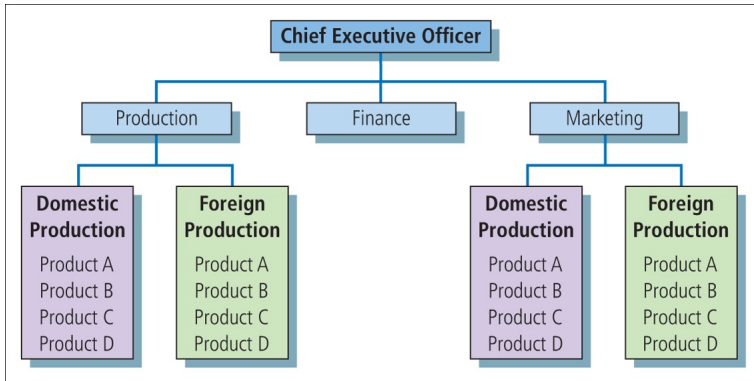
2. Global area structure

- Primary operational responsibility is delegated to area managers, each responsible for a geographic region. Eg. **Coca-Cola** (its reporting segments are regions: EMEA, Latin America, North America, Asia Pacific); **McDonald's** (US, International Operated, International Licensed markets); **Nestlé** in its pre-2000s form.



3. Global functional structure

- Built around the basic tasks of the organisation — production, marketing, finance, engineering — rather than around products or regions. Eg. **Apple**, the best-known large example: it has no product divisions with their own profit targets, but company-wide heads of Hardware Engineering, Software, Operations, Marketing (Podolny & Hansen, *HBR* 2020); also **Accenture** (Strategy, Consulting, Operations) and **Pfizer** in its early stages.



4. Matrix structure (eg. below, a geographic matrix structure)

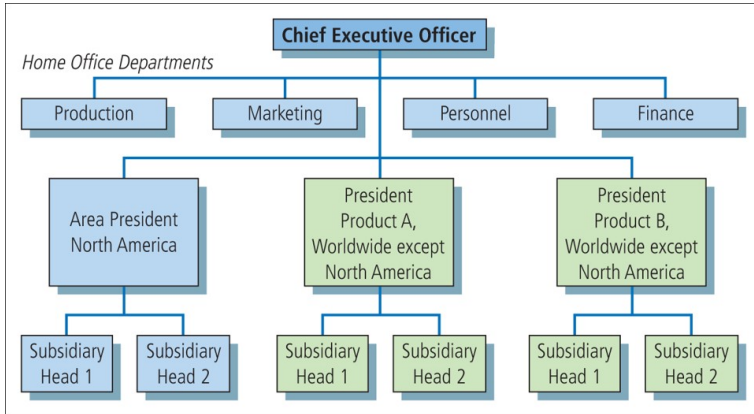
An arrangement that blends *two* lines of responsibility — typically product and region, so a manager reports to both. Eg. **ABB**, the textbook case of a product × country matrix; **Philips**, whose Consumer Electronics unit in China answered to both a product head and a country head; **Shell**, balancing product units against geographic business lines.

Regions Products	Country A	Country B	Country C
Product 1			
Product 2			
Product 3			

A geographic matrix structure

5. Mixed structure

A hybrid organization design that combines structural arrangements in a way that best meets the needs of the enterprise. Samsung, Product divisions (semiconductors, electronics) with regional arms. PepsiCo, Mix of product categories and geographic business units. Nestlé, Product divisions (e.g., Beverages, Infant Nutrition) are global, but operations in each region have considerable autonomy.



