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Institutions and emerging markets: effects and implications for multinational corporations

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Abstract

Purpose – The purpose of this paper is to discuss the role of institutions in emerging markets by sketching out the unique institutional features of these markets and their implications for multinational corporations (MNCs).

Design/methodology/approach – The study is conceptual in nature and provides an examination and interrelation of some of the key developments of institution-based research in the context of emerging market studies.

Findings – This paper examines several idiosyncratic institutional features of emerging markets, including institutional voids, the relative importance of informal compared to formal institutions, institutional pressures by local governments, as well as institutional change and transitions.

Practical implications – The paper discusses key effects and implications of the unique institutional environments of emerging markets for managers of MNCs, such as the relevance and importance of context, political, economic and social adaptability, as well as institutional arbitrage.

Social implications – The paper discusses institutional legitimacy pressures in emerging markets for MNCs' social performance, the relevance and importance of social institutions in these markets, as well as the need for social adaptation in order to successfully do business in emerging markets.

Originality/value – This paper provides a current and relevant discussion of the key formal and informal institutional idiosyncrasies of emerging markets compared to developed markets and forwards a number or practical prescriptions for how to navigate these different and unique institutional environments.

Keywords Emerging markets, Institutions, Multinational corporations

Paper type Conceptual paper

Introduction

Considering the fact that the application of institutional theory to the realm of organizational analysis traces its roots back to the seminal work of the sociologist Philip Selznick on *Leadership in Administration*, published in 1957, it seems striking that it took nearly a half century before organization theorists noted that institutional theory has developed from the stage of "adolescence" (Scott, 1987, p. 493) to the stage of "youthful adulthood" (Scott, 2001, p. 208). Since then, institutional theory has become a "popular and powerful" (Dacin *et al.*, 2002, p. 45) conceptual lens through which researcher have examined the structures, actions, transformations and strategies of organizations. More recently, particularly over the past decade, the application of institutional theory to the context of emerging markets has proliferated. The term "institutions" has become ubiquitous in the literature on emerging markets and entirely new academic organizations, conferences and journals, such as the *International Journal of Emerging Markets*, have since been established and dedicated its existence to study the unique (institutional) context of these markets.

The purpose of this paper is to examine the role of institutions in emerging markets by exploring the effects and implications of institutions for multinational corporations

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(MNCs) that are operating in the unique context of these markets. In so doing, I do not intend to provide a comprehensive survey and synthesis of the entire literatures on institutions and emerging markets, a considerable task that would require several review papers. Instead, the objective of this paper is to discuss and interrelate key developments and applications of institution-based research in the context of emerging market studies. In so doing, this paper provides an important and relevant institution-based account of this unique market context for academic scholars and business practitioners. To achieve this objective, I will first provide a brief account of institutional theory and emerging markets before discussing the application of the former in the context of the latter.

Institutional theory and institutions

The key characteristics of institutional theory are its systematic consideration of the social environment of organizations, as well as its explicit conceptualization of this environment and its impact on organizations. More specifically, institutional theory suggests that an organization's structure and actions are affected by its social environment. An organization's social environment consists of the surrounding society, such as federal and local governments, regulatory authorities, customers, suppliers, the media, the financial community, the general public and other organizations. It comprises the formal laws, rules and regulations established by a government and regulatory authorities (North, 1990), as well as the informal rules and constraints, such as widely shared values, norms and beliefs, that are supported by the general society (DiMaggio and Powell, 1983; Markus and Zajonc, 1985; Selznick, 1957). Hence, institutions are defined as "the rules of the game in a society (which constitute) humanly devised constraints that shape human interaction" (North, 1990, p. 3, content in brackets supplied). Organizations' conformity to these formal and explicit as well as informal and tacit rules and constraints is enforced by the social environment. Organizations that do not conform to the rules, values and beliefs are legally sanctioned and lose the support of, and acceptance by, the surrounding society in which they are embedded. Lack of support and acceptance by the social environment jeopardizes organizational success and commonly entails organizational demise (Scott, 2014).

