

Foreign direct investment

[Finance](#), [Investment](#)



Foreign Direct Investment Learning objectives - Be familiar with current trends regarding FDI in the world economy. - Understand the different theories of foreign direct investment. - Appreciate how political ideology shapes a government's attitudes towards FDI. - Understand the benefits and costs of FDI to home and host countries. - Be able to discuss the range of policy instruments that governments use to influence FDI. - Articulate the implications for management practice of the theory and government policies associated with FDI. The focus of this chapter is foreign direct investment (FDI). The growth of foreign direct investment in the last 25 years has been phenomenal. FDI can take the form of a foreign firm buying a firm in a different country, or deciding to invest in a different country by building operations there. With FDI, a firm has a significant ownership in a foreign operation and the potential to affect managerial decisions of the operation. The goal of our coverage of FDI is to understand the pattern of FDI that occurs between countries, and why firms undertake FDI and become multinational in their operations as well as why firms undertake FDI rather than simply exporting products or licensing their know-how. The opening case describes the international growth of Spain's Telefonica. Until the 1990s, Telefonica was a typical state-owned firm. Today, it has expanded into Latin America and Europe. The closing case explores Mittal Steel's expansion from a small, family-run operation in India, to being the world's largest steel company headquartered in Rotterdam.

OUTLINE OF CHAPTER 7:
FOREIGN DIRECT INVESTMENT
Opening Case: Spain's Telefonica
Introduction
Foreign Direct Investment in the World Economy
Trends in FDI
The Direction of FDI
The Source of FDI
The Form of FDI: Acquisitions versus Greenfield

Investments The Shift to Services Country Focus: Foreign Direct Investment in China Theories of Foreign Direct Investment Why Foreign Direct Investment? The Pattern of Foreign Direct Investment The Eclectic Paradigm Management Focus: Foreign Direct Investment by Cemex Political Ideology and Foreign Direct Investment The Radical View The Free Market View Pragmatic Nationalism Shifting Ideology Management Focus: DP World and the United States Benefits and Costs of FDI Host Country Benefits Host Country Costs Home Country Benefits Home Country Costs International Trade Theory and FDI Government Policy Instruments and FDI Home Country Policies Host Country Policies International Institutions and the Liberalization of FDI Implications for Managers The Theory of FDI Government Policy Chapter Summary Critical Thinking and Discussion Questions Closing Case: Cemex's Foreign Direct Investment CLASSROOM DISCUSSION POINT Ask students for examples of foreign firms that have invested in the U. S. Jot them down on the board. Then, discuss why these companies invested in the U. S. Try to follow the framework presented in the text, and refer back to the board during the presentation of the material. Next, explore what the investment means for the U. S. OPENING CASE: Spain's Telefonica The opening case explores the international growth of Telefonica, a Spanish telecommunications firm. For decades, Telefonica had operated as a typical state-owned enterprise, but privatization and deregulation changes that path in the 1990s. Telefonica began to aggressively pursue expansion opportunities in Latin America where it quickly became the number 1 or 2 player in nearly every country. Later, Telefonica turned its sights on Europe where its acquisitions helped transform the company into the second biggest

mobile phone operator in the world. Discussion of the case can revolve around the following questions: 1. Reflect on the various market entry strategies used by Telefonica. What type of entry strategy did Telefonica use in its expansion into Latin America? Why did Telefonica choose this approach over other forms of market entry? 2. Why was Latin America such an attractive market for Telefonica? How important were the historical ties between the region and Spain to Telefonica's decision to invest? 3. Where do you think the best opportunities for future growth lie for Telefonica? Why?

Another Perspective: Telefonica's web site is available at {<http://www.telefonica.com/en/home/jsp/home.jsp>}. Another Perspective: Telefonica has expanded its alliance with China's Unicom. To learn more, go to {http://www.businessweek.com/globalbiz/content/jul2008/gb2008079_485740.htm}.

LECTURE OUTLINE This lecture outline follows the Power Point Presentation (PPT) provided along with this instructor's manual. The PPT slides include additional notes that can be viewed by clicking on "view", then on "notes".

The following provides a brief overview of each Power Point slide along with teaching tips, and additional perspectives. Slide 7-3 What Is Foreign Direct

Investment? Foreign direct investment (FDI) occurs when a firm invests directly in new facilities to produce and/or market in a foreign country. Once a firm undertakes FDI it becomes a multinational enterprise. Another

Perspective: Each year Fortune magazine publishes a list of the 500 largest global corporations in the world. Fortune calls its list the "Global 500." This list can be accessed at {<http://money.cnn.com/magazines/fortune/global500/2009/index.html>}.

The article contains an excellent discussion of the role of global firms in the world economy. FDI can

<https://assignbuster.com/foreign-direct-investment/>

take the form of a greenfield investment where a wholly new operation is established in a foreign country, or it can take place via acquisitions or mergers with existing firms in the foreign country. Another Perspective: Another web site that provides an excellent discussion of the role of multinational corporations in the world economy is available at {http://www.oecdobserver.org/news/fullstory.php/aid/446/The_trust_business.html}. The flow of FDI refers to the amount of FDI undertaken over a given time period, while the stock of FDI refers to the total accumulated value of foreign-owned assets at a given time. Outflows of FDI are the flows of FDI out of a country, and inflows of FDI are the flows of FDI into a country. Slides 7-6-7-9 Trends in FDI There has been a marked increase in both the flow and stock of FDI in the world economy over the last 30 years. While the United States remains a top destination for FDI flows, South, East, and Southeast Asia, and particularly China, are now seeing an increase of FDI inflows, and Latin America is also emerging as an important region for FDI. Another Perspective: FDI in China continues to be strong, and India is emerging as another hotspot for FDI. To learn more about these markets go to {http://www.businessweek.com/globalbiz/content/mar2009/gb20090318_214447.htm}. Slides 7-11-7-12 The Source of FDI Since World War II, the U. S. has been the largest source country for FDI. The United Kingdom, the Netherlands, France, Germany, and Japan are other important source countries. Another Perspective: Since the recent global recession, Great Britain has seen its economic position in the Europe Union and within the global economy shift. To learn more about the country's changing fortunes, go to {<http://www.https://assignbuster.com/foreign-direct-investment/>}

businessweek.com/globalbiz/content/feb2009/gb20090224_856591.htm}.

