5. Arbitrage Strategies

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Arbitrage is a way of exploiting differences by seeking absolute economies rather than the scale economies gained through standardization. It treats differences across borders as opportunities, not as constraints. This note begins by underscoring the importance of arbitrage. Then, the CAGE framework is used to unpack potential bases of arbitrage and the ADDING Value scorecard is applied to analyze arbitrage strategies.

The Absolute Importance of Arbitrage

Arbitrage, of course, is the original cross-border strategy. Many of the great traders throughout history got their start by trading luxuries that were subject to extreme differences in absolute costs and availability. Thus, Europe’s spice trade with India because spices could (initially) be sold in Europe for several hundred times what they cost in India. Furs and fish that were abundant only in North America helped create a transatlantic trade and, incidentally, led to the colonization of the continent.

Despite its long history, arbitrage is often glossed over in contemporary discussions of globalization and strategy. Consider Wal-Mart once again as an example. Most of the general discussion of its internationalization focuses on its non-U.S. stores: it had 4,000 of them at the end of 2009, versus 3,700 in the United States, and they generated $100 billion in revenues (one-fourth the corporate total) and $5 billion in operating income (one-fifth of the total) that year. What attracts significantly less attention is Wal-Mart’s global sourcing effort, particularly from China. While the company does not disclosed the extent of its procurement from China, estimates suggest that the savings from sourcing in there are larger than the operating income generated by all the international stores—on a much smaller investment base!

There are multiple reasons why arbitrage often doesn’t get the attention that it deserves – and they need to be identified before they can be corrected. First, arbitrage is not glamorous and many underestimate the sophistication required to implement it successfully in a semiglobalized world. Second, there is the belief that arbitraging fundamental factors, such as capital and labor, offers only limited opportunities for competitive advantage and may not be sustainable for very long because the factors are available to all. Again, the reality of semiglobalization provides a counterpoint to this perspective. A third stereotype, related to the second one, involves the notion that the profit potential from arbitrage is quite limited - clearly contradicted by the Wal-Mart example, and many others. Fourth – and this gets to the issue of why companies don’t do more to talk up arbitrage opportunities even when the recognize them – there is a great deal of political sensitivity about arbitrage, particularly labor arbitrage, even though it is happening all around us. Finally, much of the discussion about arbitrage focuses – like the Wal-Mart example – on obtaining labor-intensive goods or services from emerging markets and selling them in developed ones. This is a very important form of arbitrage, but it is far from the only one. Applying the CAGE framework can help broaden the set of arbitrage opportunities under consideration.
CAGE and Arbitrage

The four dimensions of the CAGE framework focus on distinct categories of differences and therefore supply distinct bases for arbitrage.

Cultural Arbitrage

Favorable effects related to country or place of origin have long supplied a basis for cultural arbitrage. For example, French culture or, more specifically, its image overseas has long underpinned the international success of French haute couture, perfumes, wines, and foods. But cultural arbitrage can also be applied to newer, more plebian products and services. U.S. fast food chains present a relevant counterpoint. Nor are such “country-of-origin” advantages reserved for rich nations. Poor countries, too, can be important platforms for cultural arbitrage. Examples include Hâitian compas music, Jamaican reggae, and dance music from the Congo, all of which enjoy image advantages in their respective regions.

Administrative Arbitrage

Legal, institutional, and political differences from country to country open up another set of strategic arbitrage opportunities. Tax differentials are, perhaps, the most obvious example – note the importance of enclaves, tax havens, free-trade areas, and export processing zones in firms’ decisions about plant locations and financial structure. Companies also exploit regulatory differences to locate production where environmental and labor laws are advantageous. However, administrative arbitrage is another area that requires a strong legal and ethical warning. While much of what goes on under the rubric of administrative arbitrage is legal or at least semi-legal, some of it clearly has an odor to it – requiring serious ethical as well as legal review.

Geographic Arbitrage

Considering all that has been said and written about the “death of distance,” it is perhaps predictable that few strategy gurus take geographic arbitrage very seriously. Yes, it’s true that transportation and communication costs have dropped sharply in the last few decades. But that drop does not necessarily translate into a decrease in the scope for geographic arbitrage. Air transportation, for example, has created a global flower market where blooms from favorable growing regions can be auctioned year-round in Aalsmeer, Netherlands and flown to customers worldwide while still fresh.

Economic Arbitrage

In a sense, all arbitrage strategies are “economic.” But the term is used here to refer to the exploitation of economic differences that don’t derive directly from cultural, administrative, or geographic differences. These factors include differences in costs of labor and capital, as well as variations in more industry-specific inputs (such as knowledge) or in the availability of complementary products. The best-known type of economic arbitrage is the exploitation of labor cost differentials, which is common in labor-intensive and capital-light manufacturing (e.g. garments). However, some high
tech companies have also been able to take advantage of labor cost arbitrage to access highly skilled workers at lower cost.

Capital cost differentials might seem, at first blush, to offer slimmer pickings than labor cost differentials – after all, the former are measured in single percentage points rather than in multiples of up to ten or twenty like the latter. But with many companies earning returns within two or three percentage points of their cost of capital, percentage points are consequential.

Analyzing Arbitrage

Given the variety of arbitrage strategies, there is no one way to analyze them. But again, the ADDING Value scorecard can be used to structure the analysis and helps suggest specific dos and don’ts. The key point to remember is that arbitrage can affect all the components of the ADDING Value scorecard, not just the first D of decreasing costs.

