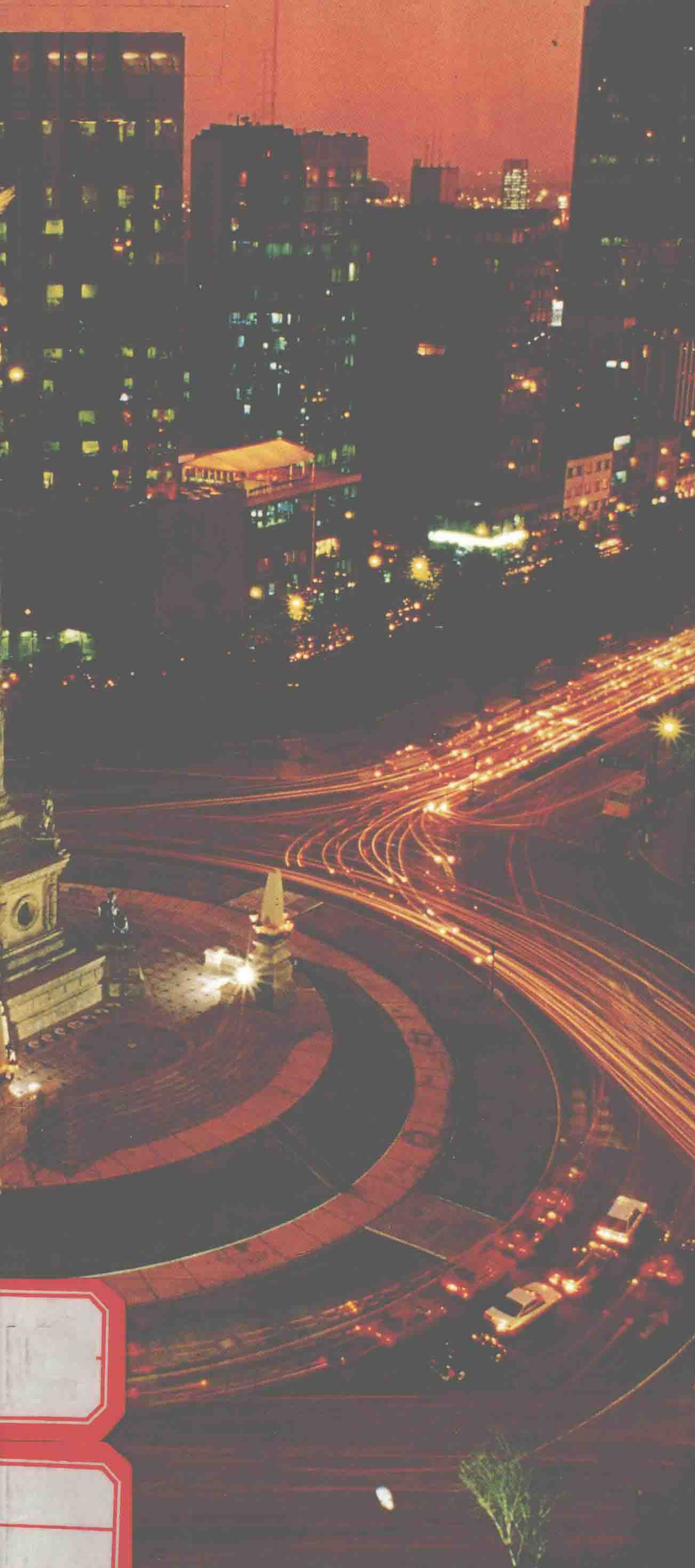

Cases in International Management

A Focus on Emerging Markets

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G. Keong Leong
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PREFACE

Worldwide, international trade has grown manyfold in the last three decades. Most of the growth in trade has been between countries that are already industrialized, but increasingly business firms have found that their best opportunities exist in the fast industrializing economies of the world. The U.S. Department of Commerce refers to these fast growing economies as "emerging markets" and maintains a list of the top ten (currently China, Indonesia, India, South Korea, Turkey, South Africa, Poland, Argentina, Brazil, and Mexico).

American business students need current information on emerging markets, particularly since change is occurring so rapidly in each of them. Business school curriculum has not always reflected the unique challenges facing business firms in emerging markets, however. In fast growing markets, businesses may cooperate more with one another since economic growth means that competition does not have to be so sharp for market share. In older, more stable markets, what one firm gains must often be at the expense of a well known competitor.