Slide 7-13 The Form of FDI: Acquisitions Versus Greenfield Investments Most cross-border investment is in the form of mergers and acquisitions rather than greenfield investments. Slide 7-14 The Shift to Services FDI is shifting away from extractive industries and manufacturing, and towards services.

Slides 7-15 Why Foreign Direct Investment? Why do firms choose FDI instead of exporting or licensing? Internalization theory (also known as market imperfections theory) suggests that licensing has three major drawbacks.

Slides 7-16 The Pattern of Foreign Direct Investment Knickerbocker looked at the relationship between FDI and rivalry in oligopolistic industries (industries composed of a limited number of large firms) and suggested that FDI flows are a reflection of strategic rivalry between firms in the global marketplace.

Vernon argued that firms undertake FDI at particular stages in the life cycle of a product they have pioneered. According to the eclectic paradigm, in addition to the various factors discussed earlier, it is important to consider: - location-specific advantages - that arise from using resource endowments or assets that are tied to a particular location and that a firm finds valuable to combine with its own unique assets and - externalities - knowledge spillovers that occur when companies in the same industry locate in the same area

Slide 7-18 Political Ideology and Foreign Direct Investment Ideology toward FDI ranges from a radical stance that is hostile to all FDI to the non-interventionist principle of free market economies. Between these two extremes is an approach that might be called pragmatic nationalism. The radical view argues that the MNE is an instrument of imperialist domination and a tool for exploiting host countries to the exclusive benefit of their

capitalist-imperialist home countries. According to the free market view, international production should be distributed among countries according to the theory of comparative advantage. Pragmatic nationalism suggests that FDI has both benefits, such as inflows of capital, technology, skills and jobs, and costs, such as repatriation of profits to the home country and a negative balance of payments effect. Recently, there has been a strong shift toward the free market stance creating: - a surge in FDI worldwide - an increase in the volume of FDI in countries with newly liberalized regimes Slide 7-19

Benefits of FDI Government policy is often shaped by a consideration of the costs and benefits of FDI. There are four main benefits of inward FDI for host countries: resource transfer effects; employment effects; balance of payments effects, and effects on competition and growth. Slides 7-21

Host Country Costs There are three main costs from inward FDI for the host country: the possible adverse effects of FDI on competition within the host nation; adverse effects on the balance of payments; and the perceived loss of national sovereignty and autonomy. Slide 7-22

Home Country Benefits The benefits of FDI for the home country include: the effect on the capital account of the home country's balance of payments from the inward flow of foreign earnings; the employment effects that arise from outward FDI; and the gains from learning valuable skills from foreign markets that can subsequently be transferred back to the home country. Slide 7-23

Home Country Costs The home country's balance of payments can suffer from the initial capital outflow required to finance the FDI; if the purpose of the FDI is to serve the home market from a low cost labor location; and if the FDI is a substitute for direct exports. International trade theory suggests that home

country concerns about the negative economic effects of offshore production (FDI undertaken to serve the home market) may not be valid. Slide 7-24 Government Policy Instruments and FDI Home countries and host countries use various policies to regulate FDI. Another Perspective: The World Bank offers information on the business environment in different countries. To explore the information, go to <http://www.worldbank.org/>, click on “countries”, and select the country in question. Governments can both encourage and restrict FDI Another Perspective: India has recently revised its regulations regarding FDI raising concerns among some analysts. To learn more about India’s new regulations go to http://www.businessweek.com/globalbiz/content/feb2009/gb20090213_539478.htm. To encourage inward FDI, governments offer incentives to foreign firms to invest in their countries, while they restrict inward FDI through ownership restraints and performance requirements. Slide 7-26 International Institutions and the Liberalization of FDI The World Trade Organization is trying to establish a universal set of rules designed to promote the liberalization of FDI. Slide 7-27-7-28 Implications for Managers Managers need to consider what trade theory implies, and the link between government policy and FDI. The direction of FDI can be explained through the location-specific advantages argument associated with John Dunning. A host government’s attitude toward FDI is an important variable in decisions about where to locate foreign production facilities and where to make a foreign direct investment.

CRITICAL THINKING AND DISCUSSION QUESTIONS QUESTION 1: In 2004, inward FDI accounted for some 24% of the gross fixed capital formation in Ireland, but only . 6% in Japan. What do you think explains the difference in

FDI inflows into the two countries? ANSWER 1: One approach to this question is to look at government policy: Ireland is FDI-friendly while Japan has discouraged inward FDI. Both are trade-dependent economies with few natural resources, but Ireland appears far less mercantilist in attitude than does Japan. Ireland has a well-educated, relatively low cost workforce and an abundant supply of labor, while Japan's workforce, also well-educated, is expensive.

QUESTION 2: Compare and contrast these explanations of FDI: internalization theory, Vernon's product life cycle theory, and

Knickerbocker's theory of FDI. Which theory do you think offers the best explanation of the historical pattern of FDI? Why? ANSWER 2:

Knickerbocker's theory suggests that firms imitate other firms in oligopolistic industries, and will "follow the leader" in undertaking FDI in certain countries, as sort of strategic defensive moves. This theory does not explain why the first firm undertakes FDI, nor why it chooses to do this rather than to export or license. The product life cycle theory suggests that firms invest in foreign countries when demand in that country will support local production or when cost pressures make it necessary to locate production in low cost locations. While this theory does explain why some FDI takes place, it does not explain why FDI is preferred over licensing or exporting. The market imperfections explanation more directly confronts these issues, and explains why FDI may be preferable to other alternatives for expanding business activities. It identifies the importance and difficulty of transferring know-how and describes some of the impediments to exporting. By explaining better exactly why a firm may undertake FDI, the market imperfections model is probably the best explanation of the historical pattern of horizontal FDI.

