

Determinants of entry mode choice into emerging markets economics essay



The business and economic environment in a country has been identified as one of the major determinants of the flow of foreign investments in and out of a country. Since no single country is self sufficient, the flow of foreign investments in and out of a country represent not just a source of economic development but also a source of technology spillovers, human capital formation, international trade integration and a platform for more competitive business environment (United Nations (UN), 2004). For firms, expansion abroad not only have advantages but also carries with it associated challenges and risks. As Bartlett et al. (2008) observe, firms, in making the important decision of investing and operating outside their home environment, some important issues such as what market opportunities exist in the foreign market, resource advantage, associated foreign risks and challenges, strategic implications and mode of entry are of critical importance

A number of studies have attempted to explain the factors that influence firms to invest abroad and the mode of entry they choose to do this.

According to Ghauri (2000) , the factors that push firms to go abroad can be broadly divided into two categories: the internal factors which includes the goals and ambitions of individuals and the organisation like resources, capabilities and strategies, and the external factors which relates to environments at home and in the foreign markets such as tax, regulations, legal requirements, potential profits, etc.

Bartlett et al (2008) describe the MNE as a firm with substantial direct investment in foreign countries and actively manages and regards these operations as integral parts of the company, both strategically and

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organistically. In this regard, the “ Multinational Enterprise (MNE) has been identified as the dominant vehicle of internationalization in the global economy” (Bartlett et al 2008). The United Nations Conference on Trade and Development (UNCTAD) defines the MNE otherwise referred to as Transnational Corporation (TNC) as “ incorporated or unincorporated enterprises comprising parent enterprises and their foreign affiliates.”. (UNCTAD website)

The aim of this paper is to analyse the business and investment context of Brazil as viewed from the global perspective, identify country specific issues in Brazil as it relates to determining the entry modes to be used in entering the market by Multinational Enterprises (MNEs) and propose the different entry modes that will suit the country’s business context. The paper also examines some theories of foreign entry modes by MNEs into emerging markets and proposes the suitable entry modes for the business context of Brazil.

To achieve this objective, the paper is divided into four sections. Following this introductory section, section 2 examines different literatures on the foreign market entry modes adopted by MNEs in entering into foreign markets and how country specific issues has been a major determinant in making this decision. In section 3, an analysis of the macroeconomic conditions of Brazil is carried out. This section focus on the analysis of the macro, business, political and investment environment in Brazil because of the role they play in accessing a country’s business and investment risks and also the impact they have in the entry mode decisions made by MNEs. In

section 4, the paper concludes with specific recommendations for MNEs looking at expanding into Brazil.

Literature Review

The choice of entry mode into foreign markets by MNEs have a considerable impact on the firms success in the host market, so careful analysis and consideration is required of management when making this major decision of internationalisation. For firms, there are various determinants of the entry mode to be adopted when expanding outside there home location, therefore a careful analysis of the risks and returns attached to each entry mode is needed inorder to choose the optimal mode that best suits the host country business context and the firms business objectives. Several factors like economic risks, political risks, investment risks, institutional risks affects the choice of entry modes into foreign market. The choice of a sub-optimal mode of entry into foreign markets by firms have considerable impacts on its resources which may sometimes cause it to postpone or cancel its expansion Cross (2000).

According to Root(1987 cited in Sharma. 2002), entry mode is defined “ as an institutional arrangement that makes possible the entry of a firm’s products, technology, human skills, management or other resources into a foreign country.”

The different entry modes available to MNEs in achieving their internationalisation strategy in a foreign country includes; exporting, franchising, licensing, foreign direct investment i. e greenfield investment (establishing a wholly owned subsidiary in the host country), entering into a

joint venture with domestic firms in the host country, merging with or/and acquiring a domestic firm in the host country.

Many literatures have undertaken studies of the different entry modes into foreign markets and the determinants of the entry modes adopted by MNEs. Cross (2000), classified these entry modes into two broad categories; non-equity modes and equity modes; in order to explain the degree of commitment adopted by MNEs in their internationalisation strategy into foreign countries. According to him, non-equity modes of foreign entry involves the firm contracting its proprietary and technological know how to firms in the host country under some form of contract. Classified under this category is licensing, franchising, management contracting and technical service agreements. Ability to overcome trade and investment barriers and low control of the licensee has been identified as the merit and demerit of the non-equity modes of entry respectively. The equity modes of foreign entry involves direct control by the firm over its operations, product quality, resources, knowhow in the foreign market. Falling into this category is direct investment (FDI), joint venture, mergers and acquisition. Higher resource commitment and direct control over resources to maximise returns have been identified as the merits of this mode while high risk level has been identified as a demerit.

