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Comments from the Editor

Tamir Agmon
Editor

The many faces of research in international business never cease to fascinate me. As it has been said many times in these pages, international business is the only multidisciplinary area of research in business and management. This is its strength, and it is also the main weakness of the field as an academic discipline. I have used *AIB Insights* as a vehicle to bring together different strands of research in international business done by different people, in different countries, coming from different research conceptual structures and bringing with them different intellectual containers. In some cases the contributors to *AIB Insights* do not see themselves as researchers in international business, and they would not classify their contribution under the heading of international business.

The current issue of *AIB Insights* provides a very good example of this aspect of the research in international business. It contains three articles: a discussion of the internationalization process of corporations in Slovenia by Marjan Svetličič, an analysis of the new concept of global leadership by Joyce Osland, and an article on the effect of different regulatory regimes on the risk of the firm as it is expressed by its capital structure by Ted Lindblom and Stefan Sjögren.

Svetličič contribution is within the literature on the economics of international business that can be traced to the classic international business approach of the Uppsala school. Osland's contribution is within the management field, and it is related to psychology in the broad sense. Lindbolm and Sjögren are financial economists, and their contribution is related to a very long discussion of the relevance, or irrelevance, of capital structure to the risk and the value of the firm. The reference lists of these three articles are totally orthogonal, and they reflect very different research traditions and research methods.

The beauty of all of this is that by reading these three diverse and different articles, one gains important insights into the real nature of international business. This is so because of the diversity. The fact that unlike most of the research in fields like cross-cultural management, internationalization processes of corporations from small countries, and the capital structure of firms, there is no technical relations among the three contributions published below which makes them more interesting and more relevant for a holistic view of international business.

The way that research is conducted, communicated, and compensated makes the multidisciplinary approach very difficult. The focused approach of most of the research in business and management has many important advantages. It may prove impossible to develop a really unique, professionally accepted, and rigorous research methodology for international business. I think that the effort to do that even by bringing together different strands of research and leave the reader to do the integration is worthwhile.

AIB Insights provides an outlet for short, topical, stimulating, and provocative articles. Please submit materials for consideration to the editor—Tamir Agmon at AgmonT@st.colman.ac.il. Submissions are reviewed by the Advisory Board.

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The "AIB Insights" plays a significant role in communicating current thinking on a number of critical international business issues to our members. Under its current Editor, Tamir Agmon, AIB Insights presented several important innovations in thinking to our members.

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Reversed internationalization path; the case of Slovenia

Marjan Svetličič

University of Ljubljana

Introduction

Today in an era of globalization and growing investment abroad by firms from emerging economies, academics are increasingly rethinking the well-established paradigms of internationalization. They mostly rest on the notion of evolutionarity, Rostowian kinds of developments from no FDI at the very early development stage (*traditional society*) to inward FDI later at transition, let's say the *take off stage* of development. As Dunning initially established (1981), such developments are a function of GDP per capita and later added country and firm specific advantages. Scandinavian schools (see Johanson and Vahlne, 1977) added more micro economic elements determining graduality of internationalization depending not only on macro circumstances but also on micro firms' determinants as well as the form of international business activities. Critics of Rostow claiming that his Western development model is based on large countries and is linearity biased are right also here, in international business approaches. We have seen different stories of small non-western countries and many cases of de-internationalization as well running against this linearity bias.

Diversity, broadening (almost all countries and most of the large and even many of SMEs) and deepening of globalization (quantitative growth, new forms and connections) increasingly question old paradigms. The question arises, therefore, whether these "departures" are exceptions (outliers) or the rule, whether existing paradigms ought to be rethought or just modified to accommodate such recent developments.

Let me outline two cases of such outliers; one case of a country, Slovenia, and one of a firm, Kolektor. Slovenia is special in international business in terms of irregularity of investment development path stages. Its firms started to invest abroad before foreign firms started to invest in Slovenia. The case of Kolektor is interesting because it is an excellent example of the enterprise development from being a Slovene company to a foreign owned company and then becoming a 100 percent owned Slovene multinational buying out its American owner.

Facts

Outward FDI started in Slovenia, then part of socialist Yugoslavia, before inward FDI. The first legal document regulating outward FDI dates back to 1960, while the first inward foreign investment law (allowing a specific type of contractual joint venture) was introduced in 1967. The process was not linear and had its ups and downs. This liberal stage was followed by a backlash stage. More restrictive legislation and the relatively close administrative monitoring of companies established abroad were introduced. Liberalization after 1991 was also gradual. Only by 1999 had outward FDI been completely liberalized according to OECD guidelines.

Up until the late 1990s the motivation for investing abroad was determined by systemic factors like sanctions imposed on Yugoslavia by Stalin in 1948 and the mar-

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ket-oriented reform of 1965. The establishment of representative offices, branches and affiliations abroad became a way of escaping the (socialist) system (hence system escape investment), of facilitating imports to Yugoslavia and later of promoting exports and lastly a privileged foreign trade and foreign exchange position. By establishing companies abroad, firms increased their competitive edge by gaining regular access to foreign exchange without losing the margin between the market and official exchange rate (Svetličič et al., 1994: 365).

Later, after gaining independence and in the transition, outward internationalization accelerated in spite of many attitudinal barriers (the exporting of capital was considered unpatriotic). Slovene multinationals, reflecting also a freed up entrepreneurial spirit, were very instrumental in acquiring new market shares abroad to compensate for the loss of the Yugoslav market after Slovenia became independent. Simultaneously some investors also underwent a disintegration process or found themselves in crises that forced them to close down their foreign operations ('investment diversion effect') since the EU market can be efficiently served by exports. For a number of affiliations abroad that had been established as a system-escape operation, the reasons for their existence simply disappeared (details in Jaklič and Svetličič, 2003: 46). Presently we are facing a real upswing of outward FDI, which has demonstrated that outward FDI flows are larger than inward ones. The rapid and constant growth of outward FDI brought the accumulated stock of outward FDI to 2,970 million EUR at the end of 2005, which is still lagging behind inward FDI stock of 5,980.1 million EUR.

