Journal of Business Research 66 (2013) 2460–2465

Contents lists available at ScienceDirect

Journal of Business Research

Response strategies of local firms to import competition in emerging markets ☆

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ARTICLE INFO

Article history:
Received 1 October 2011
Received in revised form 1 December 2012
Accepted 1 January 2013
Available online 12 June 2013

Keywords:
Response strategies
Import/foreign competition
Emerging markets
Performance and Indian firms

ABSTRACT

Using a sample of 3808 firms from 1996 to 2007, the impact of three strategic options that can be implemented by local Asian (i.e., Indian) firms facing increased import competition in their domestic market is analyzed. On average, firms with greater investments in intangible resources and tighter product focus do better, while firms with greater international sales perform poorly compared to their peers. However, in industries characterized by high import competition, firms with international operations and product focus tend to have higher performance, while firms with intangible resources perform poorly.

1. Introduction

The removal of tight restrictions over imports has been a trend throughout most emerging markets in Asia and around the world. The opening of such markets to imports has led to a rapid rise in the variety of products available locally, thereby increasing competition for incumbent firms. This altered landscape changes the scope of competition from primarily local to a diverse mix of foreign and local firms with large differences in motivations, resource bases and competitive advantages. Typically, such situations result in falling industry margins, pressures of efficiency, and rapid innovation, leading to intense competition between firms (Wiersema & Bowen, 2008). Firms that do not respond appropriately to the new entrants and competitive conditions tend to fail, while at the same time firms who respond well can prosper in such circumstances (Caves, 1996). Therefore these types of environments may spell opportunity or demise for firms, depending on their strategic response to such competition, and they must learn and adapt well to a changed environment.

This study's focus is on the response strategies of firms to import competition in one such emerging market, India. Historically, the Indian market, like many Asian emerging markets, has been regulated and protected from imports through stiff tariffs and other administrative restrictions. With a large population base and some state encouragement, coupled with frequent market intervention and tight regulative control, this market, once closed to foreign competition, allowed many local firms to thrive and grow. However, in recent decades, imports surged from US$ 24.07 billion in 1990 to US$ 286.82 billion in 2009, a more than ten-fold increase, while average (unweighted) tariff rate on imports declined from 130% in 1990 to 12.5% in 2006 (World Bank, 2006). This pattern is emblematic of many Asian markets and therefore serves as an ideal setting to study response strategies of firms (Singh, Nejadmalayeri, & Mathur, 2007).

A small number of studies have highlighted the importance of developing proper strategic direction in an emerging market context (Zhou, Gao, Yang, & Zhou, 2005) and have examined broader market reforms and their impact on firm profitability (e.g., Chari & David, 2012; Cuervo-Cazurra & Dau, 2009) using aggregate index measures of market reforms. This study seeks to empirically test the specific relationship between the various strategies employed by Indian firms and the impact on performance under import competition using a panel dataset of 3808 Indian firms (unbalanced sample of 22,271 observations) for the years 1996–2007.

2. Conceptual background and hypothesis development

The notion that "…international trade provides a source of discipline on market performance is relatively uncontroversial…" (Ghellinck, Geroski, & Jacquemin, 1988: page 1). Trade which brings competition via imports leads to increased rivalry in an industry and reduced profits in many instances (Caves & Porter, 1978). Several reasons for this were offered under the rationale of structure–conduct–performance (S–C–P) framework (Porter, 1981). First, there are instances in the literature where foreign firms export their products to

☆ Part of this project was undertaken during the first author's sabbatical leave from Illinois State University and during his appointment as Visiting Professor of International Business at the University of Sydney Business School.

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http://dx.doi.org/10.1016/j.jbusres.2013.05.035

other nations in order to gain market share with little or no profit. Second, foreign firms have different factor advantages which allow them to compete on the basis of low price or through differentiation. In such circumstances, domestic firms are forced to reduce prices or increase product value, usually leading to lower profits. Third, the entry of imports brings in new substitutes in a market and creates overcapacity in an industry. Finally, they may increase the battle for market share resulting in price wars among firms. In some circumstances, incumbent firms may face increased operating costs because of reduced sales volume (Porter, 1979). While a majority of the studies on import competition have focused on developed countries and support the above assertions (e.g., Esposito & Esposito, 1971; Melo & Urata, 1986; Oster, 1994; Pagoulatus & Sorenson, 1976; Pugel, 1980; Turner, 1980), two studies focus on emerging markets. Melo and Urata (1986) report similar results with respect to Chile, and in the Indian context, Katrak (1980) reports that import competition reduces profit margins for manufacturing firms.