A mixed structure

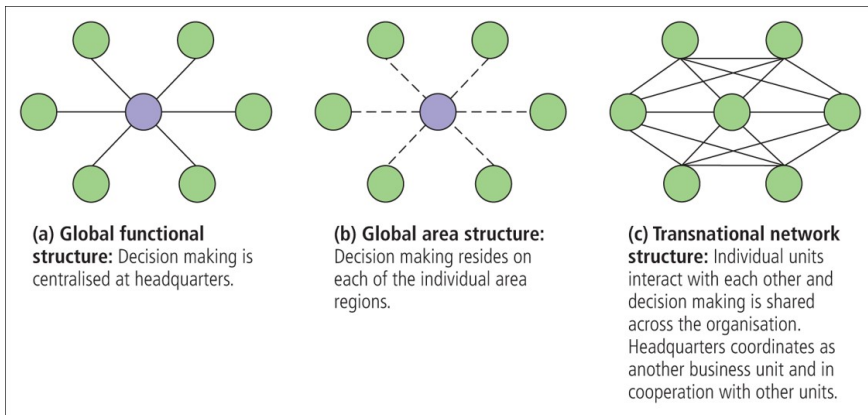
6. Transnational network structure

- Designed to help MNEs take advantage of global economies of scales while also being responsive to local customer demands.
 - Relies on a network arrangement to link the various worldwide subsidiaries.
- Three components:
 - **Dispersed subunits**
 - **Specialized operation**
 - **Interdependent relationships.**

At the center of the transnational network structure are **nodes**, which are **units charged** with coordinating product, functional, and geographic information.

Transnational network structure (continued)

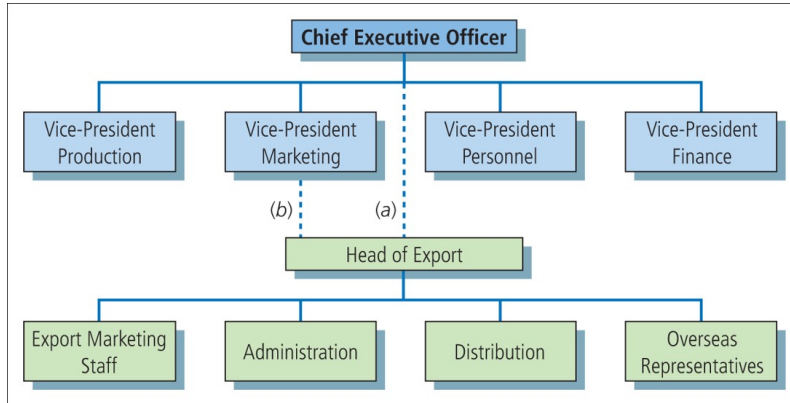
This structural design combines elements of functional, product and geographic designs, while relying on a network arrangement to link the various worldwide subsidiaries. Eg. Unilever (current strategy), Encourages knowledge sharing across subsidiaries, with global brands adapted locally (e.g., Dove, Lifebuoy). L'Oréal Centralized innovation; decentralized marketing and distribution.



A transnational network structure. **Strength:** Dynamic learning and responsiveness. **Weakness:** High coordination costs, complexity.

Early organization structures

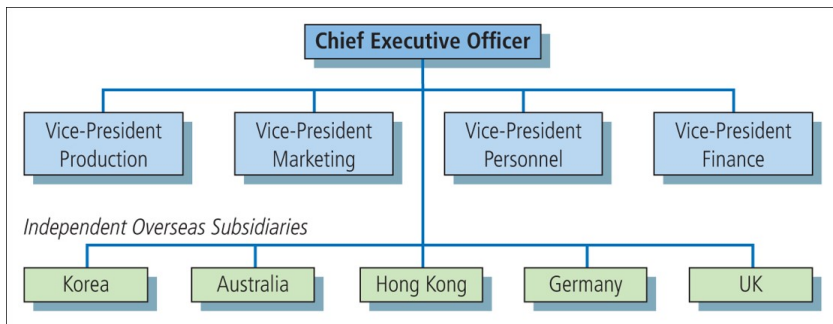
SMEs today: Many medium-sized German Mittelstand firms use this structure when they begin exporting high-tech components abroad but are not yet multinational in scale. Italian fashion SMEs or Spanish wineries often start with an export department before forming international subsidiaries.



An export department structure: This structure is suitable when: Foreign sales are less than 20% of total revenue. The company has limited customization needs for foreign markets. It needs to test the waters of international demand before deeper commitment.

Early organization structures (Continued)

Eg. Coca-Cola (early expansion phases). For decades, Nestlé operated as a decentralized multinational, with independent country subsidiaries making localized decisions — especially in developing markets like India and Brazil.



Use of subsidiaries during the early stages of internationalization. **Strengths:** Allows for local responsiveness. Facilitates decentralized decision-making, which is crucial in culturally and economically diverse markets. **Weaknesses:** Risk of duplication of efforts. May lead to inefficiencies or loss of control from HQ. Coordination difficulties across markets.