Macroeconomic data suggest that Slovenia is now somewhere between the second and third stage of IDP with the tendency of outward FDI overtaking inward FDI flows, which took place for the first time in 2003. Due to the relatively low inflow of FDI this may be an overstatement since the inward FDI stock was still two times larger than outward FDI in 2005. Yet, descriptive evidence and case studies suggest that Slovenia is, nevertheless, still at an earlier stage. Its socialist infant internationalization phase could be considered as a 'system-specific reversed investment development path start'.

Why reversed IDP?

There are several explanations for such a reversed sequence: Strangely enough, outward FDI was allowed in then Yugoslavia before inward FDI was. Yugoslav outward FDI was a spin-off of developments in the Yugoslav economic system and the role of international economic relations in that system, as well as a reflection of macroeconomic trends. Up until the late 1990s, the motivation for investing abroad was determined by systemic factors, by the socialist economic system's deficiencies, which motivated firms to avoid them. This outward FDI was to a great extent not driven by genuine firm-specific advantages. The third, less important reason, stability seeking one was a kind of firm and internalization specific one. Very few companies used outward FDI as an instrument to strengthen their competitive position in the international market by relocating some labor-intensive activities

Table 1: Slovenia: Annual FDI flows, 1996-2006[1] (Millions of EUR)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Outward FDI	5.6	27.7	4.9	44.7	71.7	161.2	165.8	421.3	441.0	503.4	590.3
Inward FDI	138.2	294.9	194.3	99.2	149.1	412.4	1721.7	270.5	665.2	444.9	303.4

Source: Bank of Slovenia, Monthly Bulletin, February- March 2007, p. 51

1 If we were to neglect two FDI transactions (Lek and NLB), which influenced the exceptionally high inflow of FDI in that year, then it could have already happened in 2002.

in developing countries. If they did, such operations mostly failed. This reason is even today rather rare (see Svetličič, 2007).

Location-specific advantages played an important role in quite a specific sense. By establishing companies abroad, Slovenian enterprises increased their competitive edge by gaining regular access to foreign exchange without losing the margin between the market and official exchange rate (Svetličič et al., 1994: 365). Outward FDI in the Yugoslav case was, therefore, to a great extent a system-escape operation and did not follow a 'normal' investment development path which starts with inward and only later has outward FDI.

Is it long term, systemic specific, exception or a rule?

Slovene enterprises have not applied a long term, consistent outward FDI strategy from the beginning. The normal IDP started only with the establishment of a real market economy; that is, with the beginning of the transition process. There are two convincing facts proving this. First, many pre-transition foreign affiliates of Slovenian firms disappeared, and secondly, a number of new affiliates abroad that appeared recently are based on very different motivating factors and have different geographical locations. The newly emerging outward FDI of Slovenian firms can therefore be partly regarded as new and partly an inherited phenomenon. Nevertheless, early internationalization positively contributed to the development of investing firms' capabilities and has been instrumental for today's, let's say more organic, internationalization. Most other investors are in fact 'leapfrogging globals', as they became global in a very short time by jumping over some of the stages.

Systemic factors, which explain the lion's share of such operations, could be an argument that challenges what appears as a 'reverse investment development path' model, meaning that outward FDI started before the inward type. Since many of these factors are system/transition related, they will cease to exist after transition. Empirical findings do not point to general patterns of such a reversed internationalization pattern or even less so for small countries in general, but to diversity and heterogeneous outcomes in different circumstances. The most important explanatory variable for differences between transition and non-transition economies, or more generally between highly and medium developed countries, may be the different weight, which is attributed to firm-specific advantages of firms and location advantages of countries (see Bellak and Cantwell, 1998; Svetličič and Bellak, 2004). This non-fitting of Slovenia's pre-transition inward-outward FDI sequence into the IDP model does not indicate a deficiency in the investment development path model but the *irregularity* of the pre-transition outward FDI of Slovenian enterprises. Only in transition did 'normal' (in terms of theory) outward FDI begin to emerge. The reverse sequence was so strongly system-based that the predictions of the theory are applicable, particularly since recent outward FDI developments do support the investment development path model.

Most other investors are in fact 'leapfrogging globals', as they became global in a very short time by jumping over some of the stages.

The Kolektor case: from Slovene, to foreign owned, *back* to Slovene multinational company

Kolektor[1], now a leading producer of commutators[2] in the world, is another dem-

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1 KOLEKTOR, d.o.o., Vojkova 10, p.o. 85, 5280 Idrija, Slovenia, http://www.kolektor.si.

2 A commutator is part of an electromotor fitted on the armature, which is used for windscreen wipers, fans, electric windows, central locking, drives to adjust the mirror, anti-block system (ABS), and many other car accessories. It is also used for washing machines, vacuum cleaners and many other household appliances.

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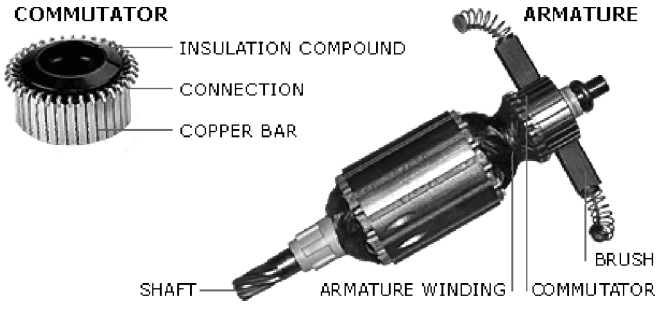
onstration of reversed internationalization. It started as a small Slovene company in 1963, entered in a joint venture agreement with a German firm in 1968, and in 2002 bought out the foreign investor and became again Slovene, now a multinational firm. This is therefore a reverse internationalization in the sense that it became again a domestically owned firm after being owned by a foreign investor in between.

