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MATCHING BUSINESS STRATEGIES AND ENVIRONMENT: THE CASE OF EUROPE 1992

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MATCHING BUSINESS STRATEGIES AND ENVIRONMENT: THE CASE OF EUROPE 1992

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Abstract

This paper analyzes the relationships between business strategies and environment in a particular setting: the European Market of 1992. Previous results show that strategies and environment must be matched to enhance corporate performance. We argue that four contingency variables will have a great impact on business strategies formulated in this environment.

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1. Introduction

The relationship between strategy and structure has received great attention in literature. Chandler (1962) argues that structure follows strategy, a thesis also supported by some empirical work (Rumelt, 1974). Later on, a body of literature on the relationships between strategy and environment appeared (Andrews, 1971; Hofer, 1975; Hambrick, 1983). In fact, classical definition of strategy by Andrews emphasizes the importance of the environment in the formulation of business strategy. Other pieces of work have related business strategies not only to environment, but to both structure and environment (Venkatraman and Camillus, 1984). In most of the cases, the authors develop a normative model relating organizational structure and environment to business strategy.

The theme of this paper is the connection between strategy and environment in a particular setting: The European Single Market of 1992. The importance of the relationships between strategy, structure, and environment in assessing the validity of a particular strategy is well known. Some authors (Miller, 1988) argue that neither strategies, nor structures alone, nor a suitable match between environment and structure, are sufficient conditions to ensure good performance. Nevertheless, it is clear that methodological motives may justify the isolation of the relations between strategy and environment.

For our specific purpose, we adopt a contingency view of strategy, according to which the appropriateness of different strategies depends on the competitive setting of the business. Our focus will be on business level strategies in undiversified firms.

In particular, we want to evaluate the degree of significance of several contingency variables in the particular environment of the European Single Market. A contingency variable is significant to the degree that businesses which differ on this variable also exhibit important differences on how strategic decisions are associated with business performance. Or, put in another way, major differences between strategic attributes and performance in differing circumstances indicate the presence of an important contingency variable.

This paper argues that four contingency variables in this particular environment – market size, demand homogeneity, stage of the product cycle, and market fragmentation – will have a particular importance in the formulation of strategy in the European market.

In the following section, I will briefly analyze the relevance of defining contingency variables in the formulation of business strategies. In the next section, I will review the effects of the changes derived from the completion of the internal market and the contingency variables relevant in this particular setting. In the final section, I will connect these variables with possible generic business strategies, offering a conceptual integration of both.

Strategy Formulation and Contingency Variables

There is a lack of consensus in the definition of strategy (Bourgeois, 1980; Hofer and Schendel, 1978). Hambrick (1983) suggests that it is due to two factors. First, strategy is multidimensional. Second, strategy must be situational and, hence, it may vary from industry to industry. Both characteristics make consensus on this definition very difficult. Three different approaches to the study of strategy have appeared: the situation-specific, the universal, and the contingency views.

The situation-specific approach considers strategy to be a skilful alignment of internal strengths and weaknesses of the organization, managerial values, and environmental opportunities and threats (Andrews, 1971). The proponents of this view tend to emphasize the importance of case research, since they contend that it is not possible to conclude anything about business strategies without understanding the firm's unique situation in its particular environment.

The universal approach is on the opposite side of the spectrum of possible strategy interpretations. It argues that universal laws of strategies exist and hold, to some extent, in a large number of settings. A clear expression of this is the law of cumulative experience formulated by the Boston Consulting Group (1971). Another example is the so-called law of market share, defined in the context of the PIMS (Profit Impact of Market Strategies) program, according to which there is a positive relationship between market share and profitability, which can be translated into dynamic strategies for all businesses (Buzzell, Gale, and Sultan, 1975). These two universal laws have very specific normative consequences, since they consider that businesses should pursue either a strategy of building cumulative experience or a strategy of conquering market share.

