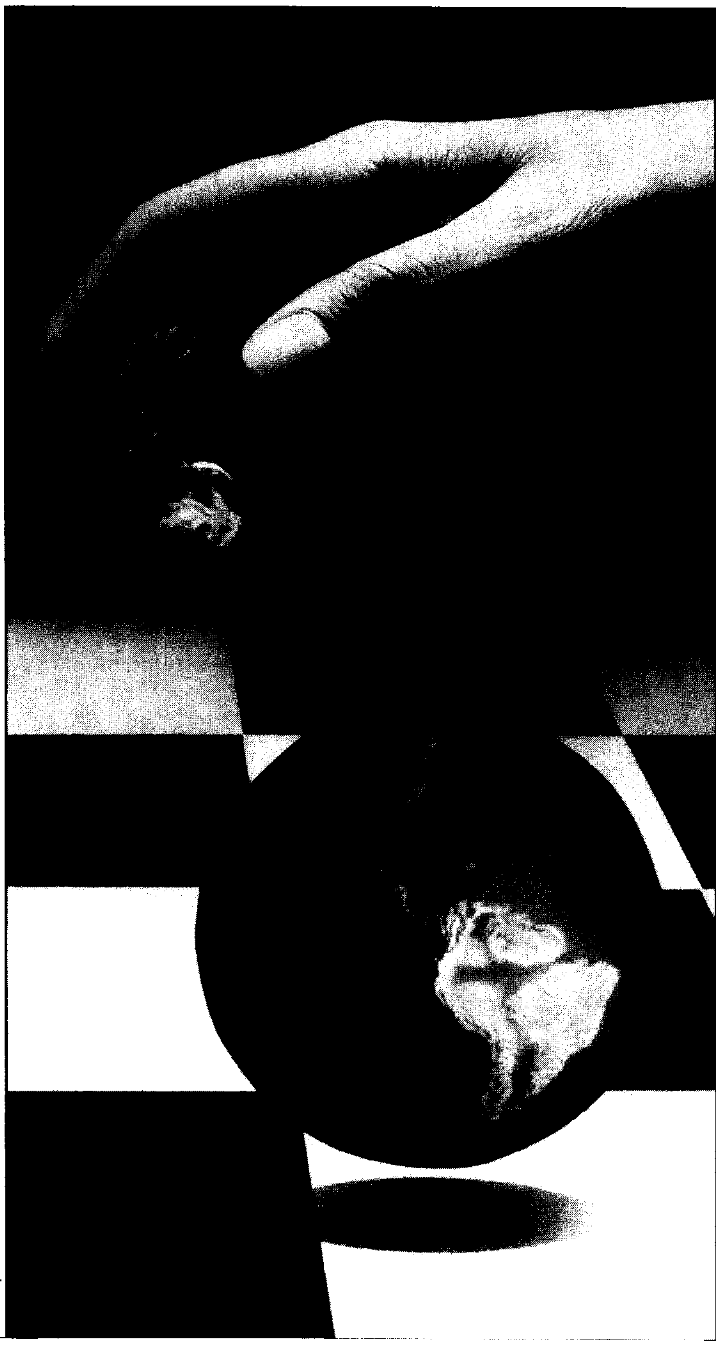
New Global Strategies for Competitive Advantage

By Michael E. Porter

Why do some nations win or lose a share of world trade? Michael Porter, author of the two most widely quoted books on strategic management, has just published a masterful new book, The Competitive Advantage of Nations, *which offers a theory to explain the triumph of some nations in some markets.*



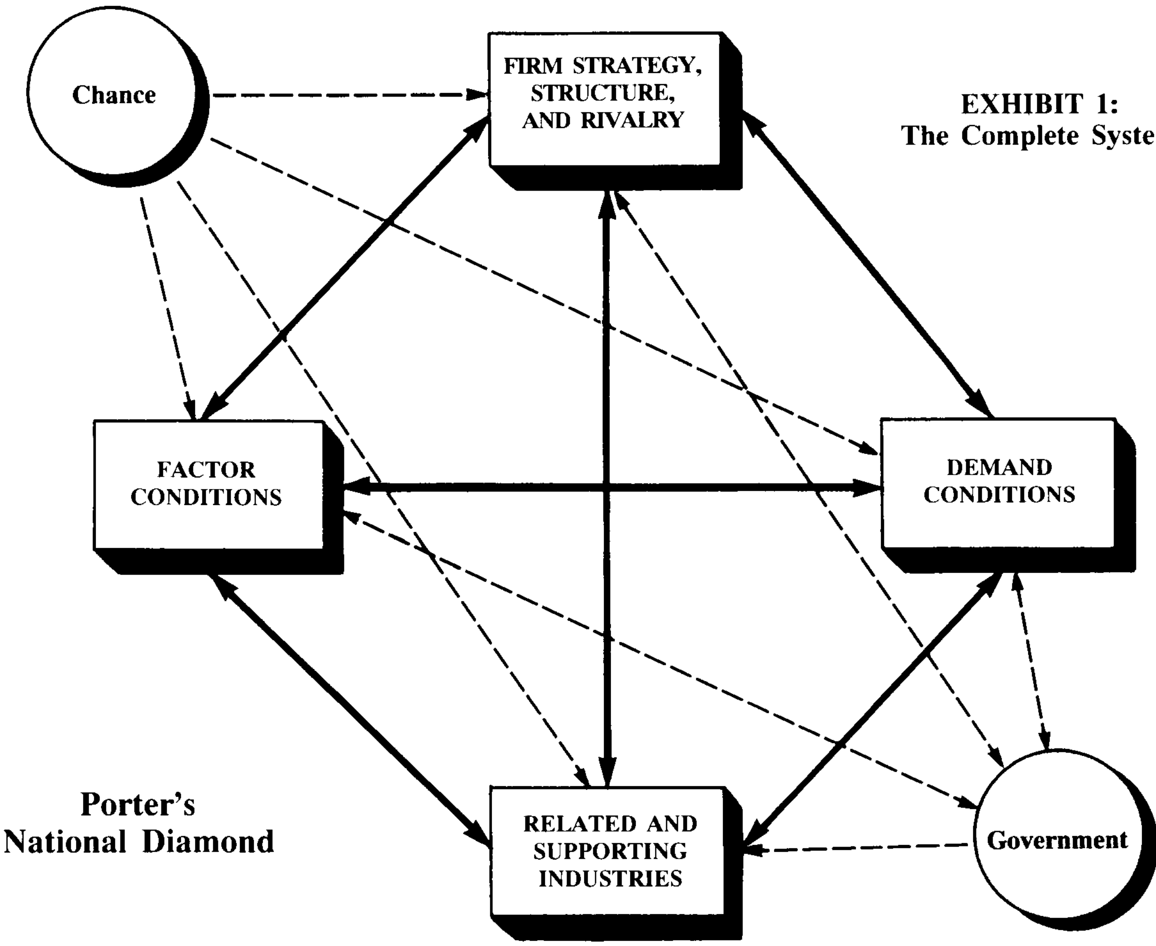
Why are some nations able to produce certain products that are recognized as the best in the world and, as a result, capture international market share? Or more bluntly, why do nations win or lose in the battles for world trade? Harvard Business School's Michael Porter, who is the author of the two most widely quoted books on strategic management and a consultant much in demand, has just published a new book that offers a theory explaining the triumph of some nations in some markets. The following excerpt is a condensation of Chapter 11, "Company Strategy," from The Competitive Advantage of Nations, *The Free Press, 1990, 831 pages.*