QUESTION 3: Read the Management Focus on Cemex and then answer the following questions: a) Which theoretical explanation, or explanations, of FDI best explains Cemex's FDI? b) What is the value that Cemex brings to the host economy? Can you see any potential drawbacks of inward investment by Cemex in an economy? c) Cemex has a strong preference for acquisitions over greenfield ventures as an entry mode. Why? d) Why do you think Cemex decided to exit Indonesia after failing to gain majority control of Semen Gresik? Why is majority control so important to Cemex? e) Why do you think politicians in Indonesia tried to block Cemex's attempt to gain majority control over Semen Gresik? Do you think Indonesia's best interests were served by limiting Cemex's FDI in the country? ANSWER 3: a) Cemex is

a cement company. Consequently, exporting is difficult because of the weight of the product. If Cemex wants to expand into new markets, the company would either need to license a local company or make an investment in the market directly. Cemex's success is due in part to its top notch customer service, and relationship with distributors. Because these advantages could be difficult to transfer, the company will probably choose to invest directly. Students should reflect on these factors as they consider the various theories to explain Cemex's FDI. b) Cemex is the third largest cement company in the world, and a powerhouse in Mexico where it controls 60 percent of the market. Cemex is highly focused on efficient manufacturing and customer service. Distributors are rewarded for their sales, as are users. The primary benefit Cemex brings to host countries involves these competitive advantages. Cemex acquires companies and then transfers technological, management, and marketing know-how to the new

units, improving their performance. The company has brought several acquired companies back to full production, increasing employment opportunities in the host country as well. c) Cemex has successfully acquired established cement makers in many countries. By acquiring companies rather than establishing them from the ground up, Cemex can avoid some of the delays that could occur in the start-up phase, while at the same time, capitalize on the benefits of an established market presence. d) Much of Cemex's success appears to be built around its customer service and attention to distributors. Indeed, it could be argued that what sets Cemex apart from its competitors, or its competitive advantage, is its superior way of dealing with external stakeholders. It is significantly easier to duplicate this sort of advantage in a wholly owned operation than in a joint venture or through licensing arrangements. e) In 2006, Cemex announced that it would be pulling out of Indonesia. Cemex entered the Indonesian market in 1998, as part of an IMF sponsored privatization program. Cemex purchased a 25 percent stake in Semen Gresik, a government owned cement maker. Cemex's decision to pull out was a result of a dispute with the Indonesian government. When Cemex has entered the market, it had been promised a majority position in Semen Gresik in 2001. However thanks to the efforts of various special interest groups, permission was never granted. Whether the decision to pull out was in the best interests of the country is difficult to say. Certainly it would seem that Semen Gresik could learn from Cemex, and utilize its knowledge to improve its own operations. However, allowing a foreign company to control an industry that is necessary to a country could be detrimental to the nation. Another Perspective: Cemex's web site is

available at {<http://www.cemex.com>}. QUESTION 4: You are the international manager of a US business that has just invented a revolutionary new personal computer that can perform the same functions as existing PCs but costs only half as much to manufacture. Several patents protect the unique design of this computer. Your CEO has asked you to formulate a recommendation for how to expand into Western Europe. Your options are (a) to export from the US, (b) to license a European firm to manufacture and market the computer in Europe, and (c) to set up a wholly owned subsidiary in Europe. Evaluate the pros and cons of each alternative and suggest a course of action to your CEO. ANSWER 4: In considering expansion into Western Europe, an international manager might consider three options: FDI, licensing, and export. With export, assuming there are no trade barriers, the key considerations would likely be transport costs and localization. While transport costs may be quite low for a relatively light and high value product like a computer, localization can present some difficulties. Power requirements, keyboards, and preferences in models all vary from country to country. It may be difficult to fully address these localization issues from the US, but not impossible. Since there are many computer manufacturers and distributors in Europe, there are likely to be a number of potential licensees. But a licensing arrangement implies that valuable technological information may have to be disclosed and that the firm's competitive advantage may be lost if the licensees uses or disseminates this proprietary knowledge improperly. FDI (setting up a wholly owned subsidiary) is clearly the most costly and time consuming approach, but the one that best guarantees that critical knowledge will not be disseminated

and that localization can be done effectively. FDI will also place you in the market into which you want to sell and allow you to be near the consumer. Given the fast pace of change in the personal computer industry, it is difficult to say how long this revolutionary new computer will retain its competitive advantage. If the firm can protect its advantage for a period of time, FDI may pay off and help assure that critical knowledge is not lost. If the innovation is not core and can be easily copied, then licensing would allow the firm to get the quickest large scale entry into Europe and make as much as it can before losing advantage.

CLOSING CASE: Lakshmi Mittal and the Growth of Mittal Steel

Summary The closing case examines the growth of Mittal Steel from a small, family owned company based in India to the world's largest steel company headquartered in Luxembourg. Mittal Steel's growth strategy involved acquiring companies in distress at low prices, improving their efficiency, and capitalizing on a growing demand for steel. Mittal Steel also used its growing power in the industry to drive down the prices of raw materials. Mittal Steel's most recent acquisition involved European steel maker Areclor, which was acquired in a hostile takeover in 2007 to create ArcelorMittal. Today, the firm boasts sales of \$110 billion and a net income of \$10.2 billion. Discussion of the case can revolve around the following questions:

QUESTION 1: What forces drove Mittal Steel to start expanding across national borders?

ANSWER 1: Mittal Steel began as a family-run operation in India based in the early 1970s. However, because of various restrictive government regulations and strong competition from a state-owned firm, SAIL, and the large, privately-owned Tata Steel, Mittal Steel felt its best prospects for growth lay outside India. In 1975, Mittal Steel began its

first foreign venture by building a steel making plant from scratch in Indonesia. QUESTION 2: Mittal Steel expanded into different nations through mergers and acquisitions, as opposed to greenfield investment investments. Why? ANSWER 2: The vast majority of Mittal Steel's expansion has taken place via acquisitions and mergers. At the time Mittal Steel was beginning its foreign expansion, the steel industry was in the throes of a twenty-five year slump, and many companies were in distress. Lakshmi Mittal, CEO, believed there was value in these distressed companies, and that with an injection of capital and a shift toward greater efficiency, the firms could be viable operations. Most students will probably suggest that the cost of building similar operations from scratch (greenfield investments) would probably be considerably higher. Moreover, by acquiring companies rather than establishing them from the ground up, Mittal Steel could avoid some of the delays that could occur in the start-up phase, while at the same time, capitalize on the benefits of an established market presence. QUESTION 3: What benefits does Mittal Steel bring to the countries that it enters? Are there any drawbacks to a nation when Mittal Steel invests there? ANSWER 3: Most students will probably agree that because Mittal Steel has focused on acquiring distressed companies and turning them around, its presence in a foreign market would probably be viewed as beneficial. Some students however, may note that Mittal Steel's most recent acquisition, Arcelor did generate a strong negative reaction from management and politicians who resisted the efforts of a foreign firm to take over an organization that was important to the European market. Indeed, some students may suggest that Europe and other countries are now vulnerable to the whims of a foreign