The third approach to the definition of business strategy is the contingency theory, which states that the appropriateness of different strategies depends on the particular setting of the business. This theory differs from the situation-specific approach and explains that some sort of generalizations can be made, especially when context characteristics are, to a certain extent, similar. It also differs from the universal strategic laws' approach by stressing that universal laws do not hold everywhere and some characteristics of the environment or the organization can invalidate the law for a particular business. Contingency theory has been accepted as one approach according to which progress in strategic content research can be attained (Hambrick, 1983; Hofer, 1975).

The crucial point in this view is to classify the different competitive settings into discrete classes. In this respect, it is necessary to define the relevant contingency variables. Contingency variables are thought to be environmental. Firms have little or no control over them and, as a consequence, the variables define the context in which a business must develop its strategy. Nevertheless, some authors (e.g., Hambrick, 1983) argue that some variables that express firms' strategic positions must also be considered as good candidates to be contingency variables. Among these, it is possible to stress the role of variables such as vertical integration, market

share, or brand image. But even then, most of these studies have concentrated on environmental contingency variables.

In a preliminary attempt, Hofer (1975) listed 54 variables that he thought should affect the election of the appropriate strategy. The large number of combinations that is feasible from this long list of variables led him to suggest some priorities in the importance of the variables considered. As a result, he contended that the product life cycle was supposed to be the most important contingency variable, and accordingly, he defined the strategic priorities in each state of the product life cycle. Nevertheless, he did not test the practical importance of this selection with real data.

Hambrick and Lei (1985) analyze the rationale for considering ten relevant contingency variables: stage of product life cycle, user sector (consumer or industrial), product differentiability, technological change, concentration rate, purchase frequency, industry imports, share instability, demand instability, and dollar importance to customers.

Using data from the PIMS program, the authors studied associations between attributes and performance. The results obtained show that the ten variables are relevant for the purpose of research, and that user sector and the purchase frequency are the most important. Stage of product life cycle ranked a strong third among the ten variables examined. The second group of variables, ranked according to their statistical importance, includes technological change, dollar importance, and differentiability.

One important lesson of this work is that, contrary to the situation-specific and universal views of strategy, it is possible to define some set of variables that can be used to formulate business strategies in more than one environment, based on similarities of the selected settings. In the next section, an analysis of the contingency variables for a particular environment – the European Single Market of 1992 – will be developed.

The Effects of the 1992 European Single Market: A Corporate Perspective

Completion of the European Single Market is provoking a number of integration effects which are promoting the efficiency of the markets and stimulating corporations to strengthen their ability to compete. In this section we seek to analyze these effects in more detail from a corporate perspective, while at the same time trying to identify some contingency variables that are very relevant in this particular setting.

The main effects of this phenomenon can be divided into three groups: 1) lower costs and new business opportunities (e.g., alliances) resulting from the enlargement of the market and the possibility of realizing scale economies and learning effects; 2) reduction in price cost margins, as a consequence of the pressure of competition on prices, and 3) non-price effects derived from increased competition, mainly production innovation and quality and range of products.

The Effects of Market Size

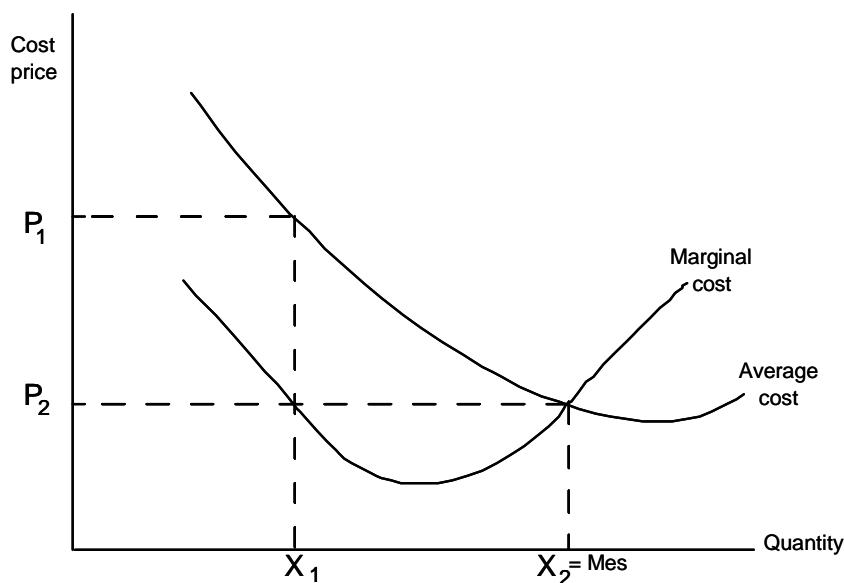
The internal market in Europe will expand the market in which corporations operate while providing a broader scope for increasing the size of operations. This tends to lead to a cost reduction process of great consequences.