Adding Volume

Arbitrage can affect volume in a number of ways. Sometimes, arbitrage opportunities can open up entirely new businesses – for example, the cut-flower business referenced under geographic arbitrage opened up new opportunities to sell previously unavailable flowers in the Northern Hemisphere in winter. At other times, the volume increments might come from the fact that, in the absence of arbitrage, one might have to turn business away – a particularly sore point among many executives in the high-tech sector, who complain about the difficulty of finding the right kind of technical talent in many developed countries. Companies that set up R&D centers in China have cited improved market access and government support as benefits. All of these mechanisms combine to account for the finding, in a recent survey, that growth is the second most frequently cited reason for offshoring, after cost reduction.3

Decreasing Costs

While cost reductions are the most frequently cited reasons for arbitrage-related moves, analyses of them are often flawed in conceptually simple but practically dangerous ways. One frequent problem is a focus on snapshots of relative costs which may change over time based on supply and demand shifts for key resources. Other frequent, related problems include a failure to adjust for likely shifts in exchange rates and for differentials in productivity. Be sure to account for nonlabor costs as well, and to think through which costs might increase as a result of offshoring.

Differentiating

The impact of arbitrage on differentiation or willingness-to-pay has attracted much less attention that its impact on costs, but can be at least as important. Cultural arbitrage, for instance, often involves raising willingness-to-pay based on country-of-origin effects. While economic arbitrage often reduces willingness-to-pay as well as costs, there are important exceptions to this rule. For example, if cost differentials are used to improve quality, offshoring may lead to increased willingness-to-pay. Again,
it is useful to remember not to treat price as a proxy for willingness-to-pay in the long run. Rather, dig deeply into buyer economics to understand the likely effects.

**Improving Industry Attractiveness or Bargaining Power**

In addition to possibly lowering costs or raising willingness-to-pay, arbitrage may improve industry attractiveness or one’s own bargaining power within it. Consider the competitive implications of different firms’ relative use of arbitrage. It may, for example, make sense for firms that face more arbitrage-dependent rivals to bid up the price of key resources.

When considering bargaining power, think also about intellectual property protection. Thus, while global companies have implanted many R&D centers in China and India, the protection of intellectual property rights remains a major concern. One study of global companies with R&D centers in China indicates that they have found several ways to address this issue. One particularly important method is to split R&D efforts across a company’s global network in such a way that the value of the projects undertaken in China is highly contingent on projects being pursued elsewhere in the global network, or more broadly, on firm-specific expertise. Note that this strategy is unavailable to local competitors, probably contributing to their lower expenditures on, and returns from, R&D.

**Normalizing Risk**

Arbitrage is subject to an extensive array of risks, both market and non-market. With regard to the former, think of all the (greater) hazards to which supply chains that cross borders are subject: exposure to unknown and potentially less reliable suppliers and to exchange rate fluctuations, the possibility of infrastructural and other bottlenecks at borders, the compounding of risks associated with supply chains that are very thinly sliced across multiple countries, and so on.

A particular type of nonmarket risk associated with arbitrage has to do with its political sensitivity – especially evident around but not confined to labor arbitrage. Successful arbitrageurs offer several lessons in this regard. First, be discreet: emphasize viability and growth as objectives rather than (just) cost reductions, and be cautious about capitalizing on health, safety, and environmental standards that are looser than at home. Second, think through a range of mechanisms – lobbying, working with natural allies including competitors, investing in job creation, and so forth – for expanding your freedom of action. A final suggestion is to favor strategies that exhibit some degree of robustness to changes in the political climate.

**Generating Knowledge – and Other Resources and Capabilities**

Arbitrage can have both positive and negative impacts on the generation of knowledge and other resources. On the positive side, taking advantage of arbitrage opportunities can open up scope for developing resources via cost reduction and via exposure to new environments and ideas—with new developments in emerging markets in particular providing the basis for recent excitement around “reverse innovation.” But possible negatives also need to be thought through. Thus, a major investment bank that outsourced many analytical functions to India later realized that
the move would significantly deplete its pool of senior analysts in a few years — unless it significantly changed its hiring and promotion policies.

**Managing Arbitrage**

A number of challenges arise in managing arbitrage strategies, many of which have already been discussed. But what merit additional comment are the sustainability of arbitrage strategies and how they are influenced by firm-level resources, particularly management capabilities, as opposed to market-level differences in prices, costs, et cetera.

Note first of all that while sustaining competitive advantage from arbitrage can be a worthwhile objective, it is not necessary for arbitrage to make sense. Even if arbitrage does not offer a sustainable advantage, it may still be worth undertaking if only to avoid ending up at a disadvantage relative to competitors that do engage in arbitrage.

Second, there may be more sustainability than analogies with financial arbitrage might suggest. The diagnosis of semiglobalization suggests that the differences in costs, prices et cetera for most products and services as well as most kinds of inputs may be large and long-lived, unlike the very small, short-lived spreads associated with financial arbitrage of certain types.

Finally, sustainability can often be enhanced by building firm-specific capabilities around an arbitrage opportunity. Thus, as part of its strategy for realizing costs savings via procurement from China, Wal-Mart has invested in a Global Procurement Center with some very sophisticated capabilities there.

**Conclusion**

Arbitrage involves exploiting differences across countries instead of treating them as constraints to be adjusted or overcome and is a source of value creation that very few companies can afford to ignore. Think broadly about arbitrage opportunities along all of the dimensions of the CAGE framework — not only about reducing labor cost. But analyze the implications of arbitrage carefully — again the ADDING Value scorecard is a useful tool. And consider the sustainability of arbitrage opportunities—and whether it can be enhanced by building up firm-specific capabilities.

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