company — a company that may or may not make decisions that benefit the local market. QUESTION 4: What are the benefits to Mittal Steel from entering different nations? ANSWER 4: By being a player in multiple markets, Mittal Steel has diversified its income streams, and reduced its dependence on any single market. In addition, its global presence enables it to control to some extent the price of raw materials in the industry. Many students will probably also recognize that the prospects for growth in the steel industry almost imply growing across borders, simply because of limited demand within any single market. QUESTION 5: The acquisition of Arcelor was very acrimonious, with many politicians objecting to it. Why do you think they objected? Were their objections reasonable? ANSWER 5: In 2006, the shareholders of Arcelor, a European firm formed through the merger of steel makers from three European countries, approved the acquisition of Arcelor by Mittal Steel. Many politicians, who saw the acquisition as a threat to their countries, objected vehemently to the merger. Most students will probably suggest that their opposition to the deal probably related to concerns that Mittal Steel had no particular loyalty to Europe and would simply make decisions that improved the value of the firm, regardless of their effects on the local market. Many students will probably suggest the concerns of the politicians were valid, but may also point out that because Mittal Steel has moved its headquarters to Rotterdam, it too was a European company. In addition, students may point out that Arcelor's shareholders believed the acquisition should go ahead. Another Perspective: ArcelorMittal's web site is available at {<http://www.arcelormittal.com/>}. INTEGRATING iGLOBES There are several iGLOBE video clips that can be integrated with the material

presented in this chapter. In particular, you might consider the following:

Title: After Chrysler Deal, Fiat to Face Tough U. S. Car Market Run Time: 8:

04 Abstract: This video explores the challenges facing Chrysler as it emerges from bankruptcy with new owners, a new leader, and a new agenda. Key

Concepts: global strategy, foreign direct investment, globalization, pressures for cost reductions, global economy, global production and sourcing, foreign

direct investment Notes: Italian car maker Fiat's recent acquisition of a large share of Chrysler is the start of a new chapter for the troubled U. S. auto

company. For Chrysler, the deal was an important component in its

restructuring. The company had been in bankruptcy, weighed down with

billions of dollars of debt and labor costs. The new, leaner Chrysler Group

which will be owned jointly by Fiat, the U. S. government, the Canadian

government, and the United Auto Workers union, will be led by the head of

Fiat, Sergio Marchionne. Under the new ownership structure, the

governments will own 10 percent of the company, Fiat will own 35 percent,

and the union will control the remaining 55 percent of the organization.

Marchionne, who is highly regarded in Italy and indeed Europe, joined Fiat

five years ago and not only helped turn the company away from financial

disaster, but helped make it into one of the stronger auto companies today.

Many analysts believe that Marchionne's experience at Fiat will serve him

well as he takes on the challenges facing Chrysler. At Fiat, Marchionne

focused on keeping costs in check, working closely with unions, and

developing a product line designed to attract customers. Fiat is important to

Chrysler's future for several reasons. One key reason is Marchionne's

experience in turning around a troubled company. Fiat also brings knowledge

of small-car platform technology and the engine technology that will allow Chrysler to meet strict new environmental regulations. Perhaps most important to Chrysler however, are Fiat's design skills. Like the Fiat of a few years ago, Chrysler has been struggling with high costs and union demands, as well as tough new CAFÉ regulations. In addition though, Chrysler has been losing customers because of its dull product line. In fact, Francesco Guerrera of the Financial Times, feels that Chrysler's inability to design exciting cars is at the root of its problems. John Wolkonowitz of HIS Global Insight agrees, and suggests that Fiat could be the key to Chrysler regaining its position as a design leader — a position it once held in the 1990s. For now, most analysts believe that Chrysler will continue to focus on improving efficiency by eliminating unnecessary layers of management and closing dealerships. Already, the firm has closed 800 dealerships. Factories that had been closed as part of the bankruptcy process are expected to reopen in the near future. In fact, there is some urgency to the process at this point because of concerns that if the company does not become operational soon, both customers and employees will begin to move away. One of the key challenges for Chrysler in the weeks ahead will be managing the various, and perhaps conflicting, interests of its many stakeholders. Because the stakeholders are expected to be quite vocal with their demands, compromise may become the name of the game.

Discussion Questions: 1. Fiat has emerged as a sort of knight in shining armor for Chrysler. The Italian automaker has acquired 35 percent of the troubled U. S. company and will now call the shots as the auto maker reemerges from bankruptcy. In addition to a much needed influx of funds, what does Fiat bring to Chrysler? How can

Fiat help Chrysler become a global player once again? 2. Comment on the new ownership structure at the Chrysler Group. How might the fact that the group is now owned by various parties from various countries influence decision making at the firm? Why have analysts suggested that it is critical for Chrysler to get back to regular operating levels quickly? 3. Fiat's acquisition of one third of Chrysler means that the American company will now be led by an Italian CEO. What challenges do you see for the restructured Chrysler Group as it tries to mesh operating styles and organizational cultures? 4. The SWOT analysis is a management tool used by many organizations to identify firm strengths and weakness, as well as opportunities the firm could capitalize on, and threats it should be aware of. Reflect on the newly restructured Chrysler Group. Based on what you know about the new Chrysler as well as the auto industry in general develop a SWOT analysis for the firm. INTEGRATING VIDEOS There are also several longer video clips that can be integrated with the material presented in this chapter. In particular, you might consider the following from International Business DVD Volume 5: Title 7: Wal-Mart's Success in China Abstract: This video explores Wal-Mart's success in China as both a buyer and as a seller. Key Concepts: foreign direct investment, trade, global economy, globalization, levels of economic development, global strategy Notes: Most Americans are probably aware that many of the products they buy are made in China. However, many Americans might be surprised to know that the U. S. retail giant Wal-Mart is actually China's eighth largest trading partner. In fact, about 70 percent of the products sold in a Wal-Mart store are manufactured in China. In 2004, Wal-Mart's purchases from China were