Reduced to a phrase, Porter's thesis is: High-intensity domestic competition breeds international success. But his new paradigm for international competitive advantage is best expressed in a diamond-shaped chart (see Exhibit 1), showing that there are key elements of domestic competitive conditions that must all be fostered if success is to be sustained. The categories are:

- *Company strategy, structure and rivalry;*
- *Factor conditions;*
- *Demand conditions; and*
- *Related and supporting industries.*

Why, for example, did Japanese manufacturers take the market lead for copiers away from powerful Xerox? Porter's "diamond" provides the framework for analysing the issues; it's the product of four years of research on ten nations. For those who want the speed-read version of his basic theory, we recommend "Why Nations Triumph," Fortune, *March 12, 1990, pages 94 to 108.*

In our selection from the book, Porter suggests which actions top management must take at home to foster strength abroad. His proposals will frighten some managers to their very core.



Companies, not nations, are on the front line of international competition. Yet, the characteristics of the home nation play a central role in a firm's international success. The home base shapes a company's capacity to innovate rapidly in technology and methods and to do so in the proper directions. It is the place from which competitive advantage ultimately emanates and from which it must be sustained. A global strategy supplements and solidifies the competitive advantage created at the home base; it is the icing, not the cake. However, on the one hand, while having a home base in the right nation helps a great deal, it does not ensure success. On the other hand, having a home base in the wrong nation raises fundamental strategic concerns.

The most important sources of national advantage must be actively sought and exploited, unlike low factor costs obtainable simply by operating in the nation. Internationally successful firms are not passive bystanders in the process of creating competitive advantage. Those we studied were caught up in a never-ending process of seeking out new advantages and struggling with rivals to protect them. They were positioned to benefit the most from their national environment. They took steps to make their home nation (and location within the nation) an even more favorable environment for competitive advantage. Finally, they amplified their home-based advantages and offset home-based disadvantages through global strategies that tapped selectively into advantages available in other nations.

Competitive advantage ultimately results from an effective combination of national circumstances and company strategy. Conditions in a nation may create an environment in which firms can attain international competitive advantage, but it is up to a company to seize the opportunity.

Harvard Business School professor Michael E. Porter, author of two influential books on strategic management, Competitive Strategy *(1980) and* Competitive Advantage *(1985), recently published what is likely to be the most talked about business book of the early 90s,* The Competitive Advantage of Nations *(New York: The Free Press, 1990; Copyright © Michael E. Porter, excerpted here by permission). Prof. Porter was a keynote speaker at The Planning Forum's 1989 Annual Conference.*

The Context for Competitive Advantage

These imperatives of competitive advantage constitute a mind-set that is not present in many companies. Indeed, the actions required to create and sustain advantage are unnatural acts. Stability is valued in most companies, not change. Protecting old ideas and techniques becomes the preoccupation, not creating new ones.

The long-term challenge for any firm is to put itself in a position where it is most likely to perceive, and best able to address the imperatives of competitive advantage. One challenge is to expose a company to new market and technological opportunities that may be hard to perceive. Another is preparing for change by upgrading and expanding the skills of employees and improving the firm's scientific and knowledge base. Ultimately, the most important challenge is overcoming complacency and inertia to act on the new opportunities and circumstances.

The challenge of action ultimately falls on the firm's leader. Much attention has rightly been placed on the importance of visionary leaders in achieving unusual organizational success. But where does a leader get the vision, and how is it transmitted in a way that produces organizational accomplishment? Great leaders are influenced by the environment in which they work. Innovation takes place because the home environment stimulates it. Innovation succeeds because the home environment supports and even forces it. The right environment not only shapes a leader's own perceptions and priorities but provides the catalyst that allows the leader to overcome inertia and produce organizational change.

Great leaders emerge in different industries in different nations, in part because national circumstances attract and encourage them. Visionaries in consumer electronics are concentrated in Japan, chemicals and pharmaceuticals in Germany and Switzerland, and computers in America. Leadership is important to any success story, but is not in and of itself sufficient to explain such successes. In many industries, the national environment provides one or two nations with a distinct advantage over their foreign competitors. Leadership often determines which particular firm or firms exploit this advantage.