In the context of multinational corporations (MNCs), institutional theory suggests that MNCs must conform to the rules and requirements of the local social environments in which they operate in order to be perceived as legitimate (Rosenzweig and Singh, 1991; Westney, 1993). As opposed to economic accounts, this perspective suggests that organizational survival and success does not depend on the quality and quantity of economic output, but rather on conformity to acceptable rules, norms, values and beliefs (Meyer and Rowan, 1977; Scott and Meyer, 1983). In other words, in order to "survive and thrive in their social environments [organizations] need social acceptability and credibility" (Scott *et al.*, 2000, p. 237, content in brackets supplied). The concept of legitimacy refers to the acceptance, approval and support of an organization by its social environment (Suchman, 1995) and constitutes the key productive resource of firms (Scott, 2014). Hence, unless MNCs understand and correctly interpret the formal regulatory and informal normative and cultural rules of a foreign institutional environment, they are unlikely to become successful in that market (Kostova and Zaheer, 1999; Scott, 2014). These formal and informal rules of the game, and related legitimacy pressures and demands on MNCs are particularly important in the context of emerging markets given their vastly different and unique institutional environments compared to developed markets.

Emerging markets

Since the creation of the term "emerging markets" by the Dutch-born US investment banker Antoine van Agtmael in 1981, the world has experienced a tremendous proliferation in the importance of these markets, which have gained significant economic and political influence (e.g. UN Conference on Trade and Development, 2015). Yet, the meaning of what constitutes an "emerging market" has changed from the inception of the term, when it was meant to replace the terms "the third world" and "developing world" (*The Economist*, 2010). Since the turn of the century, the fastest-growing large emerging markets, Brazil, Russia, India and China, referred to as BRIC (O'Neill, 2001), have received considerable attention in academia and business practice, followed by a number of other emerging markets in Latin America, Southeast Asia, Central and Eastern Europe and, more recently, Africa.

Despite its ubiquitous use, the term "emerging markets" has not been defined uniformly in the literature. It seems to be an easier task to define what emerging markets are not than what they are. An often used categorization in the literature, therefore, first defines developed markets and then considers all remaining countries as emerging (e.g. Buckley *et al.*, 2007). One of the operationalizations of developed markets is membership in the Organization for Economic Co-operation and Development (OECD) (e.g. Gubbi *et al.*, 2010), a group of 34 countries that includes many of the world's most developed countries but also emerging countries such as Mexico, Chile and Turkey. Counties that are not members of the OECD are often considered emerging. Other scholars have attempted to describe emerging markets more explicitly and defined them as "low-income, rapid-growth countries using liberalization as their primary engine of growth" (Hoskisson *et al.*, 2000, p. 249), a definition that identified 64 countries as emerging at the time. An emerging stream of research has attempted to provide a more fine grained taxonomy of emerging markets, such as a recent article by Hoskisson *et al.* (2013) which categorized these markets into traditional emerging economies, mid-range emerging economies and newly developed economies.

Despite these various definitions and categorizations of emerging vs developed markets and the fact that each of these two groups of countries are heterogeneous, there seems to be a consensus in the literature that, from an institutional perspective, emerging markets are characterized by a number of institutional idiosyncrasies that developed markets do not possess. Institutional theory, therefore, constitutes a particularly valuable lens through which to examine the differences between emerging and developed markets as well as the effects and implications of the unique institutional environments of emerging markets for MNCs operating in these markets.

Unique institutional environments of emerging markets

Emerging markets are characterized by a number of unique institutional features that generally do not exist in developed markets. These include institutional voids, relative importance of informal compared to formal institutions, institutional pressures by local governments, as well as institutional change and transitions.