Kolektor was established by the municipality of Idrija in 1963. Initially, the company employed only 20 employees. At that time ISKRA was one of the leading firms in Slovenia, and when it started to relocate production of some less important products to other companies, Kolektor took up ISKRA's commutators, an intermediate product. ISKRA provided the needed, but rather old, technology and consequently the product was of low quality. Production was for known buyers and was mostly home market oriented. It was obvious that Kolektor was far away from being competitive internationally. The political system at that time did not encourage its own research and development (R&D). Even though Kolektor was more than willing to export its products, it just could not access foreign markets due to low product quality, lack of expertise (management, marketing) and no economies of scale (low productivity).

After facing serious economic crises, Yugoslavia adopted the first quasi-foreign investment, a rather contractual joint venture legislation in 1967, as a final step of major, market oriented economic reform initiated in 1965. It eliminated state ownership of firms (social ownership was introduced) and inaugurated a kind of market. The law enabled foreigners to participate in managing and profit sharing of Slovenian (Yugoslavian) companies. Soon after the quasi FDI law was adopted, in 1968 Kolektor signed a joint-venture (49 percent share of foreigner) and a licensing contract with German commutator producer Kautt&Bux (K&B), a leading European commutator producer, in order to get access to the new technology and to change the production program. In 1973 Kolektor enlarged its capacities and consequently started selling on the world market under the trade name of K&B. However, potential buyers, when purchasing commutators from K&B produced in Indrija, knew that they were produced by Kolektor since before production started, they had to negotiate with Kolektor on how to modify the product and tools for their production to their specific needs. All these induced some local R&D activities. It was facilitated by the improving structure of its employees (first university graduated engineer was employed in 1970) and in such a way there was a gradual strengthening of local skills and expertise by acquiring it from the foreign partner (regular training), enhanced by its own efforts.

The crucial period in the company's development was 1980–1984 when Kolektor invested in the production of wrap-strip commutators and started manufacturing commutators, which were developed already in house and acquired the first patent. In this period Kolektor started building up its own R&D department. By 1988, they already outpaced K&B by the number of patents, achieving the leading position among commutator producers in Europe. Along with this process, K&B started to lag behind the new technology and marketing trends. To improve its creditworthiness position, K&B wanted to become a majority owner



of Kolektor in order to consolidate financial statements. Coincidentally, at the end of 1988 the new FDI legislation was adopted in then-Yugoslavia, which was the first real equity FDI legislation allowing 100 percent foreign ownership. At the same time the privatization process of Kolektor was completed. Having its first option on its share in joint venture, Kolektor was seriously considering buying out its foreign partner to gain more autonomy. But the question was whether it would be the money-wise best option, in view of others available, to achieve the same goals by alternative means, by an enhanced negotiating position in view of K&B difficulties and their need to get a loan to escape from bankruptcy.

In 1990 Kolektor agreed that K&B become the majority (51 percent) owner. One of the conditions of Kolektor to allow K&B to acquire the majority share was to include a new partnership agreement that would require 75 percent share in the management board (2 from Kolektor, 1 from K&B). If there were no agreement among owners, it would then be the Kolektor management that would decide. Obviously the Kolektor management grasped the strategic opportunity of the weak bargaining position of K&B by acquiring more autonomy, marketing its products on selected markets of Central and Eastern Europe under its own trademark. There were some transitional difficulties in 1993, but 1994 was a big success, and sales of products under its own brand name increased substantially. A majority of Kolektor products started to be exported to EU market (68 percent compared with 30 percent in 1993), and only 18 percent of total exports were allocated to the markets controlled by foreign partner network (with respect to 74 percent in 1990).

Becoming a majority owner of Kolektor allowed K&B to receive a loan from German banks, which ultimately did not save K&B. In 1993, K&B was taken over by the US firm Kirkwood, a leading producer of commutators in the world, and continued to operate under the K&B name. Kolektor consequently offered to Kirkwood to co-operate as equal partners, especially in marketing and product development (a kind of strategic partnership) in order to reduce increasing risks imposed by technological developments and declining product life cycle of their product, but the offer was not accepted. In 1997 Kolektor became a leading producer of commutators in Europe.

The key to success was the fact that Kolektor recognized that it needed to modernize technology and upgrade products. It was facilitated by the assimilation and adaptation of foreign technology but by simultaneously enhancing its own R&D efforts, developing its own patents and educating its labor. Special textbooks for additional education of its employees were written in-house, and innovations were stimulated by special rewards. It also strengthened its competitiveness by shortening the process of development of new products (testing, new tools, etc.). Yet in maximizing market share and becoming a global leader, strategy had increasingly become limited by a continuation of existing strategy based on producing only in Idrija. Parallel aging of the product and fast technological developments started to threaten the existing development strategy. New initiatives were needed in order to increase market shares in Asia and the USA. Internationalization, meaning getting closer to customers, in the countries where the customers are located, was one among them. This is why in 2000 Kolektor acquired the manufacturing company Sinyung (South Korea) and established TKI Inc. USA as a greenfield investment, which started the commutator production in 2001. The most important strategic move by Slovene owners of Kolektor was purchasing a K&B share from Kirkwood in 2002.

But the question was whether it would be the money-wise best option, in view of others available, to achieve the same goals by alternative means, by an enhanced negotiating position in view of K&B difficulties and their need to get a loan to escape from bankruptcy.

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At the same time Kolektor purchased the Kautt&Bux factory in Germany from Kirkwood. In such a way Kolektor transformed itself from foreign owned to a Slovenian multinational company. Thus, Kolektor at that point manufactured, besides the Slovenia location, in three other locations: Germany, USA, and South Korea.