The first possibility of reducing costs arises from scale economies, a phenomenon that enables a firm to reduce unit costs when output increases. There are two sources of scale economies: the plant-level and the firm-level.

At the plant-level scale economies, it is useful to define the concept of minimum effect scale (MES), which expresses the minimum size of the plant necessary to realize scale economies, as it is shown in Figure 1. Empirical evidence (Scherer, 1980) suggests several conclusions about this sort of scale economies. First, in many industries, cost disadvantages of operating at a volume substantially less than MES are low. Second, when MES is reached, additional cost reductions at the plant level are difficult to achieve. Third, the empirical experience says that for many industries, MES is reached at low volumes of production.

Figure 1.

Exploitation of Scale Economies



This evidence has to be compared with the firm-level scale economies that can be reached in other tasks, such as marketing, finance, distribution, or research and development. For instance, as a matter of experience, the cost of capital is lower for large corporations in comparison with small firms and the reasons are quite straightforward.

In the context of European industry (European Commission, 1988), it has been shown that economies of scale are larger in transport equipment, chemicals, machinery and instrument manufacture, and paper and printing. These sectors together account for about 55% of industrial output in the EC. By contrast, economies of scale are smaller in food, drink and tobacco, textiles, clothing, and leather goods. These sectors are characterized by a low technological content of products and a slackening demand. However, one has to be cautious in interpreting these results, since in the rest of industries firms are operating at the MES.

No results have been obtained in the setting of firm-level scale economies. It is important to note that the process towards European integration will not cause an immediate full exploitation of scale economies. This is a process which will take some time and the potential effects will only appear in the long run.

The second source of cost reduction are scope economies (Teece, 1980), which imply that the joint production of two or more products is cheaper than its independent production. The advantages of joint production stem from sharing resources in more than one line of products, thus enabling the firm to reduce costs for a given output. The abolition of barriers will make the production of some goods that can share resources more attractive.

The third source of cost economies springs from learning effects. In addition to scale economies – which are essentially static – there is the phenomenon of learning. It consists of a fall in unit cost of a product at a constant price when the cumulative production of this product is doubled. The actual fall in cost depends on the particular type of product.

The initial explanation of this effect (Boston Consulting Group, 1971) assumed that learning effects persist over time. However, evidence suggests that learning effects are greater during the start-up period of a new production process and they tend to decline or die out once a certain volume of output has been reached. Figure 2 introduces the evolution of learning effects depending on the type and complexity of the process.

The empirical evidence indicates that the volume of output of several European industries is artificially constrained by nontariff barriers. The completion of the European Single Market will enlarge the market for most of the industries and enable the firms operating in them to reap the benefit of some important cost reductions.

Figure 2.

COMPLEXITY OF PROCESS	LOW	Learning during short time period	Low learning
	HIGH	Learning during long time period	Low learning
		NEW	OLD
TYPE OF PROCESS			

Competition and Price Cost-Margins

The existence of barriers that fragment the European market reduces the economic efficiency at which firms operate. A useful indicator in this respect is the difference in the price of a given product from one country to another. International comparison of prices is always a difficult task. To reach some valid results for such a comparison, products have to be available in all the surveyed countries simultaneously; consumption patterns for these products have to be similar.