More broadly, the ability of any firm to innovate has much to do with the environment to which it is exposed, the information sources it has available—and consults—and the types of challenges it chooses to face. Seeking safe havens and comfortable customer relationships only reinforces past behavior. Maintaining suppliers who are captive degrades a source of stimulus, assistance, and insight. Lobbying against stringent product standards sends the wrong signal to an organization about norms and aspirations.

Innovation grows out of pressure and challenge. It also comes from finding the right challenges to meet. The main role of the firm's leader is to create the environment that meets these conditions. One essential part of the task is to take advantage of the national "diamond" (see Exhibit 1) that currently describes competition in the industry.

The New Rules for Innovation

A company should actively seek out pressure and challenge, not try to avoid them. Part of the task is to take advantage of the home nation in order to create the impetus for innovation. Some of the ways of doing so are:

■ **Sell to the most sophisticated and demanding buyers and channels.** Some buyers (and channels) will stimulate the fastest improvement because they are knowledgeable and expect the best performance. They will set a standard for the organization and provide the most valuable feedback. However, sophisticated and demanding buyers and channels need not be the firm's only customers. Focusing on them exclusively may unnecessarily diminish long-term profitability. Nevertheless, serving a group of such buyers, chosen because their needs will challenge the firm's particular approach to competing, must be an explicit part of any strategy.

■ **Seek out the buyers with the most difficult needs.** Buyers who face especially difficult operating requirements (such as climate, maintenance requirements, or hours of use), who confront factor cost disadvantages in their own businesses that create unusual pressures for performance, who have particularly tough competition, or who compete with strategies that place especially heavy demands on the firm's product or service, are buyers that will provide the laboratory (and the pressure) to upgrade performance and extend features and services. Such buyers should be identified and cultivated. They become part of a firm's R&D program.

■ **Establish norms of exceeding the toughest regulatory hurdles or product standards.** Some localities (or user industries) will lead in terms of the stringency of product standards, pollution limits, noise guidelines, and the like. Tough regulating standards are not a hindrance but an opportunity to move early to upgrade products and processes. Older or simplified models can be sold elsewhere.

■ **Source from the most advanced and international home-based suppliers.** Suppliers who themselves possess competitive advantage, as well as the insight that comes from international activities, will challenge the firm to improve and upgrade as well as provide insights and assistance in doing so.

■ **Treat employees as permanent.** When employees are viewed as permanent instead of as workers who can be hired and fired at will, pressures are created that work to upgrade and sustain competitive advantage. New employees are hired with care, and continuous efforts are made to improve productivity instead of adding workers. Employees are trained on an ongoing basis to support more sophisticated competitive advantages. They are transferred to new functions instead of laid off. Ideas for new products and related diversification are stimulated in order to redeploy skilled people.

Unions, for their part, must also change their attitudes. Impediments to productivity improvement, job movement, and advancement on merit must be eliminated.

■ **Establish outstanding competitors as motivators.** Those competitors who most closely match a company's competitive advantages, or exceed them, must become the standard of comparison. Such competitors can be a source of learning as well as a powerful focal point to overcome parochial concerns and motivate change for the entire organization. They become the common enemy to be bested. Komatsu (Japan), for example, has long seen Caterpillar (United States) this way, and the goal of beating Caterpillar has energized remarkable improvements in Komatsu's product quality, productivity, and relationship with distribution channels.

The implication is not that a firm should imitate such competitors, because imitative strategies rarely succeed. Komatsu competes differently from Caterpillar in important respects. Nevertheless, outstanding competitors should serve as benchmarks and motivators. Instead, companies have a tendency to compare themselves with competitors that make them look good. This only reinforces complacency and inertia.

The True Costs of Stability

These prescriptions may seem counterintuitive. The ideal would seem to be the stability growing out of obedient customers, captive and dependent suppliers, and sleepy competitors. Such a search for a quiet life, an understandable instinct, has led many companies to buy direct competitors or form alliances with them. In a closed, static world, monopoly would indeed be the most comfortable and profitable solution.

In reality, however, competition is dynamic. Complacent firms will lose to other firms who come from a more dynamic environment. Good managers always run a little scared. They respect and study competitors. Seeking out and meeting challenges is part of their organizational norm. By contrast, an organization that values stability and lacks self-perceived competition breeds inertia and creates vulnerabilities. Some companies maintain only the myth that they believe in competition. Success grows out of making the myth a reality.

If competition were purely domestic, confronting powerful customers and tough competitors might seem to result in lower company profitability, because of high buyer power and intense rivalry. But even in domestic competition, gaining competitive advantage allows a firm to outperform its industry. A firm need not exclusively serve demanding buyers nor should it compete head on with any rival. The aim in seeking pressure and challenge is to create the conditions in which competitive advantage can be preserved. Short-term pressure leads to long-term sustainability.

In global competition, the pressures of demanding local buyers, capable suppliers, and aggressive domestic rivalry are even more valuable and necessary for long-term profitability. These drive the firm to a faster rate of progress and upgrading than international rivals, and lead to sustained competitive advantage and superior long-term profitability. A tough domestic industry structure creates advantage in the international industry. A comfortable, easy home base, in contrast, leaves a firm vulnerable to rivals who enjoy greater dynamism at home.

A home base with demanding buyers, stringent needs, and able competitors, then, is a distinct advantage to a firm. A firm must actively position itself to capture the benefits, however. If a firm lacks the pressures for improvement and innovation, it must create them.

Perceiving Industry Change

Beyond pressure to innovate, one of the most important advantages an industry can have is early insight into important needs, environmental forces and trends that others have not noticed. Japanese firms had an early and clear warning about the importance of energy efficiency. American firms have often gotten a jump in seeing demand for new services, giving them a head start in many service industries. Better insight and early warning signals lead to competitive advantages. Firms gain competitive position before rivals perceive an opportunity (or a threat) and are able to respond.