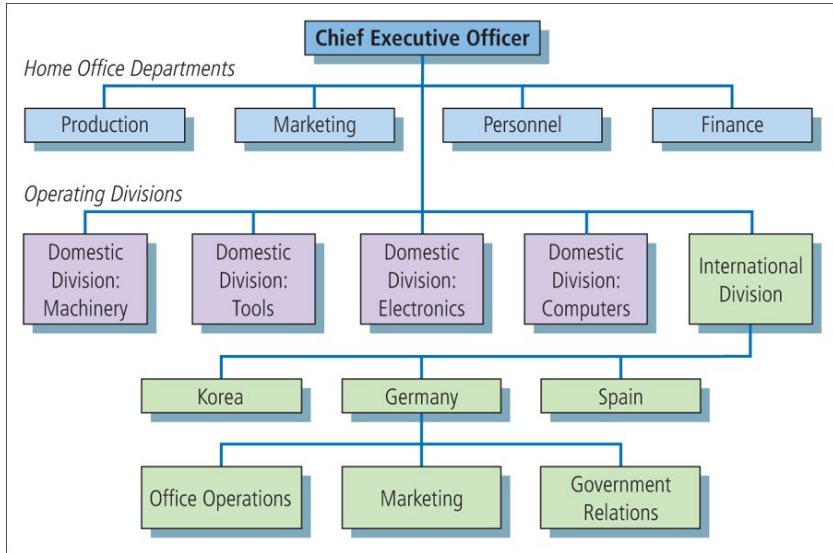
The international division

- The **international division structure** centralizes all the international operations.

Advantages:

- It reduces the CEO's burden of direct operation of overseas subsidiaries and domestic operations.
- It raises the status of overseas operations to that of the domestic divisions.
- Eg. General Motors (GM) – historically, before adopting a more global matrix structure. IBM – mid-20th century. Early Procter & Gamble (P&G).

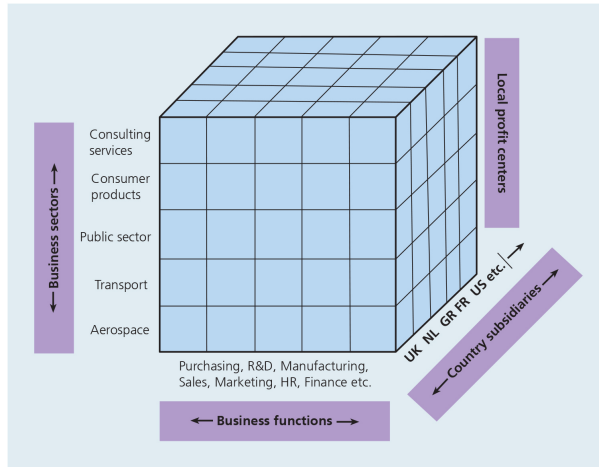
The international division (Continued)



An international division structure (Any disadvantages of this?)

A multinational matrix structure (function, product and geography)

In a **matrix** a manager has *two* bosses instead of one. Read the chart as a grid: each unit answers *down* one line (its product or function) and *across* another (its country or region).



Why do it: the product line pushes for worldwide efficiency while the country manager defends what local customers need — both voices reach the same decision. **What it costs:** slower decisions, and conflicting instructions when the two disagree.

Influence costs: effort spent persuading head office instead of doing the job (Milgrom–Roberts).

- When head office decides who gets the budget, a manager may gain more from lobbying than from producing — and in a matrix, with two bosses, there are twice as many people to lobby.
- It is the same internal-capital-market problem we met on Monday, now visible in the organisation chart.
- **Remedies:** budget formulas that leave less to argue about; rotating managers between units; making *one* axis clearly accountable for profit — or dropping the matrix and accepting some duplication.

The more discretion head office keeps, the more talent moves out of operations and into persuasion.

A mandate is the right to run an activity for the whole group — and subsidiaries compete for it.