Institutional voids

One of the key characteristics of many emerging markets includes institutional voids, i.e. the lack or underdevelopment of certain institutions. Khanna and Palepu (1997) described institutional voids as "the utter absence of institutions" (p. 42) and noted that in emerging markets "many types of institutions […] are either under-developed or

entirely missing" (Khanna and Palepu, 2005, p. 6). The existence of institutional voids and consequent market failures are a key distinction between emerging and developed markets. Main sources of market failures due to institutional voids include: lack of reliable and adequate information for consumers, employers in labor markets and investors to assess the quality of goods, services and investments; misguided regulations by local governments that favor political goals over economic efficiency (such as employment-protection laws to bolster social stability at the cost of labor market flexibility); inefficient judicial systems that are incapable of enforcing contracts in a reliable and predictable way (and so considerably increase uncertainty and consequently transaction costs for MNCs when doing business in these markets); and the absence of intermediary institutions that facilitate economic transactions, such as functioning financial markets, audit committees and certification agencies, as well as aggregators and distributors (which make it considerably more costly to acquire necessary inputs such as financial resources, management talent, technology, etc. and so more risky to conduct business in emerging markets, and also limits the scope for sustainable economic growth in these markets) (Khanna and Palepu, 1997, 1999, 2000, 2005). Due to the existence of institutional voids, MNCs operating in emerging markets face more uncertainty, higher risks and thus, higher transaction costs. Furthermore, MNCs operating in emerging markets have to perform basic functions that are taken for granted in developed markets (such as access to reliable and adequate information, economically sound regulations, efficient judicial systems etc.) themselves, which is the crucial distinction between doing business in these compared to developed markets (Khanna and Palepu, 1997).

Relative importance of informal vs formal institutions

In order to fill the void of institutions, in general, and the lack of market intermediaries, in particular, informal institutions have developed in emerging markets and become crucial for economic activity compared to formal institutions that drive economic activity in developed markets (Khanna and Palepu, 2010). Such informal institutions comprise local providers of specific intermediary services that are only open to selective rather than all market participants, and thus do not constitute a substitute to formal institutions that are taken for granted in developed countries. For example, in India, the formal market intermediary of a realtor is largely non-existent and highly connected members of local communities fulfill this role informally by advertising the availability of houses within their social networks. Another example in the same country context relates to local loan providers who provide financial capital based on social network ties and relationships rather than formal credit scores and business plans, and who typically rely on peer pressure to ensure payback rather than depend on formal enforcement mechanisms that are non-existent or underdeveloped in these markets. In fact, emerging markets typically bridge formal and information institutions, heavily rely on the informal economy in which social (as opposed to legal) contracts stipulate economic transactions and attach significant importance to social institutions (deSoto, 2000). As opposed to developed countries with functioning capital markets and reliable and predictable formal regulatory, political, legal and economic institutions, in emerging markets "social contracts and social institutions dominate […] and social performance matters" (London and Hart, 2004, p. 367). This dominance of informal social institutions and social contracts compared to formal economic rules and legal contracts, therefore, constitutes another key distinction between emerging and developed markets.

Institutional pressures by local governments

Given the prevalence and higher relative importance of informal social compared to formal legal and economic institutions, governments in emerging markets typically have a much stronger social orientation (Aturupane *et al.*, 1994; Sen, 1999) and exercise greater influence and control over companies than governments in developed countries (Boubaker and Nguyen, 2014). MNCs operating in emerging markets therefore are confronted with legitimacy pressures for social performance and an active involvement in their local communities. These informal legitimacy demands are often combined with the formal requirement to grant local governments a stake in the local operations of foreign MNCs or the requirement to partner with local, state-owned companies. Local governments, therefore, become a central player in the corporate governance system in emerging markets and so have more influence over the actions, structures and strategies of companies compared to governments in developed countries (Boubaker and Nguyen, 2014; Cuervo-Cazurra *et al.*, 2014).

Furthermore, governments in emerging markets impose various institutional pressures on MNCs that constitute considerable costs of doing business in these markets. For example, the governments of the two largest emerging markets, China and India, which account for more than one-third of the world's population and already constitute the world's largest and third largest economies, respectively (based on GDP adjusted for purchasing power) are known to establish price ceilings for products and selectively grant or withdraw the right to sell certain products; regulations that often put foreign MNCs at a disadvantage. India, for instance, has recently revoked Pfizer's patent for a drug to treat cancer and granted an Indian manufacturer, Cipla, the right to produce a generic version of the drug and sell it for a fraction of the price Pfizer had charged (Bremmer, 2014). This new form of discrimination against foreign firms, which has proliferated in the aftermath of the Great Recession of 2007-2010, is referred to as guarded globalization. As noted by Bremmer (2014) "[g]overnments of developing nations have become wary of opening more industries to multinational companies and are zealously protecting local interests. They choose the countries or regions with which they want to do business, pick the sectors in which they will allow capital investment, and select the local, often state-owned, companies they wish to promote. That's a very different flavor of globalization: slow-moving, selective, and with a heavy dash of nationalism and regionalism" (p. 104). This rise of state capitalism in emerging markets, which has become particularly predominant in the BRIC nations, constitutes a considerable liability of foreignness, particularly for Western-based MNCs that are operating in these markets.