Studies conducted by the European Commission (1988) show that price levels differ from one member state to another in a very significant way. In 1985, the price dispersion for consumption goods (including taxes), measured by the standard deviation, came to about 22% of the average price in the European Community.

Important reductions of these differentials in prices are expected when all nontariff barriers have disappeared. Nevertheless, even after the removal of physical, technical and legal barriers, and the opening up of public procurement, some factors will continue to explain price differences among countries. This is the case of transport costs, differences in distribution networks, homogeneity of demand patterns, cultural differences, or different competitive settings. All of this means that fragmentation of the market and, in general, demand homogeneity, are going to play a significant role in this process and, hence, its relevance for business strategies in this respect is considerable.

How Does the Single Market Shape Competition in a Particular Industry?

The five forces framework (Porter, 1980) can be very useful to analyze the possible effects of the completion of the European Single Market at the industry level (Canals, 1990; Daems, 1989). In fact, each one of the changes described previously is relevant if they affect some of the forces that configure the structural characteristics of competition in a particular industry.

Rivalry within the industry is the first of these structural forces. In fact, this factor is important since it affects the capacity of attraction of a particular industry. The most important factors of rivalry are demand growth, product differentiation, barriers to exit and importance of fixed costs. The disappearance of market boundaries will imply the appearance of new competitors. In particular, the entry of foreign competitors through imports or foreign direct investment promises to be one of the most important effects of the removal of barriers that 1992 will encompass, and will tend to increase the degree of rivalry within the industry. However, there are additional factors that are going to push rivalry along the same direction, such as the expansion of production facilities in order to take advantage of the enlarged market, or the disappearance of national monopolies in crucial industries like telecommunications.

Barriers to entry are another important factor in shaping competition in a particular industry. In fact, the threat of entry into an industry depends on the barriers to entry coupled with the reaction of the incumbents. The six major sources of barriers to entry identified in the literature (Scherer, 1980) are economies of scale, learning effects, product differentiation, capital requirements, switching costs and government policies. Each of these factors appears to have an important role in the completion of the single market in the sense that barriers to entry will increase on the side of scale economies, learning effects and capital requirements, but regulatory policies and barriers will decrease. The final effect will depend on the balance of these factors in a particular industry.

Buyer power will also be affected by 1992. In general, buyers bargain for higher quality or lower prices. Buyers are expected to increase their power since they will have more options as a result of the increasing competition in many industries and the disappearance of the actual price differentials within the Community. In both cases, increasing supply will mean lower prices and more buyer power.

The evolution of suppliers' power is more uncertain. On one hand, in industries where competition will increase, buyers will detract power from suppliers. The real advantage of 1992 for suppliers will be the enlargement of the number of markets and customers to serve as a direct result of the removal of the different barriers. According to this force, suppliers will depend on a more diversified number of customers.

The risk of substitution is the last force to be considered. In a particular industry, firms compete with those of other industries producing substitute products. Substitutes limit the potential returns of an industry, by placing a ceiling on the prices the firms can set up. The key factor in assessing the importance of the risk of substitution in a particular industry is the existence of other products that can perform the same function as the original product. The completion of internal market may increase this risk by permitting the entry of foreign products and by fostering competition through differentiation.

As we have observed, the role of each one of the structural forces of the industry will vary widely from one sector to another. Nevertheless, the above conceptual framework has proven to be useful in assessing the relative importance of these factors in a particular environment, and evaluating how the changes from the completion of the European market will affect a particular industry.

Some Relevant Contingency Variables

From the above study on the effects of the European Single Market, we can conclude that there are some contingency variables that are going to have a great impact in this particular context. From the point of view of market size, two variables can be considered crucial in this respect: scale effects derived in the enlarged market, and the stage of the product life cycle (variable related to learning effects). From the point of view of the reduction of price differentials, there are two important variables: fragmentation of the market and homogeneity of the demand. Let us look with more detail to each one of these contingency variables. Figure 3 introduces the relation between environment's characteristics and contingency variables.