Yet it became clear that Korea was not enough to satisfy all of Asia's needs. The fast growing automobile market in China made entry to China a must. In 2004 Kolektor started the manufacturing of wrap-strip commutators in Swi Shie Company (greenfield investment near Shanghai) and in a joint venture with a local company Wuxi (near Hong Kong). In order to grasp the expanding automobile market in Latin America, the company Zektor was established in Brazil in 2004 and later Asteh in Iran. Cost consideration also motivated relocation of production to Bosnia and Herzegovina, Serbian Krajina.

…a development of a company from being domestic, to foreign owned and finally again domestically owned but now multinational firm is also rather rare, but its lessons are extremely important.

As a response to the aging of the product and potential technological changes, Kolektor decided to diversify its activities. The Kolektor Group trust was reorganized in 2004 and now includes over 20 companies engaged in the fields of finance and banking, information flow and promotion, sales, commutator production, production of electronics, ferrites and wounds, plastic components, and the development of future products into plastic products. Kolektor Group trust has also established a development centre for nanotechnology. Among its new products is an omni directional display enabling large numbers of observers to get the same information all around the display (at shopping centers, bus stations, train stations, airports). FIFA chose the OMNI 450 PRN to welcome the world in their official FIFA Hotels in Munich, Frankfurt and Berlin for the soccer World Championship. The core operation comprises development, production, and marketing of commutators, where the firm is leading supplier and commutator manufacturer, covering 20 percent of the worldwide demands and over 50 percent of the European demands.

Conclusions

The two stories, country and case study, demonstrate a deviation from "regular" IDP and sequential theory of outward internationalization. Slovenia is an outlier in terms of its IDP, which deviates substantially from the theoretical IDP. Macroeconomic policies and political changes (which are location specific) decisively influenced the early start of Slovenian outward investment and its recent upswing in the direction of former Yugoslav markets. Firm-specific advantages of Slovenian firms played a less important role, as they have not been founded on very new technologies or products. Analysis has not provided enough evidence to challenge the general validity of the IDP paradigm. However, it has provided some additional qualifications for the relative importance of different factors deterring the IDP path, like systemic factors including the recent process of transition.

The Kolektor case, a development of a company from being domestic, to foreign owned and finally again domestically owned but now multinational firm is also rather rare, but its lessons are extremely important. First, such a path is possible provided there is a good and ambitious management able to grasp the (Porter diamond) chance when it occurs and following ambitious development strategy, not relying only on foreign know how but also on its own R&D efforts. The type of product (intermediate product for known customers) also facilitated ambitions to become independent once again. Finally, external circumstances (transition) also facilitated such a strategy and all together made such an exceptional path possible. Contrary to the country case, which appears more as a deviation from the rule, there is a ground to argue that we may see more of such micro reversed internationalization at the firm level in the future.

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Global Leadership

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The spread of globalization has expanded the nature of leadership in global jobs. "The term 'global' encompasses more than simple *geographic reach* in terms of business operations. It also includes the notion of *cultural reach* in terms of people and *intellectual reach* in the development of a global mindset" (Osland, Bird, Mendenhall & Osland, 2006: 197) and global skills. The global context or crucible that shapes and challenges this type of leader is characterized by:

- *multiplicity* across a range of dimensions;
- *interdependence* among a host of stakeholders, sociocultural, political, economic and environmental systems;
- *ambiguity* in terms of understanding causal relationships, interpreting cues and signals, identifying appropriate actions and pursuing plausible goals; and
- *flux* in terms of quickly transitioning systems, shifting values and emergent patterns of organizational structure and behavior.

(Lane, Maznevski, Mendenhall & McNett, 2004)

In some ways, global leadership (GL) appears to be qualitatively different from domestic leadership. In a related example, a direct comparison of domestic and expatriate work found that expatriates reported significantly higher demands for social and perceptual skills, reasoning ability, and adjustment- and achievement-orientation personality requirements in their work (Shin, Morgeson and Campion, 2007). Scholars have yet to directly compare and contrast the demands and competencies of domestic and global leadership. Early findings indicate both shared similarities and differences of degree and kind with domestic leadership, due to contextual factors (Mendenhall, 2008). Thus, in addition to leadership theory, GL has multidisciplinary intellectual roots in intercultural communication competence, expatriation, global management and comparative leadership (Osland, 2008).

As yet, there is no accepted definition of the global leadership construct or well-developed and tested theories. A brief definition, drawn from Adler (2001) and Festing (2001), is the *process* of influencing the thinking, attitudes, and behaviors of a global community to work together synergistically toward a common vision and common goals (Osland et al, 2006: 204). An expanded definition captures Kotter's (1990) distinction between managers and leaders: "individuals who effect significant positive change in organizations by building communities through the development of trust and the arrangement of organizational structures and processes in a context involving multiple stakeholders, multiple sources of external authority, and multiple cultures under conditions of temporal, geographical and cultural complexity" (Osland, Bird, Osland & Oddou, 2007: 2). The second definition assumes that not all global managers are global leaders.

There are several GL literature reviews (Hollenbeck, 2001; Suutari, 2002; Jokinen, 2004; Osland, Bird, Mendenhall & Osland, 2006; Mendenhall, Osland, Bird, Oddou & Maznevski, 2008; Osland, 2008) and ten empirical studies to date. Most scholars have sought to answer one or both of these questions: "What capabilities do global leaders need to acquire in order to be effective?" and "How is global leadership developed?" The resultant lists of competencies (Black, Morrison & Gregersen, 1999; Goldsmith, Greenberg, Robertson & Hu-Chan, 2003;

Kets De Vries, Vrignaud & Florent-Treacy, 2004; McCall & Hollenbeck, 2002; Rosen, Digh, Singer, & Phillips, 2000; Yeung & Ready, 1995) are overlapping and separated at times only by semantic differences (Jokinen, 2005).