Anderson and Gatignon (1986) in their work categorised modes of entry into three according to the degree of control firms wish to have on their foreign operations. For maximum control of foreign operations, high-control modes of entry that involves equity ownership like joint ventures, wholly owned subsidiaries were proposed. For medium control, modes of entry like <https://assignbuster.com/determinants-of-entry-mode-choice-into-emerging-markets-economics-essay/>

licensing, franchising and management contracts were classified under this while modes of entry like exporting was suggested for low control modes.

Due to the dearth of literatures explaining the determinants of entry mode choice by MNEs into emerging markets, Zhang et al. (2007) explained the choice of gradual FDI entry modes into emerging markets. The study critiqued the stereotyped model of using the same determinants of entry mode choice into developed countries to decide entry mode choice into emerging markets like China. It concluded that sequential FDI entry mode choice adopted by MNEs in emerging markets is inline with the internationalisation process model. An important finding of the paper is that MNEs undertake experimental and gradual investments in emerging economies because of the perceived uncertainties in these emerging markets. This finding is perfectly in line with the Uppsalla model of internationalisation which proposed gradual acquisition of knowledge about a foreign market rather than a deliberate knowledge acquisition.

A limitation of these studies reviewed above is that they did not address possible entry modes available to MNEs that can be employed to overcome the perceived uncertainties and risks in emerging markets with unfavorable macro indicators although in this markets the opportunities available far outweighs the loss.

Sharma (2002) in his study of how economic, business, political environment and consumer market indicators determine the extent of committment and hence mode of entry to be adopted by MNEs into emerging markets in Latin America, classified the different modes of entry into two categories ; high

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resource commitment modes and low resource commitment modes. MNEs will enter countries with positive and favorable economic and consumer market indicators on a high level of resources commitments using entry modes like greenfield investment, joint venture and mergers and acquisition. On the other hand, firms view countries with unfavorable economic indicators with perceived uncertainties and will prefer to enter this market on a low level resource commitment in order to mitigate the risks attached to internationalising into this markets. Entry modes classified under low resource commitment modes includes exporting, franchising and licensing. In his study, a positive correlation was found between favorable government policies, large consumer size, high per capita income and high resource commitment modes while a positive correlation was also detected between unfavorable economic policies, political instability, poor infrastructure and low resource commitment.

The paper further argued that although some countries in Latin America poses unfavorable economic and market indicators which requires firm to enter on a low level of commitment to mitigate their risks, it is rather advisable to enter these countries on a large resource commitment level as these countries possesses greater and long term opportunities in terms of market size, first mover advantage, cheap labor, resources which will compensates for the perceived risks and uncertainties in these countries.

In line with these argument stated above, this essay seeks to justify the reasons for the adoption of high resource commitment entry modes to explore emerging markets like Brazil that offers wide opportunities to MNEs even though uncertainties and risks still exists in this economy.

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Brazil: A review of macroeconomic conditions

According to the World Bank Country Brief on Brazil (n. d), Brazil is an economic giant whose economy ranked among the world's ten highest Gross Domestic Product (GDP) in 2009 with a GDP of US\$1, 571 Trillion. Brazil, an upper middle-income level country with a GDP per capita estimate (in terms of Purchasing Power Parity) of US\$10, 520, has been identified as one of four countries (Brazil, Russia, India, China) whose economies could be a much larger force in the world economy by the 21st century (Economic Intelligence Unit Report (EIR), 2010; World Bank, 2010).