The emerging markets of the world have other characteristics that students need to appreciate. Decision making is difficult due to the more volatile economic environment. Sudden, sharp exchange rate changes may occur without warning. Government policies regarding basic investment rules change. In some cases, policy may dictate a wholesale change from a planned to a market economy. In all these situations, strategic planning is complicated and organizations may have to redesign themselves repeatedly to match the new environments.

Rapid advances in communication, sharp declines in the costs of transportation and the increased mobility of capital have had interesting, unanticipated consequences. International competition has increased dramatically, decisions must often be made on the spot, and firms find it hard to maintain comparative advantage for very long -- with one important exception. The way in which human resources are organized and managed can help create organizational successes that are hard to imitate.

The set of cases collected here are representative of a variety of problems that managers are likely to encounter in emerging markets. The impetus for collecting the cases has come from the establishment of a Center for International Business Education and Research (CIBER) in the Fisher College of Business at the Ohio State University. The editors of the volume are all associated with the CIBER, whose focus is also on emerging markets.

Several of the cases on Mexico were prepared by MBA students in the Fisher College as part of a course that they designed for themselves in the academic year 1994-95. Students identified companies that were strongly affected by the sharp and unexpected devaluation of the Peso in 1994 and traveled to Mexico to interview top level managers in these companies. The companies have also been adjusting to new trading rules adopted through the establishment of the North American Free Trade Agreement. The adjustments these companies are making allow students to examine the interplay of government policy with business strategy.

A second set of cases focuses on problems that are inherent in countries where the economic activity of a centrally planned system is suddenly transformed to free market activity. The experiences of managers in China, Ethiopia, Hungary, and Russia are examined. Problems differ significantly from those encountered in countries with long histories of free market business practice. A final pair of cases examines interesting changes in business practices in Thailand and India.

This case book can be used in conjunction with an introductory text in International Business, or it can be used alone by instructors who want to teach the principles of international business in the context of fast emerging markets. In either case, the breadth of cases, in terms of country, culture, industry, size of firm, and business environment should provide the student with a realistic preview of what might be in store as businesses become more and more global.

We give special thanks to the CIBER staff at Ohio State, to Joe Cheng, Academic Director of International Programs, to Cheryl Ryan, CIBER Director, and to Melynda Hicks, CIBER Program Coordinator, Fanza Andriamialisoa and all those who have allowed us to include their work in this text.

Stephen M. Hills
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Case 1.1

FOREIGN INVESTMENT ACTIVITY AND THE MEXICAN PESO DEVALUATION OF 1994[1]

<u>Summary</u>

The financial environment of Mexico prior to the December, 1994 devaluation is described. Reasons for the large outflow of capital in early 1994 are examined retrospectively. The recovery plan and its anticipated consequences are analyzed. The case establishes the financial background to other cases from Mexico but also describes conditions that are all too familiar in emerging markets. Betting on emerging markets can be risky business.

<u>Investors were once again reminded that betting on emerging markets is risky business.</u>

On Tuesday, December 20, 1994, Mexico reversed a long-standing currency policy and allowed the peso to fall 12.7% relative to the U.S. dollar. This decision came four days after Finance Minister Dr. Jaime Serra Puche, had assured investors there would not be any change in the peso policy. Within a month, the peso lost 40% of its value. The new administration, led by President Ernesto Zedillo, blamed the devaluation and other economic problems on the resurgence of revolt in Chiapas led Indian rebels.

The economic crisis was actually a consequence of accumulated economic and political problems that coincided and led to the crisis (see Exhibit 1: Timeline of the Significant Events of 1994). Political instability, assassinations and kidnappings, uncertainty about the results of the August elections and the anticipated fear of a possible economic rupture in case of a PRI (Institutional Revolutionary Party) defeat caused significant capital outflow in Spring of 1994. The consequences of the political and social problems were, and include:

- Halt in economic growth,
- Sudden sharp increase in interest rates,
- Limiting of the availability of credit lines,
- Decrease in international reserves,
- Sharp devaluation of the peso, and
- Loss of confidence in Mexico's current administration

By March 1995, a recession was looming over Mexico's economy. The peso's fall had led to even greater economic woes: high interest rates and inflationary forces drove commercial and consumer loan default rates up. Sales of consumer goods were off 30 to 50%, as workers' salary increases were capped at 7% while

[1] The framework for this case was provided by Mr. Johannes Hauser, Sub Director of the German/Mexican Chamber of Commerce, in a presentation to German and Swiss financiers, and Ohio State University MBA students on March 23, 1995, in Mexico City, Mexico.