Three frameworks attempt to organize the lengthy list of, at last count, 62 GL competencies. First, Mendenhall and Osland (2002) concluded that GL is a multi-dimensional construct with at least six core categories of competencies: 1) cross-cultural relationship skills, 2) traits and values, 3) cognitive orientation, 4) global business expertise, 5) global organizing expertise, and 6) visioning. Second, Jokinen (2005) identified three main types of GL competencies: 1) fundamental competencies (personal transformation, self awareness, inquisitiveness), 2) desired mental characteristics (e.g., empathy, self-regulation), and 3) desired behavioral competencies (e.g., social networking, knowledge). Third, the pyramid model[1] consists of knowledge, traits, attitudes & orientations (global mindset), interpersonal skills, and system skills (Osland, 2008).

Two studies focus more directly on tasks and effectiveness than competencies. Caliguiri (2006) identified ten global leader tasks and worked backwards to determine the knowledge, skills, ability and other personal characteristics (KSAOs) that lead to their effective performance and make recommendations about training and development. To measure more directly how global leaders think and behave, Osland, Bird, Osland and Oddou (2007) studied expert cognition in highly effective global leaders using cognitive task analysis (Crandall, Hoffman & Klein, 2006). In addition to the high-level problem solving and strategic thinking that one would expect in such a population, their cues and strategies evidence well-developed schemas for boundary spanning and stakeholder management, reading cultural and emotional cues, and seeking clarity. They deal with the extreme ambiguity of challenging situations by relying on a learned problem solving process, choosing the right people for their teams, and developing a high level of trust among both teams and stakeholders (Osland et al., 2007).

As with all nascent fields, a great deal of foundational research remains to be done (Osland et al., 2006). While firms and universities have instituted GL training programs, their theoretical underpinnings require strengthening, and there is no work to date on the efficacy of training methods. The main lessons learned to date are summarized below:

- There seems to be a positive relationship between MNC financial success and their ability to successfully develop GL competencies (Stroh & Caligiuri, 1998).
- Businesses have reported an inadequate number of global leaders (Gregersen, Morrison & Black, 1998), and a future global leadership gap is predicted in for-profit, public, and non-profit sectors (Bikson, Treverton, Moini, & Lindstrom, 2003).
- A comparison of effective and ineffective global leaders found that the former group: had significantly higher conscientiousness scores and significantly lower neuroticism scores on the "Big Five" Personality test; came from diverse families; participated in more geographically distributed teams; had long-term international assignments; and were mentored by people from a different culture (Caligiuri, 2004).
- There is growing consensus that global leadership consists of core characteristics, context-specific abilities, and universal leadership skills (Osland, 2008).
- GL training and development is based on the assumption that this form of leadership requires different types of knowledge, cognitive and behavioral skills.
- Many aspects of GL development involve personal transformation (McCall & Hollenbeck, 2002; Osland et al., 2006; Osland & Bird, 2008), which

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1 This model was originally developed by ION scholars for global managers (Bird & Osland, 2004) and subsequently adapted by those authors based on the findings of empirical GL studies.

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makes GL development less linear and predictable (Mendenhall, 2006; Osland et al., 2006).

- Several instruments have been designed to assess aspects of global leadership. Bird (2008) reviews their strengths, weaknesses, and recommended applications.

Global leadership, like global mindset, seems destined to be an important source of competitive advantage for transnational corporations.

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The Effects of Market Deregulation—A Financial Structure Analysis

Introduction

During the past decades, country after country in Europe and in many other western economies have restructured and reformed traditionally regulated markets and industries, like electric power, natural gas, public transport, airline, telecommunication, banking and insurance. The main objective has been to enhance the overall efficiency within the industries. In theory, market deregulation should open up for and foster competition, putting pressure on operating firms to minimize costs, adopt new efficient technology and improve customer services. A large number of studies have explored and evaluated the efficiency effects of regulation and deregulation. The focus has in general been on changes in market prices, production costs, innovation activities and social welfare (e.g., Stigler, 1971; Douglas and Miller, 1974; Chen and Sanger, 1985; Peltzman, 1976, 1989; Joskow, 2004; Hausman, 1999; Evans and Guthrie, 2005). Comparatively less attention has been paid to changes in the business risk of firms, let alone effects on their financial architecture. Two rival theories – the buffering hypothesis and the regulatory lag hypothesis – predict opposite effects on firms' exposure to risks (Fraser and Kannan, 1990) and there are empirical studies lending support to each theory. The way regulation is designed and exercised is very crucial for the risk exposure of operating firms (Evans and Guthrie, 2005) and, thus, for the likely effect of market deregulation. This is recognized by Taggart (1985), who identifies the effects of market regulation on utility financing combining three regulation theories and three capital structure theories. The expected effect on prices and profits is mainly depending on whether regulation is:

a) implemented to prevent monopolistic behaviour and pricing ('Public interest' or 'Market failure theory'),

b) a means for redistributing wealth between producers and consumers, where according to Peltzman (1976: 227). *"Regulation will tend to be more heavily weighted toward producer protection in depressions and toward consumer protection in expansions."* ('Political economy theory'), or,

c) subject to *informational asymmetries* between producers, consumers and regulators that may be strategically utilised by a group possessing unique information to obtain abnormal profit for a certain time period, i.e., until other groups learn from experience and procedural regulatory rules are adjusted ('Imperfect monitoring theory').

The three described capital structure theories are 1) financing hierarchy theory—asymmetric information depicts a pecking order 2) debt capacity theory—financial flexibility is important for and valued by managers, and 3) the Modigliani & Miller perfect capital market theory—debt/equity choices are irrelevant to firm value.

1 In accordance with the buffering theory, Peltzman (1976) argued that regulation will lead to lower variability in profits and stock prices. He found that the total risk, i.e., unsystematic as well as the systematic risk, declined for the drug and rail industries after being regulated. Also later studies by, e.g., Chen and Sanger (1985), Chen and Merville (1986), Cavarra, Stover and Allen (1981), and Fraser and Kannan (1990) lend support to the buffering hypothesis. However, there is also evidence from other studies that tends to be more in line with the regulatory lag hypothesis, especially regarding financial industries (e.g., Aharony, Saunders and Swary, 1988) but also regarding industries in general (e.g., Evans and Guthrie, 2005).