estimated to be about \$18 billion. Wal-Mart's relationship with China is not a one-way street though. Wal-Mart has successfully opened several stores in China that attract crowds of shoppers. One man even bought his house so that he could be close to the store. Chinese exports to the United States are attractive to Americans because of their low prices. Experts also note that the low prices also help hold down inflation rates in the United States. The Chinese are able to sell their products cheaply because of the low wage rates in China. In 2002 for example, the average Chinese factory worker made just \$0.64 per hour as compared to the \$21 per hour earned by an American factory worker. While some Americans raise concerns about the possibility of more manufacturing jobs being shifted to China, experts agree that those jobs have already left the United States, and will not return. If the Chinese do not manufacture the goods, another low-cost Asian country will. China's exports to the United States are also important to Americans because they give the Chinese the income to buy American-made goods like airplanes and cars. Roads in China are now clogged with American-made cars, and shopping districts advertise American products like McDonald's, KFC, Pepsi, and Coca-Cola. The Chinese are likely to continue to buy more and more products labeled "Made in America" thanks to new legislation that further opens the Chinese market to American companies. U. S. companies like Wal-Mart now have permission to build as many stores as they want, wherever they want. America's love affair with Wal-Mart and the inexpensive Chinese-made goods it sells is strong, and now it seems the legendary retailer has captured the hearts of the Chinese as well. Discussion Questions: 1. What type of investment does Wal-Mart have in China? Why do you think Wal-Mart

followed this strategy? What are the benefits to China of Wal-Mart's investment? 2. Approximately 70 percent of everything Wal-Mart sells is made in China. Why does Wal-Mart buy so much from China? 3. Explain the three approaches to foreign direct investment. Which approach best reflects China's attitude toward foreign investment? What does your answer imply for companies seeking to expand into China? 4. What actions can China take to ensure that it continues to attract inward foreign direct investment? What challenges do you see for China as it courts new investment? 5. China has attracted significant investment from foreign companies including Wal-Mart in recent years. How has its trade and investment affected economic and social development in China? INCORPORATING globalEDGE™ EXERCISES Use the globalEDGE™ site {<http://globalEDGE.msu.edu/>} to complete the following exercises: Exercise 1 The World Investment Report published annually by UNCTAD provides quick electronic access to comprehensive statistics on the operations of the largest transnational corporations. Gather a list of the top 10 non-financial transnational corporations from south-east Europe and the Commonwealth of Independent States (CIS). Provide a summary of the countries and industries represented. Do you notice any common traits from your analysis? Exercise 2 Your venture capital firm is considering a partnership with entrepreneurs in Asian-Pacific countries which make it easy to do business. The owner of your company suggests that you prepare a report based on information from the Country Brand Index. How many countries have you identified? After using the same resource to evaluate Asian-Pacific countries that are ideal for doing business, which countries will you suggest for developing partnerships and investing venture

capital? Answers to Exercises Exercise 1 The data source can be accessed by searching the term “ World Investment Report” at <http://globaledge.msu.edu/ResourceDesk/>. The link to the World Investment Report is found under the globalEDGE category “ Research: Statistical Data Sources”. On this website, the list of members top transnational corporations can be found under the “ Largest TNCs” link, located on the left or at the top of the page. Be sure to click on the Resource Desk link to search this area of the globalEDGE website. Search Phrase: “ World Investment Report” Resource Name: UNCTAD: Largest Transnational Corporations Website: <http://www.unctad.org/Templates/Page.asp?intItemID=2443> globalEDGE™ Category: “ News & Periodicals: Publications”

Exercise 2 The Country Brand Index website provides both business- and tourist-related information concerning the countries of the world. This resource can be accessed by searching “ Country Brand Index” at <http://globaledge.msu.edu/ResourceDesk/>. The link to is found under the globalEDGE category “ Reference: Travel/Living Abroad”. On this website, both categories described in the exercise can be found, located at the bottom of the page. Be sure to click on the Resource Desk link to search this area of the globalEDGE website. Search Phrase: “ Country Brand Index” Resource Name: Country Brand Index Website: <http://www.countrybrandindex.com/> globalEDGE™ Category: “ Reference: Travel/Living Abroad”

Entry Strategy and Strategic Alliances Learning objectives - Explain the three basic differences that firms contemplating foreign expansion must make: which markets to enter, when to enter those markets, and on what scale. - Outline the advantages and disadvantages of the different modes that firms use to enter foreign

markets. - Identify the factors that influence a firm's choice of entry strategy. - Evaluate the pros and cons of acquisitions versus greenfield ventures as an entry strategy. - Evaluate the pros and cons of entering into strategic alliances. This chapter is concerned with three closely related topics: the decisions of which markets to enter, when to enter those markets, and on what scale. When a firm that wishes to enter a foreign market, it has several options, including exporting, licensing or franchising to host country firms, setting up a joint venture with a host country firm, or setting up a wholly owned subsidiary in the host country to serve that market. Each of these options has its advantages and each has its disadvantages. Strategic alliances have become more frequent. They may be seen as one way for firms to enter into cooperative agreements between actual or potential competitors. The term "strategic alliances" is often used rather loosely to include a wide range of arrangements between firms, including cross-share holding deals, licensing arrangements, formal joint ventures, and informal cooperative deals. The magnitude of the advantages and disadvantages associated with each entry mode are determined by a number of different factors, including transport costs and trade barriers, political and economic risks, and firm strategy. The opening case discusses General Electric's changing perspective on the value of joint ventures as a market entry mode. In the past, General Electric has avoided joint ventures and the shared control they imply when entering foreign markets, but more recently, the company has embraced the entry mode as a means of acquiring knowledge of the local market. The closing case explores JCB's market entry strategy in India. **OUTLINE OF CHAPTER 14: ENTRY STRATEGY AND STRATEGIC**