This case was written by Cheol-In Kim and Donald Murray, MBA students in 1995 in the Max M. Fisher College of Business, The Ohio State University, under the supervision of Professors Roberto Garcia, Stephen Hills, and G. Keong Leong. This case was written for class discussion and does not necessarily imply good or poor management practices.

inflation exceeded 40%. Around the world, business leaders and investors were split on their assessment of the situation. Pessimists saw a financial meltdown, but optimists anticipated a more temporary crisis.

The most devastating effects of the devaluation were the loss of confidence in the Zedillo government and the loss of belief in Mexico as a prosperous, developing country. To help the country's economy survive, Mexico requested the largest concerted, international emergency aid (US$53 billion) bailout in history.

1994's Forecast was Positive

Mexico had gone through economic crisises before (see Exhibit 2: Peso History) and recovered. Since the late 1980s, Mexico's economy had shown constant improvement. Formerly state-owned businesses had been privatized and in 1994, the budget was nearly balanced. NAFTA, which went into effect January 1, 1994, opened Mexico's economy to greater foreign direct investment and global competition. NAFTA meant opportunities for increasing trade volume, higher confidence in Mexico's economic stability, increased foreign investments, decreased unemployment and an increased demand for infrastructure development.

According to the U.S. Department of Commerce, U.S. exports to Mexico were up 16.7% in the first six months of 1994, compared to the same time period one year earlier. In 1994, Mexicans bought some US$50 billion worth of American products, an amount sufficient to give the U.S. one of its largest bi-lateral trade surpluses. At that time, economists were predicting a rosy picture for Mexico's growth potential. Foreign direct investment was increasing, Mexican industries were working to become more competitive, infrastructure spending was continuing upward and 1995's growth in GDP was predicted to be 4%, compared to 0.4% in 1993, and an estimated 2.5% for 1994.

Nonetheless, Mexican investors had seen their stock investments decline 32% in 1994 when growth was expected to be nearly 40%. When the devaluation occurred, speculative investors immediately lost 12.7% of their US$75 billion holdings, and, those who kept their investments in place lost nearly 50% by March. Speculative investors were the crisis' biggest losers.

Long-term foreign direct investors suffered from lowered sales caused by the lull in the economy. However, most of these investors had wisely hedged against unforeseen changes in the exchange rate, and did not suffer the immediate reduction of holdings that short-term speculators did.

What Happened

Mexico's current account deficit was often cited as the primary cause of the peso's 1994 decline. In 1994 the current account deficit had surpassed US$28 billion, or 8% of its GDP (the U.S. current account deficit was approximately 3% of its GDP). What made Mexico particularly vulnerable before devaluation was its reliance on short-term debt instruments, called *tesobonos,*[2] to finance the deficit. Mexico had received a tremendous inflow of speculative, short term capital. In 1994, nearly three-fourths of all Mexican foreign capital was invested in highly speculative stock; only one-fourth was in direct capital investments.

On December 20, when Finance Minister Jaime Serra Puche lowered the currency's floor[3] by 53 centavos, widening the exchange rate band by 15%, the stock market began its fall. Dr. Serra commented that this step did not signify a move towards devaluation rather the move was intended as a measure to defend Mexico's

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[2] Tesobonos are peso denominated bonds fixed to the U.S. dollar
[3] Mexico used a managing float method to control the peso's value

international reserves, which were at dangerously low levels (see Exhibit 3: International Reserve History). Market investors agreed that international reserves were low but were not convinced that this was the only reason for widening the exchange rate band. Nor did they think that the lowered exchange rate was a one-time event.

By the end of December 20, US$3.5 billion had left the country. That night the Central Bank of Mexico announced its intention to allow the peso to float freely on the market. The next morning the market opened with an exchange rate of US$1 : N$5.60. The day before, the exchange rate had been US$1 : N$3.47.