Scale effects have been defined above. It was seen that effects at the firm – level – and not only at the plant-level – are considered important. From a corporate perspective, this variable depicts how sensitive a business is to scale opportunities in different tasks, like manufacturing, R&D, product development, finance, and distribution channels. Opportunities tend to be higher in industries with global brands, asset intensity, global sourcing, easy transportation, proprietary technology, and simple distribution channels. The car industry is a good example of an industry drawn by scale economies and learning effects.

Figure 3.

Relationship between Particular Characteristics of the Environment and Contingency Variables

		Environment's characteristics		
		Market size	Competition and price-cost margins	Competition, innovation and growth
Contingency variables	Scale effects	X		
	Fragmentation		X	
	Demand Homogeneity		X	
	Stage of the industry evolution			X

The stage of the product life cycle is another important variable that affects, in this respect, the possibility of getting positive effects from learning processes. It also has other implications for business strategies in terms of spending in R&D or expanding capacity. Industry changes are important for a firm if they affect the underlying forces that determine competition in a particular industry.

One comprehensive explanation of the evolution of an industry is the product life cycle model. Its main hypothesis is that an industry passes through a number of phases: introduction, growth, maturity, and decline. Industry evolution follows an S-shaped curve, by expressing the effects of the process of innovation and diffusion of new products. It is well known that, as an industry goes through its life cycle, the nature of competition will evolve, thereby affecting the strategy that should be followed by the firm. The criticisms received by this theory are important: the duration of the stages differs from industry to industry; firms can affect the shape of the growth curve through product innovation; and industry growth does not always go through the S-shaped pattern. Nevertheless, the concept is important and, from a corporate point of view, the relevance of the different stages is great, since they point out the growth potential of the industry despite the fact that the traditional formulation of the model and, hence, its particular normative predictions, may have lost some of the initial appeal.

The other two contingency variables are related to price differentials. The first variable is demand homogeneity. When this is high, price differentials tend to decrease. Homogeneity is important when there is a global brand name for a particular product; if technical standards are uniform across countries; if there is a great concentration of users in some countries; or if the functional usage of the product tends to be the same. Financial service is an industry which is being forced towards globalization, but national differences in consumer patterns are still very important.

From the point of view of the evolution of demand homogeneity, there are some relevant questions: Are the products commodity-like or are they tailor-made? Are product specifications local or global? Are product images local or global? Are usage patterns culturally or functionally different? From these considerations, demand homogeneity can be singled out as a very important contingency variable in setting strategies in the European Single Market.

The second contingency variable in this context is the fragmentation of the market due to regulatory policies – still very important in some industries – whose effects will die out very slowly. The effects of competition may work very slowly, especially in industries where the public sector has had historically a high intervention, through regulatory practices or through state-owned corporations. The telecommunications industry is a clear example; this industry has a great growth potential, but public policies protect it from more competition.

The disappearance of market boundaries will imply the emergence of new competitors, national and foreign. In particular, the entry of foreign competitors, through imports or through foreign direct investment, is going to be one of the most important effects of the removal of barriers that 1992 will encompass, and it will tend to increase the degree of rivalry within the car industry; the U.S. and Japanese investments in Europe are good example. But there are other factors that are going to push rivalry along the same direction, such as the expansion of production facilities so as to take advantage of the enlarged market, and the disappearance of national monopolies in crucial industries like telecommunications.