With an average GDP growth rate of 4. 8% per year between 2004 – 2008, falling by 0. 2% in 2009 and a growth forecast of 5. 9% and 5% in the next few years, the economy of Brazil has been identified as an important one in the Latin American region (Banco Central do Brazil, BCB (n. d); BBVA Research (2010). The economic growth in Brazil is driven by private consumption, public spending, investment and external demand (BBVA Research, 2010). The high economic growth rate in Brazil has been facilitated by the pursuance of stable economic policies by the Brazilian government. To stimulate the economy, expansionary fiscal and monetary policies like increase in public expenditures, reduction in tax rates, flexible exchange rate, increased accessibility to credits from public banks were introduced. In curbing inflation which increased from 3. 6% to 5. 7% between 2007 and 2008 (refer to Table 1) as a result of the expansionary monetary policies introduced earlier, inflation targeting monetary policies like reduction in the interest rates was introduced leading to a reduction in the inflation rate to 4. 9% in 2009. According to the EIU Report (2010), the 12-

month consumer-price inflation rate as at September 2010 stands at 4.49%, just 0.01 basis points less than the Central bank's target rate of 4.5% in 2010. This strong fundamentals of the economy is currently been reflected in the appreciation of the Brazilian Real against the US Dollar.

The foreign reserves of Brazil as at 2009 stood at US\$238,539 Trillion, a 32% and 23% increase from the 2007 and 2008 balance respectively. With this solid reserve, the country can adequately support its balance of payments position (BOP) and smoothen any volatility in the value of its currency, the Brazilian Real. Analysing Brazil's sovereign credit risk rating showed that it has increased substantially with a foreign reserve that is 15% of GDP, this reflects that Brazil can fully service its external debt (Garcia-Herrero, 2009). The country ran a modest current account deficit of 1.5% of GDP in 2009 but external solvency is not a risk in the short term as the foreign reserves provides adequate buffer. According to The Economist (2009), Brazil is one of the first Latin American economies to emerge from the recession. The quick recovery can be attributed to the strong domestic demand and accessibility to credits that existed in the economy which was facilitated by government's adoption of expansive fiscal and monetary policies using the large reserves as a means. Also, Brazil operates a well diversified economy with the service, manufacturing and agricultural sectors accounting for 68.5%, 25.9% and 6.1% of GDP respectively.

Table 1: Economic indicators of Brazil

Indicators

2005

2006

2007

2008

2009

GDP (US\$ Billion)

882, 185

1, 088, 920

1, 365, 980

1, 638, 610

1, 571, 980

GDP Growth (annual %)

3. 2

4

6. 1

5. 1

-0. 2

GDP per capita

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4, 741

5, 787

7, 185

8, 536

8, 114

Total Reserves (US\$ Billion)

53, 799

85, 842

180, 334

193, 783

238, 539

Exports of goods & services (% of GDP)

15

14

13

14

13

Imports of goods & services (% of GDP)

12

11

12

14

13

Current account bal (US\$ Billion)

13, 984

13, 621

1, 550, 784

-28, 192

-24, 302

FDI net inflows (US\$ Billion)

15, 066

18, 782

34584

45058

25948

Inflation, consumer prices (annual %)

6.9

4.2

3.6

5.7

4.9

Source: World Bank DataBank

According to Sacerdoti et al. (2005), the quality of institutions in an economy plays an important role in explaining its economic performance. The government of Brazil can be said to have a strong weight on the economy as observed in its high level of intervention in the economy. Despite the fact that the country operates a democratic system of government with a constitution that has been in effect since 5 October 1988, the political climate in Brazil can be said to be fairly unstable having a history of dictatorship and government intervention in the economy. Although, the current administration of President Lula da Silva has been credited for maintaining policy credibility, political stability, a strong macro-economy and improved domestic investment climate, the noticeable rise in fiscal spending and the strong interventionist role of the government in the economy has been a major concern (EIU Report 2010). The government still operates restrictive

investment policies in some sectors, as it's actively involved in the management of the country's key sectors owning significant stakes in the oil, financial and energy sector thereby restricting private investments in these sectors. Also, the conduct of a successful election in October 2010 has boosted Brazil's political climate as seen from the global perspective.

Brazil operates a legal system based on the Roman codes and is yet to accept the International Court of Justice (ICJ) jurisdiction. The legal process in Brazil is very bureaucratic and cumbersome thereby impeding private business development and execution of legal contracts. In all, contracts in Brazil can be said to be secure as the judiciary and civil court services are fair but the bureaucratic procedures hamper their ability to make speedy judgments (EIU Reports (2010)).