Institutional change and transitions

The relatively sudden change in ideology by emerging market governments to reverse the opening of their markets for international trade and investment, which happened during the rapid globalization phase of the world's economies in the two decades surrounding the turn of the century, to a more protectionist mindset that is guarding their economies and indigenous companies since the recent global economic and financial crises illustrates another key characteristic of these markets: institutional change and transitions. While developed markets are also characterized by institutional change, the nature and pace of change is considerably different in emerging markets.

Developed markets commonly are characterized by stable institutions that regulate markets and encourage economic activity in predictable, reliable and transparent ways, and any change in these institutions is generally incremental and thus calculable and

manageable for companies operating in these markets (North, 1990). Institutional change in emerging markets, however, is typically more sudden and unpredictable and so difficult for MNCs to manage. For example, Zhao *et al.* (2014) note that formal institutions in form of "[r]egulatory systems in emerging markets are relatively unstable, inconsistent, and arbitrarily enforced, unlike those in developed countries" (p. 844). While such unstable institutions may constitute (largely unethical but legal) opportunities for MNCs to exploit loopholes in formal rules and regulations at the cost of local social and environmental interests (Arnold and Bowie, 2003), stakeholder expectations in emerging markets typically change with economic growth and so require MNCs operating in these markets to change their actions and behaviors accordingly (Ramamurti, 2001; Zhao *et al.*, 2014).

Such changing stakeholder expectations illustrate a related characteristic of emerging markets: institutional transitions. Whereas institutional change refers to any change in institutions regardless of direction (i.e. whether institutions become more or less developed), the term institutional transition connotes a change forward. The literature on the topic generally refers to the transitioning of political and economic institutions, i.e. from previously totalitarian to democratic political systems and from previously centrally planned to market economies through the processes of political progress and economic liberalization, respectively. For example, serval countries in Central and Eastern Europe are considered transitioning economies as their political systems have largely become democratic since these countries' independence from the former Union of Soviet Socialist Republics, and their economies have become one of the fasted growing in Europe. Puffer *et al.* (2016), for instance, analyze the political transition and economic development of Poland through the lens of institutional theory and examine how the country's successful institutional transformation may inform the institutional transitions of other emerging markets, such as Brazil and Russia.

Clearly, many emerging markets have not stagnated and become more developed from an institutional perspective. Hoskisson *et al.* (2013), for example, note that "various emerging economies have increased both the development of their market institutions and the necessary economic infrastructure to be considered 'mid-range emerging economies' between (newly) developed economies and traditional emerging economies" (p. 2). These authors describe institutional transitions in emerging markets as the process of developing market-supporting political, legal and economic institutions and refer to the BRIC countries, for example, no longer as "traditional" emerging but as newly "mid-range" emerging economies. Hence, these significant and largely unpredictable institutional changes and transitions distinguish emerging markets from institutionally stable developed countries.

Implications for MNCs

The afore-discussed institutional idiosyncrasies of emerging markets – institutional voids, relative importance of informal compared to formal institutions, institutional pressures by local governments, as well as institutional change and transitions – have important implications for MNCs operating in these markets. These implications include the realization that emerging markets are characterized by unique institutional contexts and that context matters, political, economic and social adaptability, as well as institutional arbitrage.