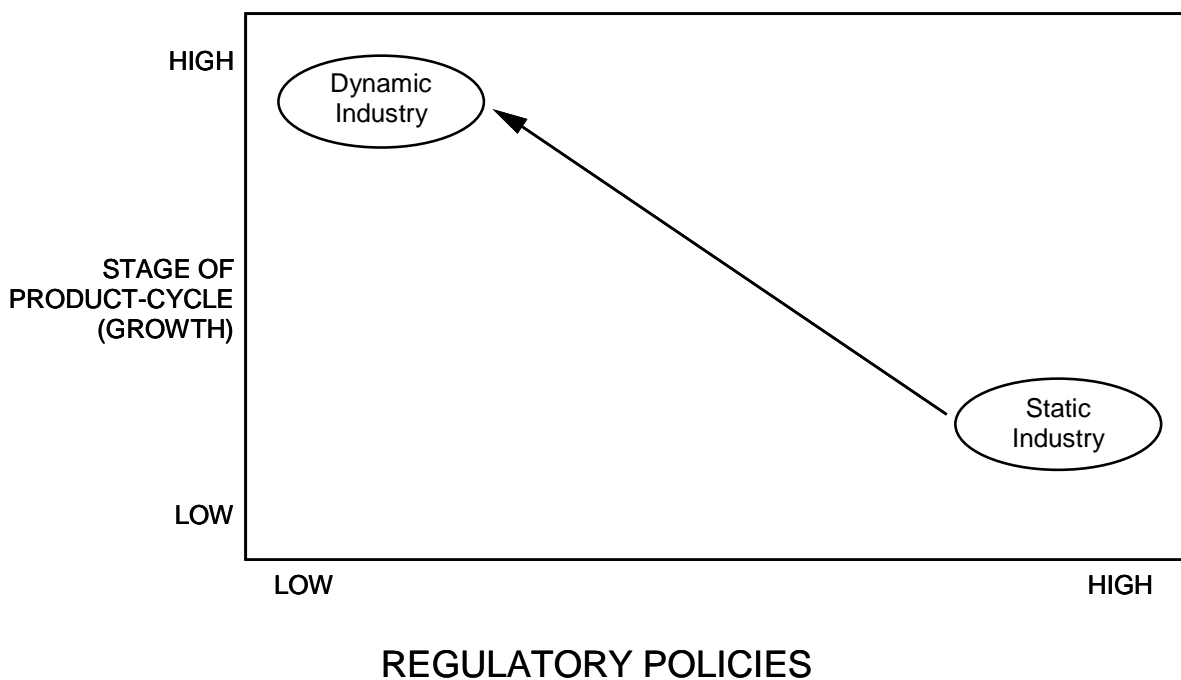
Contingency Variables and Business Strategies in the European Market

In the last section we introduced four contingency variables which will play a significant role in understanding the factors that influence the design of business strategies in the European market. In this section, we want to demonstrate how these variables work and identify the most appropriate business strategies in order to match environment with strategy.

We are going to analyze them in the following way: The analysis of the product cycle stage of the industry and regulatory policies allows us to talk specifically about the speed of change in the environment where a firm competes or, in other terms, its dynamics. This analysis can be visualized in Figure 4. When the fragmentation is high and the stage of the industry evolution – in terms of demand growth – is mature, the changes will be of little consequence. This may be the case of the steel industry. On the other hand, when the fragmentation is low and the growth is high, the changes are going to be quite dramatic, as in the case of the consumer electronics industry. Obviously, this is a rough approach to the particular situation of each industry, but it offers a very interesting perspective.

Figure 4.