However, infrastructural development has been a challenge to the economic growth of Brazil. The overutilized airport, poor road and rail network and congested port has contributed to the increase in logistics costs to MNEs and hampering international trade. Also the annual increase in electricity consumption has put a pressure on the energy capacity of the country thereby necessitating an expansion of the energy infrastructure. In resolving the infrastructure problem, the government has initiated a Public-Private Partnership to encourage investment in infrastructure. Also, it has invested billions of dollars to improve its rail network.

The net inflows of FDI into the country over the years has been overwhelming. The net inflow of FDI into the country increased from US\$15 Trillion in 2005 to US\$45 Trillion in 2008 representing a 200% increase over

the 3 years period. However this fell by 42% in 2009 as a result of the global financial crisis. The stock of FDI and flow of FDI accounted for 20% and 1.65% of GDP respectively. Brazil, a member of the World Trade Organisation (WTO) has been identified as the third-most-attractive country for future foreign direct investment, behind China and India (World Investment Prospects Survey 2010-12). To encourage foreign investments, the government has implemented favorable trade policies like the signing of major bilateral trade agreements with countries like the USA, Argentina, Chile to mention a few. This agreement has led to a major reduction in the import tariff on the agricultural products and automotive products.

The trade partners of Brazil have been identified to be the Netherlands accounting for 20.6% of FDI inflows during the first half of 2010, the US (15.5%), Spain (10.8%), Germany (7.8%) and France (6.8%).

According to the 2011 World Bank Ease of Doing Business Report, the country slipped 3 places from 127th position in 2009 to 129th place in 2010 among 183 economies in terms of overall ease of doing business. As shown in Table 2, the process of registering new businesses, properties, getting credits, closing businesses is cumbersome and bureaucratic. Moreover, companies' operations are subjected to a high tax burden and a rigid labor law which impedes the enforcement of employment engagement contracts. Although the official language in Brazil is Portuguese, the commonly used business language is English. Registered foreign companies in Brazil are treated equally with their domestic partners when bidding for contracts although the government still adopts policies that restrict investments in its aviation, media communication and the rural agriculture.

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Table 2: Brazil's Ease of Doing Business (DB) Ranking

Ranking

DB 2011 Rank

DB 2010 Rank

Absolute Change

Starting a business

128

128

0

Dealing with construction permit

112

113

1

Registering property

122

121

-1

Getting credits

89

87

-2

Protecting investors

74

73

-1

Paying Taxes

152

149

-3

Trading across borders

114

98

-16

Enforcing contracts

98

98

0

Closing a business

132

130

-2

Source: World Bank Databank

Brazil is the largest country in area and population in Latin America and the Caribbean with a population size of 193.7 Million in 2009. It is bordered by the Atlantic Ocean and share common boundaries with every South American country except Chile and Ecuador (World Bank Country Brief ; CIA Factbook (2009) thereby making it an import and export gateway to other Latin American countries. As a major commodity export country, the total exports of Brazil accounted for 13% of the GDP figure in 2009, a 7% decline from the 2008 figures while total imports accounted for 13% of the GDP. Rising international prices for agricultural and mining commodities and rising demand from Asian markets has been identified as an important driver of Brazil's economic growth (EIU (2010)). The value of exports is expected to increase by 12.8% year-on-year in 2010.

Brazil offers a very large consumer and attractive labor market for foreign firms. The country's human development indicators have been impressive

over the years with the proportion of the population living below poverty line reducing from 1.8% to 1.3% between 2006 and 2007 and a adult literacy rate of 90% was recorded over the two year period (Refer to Table 3). Public spending on education as a percentage of GDP increased from 4.5% in 2005 to 5.2% in 2006. Brazil recorded a total labor force of 99 million in 2009, a 2% increase from the 2008 figure while the 2008 unemployment proportion of labor figure declined to 7.9% from 9.3% in 2007. There has also been a noticeable reduction in the income inequality gap in Brazil. This can be attributed to the upward trend in the real household income level as reflected in the GDP per capita figures over the years. As shown in Table 1, in per capita income terms, the GDP grew by 72% between 2005 - 2010 reflecting an increase in the income and purchasing power of an average Brazilian. As a result of the surge in the number of internet users in Brazil, the country's e-commerce activities has also increased significantly boosting the already bouyant service industry in Brazil.