Perceiving possibilities for new strategies more clearly or earlier comes in part from simply being in the right nation at the right time. Yet it is possible for a firm to more actively position itself to see the signals of change and act on them. It must find the right focus or location within the nation, and work to overcome the filters that distort or limit the flow of information.

Identify and serve buyers (and channels) with the most anticipatory needs. Some buyers will confront new problems or have new needs before others, because of their demographics, location, industry, or strategy. Teaching hospitals see the most difficult medical cases,

Competitive Advantages and Disadvantages

The "diamond" provides a framework for assessing important areas of competitive strength and weakness.

Factor Conditions. International rivals will differ in the mix and cost of available factors and the rate of factor creation. Swedish automobile firms, for example, benefit from the solidarity wage system that makes the wages of Swedish auto workers closer to those of other Swedish industries, but relatively lower than the wages of auto workers in other advanced nations.

Demand Conditions. Competitors from other nations will face differing segment structures of home demand, differing home buyer needs, and home buyers with various levels of sophistication. Demand conditions at their home base will help predict foreign competitors' directions of product change as well as their likely success in product development, among other things.

Related and Supporting Industries. Competitors based in other nations will differ in the availability of domestic suppliers, the quality of interaction with supplier industries, and the presence of related industries. Italian footwear firms and leather goods producers, for example, have early access to new tanned leather styles because of the world-leading Italian leather tanning industry.

Firm Strategy, Structure, and Rivalry. The environment in their home nation will strongly influence the strategic choices of foreign rivals. Italian packaging equipment firms, for example, reflect their Italian context. They are mostly small and managed by strong, paternal leaders. Owners of firms have personal relationships with significant buyers. This makes them unusually responsive to market trends and provides the ability to custom-tailor machinery to buyer circumstances.

for example, and usually experiment first with new medical procedures and equipment. Customers facing the most acute labor shortages will be unusually attuned to new automation equipment or labor-saving business services.

Buyers with anticipatory needs should be identified, designated as priorities, and cultivated. Managers in all functions, as well as the chief executive, should have direct contact with them regularly.

Investigate all emerging new buyers or channels. These types of buyers or channels often provide the opportunity for shifts in competitive position. The early emergence of the suburban market in the United States, for example, reated opportunities in numerous industries for new products, such as do-it-yourself tools, that later penetrated foreign markets.

Find the localities in the regulatory vanguard elsewhere. Some regions and cities will typically lead others in terms of their concern with social problems such as safety, environmental quality, and the like. Instead of avoiding such areas, as some companies do, they should be sought out. A firm should define its internal goals as meeting, or exceeding, their standards. An advantage will result as other regions, and ultimately other nations, modify regulations to follow suit.

Discover and highlight trends in factor costs. Increases in the costs of particular factors or other inputs may signal future opportunities to leapfrog competitors by innovating to deploy inputs more effectively or to avoid the need for them altogether. A firm should know which markets or regions are likely to reflect such trends first.

Maintain ongoing relationships with centers of research and sources of the most talented people. A firm must identify the places in the nation where the best new knowledge is being created that is now or might become relevant to its industry. Equally important is to identify the schools, institutions, and other companies where the best specialized human resources needed in the industry are being trained. Investment in time, money, and ongoing contact is necessary to ensure access to people and research. Regularly recruiting personnel from the top schools, or other training grounds, is a good way to introduce new ideas and skills into the company.

Study all competitors, especially the new and unconventional ones. Rivals sometimes discover new ideas first. Innovators are often smaller, more focused competitors that are new to the industry. Alternatively, they may be firms led by managers with backgrounds in other industries not bound by conventional wisdom. Such "outsiders," with fewer blinders to cloud their perception of new opportunities and fewer perceived constraints in abandoning past practices frequently become industry innovators. A firm should designate the most forward-looking or unconventional competitors for particular study, including foreign competitors who may enjoy the benefits of a very different home base. The aim is as much to learn from competitors as to develop strategies to counter them.

Bring some outsiders into the management team. The incorporation of new thinking in the management process is often speeded by the presence of one or more "outsiders"—managers from other companies or industries or from the company's foreign subsidiaries. While internal development of most management is desirable for accumulating skills, the regular effort to introduce new management perspectives will benefit the innovation process.

Interchange Within the National Cluster

A firm gains important competitive advantages from the presence in its home nation of world-class buyers, suppliers, and related industries. They provide insight into future market needs and technological developments. They contribute to a climate for change and improvement, and become partners and allies in the innovation process. Having a strong cluster at home unblocks the flows of information and allows deeper and more open contact than is possible when dealing with foreign firms. Being part of a cluster localized in a small geographic area is even more valuable.

Buyers, Channels, and Suppliers. The first hurdle to be cleared in taking advantage of the domestic cluster is attitudinal It means recognizing that home-based buyers and suppliers are allies in international competition and not just the other side of transactions. A firm must also pursue:

- Regular senior management contact.
- Formal and ongoing interchange between research organizations.
- Reciprocity in serving as test sites for new products or services.
- Cooperation in penetrating and serving international markets.

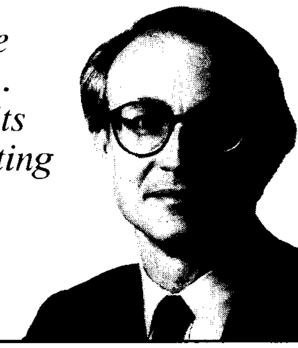
Working with buyers, suppliers, and channels involves helping them upgrade and extend their own competitive advantages. Their health and strength will only enhance their capacity to speed the firm's own rate of innovation. Open communications with local buyers or suppliers, and early access to new equipment, services, and ideas, are important for sustaining competitive advantage. Such communication will be freer, more timely, and more meaningful than is usually possible with foreign firms.