As capital flight continued, Mexico's low international reserves proved too little to shore up the peso. When federal reserves hit $5 billion during the first week of January, the government announced it would (could) no longer support the peso's value - at any level. This resulted in a peso nose-dive that led to increased capital flight and a continued decline in the value of the peso.

By the second week of January, 1995, the peso had been devalued by more than 35% and stock market shares had lost more that 20% of their value. Speculators were pulling out, exacerbating capital flight. Most direct investors stood fast, prepared to ride out the storm, but they controlled too little of the country's capital to stop the outward flow of capital.

Other factors contributed to the devaluation of the peso. Exhibits 4, 5 and 6 graphically display how key events in 1994 (refer to Exhibit 1) affected the exchange rate, interest rates and stock market performance.

The Recovery Plan

On January 3, the Zedillo administration announced an emergency package to put Mexico's economy back on track. The plan met with surprisingly little enthusiasm from the investment community. The plan called for government spending cuts of $3.7 billion (1.3% of GDP), a 7% ceiling on wage increase (an agreement reached with the labor unions), expanded privatization, no exchange controls and a suppression of price increases in the public and private sectors. In an attempt to further soothe the market, a few days later the government also promised to freeze hiring, ban state spending on real estate and new cars, and reduce budgets for official travel, phone use and other expenses.

On March 9, the government announced a new economic program:

- A value added tax (VAT) increase from 10 to 15%,
- Gasoline and electricity prices to rise immediately by 20%,
- Public sector to cut expenses by almost 10%,
- A minimum salary increase of 10% by April 1,
- Banks to be backed with a US$3 billion credit by international institutions,
- A planned restructuring of credits.

This program, some say imposed by international organizations and the U.S. government, was aimed at stabilizing the financial markets. The plan received mixed reactions from Mexico's private sector. But the only alternative to the program was to declare a suspension of payments, a move that would have meant a financial relapse similar to that experienced in the early '80s and restricted access to international financial markets.

Many analysts were concerned with the social implications of Zedillo's proposal. The Mexican population had suffered from what seemed to be a permanent reduction of purchasing power in order to battle inflation.

Mexico rested on top of a barrel of gunpowder in wait of a spark. Already, Mexicans, including the usually docile middle class, had taken to the streets in often volatile protest.

The government's preoccupation in 1995 was that uncontrolled inflation could neutralize the positive effects of the devaluation for the local export industry. The inflation rate for January and February of 1995 was 8.16%, an annual rate of 49%, and this did not take into account the inflationary effects of increases in VAT, electricity, gasoline and public service announced in March.

Effect on Foreign Companies

Foreign companies (Mexico's top three foreign investors in 1995 were the U.S., Great Britain and Germany) had extended their presence in Mexico even before NAFTA, anticipating a closer cooperation with North America and possible ties to the rest of Latin America.

How badly a company was affected by the crisis varied according to its sources of capital, whether it was a net importer or exporter, and how well it used hedging to minimize currency fluctuation risk.

A company can hedge against transaction risk by raising capital in the market in which it operates. However, many large company subsidiaries rely on parent organizations for capital inflows. This means that the company must set up balancing flows of imports and exports or use financial hedging tools to protect against unexpected currency parity shifts.

Although the International Monetary Fund (IMF) had warned Mexico that its currency was trading at an inflated rate, the IMF did not publicize this warning to the general market. Using a U.S.-Mexico, intra-country, differential inflation and interest rate calculation, (see Exhibits 7 and 8) many companies knew the peso was overvalued, and consequently hedged accordingly. Those that did not suffered significant losses.

Outlook

The most positive aspect of the devaluation was the elimination of the artificial exchange rate. The peso was now to be evaluated by the market and not manipulated by political strategies. The low peso gave the export sector increased trading capabilities. During the first two months of 1995 trade figures showed a surprisingly good performance: the deficit was US$78 million, whereas in the same period in 1994 the deficit had been US$3 billion.

In February, Mexico realized a surplus of US$452 million. However, it should be pointed out that a significant portion of this surplus was due to a drastic decrease in imports.