Context matters

The first and most obvious implication for MNCs is the need for the realization that emerging markets are characterized by idiosyncratic institutions in form of

"unique social, political, and economic contexts" (Wright *et al.*, 2005, p. 2) and the basic understanding that context matters. While this implication seems trivial, it is stunning to realize how many managers either do not understand or simply ignore this fact when expanding to emerging markets. Emerging markets, which now receive more than half of the world's foreign direct investment (UN Conference on Trade and Development, 2015), account for nearly 80 percent of the world's population and already comprise some of the world's largest economies are not merely "less advanced" extensions of their more developed counterparts as Thomas Friedman's (2005) "the world is flat" analogy may misleadingly suggest. Instead, emerging markets are characterized by different formal rules, laws and regulations as well as dissimilar informal cultural and normative expectations and obligations that require managers of MNCs to question the underlying assumptions of how to do business in these markets. When it comes to doing business in emerging markets, or even across emerging markets, there are no universal truths about how to be successful, and best practices developed in one market may not be applicable in another (Khanna, 2014).

The same accounts for academic scholars, who cannot simply apply theories developed in a Western-context to emerging markets (Boyacigiller and Adler, 1991). While some of these theories may have predictive power when being properly adjusted for the specific context of emerging markets, which includes institutional theory (Kostova *et al.*, 2008), others may lead to results contrary to those found in the context of developed markets (e.g. Reus and Rottig, 2009) and yet others may not have any predictive power and need to be substituted by theories that were developed in and for the unique context of MNCs operating in these markets (Roth and Kostova, 2003). Reus and Rottig (2009), for example, studied the predictive power of agency theory in developed vs emerging market contexts based on a meta-analysis of the literature on international joint ventures (IJVs). The study found that partner conflict has a significantly less harmful effect on IJV performance for Chinese joint ventures when compared to IJVs in developed countries. The study further found that hierarchical control of a Chinese joint venture partner by the foreign partner actually benefited the IJV relationship by reducing partner conflict, as opposed to Western-based IJVs in which hierarchical control by one partner significantly increased partner conflict.

Scholars therefore need to understand the unique context when studying emerging markets and adjust their conceptual lenses and methods to fit the respective institutional contexts (London and Hart, 2004; Rottig, 2009). Some scholars have begun to advocate and use inductive theory building and exploratory methodologies when studying these markets, such as case studies based on content analyses of media accounts, company documents and in-depth interviews (e.g. Pavlovich *et al.*, 2016; Thomé and Medeiros, 2016), ethnographies (e.g. Turcan and Norman, 2016), and the use of metaphors (Rottig, 2013) given that such "[q]ualitative research, rather than traditional quantitative empirical tools, is particularly useful for exploring implicit assumptions and examining new relationships, abstract concepts, and operational definitions [and so are] particularly useful for researchers interested in examining strategies in emerging economies" (London and Hart, 2004, p. 356, content in brackets supplied).

Academic scholars and managers of MNCs alike, therefore, need to carefully examine the unique contexts of emerging markets, identify which business practices are universal and which are context-specific and, in the latter case, gain a firm grasp of the local variations of formal and informal institutions in order to develop context-specific conceptual frameworks, strategies and business models (Khanna, 2014). In fact, the raison d'être for the academic field of international business is the study of different

contexts for doing business around the world and the implications of different contexts for MNCs that expand and operate internationally (Calhoun, 2010), and managers of companies that understand and successfully navigate these differences possess "contextual intelligence" (Khanna, 2014).

Adaptability

Managers who possess contextual intelligence understand that the unique institutional environments of emerging markets require their MNCs to adapt, which can be considered a dynamic capability in global markets. Such adaptability includes political, economic and social adaptation that allow MNCs to fill institutional voids, adjust to the importance of informal institutions, manage the institutional pressures by local governments, and better deal with institutional change and transitions.