Encouraging and assisting domestic buyers and suppliers to compete globally is one part of the task of upgrading them. A company's local buyers and suppliers cannot ultimately sustain competitive advantage in many cases unless they compete globally. Buyers and suppliers need exposure to the pressures of worldwide competition in order to advance themselves. Trying to keep them "captive" and prevent them from selling their products abroad is ultimately self-defeating.

Some managements find it worrisome that internationally active buyers and suppliers might become overly influenced by foreign firms. These sorts of concerns, while understandable, reflect a static and overly narrow view of competitive advantage. Competitive advantage grows out of ongoing improvement and innovation. Worrying about protecting today's secrets is less important than creating tomorrow's.

Attempting to prevent local suppliers from selling the current generation of equipment outside the nation looks backward instead of forward toward the next source of competitive advantage. It will encourage efforts to protect old advantages rather than create new ones, ultimately leading to a loss in position. This happened many times in the history of British industry. The result was always the same—foreign suppliers innovated while British suppliers became uncompetitive.

> *"Find localities in the regulatory vanguard... A firm should define its internal goals as meeting or exceeding their standards."*
>
> ***Michael E. Porter***



Hesitation in encouraging local buyers to sell and even produce abroad is equally backward looking. It is far better to face pressure from more sophisticated local buyers and also to develop the capability to serve them in foreign nations. Home buyers and suppliers with a global scope and outlook, will provide better insight into international and not just domestic needs and technological possibilities. Buyers and suppliers who are not captive will also challenge the firm to improve and upgrade, the only way to sustain competitive advantage.

An orientation toward closer vertical relationships is only just starting to take hold in many American companies, though it is quite typical in Japanese and Swedish companies. Interchange with buyers, channels, and suppliers always involves some tension, because there is inevitably the need to bargain with them over prices and service. In global industries, however, the competitive advantage to be gained from interchange more than compensates for some sacrifice in bargaining leverage. Interchange should not create dependence but interdependence. A firm should work with a group of suppliers and customers, not just one.

Related Industries. Industries that are related or potentially related in terms of technology, channels, buyers, or the way buyers obtain or use products, are potentially important to creating and sustaining competitive advantage. The presence in a nation of such industries deserves special attention. These industries are often essential sources of innovation. They can also become new suppliers, buyers, or even new competitors.

At a minimum, senior management should be visiting leading companies in related industries on a regular basis. The purpose is to exchange ideas about industry developments. Formal joint research projects, or other more structured ways to explore new ideas, are advisable where the related industry holds more immediate potential to affect competitive advantage.

Locating Within the Nation. A firm should locate activities and its headquarters at those locations in the nation where there are concentrations of sophisticated buyers, important suppliers, groups of competitors, or especially significant factor-creating mechanisms for its industry (such as universities with specialized programs or laboratories with expertise in important technologies). Geographic proximity makes the relationships within a cluster closer and more fluid. It also makes domestic rivalry more valuable for competitive advantage.

Serving Home Base Buyers Who Are International and Multinational

To transform domestic competitive advantage into a global strategy, a firm should identify and serve buyers at home that it can also serve abroad. Such buyers are domestic companies that have international operations, individuals who travel frequently to other nations, and local subsidiaries of foreign firms. Targeting such buyers has two benefits. First, they can provide a base of demand in foreign markets to help offset the costs of entry. More important, they will often be sophisticated buyers who can provide a window into international market needs.

Improving the National Competitive Environment

Sustaining competitive advantage is not only a function of making the most of the national environment. Firms must work actively to improve their home base by upgrading the national "diamond" (see Exhibit 1). A company draws on its home nation to extend and upgrade its own competitive advantages. The firm has a stake in making its home base a better platform for international success.

Playing this role demands that a company understand how each part of the "diamond" best contributes to competitive advantage. It also requires a long-term perspective, because the investments required to improve the home base often take years or even decades to bear fruit. What is more, short-term profits are elevated by foregoing such investments, and by shifting important activities abroad instead of upgrading the ability to perform them at home. Both actions will diminish the sustainability of a firm's competitive advantages in the long run.

Firms have a tendency to see the task of ensuring high-quality human resources, infrastructure, and scientific knowledge as someone else's responsibility. Another common misconception is that, because competition is global, the home base is unimportant. Too often, U.S. and British companies in particular leave investments in the national "diamond" to others or to the government. The result is that companies are well managed but lack the human resources, technology, and access to capable suppliers and customers needed to succeed against foreign rivals.

Where and How to Compete

A firm's home nation shapes where and how it is likely to succeed in global competition. Germany is a superb environment for competing in printing equipment, but does not offer one conducive to international success in heavily advertised consumer packaged goods. Italy represents a remarkable setting for innovation in fashion and furnishing, but a poor environment for success in industries that sell to government agencies or infrastructure providers.

Within an industry, a nation's circumstances also favor competing in particular industry segments and with certain competitive strategies. Given local housing conditions, for example, Japan is a good home base for competing globally in compact models of appliances and in appliances that are inherently compact (such as microwave ovens) but a poor home base for competing in full-sized refrigerators. Within compact appliances, the Japanese environment is particularly conducive to differentiation strategies based on rapid new model introduction and high product quality.

Korea, on the other hand is without advanced local demand and far from major markets. However, it provides an environment that favors low-cost strategies in relatively standardized product segments. Korean home-demand conditions also mean that firms almost invariably compete in compact, smaller-size models.