In 1995, many Mexican companies were unable to pay their bills or finance new supplies and equipment. This left collectors in a position of writing off uncollectable loan losses or restructuring them to a level customers could pay. Financially, in the short run no one could win. The primary consideration was to maintain long-term relations that would last, and to prosper as the crisis diminished.

In mid-February 1995, the U.S. assembled an aid package of US$49 billion for Mexico. This proposal had U.S. bipartisan support, but still met with criticism by anti-NAFTA proponents and by law makers wary of foreign entanglements. The aid did not come free of strings. Mexico had to agree to cut government spending, slow the growth of private credit, limit its money supply, and sell off more state-owned industries.

Most experts agreed that Mexico would rebound. Many business leaders predicted that full recovery would occur within two to three years. These same leaders were beginning to prepare their companies to take advantage of the expected new opportunities.

<u>Questions for students</u>

1. In retrospect, should investors have been aware much sooner of the possibility for devaluation of the Peso? Why or why not?

2. What lessons have been learned -- for the Mexican government, for short term investors, for long term investors, and for the international economic community?

3. Effects of the devaluation have been extreme for ordinary citizens of Mexico. What are the political ramifications?

Exhibit 1: Significant Events of 1994 Leading Up to the Devaluation

Jan	Beginning of revolt in Chiapas
Feb	Kidnapping of Mr. Harp (Chairman of Banamex)
Mar 23	Assassination of Luis Donaldo Colosio (Presidential Candidate)
July	Kidnapping of Mr. Losada (Vice-President Gigante)
Aug	Excess expansion of the peso money supply during the presidential election, presumably to support the re-election of the incumbent PRI party.
Aug 21	Peaceful elections - Ernesto Zedillo Ponce de Léon (PRI) new president
Sep 28	Assassination of José Francisoco Ruiz Massieu, Secretary General of PRI (Ruiz Massieu was slated to a major player in reforming Mexico's next government)
Dec 1	Peaceful installation of the new government
Dec	Renewed political instability in the southern state of Chiapas
Dec 20	Finance Minister, Dr. Jaime Serra Puche, widens the peso's trading band

Exhibit 2: Peso History

1955 - 1976	Exchange rate fixed at 12.5 pesos to US$1 government artificially maintained rate by intervention and import controls
1976	Currency devalued to 20.5 : 1. Exchange rate holds until 1982
1982	Devalued to 38.5 : 1, then 47.5 : 1 Dual rates established, official and free-market, both quickly rose to 105 : 1
1984	Rate at 143.9 : 1
1989	Rate has climbed to 2,281 : 1
1993	Government changed decimal point, exchange rate now 3.1154 : 1
until Dec 1994	Exchange rate held above 3.4712 pesos to the dollar
Dec 20, 1994	Peso given permission to go as low as 4.0016 pesos per dollar Peso immediately drops to 4.0016 : 1
Dec 21	Free floatation of peso

Exhibit 3: International Reserve Levels (in billions US$)