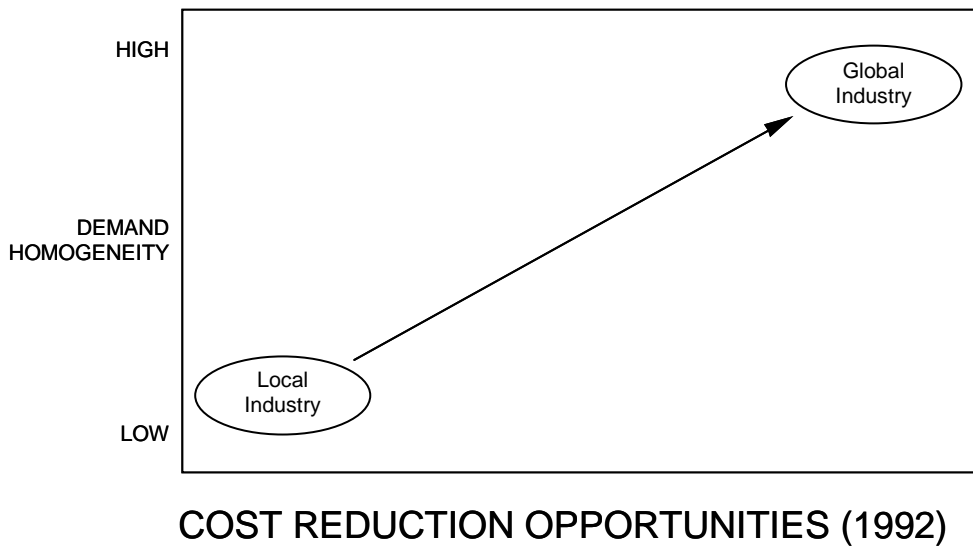
Degree of Change of the Environment



The analysis of the other two variables, scale opportunities, and demand homogeneity, will enable us to discuss the evolution of a particular industry in terms of its pattern of globalization. This combination is represented in Figure 5. When demand homogeneity is high and scale opportunities are also high, the boundaries of the industry will be global. This is the case of consumer electronics and steel industries. On the other hand, if scale opportunities are low and demand homogeneity is also low – differing from country to country – the industry will be rather local.

Figure 5.

Globalization of the Industry



The combination of the two dimensions – dynamics and globalization – that springs from the four contingency variable permits us to establish a typology of generic strategies with which to compete in a particular environment. It is possible to identify firms in the same industry which do not follow the same strategy. The reason is that the strengths and weaknesses of firms differ widely across the same industry and, therefore, firms adapt to the environment in different ways; nevertheless, in this paper we try to isolate the effects of the evolving characteristics of the environment. In Figure 6 we have represented the possible outcome.

Figure 6.

Sources of generic strategies for 1992

Degree of Change	Dynamic	Product differentiation and cost reductions in a particular market ----- Alliances	Product innovation and product differentiation ----- Alliances or proprietary technology
	Static	Low cost in a particular market ----- Mergers or Alliances	Process innovation and low cost ----- Mergers
		Local	Global

Globalization of the Industry

The strategies identified are different from those posed by Porter (1980). Over the past years a number of refinements of Porter's strategies have appeared (Hall, 1980; Hill, 1988; White, 1986; Wright, 1987). In this case, the differences refer to the fact that differentiation leadership and cost leadership may be in fact more compatible strategies than they were initially thought to be. We will not discuss this interesting issue (see Hill, 1988). Rather, we want to figure out the best generic strategies in each of the cases described.

When the scope of the business is local and the industry is static, few changes are likely to occur in this particular industry. In this case, a focus strategy based on a process of market segmentation is needed. The firm should select a segment of the market and tailor its strategy to meet it. The focus should be on cost rather than on differentiation, since the first will probably be cheaper than the second. Usually, in stable environments, differentiation is not needed and tends to be more expensive (Hambrick, 1985; Miles and Snow, 1978; Miller and Friesen, 1984; Miller, 1988). Through this strategy, the company can achieve a competitive advantage by dedicating itself to a segment exclusively, in which it can exploit some differences in cost behavior. In order to reach the minimum size, a merger may be a good choice for some firms or, in some exceptional cases, alliances. Chloride Group, an English manufacturer of batteries, and, in particular, the lightning unit, is a clear example of a strategy in a local market and a static industry. Chloride's sales in EC countries other than United Kingdom were negligible. In most countries suppliers are national in scope. The reason is that market is fragmented: cross-border trade in this industry has traditionally been severely limited by differences in national standards and government – influenced purchasing. After 1992, cost reduction opportunities in this industry will remain low, but Chloride lightning has to develop process innovation to protect the British market and, if possible, attack other EC markets through alliances.