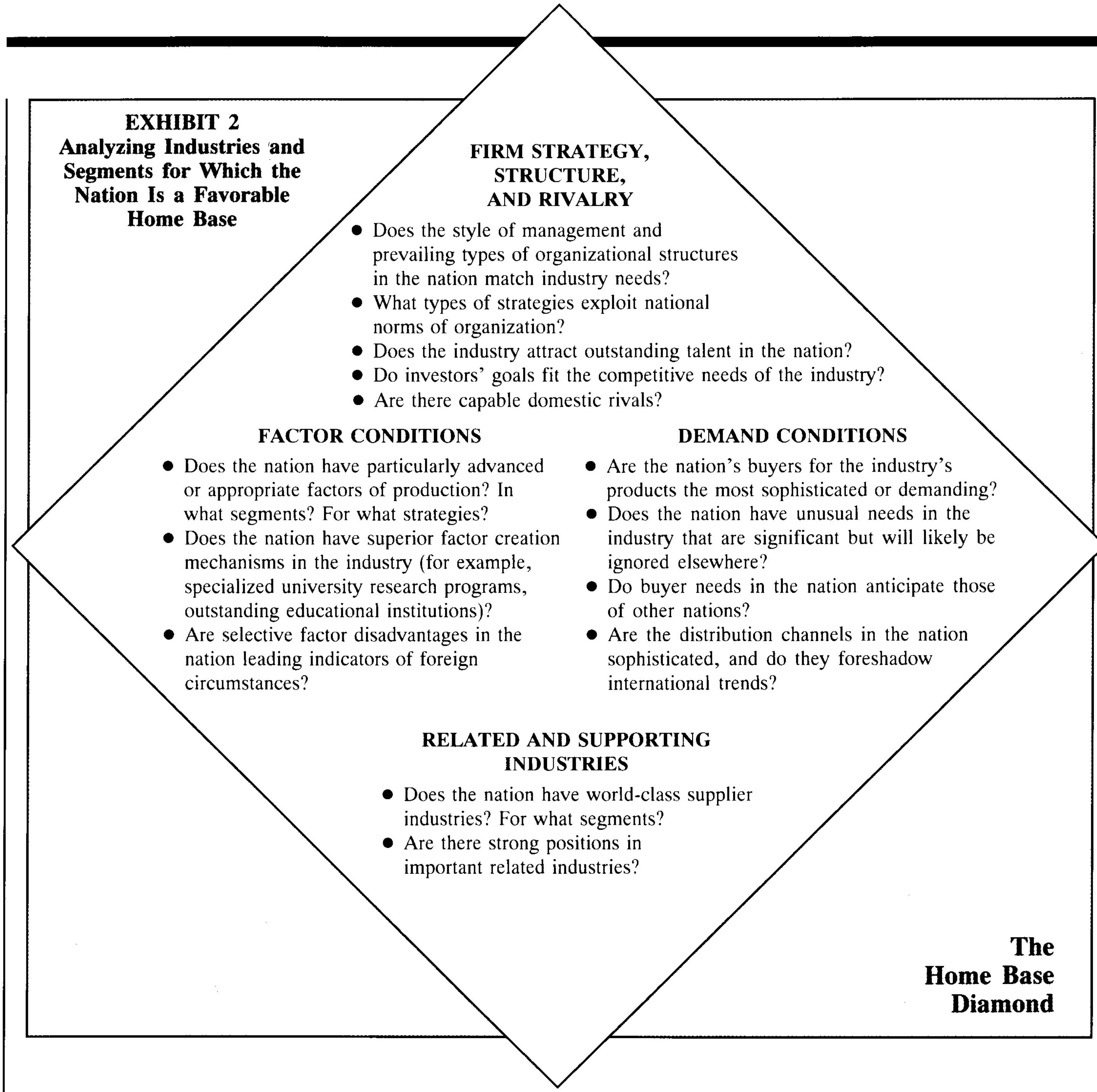
The national "diamond" becomes central to choosing the industries to compete in as well as the appropriate strategy. The home base is an important determinant of a firm's strengths and weaknesses relative to foreign rivals.

Understanding the home base of foreign competitors is essential in analyzing them. Their home nation yields them advantages and disadvantages. It also shapes their likely future strategies. The "diamond" serves as an important tool for competitor analysis in international industries.

Choosing Industries and Strategies

The likelihood that a firm can achieve breakthroughs or innovations of strategic importance in an industry is also influenced by its home nation. Innovation and entrepreneurial behavior is partly a function of chance. But it also depends to a considerable degree on the environment in which the innovator or entrepreneur works. The "diamond" has a strong influence on which

EXHIBIT 2
Analyzing Industries and Segments for Which the Nation Is a Favorable Home Base



nation (and even on which region within that nation) will be the source of an innovation.

Important innovations in Denmark, for example, have occurred in enzymes for food processing, in natural vitamins, in measuring instruments related to food processing, and in drugs isolated from animal organs (insulin and the anticoagulant, heparin). These are hardly random in a nation whose exports are dominated by a large cluster of food-and-beverage-related industries. A firm or individual has the best odds of succeeding in innovation, or in creating a new business, where the national "diamond" provides the best environment.

A firm's home base defines, in part, its competitive advantages and disadvantages in global industries. Korean firms in the automobile and apparel industries enjoy a large pool of dedicated, disciplined workers who still earn moderate wages. Yet firms lack sophisticated local demand and must import many parts and most machinery because domestic suppliers are poorly developed. American medical equipment firms face relatively high wages as well as pressures to report high levels of profitability, yet they benefit from the world's most advanced buyers, rapid and specialized factor creation both in medical science and human resources, and a pull-through effect from medical personnel trained in the United States who practice abroad.

The national circumstances most significant for competitive advantage depend on a firm's industry and strategy. In a resource- or basic factor-driven industry, the most important national attribute is a supply of superior or low-cost factors. In a fashion-sensitive industry, the presence of advanced and cutting-edge customers is paramount. In an industry heavily based on scientific research, the quality of factor-creating mechanisms in human resources and technology, coupled with access to sophisticated buyers and suppliers, are decisive.