Table 3: Human development indicators

Indicators

2005

2006

2007

2008

Poverty gap at \$1.25 a day

1.6

1. 8

1. 3

N/A

Total labor force (million)

94, 507

97, 036

97, 879

99, 945

Unemployment (% of total labor force)

9. 3

8. 4

9. 3

7. 9

Adult literacy rate

89%

90

90

N/A

Source: World Bank Data Bank

In Latin America, Brazil's economy is an important economy in the region because of its closeness to the US market and its possession of a well developed agricultural, mining, manufacturing and service sector (CIA Factbook,(2009). Owing to its macro economic and political stability over the years, its richness in natural resources like oil, mining and agricultural resources and vast local market, Brazil has become an attractive destination for foreign direct investment (FDI) among emerging-market economies (EIR; 2010). As a result of Brazil's identification as a prospective regional economic driver in the Latin America, many MNEs are using the country as a base for their operations in Latin America. Examples include General Electric, Hyundai, GE Healthcare.

Conclusion/Recommendation

Analysis of the macroeconomic indicators of Brazil showed that the country offers a basket of opportunities for MNEs as well as handful of risks. Interm of favorable indicators, the country offers large consumer market with purchasing capacity, natural resources, availability of educated and skilled labor and in general expansion into the Latin America region for MNEs. While the unfavorable indicators identified includes strong currency appreciation against the US dollar affecting the competitiveness of goods exported from Brazil, high government intervention in the economy, fairly unstable political climate, poor infrastructural facilities which increases the cost of doing trade,

restrictive trade policies, cumbersome and bureaucratic process of doing business.

While weighing these indicators against each other, it is understandable if the existence of the handful of risks in Brazil discourage MNEs and in mitigating these risks, they prefer to explore the opportunities on a low level resource commitment. This is not advisable as the opportunities far outweighs the risks and MNEs exploring the market on a low resource level will loose out to competitors. It is recommended that MNEs explore the market on a high resource commitment level as the existent risks can be mitigated by adopting the optimal entry mode that suits the business context of Brazil.

Moreso, these handful of risks existence can be said to shorterm in nature as seen in the recent improvements in the unfavorable indicators identified while the favorable indicators offers an array of longterm benefits to the MNEs.

However, in adopting the high level resource commitment mode of entry, this essay will recommmend entry into Brazil by MNEs via foreign direct investment (FDI) using specifically entry modes like joint ventures and direct acquisition of local firms. By entering into joint ventures (JV) with domestic firms in Brazil who already possess the experience and knowledge of the market, MNEs can keep thier options open as a way of mitigating their risks. They can acquire experience from partner firms in the joint venture and the success or failure of this patnership can help determine the next level of resource commitment to be undertaken. The success of the joint venture can

prompt the firm to acquire the partner in the joint venture by buying more equity stakes and gaining maximum control while the failure of the partnership will prompt the firm to sell its holdings to the partner and exit the country. In deciding whether to increase or reduce their level of resource commitments, MNEs can also review success or failure of their operations in the Brazil by the improvements or the deterioration of the previously identified unfavorable indicators. Also, by entering into a JV, MNEs can control their level of resource commitment as the JV agreements are usually for a given period of time and sharing of risks and returns are based on the ratio of shareholding of the partners involved. This entry mode also offers MNEs the opportunity to overcome the restrictive trade and investment policies in Brazil as entering into a JV with a domestic firm in Brazil offers that synergic benefits like the JV being treated as a local firm and enjoying same benefits as local firms.

The demerits of the JV mode of entry is the divergence of interests and objectives of the parties in the venture and the incomplete control and ownership of resources.

Also, MNEs can enter the Brazilian market by directly acquiring small domestic firms that are doing very well. This offers the advantage of quick entry into the market as problems associated with acquiring information about the local market and getting new customer base is overcome. This entry mode provides easy accessibility to local knowledge of the new market and acquisition of the domestic company's customer base, distribution networks and market share. High search costs, overvaluation of assets and

integration of acquired firm into the larger firm has been identified as the disadvantages of this entry mode.

In conclusion, by entering the market on a high resource commitment level, the MNEs can position themselves for global market opportunities as forecasted to happen in Brazil and Latin America in the future. Also, it offers to MNEs the advantage of maximum control over operations, technological know and resources and optimal exploration of opportunities that exists.