ALLIANCES Opening Case: General Electric's Joint Ventures Introduction Basic Entry Decisions Which Foreign Markets? Timing of Entry Scale of Entry and Strategic Commitments Summary Management Focus: Tesco's International Growth Strategy Management Focus: The Jollibee Phenomenon–A Philippine Multinational Entry Modes Exporting Turnkey Projects Licensing Franchising Joint Ventures Wholly Owned Subsidiaries Selecting an Entry Mode Core Competencies and Entry Mode Pressures for Cost Reductions and Entry Mode Greenfield Venture or Acquisition? Pros and Cons of Acquisitions Pros and Cons of Greenfield Ventures Greenfield or Acquisition? Strategic Alliances The Advantages of Strategic Alliances The Disadvantages of Strategic Alliances Making Alliances Work Management Focus: Cisco and Fujitsu Chapter Summary Critical Thinking and Discussion Questions Closing Case: JCB in India CLASSROOM DISCUSSION POINT Ask students to find several examples of companies expanding into new markets. Students can use publications like the Wall Street Journal or Business Week as sources. Then ask students to consider why the companies involved chose the form of market entry involved. Try to get students to think about the trade-offs involved with the various forms of market entry. Jot their responses on the board using the framework presented in the text. Finally, refer back to the discussion during the presentation of the material so students recognize the trade-offs companies make. OPENING CASE: General Electric's Joint Ventures The opening case explores General Electric's change in strategy. For years, General Electric entered new markets using wholly owned operations that it built from the ground up. Today however, the company has moved to a joint venture approach. Discussion of the case can revolve around the following

questions: 1. General Electric has traditionally followed a strategy of expanding into new markets using wholly owned greenfield ventures. More recently however, the company has shifted to a strategy of forming joint ventures with local companies. Explain why General Electric has made this strategic shift. 2. What are the disadvantages of General Electric's new strategy of using joint ventures to enter foreign markets? Another

Perspective: To explore General Electric's international operations in more depth, go to {<http://www.ge.com/>}. Another Perspective: To extend this case, consider {http://www.businessweek.com/innovate/content/may2008/id20080515_212057.htm?chan=search}.

LECTURE OUTLINE FOR CHAPTER This lecture outline follows the Power Point Presentation (PPT) provided along with this instructor's manual. The PPT slides include additional notes that can be viewed by clicking on "view", then on "notes". The following provides a brief overview of each Power Point slide along with teaching tips, and additional perspectives. Slides 14-3 Basic Entry Decisions Firms expanding internationally must decide which markets to enter, when to enter them and on what scale, and which entry mode to use. Entry modes include exporting, licensing or franchising to a company in the host nation, establishing a joint venture with a local company, establishing a new wholly owned subsidiary, or acquiring an established enterprise. Slide -14-4 What Influences Entry Mode Choice Several factors affect the choice of entry mode including transport costs, trade barriers, political and economic risks, costs, and firm strategy. Slide 14-5 Which Foreign Markets? The choice of foreign markets will depend on their long run profit potential. Slides 14-6- 14-8 Timing of Entry Once attractive markets

are identified, the firm must consider the timing of entry. Entry is early when the firm enters a foreign market before other foreign firms, and late when the firm enters the market after firms have already established themselves in the market. First mover advantages are the advantages associated with entering a market early. First mover disadvantages are disadvantages associated with entering a foreign market before other international businesses. Slide 14-10 Scale of Entry and Strategic Commitments After choosing which market to enter and the timing of entry, firms need to decide on the scale of market entry. Large-scale entry may keep rivals out and may stimulate indigenous competitive response. Small-scale entry allows time to learn about the market and reduces risk exposure. Slide 14-11 Which is Best? There are no “right” decisions when deciding which markets to enter, and the timing and scale of entry, just decisions that are associated with different levels of risk and reward. Slide 14-12-14-13 Entry Modes The six entry modes are exporting, turnkey projects, licensing, franchising, joint ventures, and wholly owned subsidiaries. Slides 14-14 Exporting Exporting avoid costs of investing in new location and may help achieve experience curve and location economies. Exporting faces challenges from tariff barriers, transportation costs, control over marketing, and local low-cost manufacturers. Another Perspective: The Business Link {<http://www.canadabusiness.ca/eng/>} provides information companies should know before they begin exporting. Students can click on the various topics to learn more about export financing, export plans, dealing with risk, and so on. Slides 14-15 Turnkey Projects Turnkey projects allow a company to get a return on knowledge assets and are less risky than conventional FDI. The

disadvantages are that there is not long-term interest in the location, the project may create a competitor, and process technology may be selling a competitive advantage. Another Perspective: To learn more about how one company, Ashoka Technologies, organizes turnkey projects for clients go to {<http://www.turnkey-projects.com/turnkey-plants.html>}. Slides 14-16

Licensing Licensing does not bear the costs and risks of investment and avoids political/economic restrictions in a country. Slides 14-17 Franchising Franchising reduces costs and risks, avoids political and economic restrictions, and allows for quicker expansion. Disadvantages include loss of control over quality. Slides 14-18 Joint Ventures Joint ventures benefit from the local partner's knowledge, shared costs, and reduced risk. Disadvantages include loss of control over technology and conflict between partners. Another Perspective: 1000ventures, available at {http://www.1000ventures.com/business_guide/jv_main.html} is a web site that offers a wealth of information about joint ventures. Slides 14-19 Wholly Owned Subsidiaries Wholly owned subsidiaries offer the most control and the highest level of risk and cost. Slides 14-22 Selecting an Entry Mode The optimal choice of entry mode involves trade-offs. Slide 14-23 Core Competencies and Entry Mode The optimal choice of entry mode for firms pursuing a multinational strategy depends to some degree on the nature of their core competencies. Slide 14-24 Pressures for Cost Reductions and Entry Mode When pressure for cost reductions is high, firms are more likely to pursue some combination of exporting and wholly owned subsidiaries. Slide 14-26 Greenfield Ventures or Acquisitions Firms can establish a wholly owned subsidiary in a country through a greenfield strategy (building a subsidiary from the ground up) or

through an acquisition strategy. Slides 14-27 Pros and Cons of Acquisitions
Pros: quick, preemptive, possibly less risky. Cons: disappointing results, overpay, optimism/hubris, culture clash, failure of synergies Slide 14-28 Pros and Cons of Greenfield Ventures Greenfield ventures allow the firm to build the subsidiary it wants, but it is slow, risky, and may involve preemption by competitors. Acquisition is quicker, so a consideration if there are competitors ready to enter. Slide 14-30 Strategic Alliances Strategic alliances refer to cooperative agreements between potential or actual competitors. Slide 14-31 The Advantages of Strategic Alliances Strategic alliances facilitate entry into a foreign market, allow firms to share the fixed costs (and associated risks) of developing new products or processes, bring together complementary skills and assets that neither partner could easily develop on its own, can help a firm establish technological standards for the industry that will benefit the firm. Strategic alliances can give competitors low-cost routes to new technology and markets, but unless a firm is careful, it can give away more than it receives. The firm must be certain that the partner is one that can help the firm achieve its goals and not act opportunistically to exploit the alliance purely for its own ends. Slides 14-32 Making Alliances Work The success of an alliance is a function of partner selection, alliance structure, and manner in which the alliance is managed. Another Perspective: The Association of Strategic Alliance Professionals {<http://www.strategic-alliances.org/>} is an organization devoted to the formation of successful strategic alliances. The organization is supported by a number of well-known global companies, and provides information on the involvement of the companies in strategic alliances. CRITICAL THINKING AND