Cost-oriented strategies are more sensitive to factor costs, the size of home demand, and the conditions that favor large-scale plant investments. Differentiation strategies tend to depend more on specialized human resources, sophisticated local buyers, and world-class local supplier industries. Focus strategies rest on the presence of unusual demand in particular segments or on factor conditions or supplier access that benefit competing in a particular product range.

As competition globalizes, and as developments such as European trade liberalization and free trade between the United States and Canada promise to eliminate artificial distortions that have insulated domestic firms from market forces, firms must increasingly compete in industries and segments where they have real strengths. This must increasingly be guided by the national "diamond."

A firm can raise the odds of success if it is competing in industries, and with strategies, where the nation provides an unusually fertile environment for competitive advantage. The questions in Exhibit 2 are designed to expose such areas. Of major importance is a forward-looking view in answering these questions. The focus must be on the nature of evolving competition, not the past requirements for success.

Diversification

While diversification is part of company strategy in virtually every nation, its track record has been mixed at best. Widespread diversification into unrelated industries was rare among the international leaders we studied. They tended instead to compete in one or two core industries or industry sectors, and their commitment to these industries was absolute. For every widely diversified Hitachi or Siemens, there were several Boeings, Koenig & Bauers, FANUCs, Novo Industries, and SKFs, who are global competitors but heavily focused on their core industry.

Internal diversification, not acquisition, has to a striking degree been the motivation for achieving leading international market positions. Sandvik's move from specialty steel to rock drills, the diversification of Swiss pharmaceuticals companies from dyes, and Canon's evolution from cameras to calculators to copiers to facsimile are just a few examples.

Where acquisitions were involved in international success stories, the acquisitions were often modest or focused ones that served as an initial entry point or reinforced an internal entry. Hewlett-Packard's acquisition of Sanborn in patient monitoring equipment, for example, was a springboard for applying HP's marketing, technological, and international marketing skills to a new industry. Whenever a firm began broad-ranging diversification, it was generally a sign that competitive advantage was about to fade. Where the diversification took place through a series of major acquisitions, the sign was even more reliable.

The reasons for this track record in diversification are not hard to understand when viewed in light of my theory. Improvement and innovation are at the heart of competitive advantage. They grow out of focus, commitment, and sustained investment in an industry. Diversification within a cluster, or that extends the cluster, tends to stimulate new ways of competing as complementary skills and resources are brought to bear.

Internal diversification facilitates a transfer of skills and resources that is quite difficult to accomplish when acquiring an independent company with its own history and way of operating. Internal entry tends to increase the overall rate of investment in factor creation. There is also an intense commitment to succeed in diversification into closely related fields because of the benefits that accrue to the base business and the effect on the overall corporate image.

Unrelated diversification, particularly through acquisition, makes no contribution to innovation. Unrelated diversification almost inevitably detracts from focus, commitment, and sustained investment in the core industries, no matter how well intentioned management is at the outset. Acquired companies, where there is no link to existing businesses, often face short-term financial pressures to justify their purchase price. It is also difficult for corporate managers of a diversified firm to be forward-looking in industries they do not know. The process of innovation and change is undermined. For example, in a number of U.S. industries we studied, the acquisition of competitors by widely diversified firms diminished the rate of innovation and investment. Examples include syringes, patient monitoring equipment, oil field equipment, and machine tools. This pattern is widespread.

The nations in which unrelated diversification has been the most popular and acquisitions are the easiest to make today are America and Britain. In both nations, diversification seems to have contributed to competitive problems. In continental Europe and Japan, many of the strongest international companies are either not diversified or have diversified into closely related businesses, often through internal development. There are disturbing signs, however, that unrelated diversification is on the rise in both these areas.

In Korea, unrelated diversification has been consistent with investment-driven competitive advantage. The ability of the chaebol to mobilize capital and management talent into new fields was a benefit as long as Korea was a nation with scarce capital and limited technical and managerial resources tended to undermine further national progress. However, today, the major *chaebol* are moving into too many unrelated industries because of misplaced self-confidence. Unfortunately, the prospects for gaining competitive advantage in such disparate businesses are dim.

The implications of my theory for diversification strategy are as follows:

■ New industries for diversification should be selected where a favorable national "diamond" is present or can be created. Diversification proposals should be screened for the attractiveness of the home base.

■ Diversification is most likely to succeed when it follows or extends clusters in which the firm already competes.

■ Internal development of new businesses, supplemented by small acquisitions, is more likely to create and sustain competitive advantage than the acquisition of large, established companies.

■ Diversification into businesses lacking common buyers, channels, suppliers, or close technological connections is not only likely to fail but will also undermine the prospects for sustaining advantage in the core businesses.

Serving Sophisticated Buyers and Markets

To sustain competitive advantage in global industries, a firm must sell to all significant country markets. Particularly important are nations that contain advanced and demanding buyers. All of the most advanced and sophisticated buyers are rarely located at home, even under the best of circumstances. Identifying such buyers in other nations will help a firm understand the most important new needs, which in turn create pressures that stimulate rapid progress in products and services. Nations with sophisticated buyers may well be where leading international competitors are based, making it all the more challenging to penetrate them.

Benetton, the leading Italian apparel producer, followed this principle very early in its development as an international company. The words of the chief executive, Luciano Benetton, describe the process:

We have always thought it essential, since 1969 in fact, that we expand our activities outside Italy. We opened our first shop in Paris in 1969 and that was a major challenge for us. It was not easy to go into the French market. I felt like a schoolboy taking a tough exam when I decided to try and bring Italian fashion to Paris. We started out by trying to satisfy the Parisian consumer—a very demanding client indeed.