As changes in prices and profits due to an imposed regulation may result in an altered business risk for the operating firm, the financial structure of the firm is also likely to be affected. According to Taggart (1985) this should be the case under both the debt capacity and the financing hierarchy capital structure theory. However, under perfect capital market conditions, where capital structure changes – in accordance with the Modigliani-Miller (MM) theorem – do not add to firm value, this ratio should in principle remain unaffected. Taggart (1985) argues that this is true only under public interest and political economy regulation. Under an imperfect monitoring regime, where regulated prices are related to the cost of capital of operating firms, there may be strong incentives to modify the debt-equity ratio in order to increase the price. Such manipulation may take many forms depending on the regulatory pricing rule. *"For example, it has been argued (see Sherman, 1977) that some regulators set the allowed return to equity independently of the firm's financing proportions. Since the cost of equity declines as financial risk is reduced, a utility operating in such an environment would want to substitute equity for debt in order to maximize the differential between the allowed return on equity and its cost."* (Taggart, 1985:264)

The inclusion of the effects of regulatory reforms on capital structure extends the analysis to also consider how a 'sudden' change in the regulatory structure would affect the risk and profit of shareholders and bondholders. Regulation theories are mainly focusing only on the distribution of welfare between producers and consumers. In that respect the approach used by Taggart (1985) offers a more comprehensive analysis and thereby deeper understanding of the economic effects of imposing different forms of regulations. No explicit analysis is however made with regard to the magnitude of these effects on the different stakeholders and their respective opportunities and possibilities to manage additional risks (and costs). Moreover, the analysis is only partial in that it does not take into consideration eventual effects on other stakeholders, like employees. Clearly, this phenomenon would be even more comprehensively understood if the analysis was conducted within an extended stakeholder framework.

In order to understand how these, so called market imperfections will affect the cost of capital, and how market deregulation will lead to redistribution of wealth, the analysis framework needs to be extended. A complete analysis must include other stakeholders than debt holders and equity holders. Certainly, market deregulation will also affect important stakeholders like labour, management, suppliers and government. There will be changes in risk and returns as well as reformulations of explicit and implicit contracts, which we later will exemplify. The aim of this paper is to develop an analysis model for measuring the effects of market deregulation on risk and wealth distribution between different stakeholders. We will use the concept of financial architecture and the idea of the firm as a nexus of contracts. Myers (1999: 138) defined financial architecture as *"… the entire financial design of the business, including ownership (e.g. concentrated vs. dispersed), the legal form of organisation (e.g. corporation vs. limited-life partnership), incentives, financing and allocation of risk"* The idea is to *"support the co-investment of human and financial capital."* (op. cit: 139) This means that a company should not be seen as a sum of the parts of valuable marketable assets, but including organisational assets and liabilities, as a nexus of contracts (Alchian and Demsetz, 1974; Jensen and Meckling, 1976). It is the introduction of implicit contracts, compared to only including explicit contracts, that has major implications for the valuation of companies and capital structure issues. It alters the view of the entity of the firm (Zingales, 2000). Organisational capital, such as labour sweat capital (an expression used in Myers, 1999), management stakes, suppliers efforts, and customer trust, is often not stipulated explicitly in the form of written contracts. This implies that stock price reactions are not reliable indicators for welfare changes. It may also lead to that temporary shocks may have long term effects on firm value. Zingales (2000: 16) explains this with an

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example where a company has a reputation to reward its labour regardless of their market value *"Counting on this reputation, the employees will make investments that are different from those they would have made in the market place. If these investments are indeed valuable and could not have been elicited with an explicit contract, the firm's reputation adds value: it represent an organisational asset. On the other hand, if these investments are wasteful, the firm's reputation will destroy value: it represents a organisational liability"*.

Analysing risk effects of regulatory reforms in a stakeholder framework

We start this analysis of risk effects of regulatory reforms within a stakeholder framework by focusing on the risk affecting shareholders, i.e., we analyse how the different kinds of risk – total, systematic or unsystematic risk – would be likely to change after imposing market deregulation.

Effects on shareholders

Let us begin by assuming an all equity firm operating under the regulatory 'public interest theory' within an MM economy with no taxes in accordance with 'the perfect capital market theory'. We directly state the obvious fact that the market value of assets (V_a) exactly equals the market value of the equity (V_e).

$$V_a = V_e \qquad (1)$$

If the buffering theory holds, market deregulation will result in an increase in the total risk on the asset side (Var_a). The market value of assets (V_a) may then decrease in relation to shareholders' inability to diversify this risk as the following relationship holds:

$$\underset{\textit{(total risk)}}{Var_a} = \underset{\textit{(systematic risk)}}{Cov_{a,m}} + \underset{\textit{(unsystematic risk)}}{Unsys_a} \qquad (2)$$

If the firm's exposure to systematic risk factors increases after deregulation is imposed, shareholders will face a drop in wealth. However, in the case the increase in total risk is all referable and due to unsystematic risk, i.e. $Cov_{a,m} = 0$, shareholders are expected to diversify away this risk in an MM economy. The only risk they will be awarded for is the systematic risk ($Cov_{a,m}$). This implies that the cost of equity capital will remain at the same level after the deregulation. Even if the cash flow from a single firm will be distributed more unevenly in an uncertain and more competitive future, shareholders will not be rewarded for this increase in firm specific risk as this risk is diversifiable.

In the case that the regulator in accordance with the public interest theory previously was very successful in preventing operating firms from monopolistic behaviour and pricing, shareholders would not be subject to any loss in wealth provided they are well diversified. The total market, measured by the number of customers, would then have the same size after as before the deregulation with total consumption of goods and services unchanged. Assets are not priced differently ex-post and ex-ante market deregulation. The cost of capital remains the same and their will be no change in the value of the assets (V_a) as the equity owners' total cash flow is unaffected.