DISCUSSION QUESTIONS QUESTION 1: Reread the Management Focus on Tesco. Then answer the following questions: a) Why did Tesco's initial international expansion strategy focus on developing nations? b) How does Tesco create value in its international operations? c) In Asia, Tesco has a long history of entering into joint venture agreements with local partners. What are the benefits of doing this for Tesco? What are the risks? How are those risks mitigated? d) In March 2006, Tesco announced that it would enter the United States. This represents a departure from its historic strategy of focusing on developing nations. Why do you think Tesco made this decision? How is the U. S. market different from others Tesco has entered? What are the risks here? How do you think Tesco will do? ANSWER 1: a) Tesco's global expansion strategy has been rather unique in the grocery industry. Rather than competing head-to-head with established retailers in developed markets like the United States and Western Europe, Tesco chose to pursue markets with strong growth potential, but little current competition. The strategy allows the company to use its expertise to grow international market share, without incurring the costs of establishing itself in already crowded markets. b) The keys to Tesco's success in its international operations is its ability to spot markets with strong underlying growth trends, identify existing companies in those locations that have a deep understanding of the local market, form a joint venture with those companies and transfer its expertise in the industry to the venture, and later buy the partner out. The strategy is highly successful, supplementing the company's UK earnings with an additional £7.6 billion in revenues in 2007. Tesco is now the number four company in the global grocery industry. c)

Tesco's strategy of entering foreign markets via joint ventures has proven to be highly successful. The company is able to bring its expertise in retailing as well as its financial strength to the venture where it is paired with the partner's knowledge of the local market. Local managers are hired to run the operations, with only support coming from expatriate managers. This format allows Tesco to use its core strengths to get into the market, and then later, after the ventures have become established, buy out its partner. d) Most students will probably agree that while Tesco's entry into the crowded market in the United States represents a departure from its traditional strategy of focusing on developing nations with little existing competition, the strategy still reflects the company's traditional strategy in that the format the company has chosen to use, Tesco Express, still avoids the head-to-head competition that the company has steered clear of in developing markets. In that sense, the strategy could prove to be highly successful. The company can enter the market using its Tesco Express format, avoid major competition while it gains brand recognition and experience in the market, and then later, expand into the traditional grocery business. Another Perspective: Students can go to Tesco's corporate home page {<http://www.tescocorporate.com/>} for up-to-date information about the company's global expansion plans. Another Perspective: To extend this feature, consider {http://www.businessweek.com/globalbiz/content/apr2009/gb20090421_205044.htm}. QUESTION 2: Licensing propriety technology to foreign competitors is the best way to give up a firm's competitive advantage. Discuss. ANSWER 2: The statement is basically correct - licensing proprietary technology to foreign competitors

does significantly increase the risk of losing the technology. Therefore licensing should generally be avoided in these situations. Yet licensing still may be a good choice in some instances. When a licensing arrangement can be structured in such a way as to reduce the risks of a firm's technological know-how being expropriated by licensees, then licensing may be appropriate. A further example is when a firm perceives its technological advantage as being only transitory, and it considers rapid imitation of its core technology by competitors to be likely. In such a case, the firm might want to license its technology as rapidly as possible to foreign firms in order to gain global acceptance for its technology before imitation occurs. Such a strategy has some advantages. By licensing its technology to competitors, the firm may deter them from developing their own, possibly superior, technology. And by licensing its technology the firm may be able to establish its technology as the dominant design in the industry. In turn, this may ensure a steady stream of royalty payments. Such situations apart, however, the attractions of licensing are probably outweighed by the risks of losing control over technology, and licensing should be avoided

QUESTION 3:
Discuss how the need for control over foreign operations varies with firms' strategies and core competencies. What are the implications of the choice of entry mode? ANSWER 3: If a firm's competitive advantage (its core competence) is based on control over proprietary technological know-how, licensing and joint venture arrangements should be avoided if possible so that the risk of losing control over that technology is minimized. For firms with a competitive advantage based on management know-how, the risk of losing control over the management skills to franchisees or joint venture

partners is not that great. Consequently, many service firms favor a combination of franchising and subsidiaries to control the franchises within particular countries or regions. The subsidiaries may be wholly owned or joint ventures, but most service firms have found that joint ventures with local partners work best for controlling subsidiaries.

QUESTION 4: A small Canadian firm that has developed some valuable new medical products using its unique biotechnology know-how is trying to decide how best to serve the European Union. Its choices are given below. The cost of investment in manufacturing facilities will be a major one for the Canadian firm, but it is not outside its reach. If these are the firm's only options, which one would you advise it to choose? Why?

- Manufacture the product at home and let foreign sales agents handle marketing.
- Manufacture the products at home and set up a wholly owned subsidiary in Europe to handle marketing.
- Enter into a strategic alliance with a large European pharmaceutical firm. The product would be manufactured in Europe by the 50/50 joint venture and marketed by the European firm.

ANSWER 4: If there were no significant barriers to exporting, then option (c) would seem unnecessarily risky and expensive. After all, the transportation costs required to ship drugs are small relative to the value of the product. Both options (a) and (b) would expose the firm to less risk of technological loss, and would allow the firm to maintain much tighter control over the quality and costs of the drug. The only other reason to consider option (c) would be if an existing pharmaceutical firm could also give it much better access to the market and potentially access to its products and technology, and that this same firm would insist on the 50/50 manufacturing joint venture rather

than agreeing to be a foreign sales agent. The choice between (a) and (b) boils down to a question of which way will be the most effective in attacking the market. If a foreign sales agent can be found that is already quite familiar with the market and who will agree to aggressively market the product, the agent may be able to increase market share more quickly than a wholly owned marketing subsidiary that will take some time to get going. On the other hand, in the long run the firm will learn a great deal more about the market and will likely earn greater profits if sets up its own sales force.