- **Birkinshaw and Hood (1998)** are two researchers of the multinational firm. Their work showed that a subsidiary's importance is not simply handed down by head office — it is *won* through the subsidiary's own initiative.
- Roles therefore evolve: *implementer* (carries out instructions) → *contributor* (improves on them) → **centre of excellence** (leads that activity for the entire group).
- Win the small-car platform or the research laboratory and investment follows; lose it and the site drifts towards being a sales office.
- Countries compete for these too: much of Ireland's and Singapore's industrial policy aims at attracting *mandates*, not merely investment.

An internal market: country managers behave like entrepreneurs pitching, head office like the investor choosing.

Between market and merger sits the alliance — everywhere at the top of the economy.

- Samsung supplies the iPhone it fights; airlines run immunised Atlantic JVs and compete elsewhere.
- Economics: share fixed costs and risk without the integration bill — at the price of leakage.
- Hamel's **learning race**: whoever absorbs the partner's capability first wins the divorce.

Read any alliance with one question: what does each side hope to learn, and how fast?

PART III

Corporate strategy and national advantage

Corporate strategy and national competitiveness

The primary objective of this part is to develop two frameworks for understanding how both nations and MNEs must fashion their strategies to achieve international competitiveness.

Integration/national responsiveness

- **Globalization:** the production and distribution of products and services of a homogeneous type and quality on a worldwide basis.
- **National responsiveness:** the ability of MNEs to understand different consumer tastes in segmented regional markets and to respond to different national standards and regulations imposed by autonomous governments and agencies.

		National Responsiveness (differentiation)	
		Low	High
Global integration (consolidation)	Low	2	4
	High	1	3

High and low levels of integration vs. diversification. Figure is designed to help MNE managers cope with the trade-offs between integration and national responsiveness

Ghemawat's AAA: three ways to make money from differences

Countries differ. A firm can adjust to the differences, ignore them, or exploit them.

Strategy	What the firm does	Where the profit comes from
Adaptation	change the offer for each market	customers pay more for a local fit (Unilever)
Aggregation	one offer across many markets	scale: one design spread over huge volume (A
Arbitrage	site each activity where it is cheapest	the gap itself: wages, taxes, skills, time zones

- Adaptation and aggregation pull *against* each other — variety costs money, standardising sacrifices local fit — so a firm normally picks one to lead and one to support.
- **Arbitrage** is the quiet one: moving production offshore, siting research where the talent is, booking profit where tax is low (Friday's topic).

Ask of any multinational: which of the three actually pays the bills? It usually explains the organisation chart.

Finance's verdict on scope, thirty years running.

- Conglomerates trade ~**15% below** matched single-segment portfolios (Berger–Ofek 1995; Lang–Stulz 1994).
- **Global** scope too: a similar discount for multinational spread (Denis–Denis–Yost 2002).
- The fight is causality: weak firms diversify (Campa–Kedia 2002) — Monday's cross-listing debate, sign reversed.

Is your geography an FSA at work — or an internal capital market subsidising its weakest country?

Where the value sits in a global value chain: the smile curve

List the stages of production left to right, plot the value each captures — the line smiles.

- A **global value chain (GVC)** is the whole sequence of steps behind a product: research and design → components → assembly → branding, distribution and after-sales service.
- Value is **high at both ends** — research, design and brand at the start; marketing, service and customer relationships at the end — and **low in the middle**, where assembly is easily copied and easily relocated. Hence the smile shape.
- Evidence: teardown studies of the iPhone found that Chinese *assembly* captured only about **2%** of the retail value (Dedrick, Kraemer and Linden).
- So economic development means **climbing the smile** — moving out of assembly into design or brand, as Taiwan and Korea did.

Trade statistics count the gross value of goods crossing a border; the profit stays with the intangibles at the two ends.

PART IV

Market structure and concentration

Product Differentiation: Can you provide some examples?

Two ways to differ: in quality, which everyone ranks the same way — or in taste, which they do not.

- **Vertical differentiation (quality):** buyers agree which is better and pay accordingly — BMW vs Dacia, business vs economy class, branded vs generic medicine.
- **Horizontal differentiation (taste):** buyers simply want different things — Coca-Cola vs Pepsi, breakfast cereals, trainer designs, Android vs iPhone.
- **Location** is differentiation too: distance, and the effort of searching, hand the shop on your corner a little pricing power over you.
- New features get copied, so any edge is temporary by construction.