Political adaptability relates to the understanding of the importance and influence of local governments and the need to adjust to the institutional demands of these governments in order to establish and maintain legitimacy (i.e. acceptance, approval and support) in emerging markets. As a key constituency able to grant legitimacy, local governments' approval, acceptance and support is critical to MNCs as these legally authorized regulatory bodies have authority over organizations (Baum and Oliver, 1991; Meyer and Scott, 1983), and control critical resources directly and indirectly by contracting with organizations as well as by transferring resources through regulation and legislation (Hybels, 1995). MNCs may therefore purposely seek to partner with local governments or state-owned organizations in emerging markets and selectively invest in building relationships and network ties with local government bodies and regulatory authorities (Boddewyn, 1988; Ellis, 2000; Murtha and Lenway, 1994). MNCs may also invest in already established local relationships that were created for other purposes – such as past interaction and interest intermediation between governments, regulatory authorities and MNCs to shape industrial policies (Murtha and Lenway, 1994) – in order to convert these relationships into valuable network ties that allow MNCs to become legitimized. Another strategy for MNCs is to localize their business operations by, for example, tapping into local sources of financing, hiring locals, and contracting with local suppliers in order to signal to the local government that they have a lasting stake in a local market environment.

Local governments, however, also possess the power to withdraw their acceptance, approval and support from MNCs, and governments in emerging markets are more prone to exercise this influence over foreign MNCs in sudden and unpredictable ways compared to governments in developed countries. Local governments in emerging markets may, for example, discriminate against foreign firms by engaging in target-specific policy interventions that entail preferential regulatory approval and acceptance of local firms (Hymer, 1960/1976; Murtha and Lenway, 1994), which is a specific type of liabilities of foreignness (Zaheer, 1995) MNCs face in local markets.

A recent conversation with CEOs of MNCs operating in Africa illustrates this politically rooted liability of foreignness MNCs face in emerging markets. Despite having lived in Africa for more than a decade, speaking Arabic and having built a multi-million dollar company from scratch that employs hundreds of Africans and nearly half of this workforce in Egypt alone, the local government suddenly and without prior warning informed the CEO of one of the companies that the company would now be considered suspicious of spying merely due to the fact that the founder and CEO was born in the USA. The Egyptian government gave the company and its CEO 24 h to close their operations and leave the country, a governmental mandate whose occurrence would be difficult to imagine in developed markets. Quick thinking

made the CEO incorporate the company as a Pan-African firm with local operations in Egypt that are now managed by a local employee. Political adaptability in emerging markets, therefore, also requires managers of MNCs to think fast, adjust quickly and develop short-notice adaptation strategies to not only deal with local institutional demands, but also to ensure the continued existence of their operations in general.

Economic adaptability refers to the understanding that the basic assumptions of how to do business differ in emerging markets and the ability to navigate largely unpredictable, generally non-transparent and changing economic environments that are heavily based on informal relationships and transactions. Managers of MNCs therefore need to adapt their entry strategies by not merely replicating their existing business models and foreign market expansion patterns to emerging markets, but by designing their entry strategies into emerging markets and the establishment of local operations from scratch. There is an increasing body of literature which emphasizes the importance of social capital-based entry modes when expanding to emerging markets and the crucial importance of building and mobilizing local social relationships and network ties when operating local operations, that allow MNCs to access location-specific knowledge and information and to tap into local informal networks that are crucial for economic success in these markets (Peng and Luo, 2000; Peng and Zhou, 2005; Rottig, 2011).

Such a reliance on local partners needs to be balanced by MNCs, however. In the presence of institutional voids, reliance on local partners may lead to negative legitimacy spill-overs in case the local partner is involved in a corporate scandal (Pavlovich *et al.*, 2016). Pavlovich *et al.* (2016) examine how three specific forms of legitimacy: pragmatic, moral, and cognitive legitimacy, may improve the performance of IJVs with local partners in case of a corporate scandal. Furthermore, managers of MNCs need to adapt their local operations in order to customize them to the unique institutional demands in emerging markets. As noted by Khanna (2014) "[g]lobal companies won't succeed in unfamiliar markets unless they adapt – or even rebuild – their operating models" (p. 61). Such adaptation often requires the localization of operations.

Economic adaptability also involves the understanding of the importance of local leadership in emerging markets, which is a form of localization. Although many Western-based MNCs have been hesitant to entrust locals with key managerial and leadership roles – especially for their operations in emerging markets – and sent expatriates instead, local managers are key to economic adaptation (Law *et al.*, 2009; Porter, 1989). Local managers have a deep understanding of the institutional environment in emerging markets, understand the impact and relevance of informal institutions, are embedded in local networks and so have access to the crucial resources needed for companies to be competitive in these markets (Luo, 2007; Peng and Luo, 2000; Rottig, 2011).