When the scope of the business is local but there is a great dynamism in the industry, focus is also needed, but in this case it should be on differentiation. Usually, when there are some uncertainties in the evolution of the industry, cost strategies are much more expensive than differentiation strategies since the environmental unpredictability and the difficulties of forecasting the behavior of competitors and customers is higher (Khandwalla, 1977; Miller, 1988). Therefore, differentiation is more useful in dynamic environments (Duncan, 1972). Nevertheless, firms in this environment must also consider the cost dimension of their strategy, since global firms can capture a bigger market share by offering lower prices. Therefore, in this case a mix of cost leadership and product differentiation may have a greater efficacy. Through this strategy, the firm looks for some segments with special needs and serves them better. This strategy demands a good understanding of customer preferences, since most of the actions are sought to inspire buyer loyalty and reduce price elasticity.

This is the case of Biokit, a Spanish biotechnology company with revenues of \$7.6 million. The company was founded in the 1970s and achieved rapid growth in the laboratory reagents market, a dynamic but still local industry. By developing proprietary technology, Biokit has relied on sales of bulk and private brand sales to distributors, which is a very cheap procedure that has allowed Biokit to concentrate its resources on R&D. This differentiation through a low cost strategy has been complemented in recent years with alliances to gain control over distribution in key markets, while maintaining cost advantages through proprietary knowledge.

When the scope of the business is global and the industry is static, the most appropriate strategy is low cost, mainly, on the basis of innovation, since it will be cheaper than differentiation, given the stability of the industry. In this particular setting, differentiation is

not needed, since consumers care more about price than about image (Miller, 1988; Miller and Friesen, 1984). Following this generic strategy, the firm wants to be the lowest cost producer in its industry. What are, in this particular case, the sources of cost advantage? The most important are scale economies, proprietary technology, and preferential access to raw materials. Being a low-cost leader means that the firm wants to exploit all sorts of advantages, not only scale economies, and demands a careful analysis of all the elements of the value chain and the particular cost drivers of each of the activities.

This has been the main reason for some recent mergers in the European industry such as that between Asea and Brown Boveri, whose combined annual sales of \$18 billion in 1988 have created the world's largest electrical engineering company. The main purpose of this strategic move is to gain size in the core business to reach scale and scope economies and become a cost leader. This is a good strategy in this context, with a global, static industry.

The last combination occurs when the industry is global and the dynamics of the industry are high. In this case, product differentiation strategy through product innovation may be the most appropriate, since the environment's uncertainty makes it cheaper than cost leadership. In this setting, products change quickly, and it is difficult to know how competitors and customers will react to new products. Firms need to differentiate if they do not want to lose market share and sales (Hofer and Schendel, 1978; Miller, 1988) and therefore avoid more costly forms of competition like price cutting. Through this strategy, a firm seeks to be unique in its industry along some dimensions valued by its customers. This uniqueness is rewarded with a premium price. Obviously, this premium price has to exceed the extra costs incurred in being unique, otherwise differentiation strategy would be a complete mistake.

The truck industry has the characteristic of globalization and is quite dynamic. Volvo Truck Corporation is a good example of a firm trying to improve product innovation and product differentiation. In the past, prices on vehicles, parts and service were set in each national market according to local conditions. Advertising and promotions were not coordinated. In the coming years, Volvo wants to emphasize product innovation to respond to national preferences and attain greater marketing coordination throughout the EC. At the same time, the recent alliance with Renault seems to stress the importance of rapid product innovation for this type of environment.

Conclusions

In this paper we have discussed the relationships between strategy and industry environment in the context of the 1992 European Single Market. After analyzing the corporate changes derived from this project, we have obtained four contingency variables which are likely to be relevant in this particular framework: scale opportunities, demand homogeneity, regulatory policies, and stage of the product cycle. A set of combinations of these contingency variables has enabled us to define the most adequate business generic strategy in each particular industry context.

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