Monopolistic competition: many firms, each with a small loyal segment — differentiation is a treadmill, not a wall.

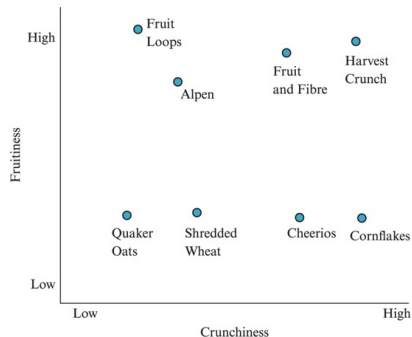
Models of product differentiation

Lancaster's product characteristics model: Examples of products and their characteristics

Product	Characteristic 1	Characteristic 2
Breakfast cereals	Crunchiness	Fruitiness
Curry sauces	Flavour	Hot, medium or mild
Musical acts	Beat	Melody
Cars	Spaciousness	Manoeuvrability

Hotelling's location model

The product with features closest to your ideal point is the one you buy.



- Consumers sit in a characteristics space — here *crunchiness* $\times$ *fruitiness*; **proximity = preference**.
- *Fruit and Fibre* serves the fruit-seekers; *Cornflakes* the crunch-only corner.
- The strategic choice: fight in crowded regions (*Cheerios* vs *Cornflakes*) or occupy an empty location (*Fruit Loops*).

Measuring competition

Herfindahl-Hirschman Index (HHI)

- Measures market concentration by summing the squares of the market shares of all firms in the market.



$$HHI = \sum_{i=1}^N s_i^2$$

where s_i is the market share of firm i and N is the number of firms.

- **Interpretation:**

- $HHI < 1500$: Competitive market.
- $1500 < HHI < 2500$: Moderately concentrated market.
- $HHI > 2500$: Highly concentrated market.

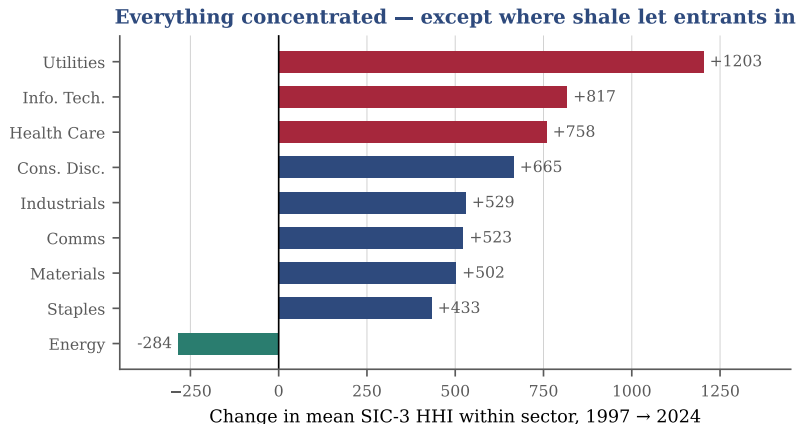
- Indicates the level of competition and potential for market power abuse.

SSNIP = a Small but Significant Non-transitory Increase in Price — a rise of 5–10% that lasts.

- **The test:** imagine one firm owned every product on your candidate list. Could it profitably raise price by 5–10%? If enough customers would escape to something *outside* the list, the list is too narrow — widen it and repeat.
- The *smallest* set of products that passes **is** the market. Only then are shares and the HHI worth computing.
- **Cellophane fallacy:** if you start from a price that is already monopolistic, everything looks like a substitute — so run the test at competitive prices.
- Real markets usually come out narrow, and often *local* (hospitals, cement).

Wednesday's crime, named: national sales grouped by 3-digit industry code fails both steps. The HHI wasn't wrong — the market definition was.

Where concentration actually rose — and the exception



Everything concentrated except **Energy**, where shale flooded the sample with entrants — one technology shock to entry, and the trend reverses. Utilities is the deregulation-merger wave; Tech is the superstar mechanism.

Own calculations, Compustat. Mean SIC-3 HHI within GICS sector, listed firms, 1997 vs 2024.

Vevox poll. Did concentration rise in most industries, or is that a myth? Predict the share.

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