Another facet of economic adaptability relates to the management of rapid organizational expansion in emerging markets that may push an MNC to its limit of being able to effectively control local subsidiaries and the actions of local partners (Zhao *et al.*, 2014). While such a fast increase in local operations seems positive at first, it may become detrimental if not managed properly. Fast organizational expansion typically requires a rapid increase of the local workforce, which is generally implemented through the hiring of low-cost local employees (Ghemawat, 2007, 2008). This, however, often leads to lack of employee training, oversight and monitoring, lower customer service quality and lax supplier management leading to more customer complaints, negative media reports and lower firm performance (Zhao *et al.*, 2014). In other words, managers of MNCs who are unable to effectively manage rapid

organizational growth in emerging markets may cause the company to lose the acceptance, approval and support by local constituencies that are able to grant such legitimacy (i.e. the government and regulatory agencies, the media, the general public) and so jeopardize the success of their local operations.

Lastly economic adaptability requires managers to anticipate worst case scenarios and to make quick decisions in order to respond to suddenly changing institutions und unpredictable economic conditions. Referring back to the aforementioned conversation about the experiences of CEOs of MNCs operating in Africa, economic adaptability was required to secure financial assets and preserve the operations of one of the companies in South Sudan, the world's youngest nation. After the recent economic collapse in November of 2015, the South Sudanese Pound (SSP) devalued overnight from a rate of 3.16 SSP per US$ to 25 SSP per US$. Naturally, companies first converted some of their US$ assets to SSP to pay back their local debt in local currency and so took advantage of the more favorable exchange rate, and then started channeling US$ resources out of the country. This development prompted the South Sudanese government and central bank to limit the amount of US$ funds that could be withdrawn per week before threatening to nationalize all local US$ accounts by converting US$ balances into SSP at the lower (for business owners and locals with US$ assets unfavorable) exchange rate of 3.16, and did so unexpectedly and suddenly without prior warning. Hence, managers of MNCs had to react quickly to withdraw US$ funds to secure the value of the company's local financial assets and so preserve the company's operations.

Social adaptability refers to the understanding of the role and impact of local social institutions in emerging markets and the importance of engaging in local corporate social responsibility (CSR), localizing CSR-based activities, building trust with local stakeholders, investing in local stakeholder relationships and meeting local stakeholders' social expectations (Zhao *et al.*, 2014). Doing so does not only facilitate the establishment of legitimacy in emerging markets by meeting expectations for social (incl. environmental) performance, but also contributes to the financial performance of MNCs in these markets (Barnett and Salomon, 2012). Crucial stakeholders in this context do not only include the local government but also local organizations and business partners, the media, the financial community, labor unions and the general public that controls critical resources on the demand side as customers and on the supply side as the local workforce. A related strategy is to become a member of influential local business groups that are characterized by reciprocal relationships and cooperation, and so fill local institutional voids. These business groups take different shapes and forms and given the social connections and relationships they are based on, they are referred to as *guanxi* in China, *blat* in Russia, and *grupos* in Mexico, for example. Building trust, commitment and cooperation with influential local stakeholders and becoming part of local business groups allow a foreign MNC to better fill institutional voids, effectively respond to informal institutional demands and better navigate institutional change and transitions in emerging markets.

One illustration can be found in the example of the recent South Sudanese economic crisis referred to before. When the South Sudanese government and central bank suddenly limited the amount of US$ funds that could be withdrawn by companies locally or wired to other bank accounts globally, social adaptation helped one of the companies secure short-term, informal loans granted by influential local stakeholders with whom the company had built valuable social capital to make payroll and so keep its workforce from leaving the company.