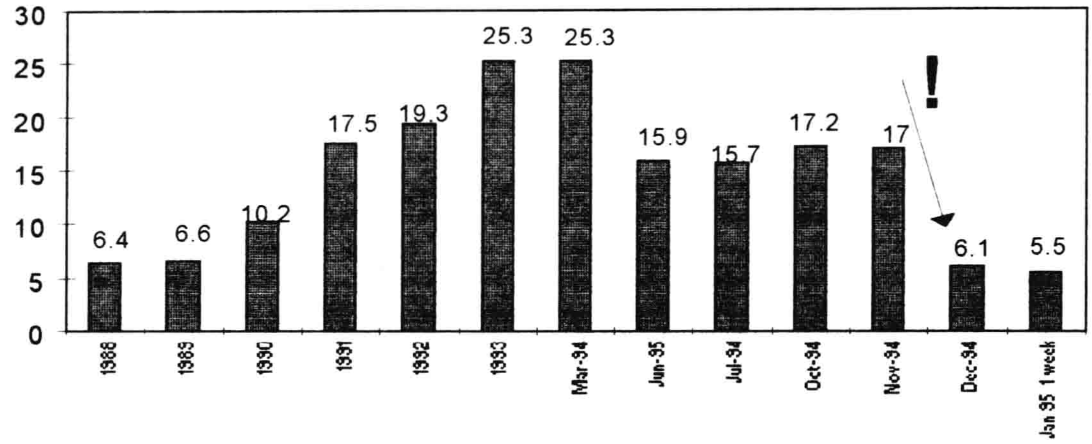


Exhibit 4: Exchange Rate Evolution MXP per USD

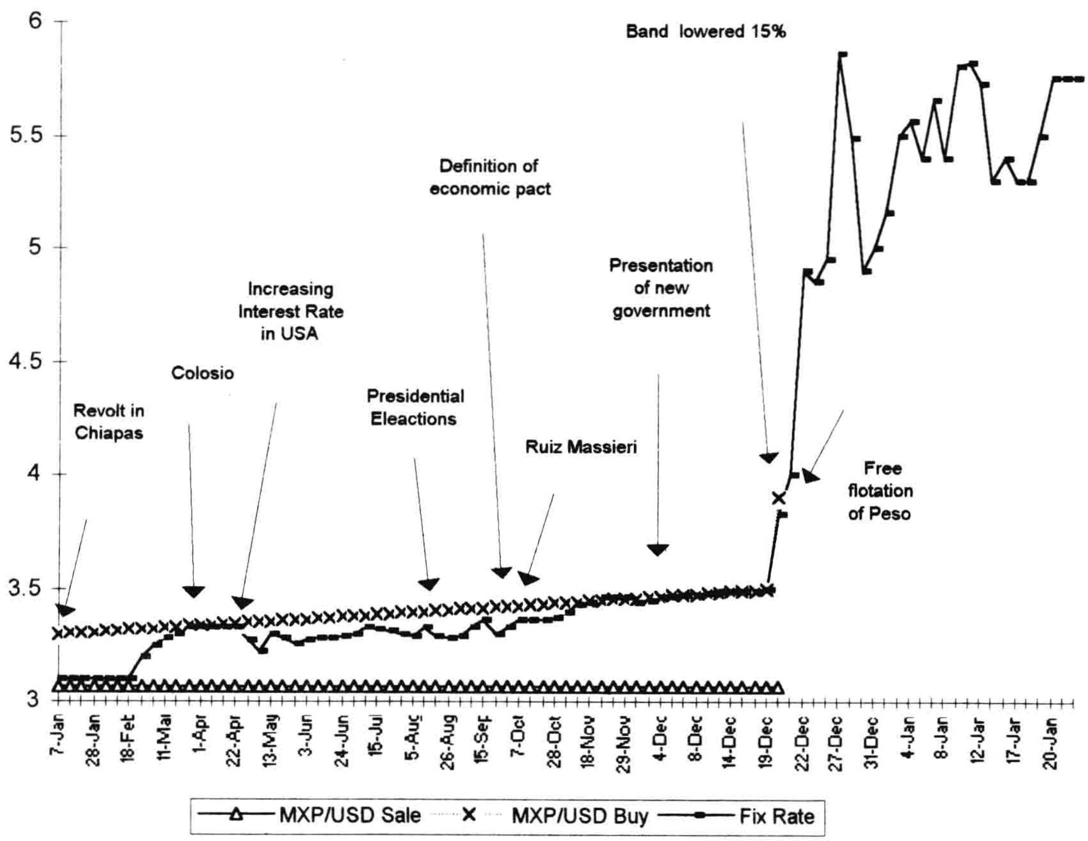


Exhibit 5: Interest Rates Evolution Mexico (in %)

