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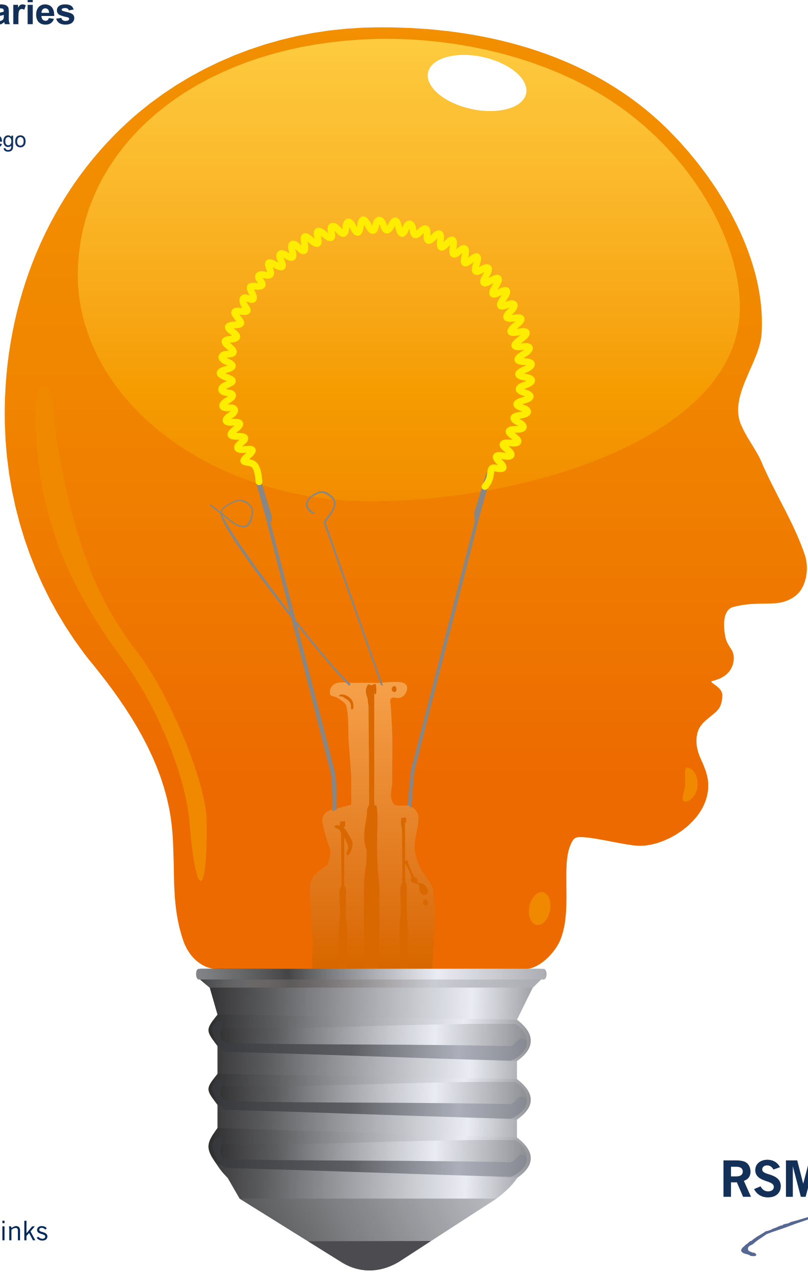

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Coping with complexity in emerging markets

by Suzana B. Rodrigues

With low growth driving European and American businesses to faster-growing economies, how do these foreign companies handle the complex challenges they face in emerging markets?

Brazil and China, two BRIC economies, are prime examples of a widening gap between business needs for growth and the availability of resources. Both countries suffer from poor infrastructure and lack of skilled manpower. Economic and social environments are non-linear and therefore complex, not only because they change fast, but because there is also an imbalance in the macrostructure.

"Depending on size and influence, a company has three ways of coping with complexity: complexity reduction, absorption and mediation."