Institutional arbitrage

The aforementioned need for adaptability is rooted in the fact that emerging markets are characterized by considerably different and unique institutional environments compared to developed markets, and such institutional distance (Kostova and Roth, 2002; Kostova and Zaheer, 1999) is often considered an obstacle to doing business in these markets, leading to liabilities of foreignness for MNCs (Mezias, 2002; Zaheer, 1995). Institutional differences between developed and emerging markets, however, do not solely constitute an obstacle to MNCs in emerging markets, but also provide the opportunity for these firms to benefit from institutional arbitrage. Institutional arbitrage refers to the exploitation of formal and informal institutional differences across countries. By taking advantage of institutional differences across countries, rather than solely focusing on the minimization of international dissimilarities, foreign MNCs may become more competitive in global markets (Ghemawat, 2003). The larger the institutional differences between a foreign MNC's home country and a local market, the more potential opportunities will arise for institutional arbitrage, and emerging markets are considerably different from developed markets from an institutional perspective.

Formal institutional arbitrage refers to taking advantage of dissimilar regulatory rules, legal systems, governmental policies and economic conditions. Given that legal, regulatory, political, economic and judicial systems differ significantly between developed and emerging markets, considerable opportunities exist for the exploitation of such differences. For example, cross-country differences in corporate tax rates inhere the opportunity for MNCs located in developed countries that typically charge relatively high taxes to take advantage of relatively lower rates or even no taxes in some emerging markets. Another example refers to differences in labor costs between developed and emerging markets, which traditionally were found in the low-skilled labor market segment (e.g. labor-intensive apparel or electronics manufacturing by Western firms in China and Viet Nam) but increasingly arise in the high-skilled labor market (e.g. IT services in India or airplane manufacturing in Brazil). Ghemawat (2003) refers to these types of formal institutional arbitrage as administrative and economic arbitrage.

Informal institutional arbitrage refers to taking advantage of dissimilar normative and cultural features around the world, which Ghemawat (2003) refers to as cultural arbitrage. For example, US-American culture that is quite popular in emerging countries has helped US-fast food chains, movie studios and music labels export their brands and products to these populous markets and so build a global competitive advantage. The same applies to German car manufacturing, Italian design and French haute couture which have made many Western-based companies such as BMW, Ferrari and Luis Vuitton very popular among the growing affluent class in emerging markets, and their products have become symbols of institutional change and transitions for the general population in these markets.

Institutional arbitrage may also be leveraged by entrepreneurs as emerging markets provide the opportunity to examine entrepreneurship in different institutional contexts, to fill institutional voids and to establish international new ventures (Alon and Rottig, 2013; Turcan and Norman, 2016). Differences in institutional environments, in general, and dissimilar informal institutions, in particular, may also provide an opportunity for technology entrepreneurship in emerging markets (Pathak *et al.*, 2016). Furthermore, a related opportunity for institutional arbitrage for entrepreneurial firms, whether new ventures or innovation-driven MNCs, is the recently developed concept of reverse innovation (Immelt *et al.*, 2009) which "refers to the case where an innovation is adopted first in poor (emerging) economies before 'trickling up' to rich countries"

(Govindarajan and Ramamurti, 2011, p. 191). Traditionally, Western-based MNCs have subscribed to the glocalization model of innovation, which prescribed the development of products in and for Western markets and the subsequent distribution of these products, often in adjusted form, to emerging markets. Reverse innovation, however, promises to allow MNCs to build a competitive advantage in emerging markets while, at the same time, strengthen their competitive advantage in developed markets (Ramamurti, 2001; Winter and Govindarajan, 2015). Hence, by understanding the unique institutional environment in emerging markets and building context-specific business model to unlock wealth in these markets (Eyring and Johnson, 2011; Kapur *et al.*, 2014; Simanis and Duke, 2014), MNCs can gain considerable advantages from institutional arbitrage by selling products and services that were innovated and developed in these markets to a large customer base in developed markets that also demand these products and services.

Conclusion

In conclusion, emerging markets constitute a double-edged sword for MNCs. They are characterized by unique and considerably different institutional environments compared to developed markets and therefore inhere a number of challenges, but they also offer limitless opportunities for institutional arbitrage that managers of MNCs can exploit if they gain a better understanding about these markets. This paper attempted to discuss some of the institutional idiosyncrasies of emerging markets and delineate key implications of these institutional differences for MNCs operating in these markets.

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