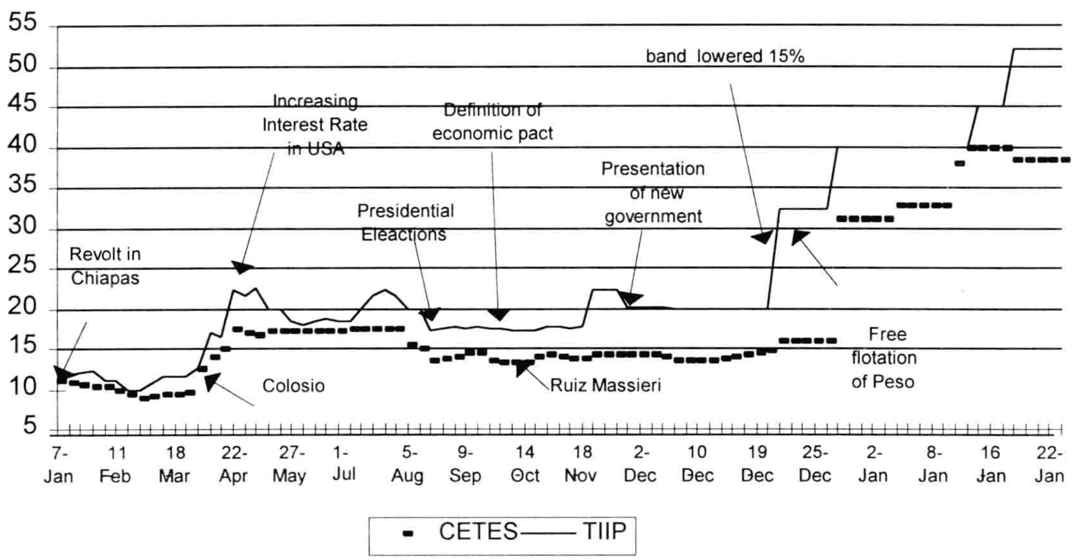


Exhibit 6: Stock Market Performance

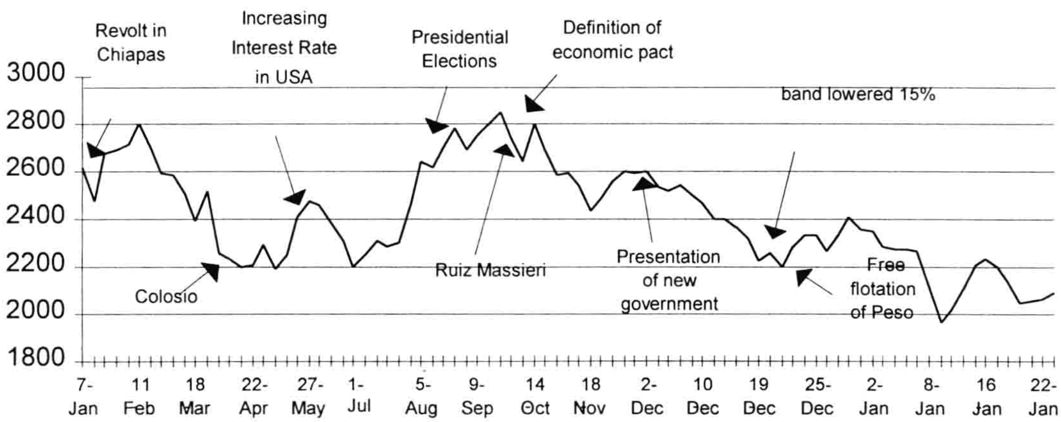
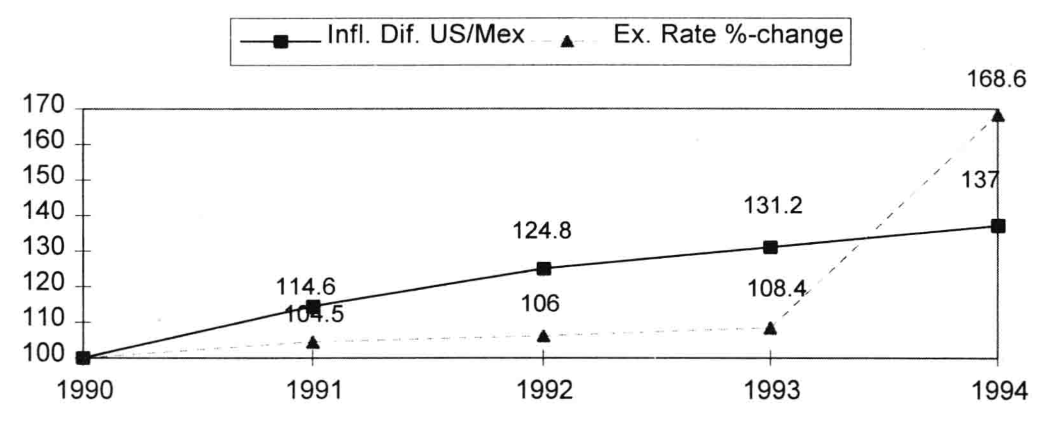