He added that, once Benetton was successful in Paris, he realized "we could make it anywhere."

Foreign Sourcing and Technology

A firm must be willing to source products or equipment from foreign firms if they are superior. At the same time, it must also work to upgrade local suppliers. Access to the world's best inputs is necessary to sustain competitive advantage. Loyalty to domestic suppliers, for its own sake, is ultimately self-defeating. By not buying cheaper foreign steel, for example, U.S. automobile companies did not really help the U.S. steel industry, and in the long run undermined their own competitive position.

The best form of loyalty to domestic suppliers is to confront them in no uncertain terms with the need to match their foreign competitors in quality and productivity in order to retain the business. Domestic suppliers should be given some leeway to allow time for adjustment, and be provided with active technical help and other assistance in upgrading. But domestic suppliers cannot be guaranteed the business. Unless they are taking aggressive action to upgrade quality, boost productivity, and globalize their own strategies, supporting domestic suppliers is no one's ultimate gain.

A firm aspiring to competitive advantage must be aware of, and ideally have some access to, all the important scientific work going on in the world that is related to its industry. No matter how favorable the home base, useful research is likely to be taking place outside the home country. Today, a firm seeking competitive advantage should question its strategy if it does not have at least one foreign site for technology monitoring or research. Such sites should be in nations with the best national "diamond," not just the ones with a top laboratory.

Meeting the Best Foreign Competitors

A firm must meet the best rivals in the marketplace in order to sustain and upgrade its advantage. Capable rivals provide the benchmark for measuring competitive advantage. They are also the best stimulus for innovation and change. Ultimately, a firm must find a way to gain advantage over the best rivals in order to assure its market position. Another reason to meet the best rivals in all the important markets is to deny them profits in safe markets that can be used to cross-subsidize low profits in contested markets.

Ideally, the most capable rivals are at home. Competing with them will lead to many self-reinforcing benefits for the entire national industry. However, a firm must meet the best rivals in other nations as well.

Korean companies, for example, view Japanese rivals as their prime competitors both for strategic and historical reasons. The result is that there is little danger that Korean firms will fall into the classic trap of firms in low labor cost countries, that of resting on labor costs as their sole advantage. They are setting out to challenge their Japanese rivals in terms of product sophistication, process technology, and foreign marketing presence. This is another example of how sustaining competitive advantage requires that a firm create pressure, not avoid it.

Locating Regional Headquarters

The principles I have described carry implications for the choice of where to locate the regional headquarters responsible for managing a firm's activities in a group of nations. Regional headquarters are best placed not for administrative convenience but in the nation with the most favorable national "diamond." Of special importance is choosing a location that will expose the firm to significant needs and pressures lacking at home. The purpose is to learn as well as raise the odds that information passes credibly back to the home base. DuPont, for example, moved its European headquarters in agricultural chemicals from Geneva to Paris to take advantage of a better developed national cluster. France is the world's second-largest market for crop protection after the United States, and is a highly sophisticated one.

Selective Foreign Acquisitions

Foreign acquisitions can serve two purposes. One is to gain access to a foreign market or to selective skills. Here the challenge of integrating the acquisition into the global strategy is significant but raises few unusual issues. The other reason for a foreign acquisition is to gain access to a highly favorable national "diamond." Sometimes the only feasible way to tap into the advantages of another nation is to acquire a local firm because an outsider is hard-pressed to penetrate such broad, systemic advantages. The challenge in this latter type of acquisition is to preserve the ability of the acquired firm to benefit from its national environment at the same time as it is integrated into the company's global strategy.

The Role of Alliances

Alliances, or coalitions, are a final mechanism by which a firm can seek to tap national advantages in other nations. Alliances are long-term agreements between firms from different nations that go beyond normal market transactions but stop short of merger. They take many forms, including joint ventures, licenses, sales agreements, and supply agreements. They have become prominent in international competition because they can speed the process of globalizing strategy, reap economies of scale, gain access to technology or markets, and achieve other benefits without giving up corporate independence or requiring an expensive merger. They are particularly common in industries undergoing structural change, especially ones in which many firms feel threatened.

Alliances are a tempting solution to the dilemma of a firm seeking the home-base advantages of another nation without giving up its own. Unfortunately, alliances are rarely a solution. They can achieve selective benefits, but they always involve significant costs in terms of coordination, reconciling goals with an independent entity, creating a competitor, and giving up profits. These costs make many alliances temporary and destined to fail. They are often transitional devices rather than stable arrangements.

No firm can depend on another independent firm for skills and assets that are central to its competitive advantage. If it does, the firm runs a grave risk of losing its competitive advantage in the long run. Alliances tend to ensure mediocrity, not create world leadership. The most serious risk of alliances is that they deter the firm's own efforts at upgrading. This may occur because management is content to rely on the partner. It may also occur because the alliance has eliminated a threatening competitor.

The Role of Leadership

Real corporate leaders believe in change. They possess an insight into how to alter competition, and do not accept constraints in carrying it out. Leaders energize their organizations to meet competitive challenges, to serve demanding needs, and above all, to keep progressing. They find ways of overcoming the filters that limit information and prevent innovation. They harness and even create external pressures to motivate change.

Leaders have a broad view of competition in which their national environment is integral to competitive success. They work hard to improve that environment and to encourage appropriate (though sometimes painful) government policies. As a result, leaders are often seen as statesmen, though few would describe their own actions that way. Leaders also think in international terms, not only in measuring their true competitive advantage but in setting strategy to enhance and extend it.

This concept of leadership has been lost in many companies. Too many companies and too many managers misperceive the true basis of competitive advantage. They become preoccupied with improving financial performance, soliciting government assistance, and seeking stability through forming alliances and merging with competitors. These sorts of steps are not good for companies or for nations. Today's competitive realities demand more. □