Therefore, given the relationship between import competition and profitability, imports clearly warrant a change in competitive behavior of domestic firms. Well-managed companies may see this as an opportunity to become stronger and better, as such opening of markets is also coupled with other forms of liberalization where firms are given greater managerial freedom to pursue strategies of their choice. In such circumstances, firms responding to these changes with a well-executed strategy are likely to fare better than those who do not (Anand, Brenes, Karnani, & Rodriquez, 2006). Using three perspectives which are well-accepted in the literature, namely, resource-based, transaction cost and competitive dynamics, three hypotheses are developed to seek to understand the relationship of import competition and response strategies with performance.

2.1. Resources

The importance of firm resources and their implications for performance has been one of the foundations of the resource-based view of the firm. In this view, a firm is seen as a bundle of resources (Barney, 1991). Firms deploy their resource bundles in the marketplace to earn above-average returns, and an assumption is that these resources are heterogeneous in nature and not perfectly mobile (Peteraf, 1993). However, the ability of the firm to sustain such returns is contingent on the inability of other firms to replicate these resources, and therefore these resources need to be neither perfectly imitable nor substitutable without great effort (Barney, 1991). Among resources, intangible resources and related capabilities serve as important sources of competitive advantage due to their isolating mechanisms (Mahoney & Pandian, 1992). Galbreath and Galvin (2008) report that such intangible resources explain variations in the performance of firms. Therefore, firms which invest in such intangible resources are more likely to do well in a market characterized by import competition, as these resources will prevent both domestic and foreign rivals from imitating a firm's strategy.

Hypothesis 1. In industries characterized by import competition, firms with more intangible resources will have higher performance.

2.2. Product focus

In response to import competition, local firms with a narrower focus are able to provide an effective counter response compared to firms who operate in multiple segments, due to reduced transaction and managerial costs, as well as closer attention. Wiersema and Bowen (2008) offer several reasons for this. First, import competition results in increased costs of managing multi-business units, since intense competition requires greater coordination, monitoring and integration to compete effectively. Second, import competition brings more uncertainty, diversity and complexity, requiring greater differentiation, collaboration and attention to firm activities. Therefore, firms which are more focused will be able to use their managerial and organizational resources to execute and respond effectively to the environment characterized by import competition. On the other hand, firms which spread across segments will find their organizational and managerial resources stretched too thin to operate effectively. Studies on the developed markets support this assertion, where asset sales by firms have led to an increase in value (Hite, Owens, & Rogers, 1987) or improved operating performance (John & Ofek, 1995). Wernerfelt and Montgomery (1988) find that the number of industries in which a firm operates is negatively related to the firm's value. In the emerging market context, Anand et al. (2006), in their study of emerging market firms, report that when faced with economic liberalization, firms who divested a portion of their businesses with a redesigned scope of operations were more successful.

Hypothesis 2. In industries characterized by import competition, firms with greater product focus will have higher performance.

2.3. International operations

The presence of foreign competitors forces local firms to upgrade their productivity to compete successfully against their new rivals. Firms failing to do this will be forced to exit the industry or operate in marginal segments (Caves, 1996). Import competition leads to increased productivity, efficiency and comparative advantage of local firms (Chung, 2001; Driffield & Love, 2007). Domestic firms possessing the ability to upgrade successfully to compete against import rivals will also seek new markets in other countries given their ability to face competition from imports (Elango & Pattnaik, 2011). Cuervo-Cazurra and Dau (2009) point out that reforms which lead to the opening of markets also increase a firm's efficiency through reduced transaction costs. The liberalization of many foreign markets also increases strategic options while seeking to penetrate new markets (Anand et al., 2006). By doing so, these firms can neutralize some of the home market advantages of import firms and also gain scale and scope in their operations, enabling them to compete successfully at home and abroad. Recent findings by Cuervo-Cazurra and Dau (2009) not only support the idea that pro-market reforms encourage international operations, but also report that the benefits of international operations are higher for developing country firms.

Hypothesis 3. In industries characterized by import competition, firms with greater international operations will have higher performance.

3. Research methodology

This study focuses on Indian manufacturing firms between the years 1996 and 2007. The primary source of data for this study sample is the PROWESS database compiled by the Centre for Monitoring Indian Economy (CMIE). This database has been used in many studies (e.g., Elango & Pattnaik, 2007; Khanna & Palepu, 2000; Khanna & Rivkin, 2001), and is widely acknowledged to be one of the most comprehensive sources of data on Indian firms. Industry import data was obtained from Department of Commerce, Ministry of Commerce and Industry database compiled by the government of India. This period was chosen, as detailed data on Indian imports by industry segment are available from 1996. Each firm's industry was identified in the PROWESS database and matched with the corresponding industry data in the Department of Commerce database. After eliminating firms with missing values, the final sample contained 3808 unique firms and an unbalanced panel of 22,271 firm year observations over eleven years. Given the data structure, fixed-effect models were employed to capture the impact of import competition on the