CLOSING CASE: JCB in India The closing case explores the joint venture between Britain's JCB, a manufacturer of construction equipment, and Indian engineering conglomerate, Escorts. The two companies linked up to make back hoe loaders for the Indian market. The joint venture was a first for JCB, and proved to be hugely successful, gaining 80 percent of the market. However, JCB felt the arrangement limited its expansion opportunities, and recently bought out its partner. Today, JCB is a major player in the construction equipment market in both India and China. The following questions can be helpful in directing the discussion. **QUESTION 1:** What was the strategic rationale underlying JCB's entry into India in 1979, and China in 2005? Given that capital to fund expansion is limited, does it make more sense for JCB to expand its presence in these markets, as opposed to more developed markets, such as those of Western Europe? **ANSWER 1:** When JCB entered the Indian market in 1979, the company felt the market was primed for growth, and that the potential in the market was too large to ignore. By entering the market early, JCB hoped to establish a foothold in the market and an advantage over competitors. **QUESTION 2:** Why do you think JCB

chose to enter India via a joint venture, as opposed to some other entry mode? ANSWER 2: JCB entered the Indian market in 1979 via a joint venture with Escorts. The decision to enter via a joint venture arrangement was prompted by high tariff barriers that made JCB's traditional strategy of exporting its product to foreign locations difficult. Given that JCB was primarily an exporter and had little experience operating in foreign locations, the joint venture arrangement offered the company a means of serving the Indian market without incurring all the risk involved in setting up a wholly owned operation. QUESTION 3: Why did JCB not simply license its technology to Escorts? ANSWER 3: JCB's technology provided the company with a key competitive advantage. JCB avoided licensing arrangements because it felt that such arrangements did not give it the control over its technology that was needed. JCB feared that licensing its technology to Escorts could eventually make Escorts a direct competitor. QUESTION 4: What were the potential disadvantages of JCB's joint venture with Escorts? ANSWER 4: JCB was concerned that the joint venture limited its ability to expand. The company did not want to share its proprietary technologies that were at the core of its competitive advantage with Escorts, and feared that without complete control over the venture, it could not properly serve the rapidly growing Indian market. QUESTION 5: What were the benefits of gaining full control of the Indian joint venture in 2002? Can you think of any drawbacks? ANSWER: While the joint venture between JCB and Escorts was successful, JCB chose to buy out its partner. JCB took advantage of new government regulations to initially buy a majority position in the venture in 1999, and later in 2002, buy it outright. Most students will probably agree that the main

benefit of gaining full control of the venture was that JCB could now transfer its leading edge technologies to the venture without fearing that it could be creating a future competitor. Furthermore, since JCB had full control over the venture, it could continue its expansion in India. Some students may wonder though whether the company has taken on too much risk in the Indian market. Another Perspective: Students can go to <http://www.jcb.com/> for additional information on the company. INTEGRATING iGLOBES There are several iGLOBE video clips that can be integrated with the material presented in this chapter. In particular, you might consider the following:

Title: As U. S. Automakers Struggle, Fiat Seizes Expansion Opportunities Run
Time: 7: 05 Abstract: This video explores the attempt by Italian automaker Fiat, to become a bigger global player through the purchase of General Motors' Opel division, and the acquisition of 35 percent of ailing U. S. automaker, Chrysler. Key Concepts: globalization, international trade, international strategy, corporate culture, global expansion, market entry
Notes: The global auto industry may soon see some major changes. Italian automaker Fiat is hoping to become a bigger player in the industry, and unlike its U. S. counterparts which are struggling to survive, Fiat is ready to expand. The company is currently in the process of acquiring up to a third of ailing Chrysler, and is in talks about a potential purchase of General Motors' Opel division. If both acquisitions proceed Fiat, which is presently the world's ninth-largest auto company, will become the fifth-largest automaker in the world. Until now, Fiat, a highly diversified company with divisions in everything from ski resorts to agricultural equipment, has been only a minor player in the United States. However, CEO Sergio Marchionne believes that in

order to survive, that situation must change. Marchionne feels that Fiat's long-term competitiveness depends on its ability to expand its reach in the United States and indeed, in Europe. It seems that Marchionne, who feels the company's current sales of 1.5 million vehicles is too small to enable Fiat to be a viable global player, wants to become a force to be reckoned with. Acquiring 35 percent of Chrysler in addition to Opel would give the company sales of 5.5 million vehicles, well above the 3.5 million level that Marchionne feels is necessary to be a strong global player. Some analysts wonder though, whether Fiat is getting in over its head. David Kiley of Businessweek, worries that Fiat is trying to do too much at once. Fiat's strategy involves the acquisition of highly distressed companies — a strategy that may prove to be difficult in the current economy. Kiley finds it telling for example, that other key players in the industry like Toyota and BMW have shied away from the opportunities that Fiat is currently pursuing. Kiley points out that acquiring a new company means that Fiat not only gains new assets and market position, but it also means that Fiat inherits a new corporate culture — one that may be vastly different from its own. BMW actually has first hand experience in the challenges of trying to mesh another company with existing operations. The company unsuccessfully tried to integrate Rover with its own operations in the 1990s only to later sell it off. Now, BMW and Toyota are looking to grow organically rather than via acquisition. Kiley also wonders whether Fiat will be able to overcome the negative perceptions many consumers currently have of Chrysler and its products. The most recent Consumer Reports, a key source of buying information for many American consumers, does not recommend that consumers purchase any

Chrysler-made products. Discussion Questions: 1. Fiat is currently trying to buy both a piece of Chrysler and General Motors' Opel division. Why does Fiat want to make these acquisitions? What advantages would they bring to Fiat? 2. Some experts worry that Italian automaker Fiat may be moving too quickly with its global expansion strategy. Reflect on the risks involved with Fiat's acquisition strategy. How might a deal with Opel affect Fiat's ability to proceed with its effort to successfully integrate part of Chrysler? 3. Fiat is currently a minor player in the U. S. auto market. Discuss how the deal with Chrysler could change that position. What role, if any, might the U. S. government play in promoting Fiat as the industry's lifesaver? 4. What are the challenges associated with growing via acquisition versus growing organically? In your opinion, does the fact that Fiat is a highly diversified company give it any advantage with its current plans to acquire General Motors' Opel division and 35 percent of Chrysler? INTEGRATING VIDEOS There are also several longer video clips that can be integrated with the material presented in this chapter. In particular, you might consider the following from International Business DVD Volume 5: Title 12: Tesco in the U. S. A. Abstract: This video explores British retailer Tesco's attempt to break into the very difficult grocery store business in the United States Key C