For a transfer of wealth between shareholders and consumers to occur the total risk on the asset side must include some sensitivity to systematic risk factors, i.e., provided that market imperfections do not prohibit diversification as in the theories of 'political economy' and 'imperfect monitoring'. If the point of departure lies in any of these regulatory structures, both systematic and unsystematic risk would be likely to increase at the same time as product prices fall. Hence, we may then expect that shareholders would both lose wealth and require a higher return on equity capital (r_e) after market deregulation, albeit the magnitude of these effects is not easy to determine in practice.

The Beta coefficient (β) was introduced by Sharpe in 1964 as an empirically useful measure for the systematic risk. To estimate beta, historical stock price data are often used under the assumption of well diversified shareholders. The beta measure fails to

capture solely the systematic risk under two circumstances and may increase in spite of no additional sensitivity to macro factors. First, shareholders are not well diversified and as a consequence they price unsystematic risk when evaluating their investments. In traditionally regulated industries, like electricity and natural gas, owners of operating firms (utilities) are often municipals that are not able to be fully diversified. However, privately held firms, in for instance the railway and airline industries, can also be suspected to not invest their money in strictly rational portfolios. Zingales (2000) puts forward the importance of increasing the attention to this problem of not well-enough diversified owners. He also stresses that the human capital within companies is not well diversified and that there is need for research focusing on other firms than large corporations. Second, the specific type of assets is affecting the measure of systematic risk. The existence of irreversible assets (investments), such as R&D, specialized equipment and organizational capital, all with low resale (opportunity) value, requires more attention compared to marketable assets. *"Despite the fact that our analysis with the Capital Asset Pricing Model (CAPM) as our valuation model, the irreversible nature of investment means that unsystematic demand risk, as well as its systematic counterpart, affects the required rate of return when the rate base is subject to optimization"* (Evans and Guthrie, 2005: 111).

The results from studies supporting the buffering theory imply that the cost of equity will increase regardless of whether the firm is exposed to systematic and/or unsystematic risk. Undiversified shareholders and irreversible assets are both anomalies in a perfect capital market theory to explain higher cost of equity capital. Hence, market deregulation is only economically motivated if the corresponding increase in the cost of capital is offset by a larger decrease in production costs.

Effects on debt holders

In the analysis of deregulation effects on shareholders, we have put forward that an increase in the total risk for assets may be partly offset by shareholders if they are able to avoid firm specific risk by diversification. The story is different for debt- or bondholders that are claiming a fixed rate of return in the form of interest (r_d). Contrary to shareholders that may sometimes benefit from higher residual income than required (expected), there is no prospect of excess returns for bondholders. They are only exposed to the downside risk, i.e., the risk of payment default.

In an MM economy a deregulatory change of an industry, regulated according to the 'public interest theory', would have no effect on bondholders' sensitivity to risk, in a levered firm, even if the total risk (Var_a) increases. In real life, the situation is different. A large bulk of research has followed since the articles by Myers (1984) and Myers and Maijluf (1984), which is lending support to 'the financing hierarchy theory' as well as the 'debt capacity theory' explaining how an optimal capital structure is determined within a firm. In short, bondholders require a premium for their (credit) risk exposure. An increase in the risk for bondholders due to market deregulation will make debt financing more expensive. This will have implications for the optimal capital structure of the firm in terms of a lower debt-equity ratio. This implies that also unsystematic risk will lead to a higher weighted average cost of capital (r_{wacc}) and consequently a reduction in the market value of assets. The following relationships should hold:

$$r_{wacc} = r_e \cdot E/A + r_d \cdot D/A \quad (3)$$

$$V_a = V_{e+} V_d \quad (4)$$

Bondholders cannot diversify away unsystematic risk in the same manner as shareholders since they have limited excess return from the firm. An increase of the risk in the product market, jeopardizing the market value of the firm's assets (V_a), will therefore result in a higher cost of capital. This is not due to the shareholders, but rather the creditors. Assuming that shareholders are able to diversify the increased risk, a drop in the value of assets would be matched by a

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decrease in the market value of debt.

To summarize, a change in asset risk, will affect the cost of capital, except for the case of an MM economy with a 'perfect capital market theory', and a well functioning regulation based on 'public interest theory'. Relaxing one of these assumptions results in higher cost of capital.

Effects on other stakeholders—considering implicit and explicit contracts

Within the economic theory (ET) literature there is a number of examples discussing regulatory effects on different parties (stakeholders) indirectly considering the implicit and explicit contracts. Evidently, there is a transfer of wealth from labour liability to consumers. The magnitude of this redistribution is dependent on the negotiation power of the parties, and the existing contracts in place. In both the U.S. and the European airlines industry there is evidence for a change in the contracts after the deregulation. In labour incentive industries, such as the U.S. airline industry market, deregulation is most likely to lead to increased labour sensitivity (Gil, 1990). The same patterns are also discovered for European airlines (Robinson, 1994) facing market deregulation about a decade later. The most significant one is the 'lay off of personnel'. Other measures for reducing labour costs have been pay restrictions, early retirement proposals, flexible work schemes, work rotations, etc. Staff unions often agreed on these measures, depending on their negotiation power (ibid). For an airline operator the labour cost stands for the second highest expense, after fuel. Perhaps even more importantly, labour cost is the largest expense under the control of managers, which clearly put the scope on reducing this cost as evident.

The industry was also subject to a significant change in the development of global markets, new technology and improved management tools (Robinson, 1994). The consequences are that suppliers will also be affected by an increased risk depending on the implicit and explicit contracts in place. As a supplier to the deregulated industry, suddenly revenues will decline depending on higher cost pressure, intense competition, and industrial and organisational changes.