Exhibit 7: BASF Mexico's Exchange Rate Forecast

MARGEN DE SOBRE/(SUB)VALUACION DEL N$ VS. USD							
(%)					1995 Estimate		
	1980 - 92	1993	1994	Q1	Q2	Q3	Q4
Inflation Mexico	758.0%	8.0%	7.1%	42.0%	54.0%	50.0%	60.0%
Inflation USA	68.1%	2.8%	2.7%	3.0%	30.0%	3.0%	3.0%
Difference	689.9%	5.2%	4.4%	39.0%	42.0%	47.0%	57.0%
Devaluation	715.1%	4.6%	50.0%	22.1%	25.1%	30.1%	40.1%
Margin	25.2%	0.6%	-45.7%	16.9%	16.9%	16.9%	16.9%
Margin accumulation	25.2%	25.8%	-19.8%	-3.0%	-3.0%	-3.0%	-3.0%
% Change			50.0%	2.2%	25.1%	30.1%	40.1%
Exchange Rate		3.33	5	6.1	6.25	6.5	7

Exhibit 8: Index of Inflation US/Mex vs. Exchange Rate %



		1991	1992	1993	1994
Peso Over-Under Valuation		9.6	17.7	21	-23.1
Inflation Mexico accumulated		18.8	11.9	8	7.1

Case 1.2

Grupo UNIKO

Summary

A Mexican auto parts firm responds to the new competitive pressures caused by an opening up of the Mexican market that has culminated in the NAFTA agreement. The case shows how UNIKO fostered an environment that was conducive to change and that maintained a focus on multiple stakeholders -its clients, shareholders, personnel and community. The management at UNIKO has taken a long term view toward what it considers a temporary comparative advantage in low wages. In preparation for increased future wages, UNIKO is investing heavily in training, is rooting itself in its community, and is using the specific knowledge of its workforce to adapt its technologies to the high quality demands of global markets.

In March of 1995, Rubén Galván, director of Grupo UNIKO (UNIKO), faced a threatening competitive and economic environment. The Mexican auto parts industry faced increasing competition due to a shrinking economy and the passage of the North American Free Trade Agreement (NAFTA). The massive devaluation of the Mexican peso spurred a financial crisis that negatively impacted most of Mexican industry. Most importantly, the economic crisis resulted in the contraction of the market for vehicles and consequently in the demand for auto parts. UNIKO had to implement a strategy that would assure the group's survival and continued performance in Mexican and international markets. Galván had to decide how to position UNIKO for global competitiveness.

Grupo UNIKO has chosen to focus on achieving long-term fundamental competitiveness through a focused corporate vision: "becoming a group of companies deploying a service spirit in an environment of continuous development and creativity." (Exhibit 1). Galván broadly defines fundamental competitiveness as the ability to satisfy and exceed customer expectations while maintaining high levels of quality and technological competence. UNIKO's customer focus, however, encompasses more than simply catering to its clients. In fact, UNIKO defines its customers as its clients, shareholders, personnel, and community (Exhibit 2). UNIKO's management believes that the group as a whole will attain fundamental competitiveness by meeting the needs of all of its customers. Therefore, UNIKO's goal is to optimize critical processes across functional areas, identified according to all of its customers' demands and needs, while maintaining high quality products and levels of technology. UNIKO must foster an environment that is conducive to change and to the implementation of its "customer focus."

Company Background

Grupo UNIKO is a collection of companies engaged in the manufacture of auto-parts for both Mexican and international original equipment manufacturers (OEMs) and distributors (aftermarket). As of 1994, exports accounted for only 20% of sales while the OEMs and aftermarket accounted for 50% and 30%, respectively. UNIKO's principal products include Constant Velocity (CV) crankshafts, pistons and related parts, pick-up boxes, valves, and valve lifters. UNIKO is composed of a number of manufacturing subsidiaries (Pistones Moresa, Vel-con, Fomasa, Morestana, Alfisa, Copresa, and Morinsa) and Tecnysia,

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This case was written by Claudia Bowles, Alan Campbell, and David Englehardt, MBA students in 1995 in the Max M. Fisher College of Business, The Ohio State University, under the supervision of Professors Roberto Garcia, Stephen Hills, and G. Keong Leong. This case was written for class discussion and