While demand for goods and services is on the rise, these economies are confronted with serious educational and transport deficits. They suffer severe shortages of specialised labour in technical, engineering and management areas, which can only be resolved in the long run. Furthermore, a heterogeneous social and economic structure and problematic legal systems may impose further demands on foreign companies planning on operating there. These firms can also experience uncertainty because of their 'foreignness', and their lack of understanding of business relationships and how to interact with the institutional system.

Understanding complexity

We find two main types of complexity in emerging markets: cognitive and relational. Cognitive complexity arises when there is difficulty in understanding the characteristics of a complex environment: how institutions function; business groups and the unfamiliar demands that they impose, and rules and regulations. Typically, information on emerging markets is insufficient and rules and laws are inconsistently applied due to an incomplete legal system and inefficient institutional enforcement. Consequently, firms cannot apply already-established procedures or extrapolate from past experience. This sort of complexity, caused by high levels of ambiguity or inconsistency of information, creates high uncertainty among foreign firms.

The second type, relational complexity, arises from the lack of stability in partnerships, or low organisational commitment. A keen desire to get rich or succeed professionally makes it difficult for company or departmental managers to create an environment of co-operation and information sharing. Critically, a problem of trust might arise.

In some cases, these two types of complexities may combine, for example, when local licence-granting agencies have inconsistent policies, and when local partners cannot deliver key competencies.

As emerging markets grow, so do the number of firms offering similar goods and services, leading to large variations in quality, prices and reliability. Because many suppliers are new entrepreneurs who have discovered gaps in a given industry, many of them take advantage of institutional failures and inconsistent customer information to profit from fraud and fake products. These complexities reduce trust among market players.

As the number of opportunities increase, so does opportunism. The combination of inconsistent ethical behaviour of some businesses and their questionable capacity to deliver (associated with their sudden rise in profits) makes markets unpredictable

and creates additional uncertainty through poor or non-delivery. This also causes problems with foreign investors.

In short, even though conventional wisdom views growth in a positive light, there is an important consequence and downside: increasing cognitive and relational complexity in emerging markets. So, how do foreign companies deal with it?

Handling complexity

Depending on size and influence, a company has three ways of coping with complexity: complexity reduction, absorption and mediation. The first, complexity reduction, refers to the direct action a company can take to simplify external complexity. When the company is relatively powerful and can actively influence its environment, such as a multinational, it is likely that its managers will use that power to reduce both cognitive and relational complexity in their dealings with the environment.

Relational complexity can be reduced by lobbying governments to create a more regulated environment through legislation and its effective enforcement; and by developing political capital that is used to gain a privileged market position. Several examples can be found among Chinese investments in Africa, where Chinese companies reduce uncertainty through favourable understandings with host governments.

In parallel, companies can reduce complexity by locking local companies into the dominant business through taking sole ownership, or at least a controlling interest. Firms can reduce cognitive complexity by replicating their own internal environment in host countries, by introducing tried-and-tested routines, standards and ethical procedures, thus avoiding the relational complexity of shared decision-making and management.

When a company cannot dominate its environment and there is a balance of power among the players and government, complexity absorption may prove more effective. Here organisational actors endeavour to understand and work with cognitive complexity by entering into multiple relationships within the system. Choosing another brand name for the subsidiary helps the company integrate into the local environment and so does the choice of local suppliers. Surrogate brand names also help protect the core business from threats that affect its reputation.

Smaller firms, on the other hand, may establish their business abroad with those that they trust or had business dealings with in the past. Their lack of power, influence and resources attracts them to the third mode of engagement, complexity mediation, where they accommodate a complex environment without absorbing complexity or reducing it to any significant extent. Mediation contrasts with both reduction and absorption in that firms attempt to cope with environmental complexity by relying on other parties.

A final thought. Despite their complexity, emerging economies may offer unprecedented opportunities for a company to grow fast. The challenge is in developing and managing strategies to mitigate risks and at the same time take advantage of opportunities. Crucially, this requires diligence in understanding the local business environment – including the politics, culture, pitfalls and barriers – and then finding mutually beneficial ways to adapt and interact. ■

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