An additional example of increased risk, depicted by changes in implicit and explicit contracts, is how management behaviour changes due to market deregulation. Managers play a vital role in establishing the outcome of a deregulation process. The important question to be raised is whether market deregulation affects strategic choice so that managers adopt riskier strategies after it is implemented? Reger, Duhaine and Stimpert (1992) examine how the deregulation of the banking industry increases risk that affect the performance of bankers directly but also indirectly through the mediating effects of strategic choice. Variables for measuring differences in strategic choice are product/market mix decisions such as the trade off between focusing on retail/wholesale banking, personal/commercial loans and agriculture/real estate loans. By relating these strategic choice variables to risk measures such as interest rate risk and default risk, and to performance measures like return on assets, they conclude that deregulation affects business risk both directly and indirectly dependent on new strategic choices made by management after deregulation. Even if this particular paper does not address the reasons for why managers are making riskier decisions, it is an indirect proof of the idea that implicit contracts are likely to be changed within a deregulated industry.

Finally, the purpose of market deregulation is to increase competition and thereby lower price levels and/or increase output. In a regulated industry the information of prices in future periods can be predicted with higher certainty. Shaffer (1984) argues that it is not for certain that all consumers will benefit from increased risk. For risk avert consumers the utility can decrease, when facing volatile prices. Shifts in supply/demand levels and product prices can affect the consumers' utility negatively. This implies that there should be a market for long term contracts. With asymmetric information on future price changes a company can offer its customers such long term contracts with fixed prices, and thereby offset some of the positive utility effects for consumers. These types of contracts were not necessary during the period of regulation.

Financial architecture—using the balance sheet and income statement to illustrate deregulatory effects.

We have argued that an increased risk due to market deregulation will affect stakeholders differently because of their different ability to diversify unsystematic risk or transforming it to other parties conditioned by explicit and implicit contracts in place. Therefore, it is equivocal whether the cost of capital will increase or not. First, it depends on the capital structure, in particular the firms' debt capacity. Secondly, it depends on the shareholders ability to diversify. Thirdly, it also depends on the extent that the assets are irreversible. Introducing contract theory and financial structure, thereby further relaxing assumptions, a fourth factor appears, namely how other stakeholders are affected by the imposed deregulation. These factors depict the fulfilment of the deregulations stated goals. By expanding the firm's entity, following the idea of Myers (1999), all present values of revenues and cost in the income statement can be viewed either on the asset (revenue) or liability (cost) side of the balance sheet.

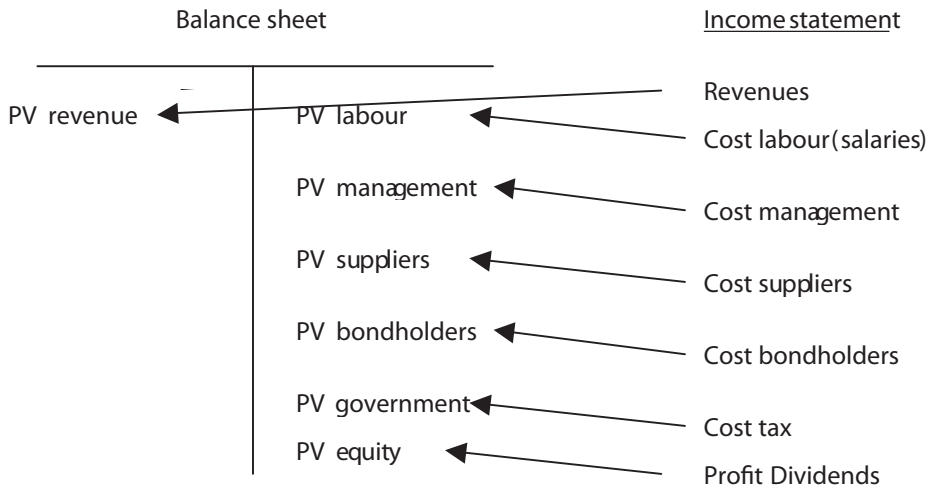

Figure 1. The firms entity defined as the present value of all stakeholders

When an increase in the volatility in sales appears, the present value of future total sales will decrease. This will lead to an identical decrease on the liability side of the balance sheet. Different stakeholders on the liability side will face changes, as described earlier, in the market value of their outstanding debt depending on their sensitivity to systematic and unsystematic risk, and not at least, different explicit and implicit contracts between the stakeholders. The increased risk in revenue stemming from a deregulation will be passed through differently to each separate stakeholder. The financial architecture idea opens up for new analysis of an optimal capital structure. A firm's ability to borrow money, i.e., its debt capacity, will vary dependent on the contracts in place with other stakeholders. The residual claimants' ability to pass on risk to other stakeholders will affect an optimal D/E ratio. A sudden change in industry structure such as a deregulation may lead to drastic changes in the contracts.

Concluding remarks

The idea of this paper originated in a discussion we had on why deregulations seldom reach the stated goal 'to lower the price facing consumers'. This was after receiving bills from the electricity distribution and sale companies that are now operating on a deregulated Swedish market. At the same time the owners of these companies seem to still be well off. The ET literature is not giving a clear view on what to expect considering price changes and wealth distribution. The major criticism against initiated and carried through market deregulation processes in various industries has been that the expected decrease in consumer prices has not occurred. We argue that the cost reduction stemming from increased competition will partly be offset by an increase in the cost of capital following the increased risk. This will have implications for the capital structure of the firm and the incentives for pursuing long-term investments in new capacity.

By introducing the concept of financial architecture and the idea of the firm as a nexus of contracts, including other stakeholders, we broaden the analysis on wealth distribution and the impact on the cost of capital. We extend the discussion by making the following remarks:

- Only measuring stock price reactions are not reliable indicators for welfare changes.
- Bondholders play an important role, incapable to diversify unsystematic risk, when determining the value of assets.
- Different stakeholders on the liability side will face different changes in the market value of debt depending on different factors such as their sensitivity to systematic and unsystematic risk, and not at least, different explicit and implicit contracts between the stakeholders.
- A change in risk for stakeholders has direct implications for the capital structure of the firm and indirectly alters the incentives for pursuing long-term investments in new capacity. These would lead to lower quality and decline in service received by consumers.

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