

COMPETITIVE ADVANTAGE,  
CORPORATE STRATEGY,  
AND THE INTERNATIONALISATION  
OF CHINESE STATE-OWNED  
MANUFACTURING ENTERPRISES

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December 1993

Submitted in accordance with the requirements  
for the degree of Doctor of Philosophy

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## ABSTRACT

Research on the internationalisation of the firm has focused mainly upon identifying the competitive advantage which enabled it to invest overseas, as well as the motives and methods of foreign entry. Strategic issues have been largely ignored in both the theoretical and empirical research. Most empirical research is based upon macro (country) and/or meso (industry) data. There have been few detailed company studies to explain the dynamic interactions between the evolution of a firm's external environment, competitive advantage, corporate strategy and its internationalisation.

This thesis by employing the case study method seeks to incorporate strategic issues into an analytical framework for examining the internationalisation of the firm. It argues for a micro (corporate) and holistic approach to the analysis of internationalisation of the firm. Specifically, it argues that while home country characteristics and their evolution may influence the creation and the nature of corporate competitive advantages of the firm, corporate strategies play an even more decisive role in the internationalisation of the firm, especially when its international involvement has reached a certain degree. The international strategy pursued by the firm has a direct impact not only upon the speed of the firm's subsequent internationalisation, but also upon the motives, methods and modes of its foreign entry.

In the past two decades, an increasing number of researchers have investigated the internationalisation of firms from the Third World or less developed countries (LDCs). In spite of China's growing importance as an outward investor, the internationalisation of Chinese firms has received scant attention. This exploratory study seeks to fill this research gap.

Based upon detailed case studies of five of China's largest state-owned manufacturing companies, this research has confirmed the importance of changing corporate strategy in the dynamic interactions between changes in the firm's external environment (especially in China's domestic economy under the economic reforms and Open-Door Policy), its internal resources and capabilities and the internationalisation of its business. This research suggests that corporate strategy has played an important intermediate role between corporate competitive advantage of the firm and the internationalisation of its business. Moreover, the international strategy pursued by the firm has not only speeded its subsequent internationalisation but also enabled it to adopt bolder methods and modes of foreign market entry.

Because of the difficulty in ascertaining the representativeness of the five case companies, the findings of this research are indicative instead of conclusive.

## ACKNOWLEDGEMENT

I would like to express my sincere gratitude to my supervisor Dr Michael McDermott for his patience in guiding me through this research endeavour. His linguistic assistance is particularly worth mentioning.

Professor Steve Young's insightful and critical suggestions and comments have kept me in the right direction. Thus I am indebted to him.

Throughout the years I spent on the research, I have benefited from intellectual inputs of many people in the Department of Marketing. Dr Andy Lowe's provocation for qualitative research and Professor Susan Shaw's seminars on research methodologies have been particularly beneficial to me. Thus they deserve my gratitude.

Hafiz Mirza at the Bradford University Management Centre has provided me with some of his valuable joint papers with Professor Peter Buckley. Teng Dexiang and Yang Yingsheng of University of International Business and Economics (China), Lu Yaobing of the State Council Development Research Centre (China) have also provided me with some materials. I thank them all for their kindness.

Many friends and people in China have helped me gain access to the companies I investigated. I would have not been able to complete this research without their help. Therefore I would like to thank them, especially to Professor Tsu Tsien-Tsun (Wuhan University), Ms Wan Li-Hong (Wuhan University), Mr Su Wen-Feng (Guangzhon Institute of Economic Management), Mr Zhao Sheng-Ting (Shenzhen Light Industrial Products Import and Export Company), Professor Fan Ming (Senior Consultant to Shenzhen Electronics Group), Mr. Wang Yan-Bing (the State Pharmaceutical Administration of China), Mr Zheng Lin-Yuan (Shenzhen Development Bank).

Some of my fellow students also deserve my gratitude. They have provided useful comments and stimulating discussions. I would like to thank particularly Chooi Kum Ying, ABM Shahidul Islam, Angie Ng Lee, Mohamad Osman.

The Chinese Government and the British Council have provided me with the scholarship to undertake an MBA course and this PhD research both at the University of Strathclyde. I thank them for their generosity.

Lastly, my heartfelt gratitude goes to my parents, my wife and daughter. We have gone through the most difficult time over the past few years. I hope my eventual completion of this research delights them all.

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## ACRONYMS AND INITIALS

BP:	British Pharmacopoeia
CIS:	Commonwealth of Independent States
COMECOM/CMEA:	Council for Mutual Economic Assistance
CP:	Chinese Pharmacopoeia
CRS:	Contract Responsibility System
EC:	European Community
FDI:	Foreign Direct Investment
FTCs:	Foreign Trade Companies
GATT:	General Agreement on Tariffs and Trade
GDP:	Gross Domestic Product
GNP:	Gross National Product
LDC:	Less Developed Countries
MNE:	Multinational Enterprise
MOFERT:	Ministry of Foreign Economic Relations & Trade
NIEs/NICs:	Newly Industrialising Economics/Countries
OEM:	Original Equipment Manufacturers
OLI:	Ownership, Locational and Internalisation Advantages
OTC:	Over the Counter
PIRI:	Pharmaceutical Industrial Research Institute
PLC:	Product Life Cycle
PR:	Public Relations
PRC:	People's Republic of China
R & D:	Research and Development
RMB/Rmb:	Renminbi (People's Currency)
SEG:	Shenzhen Electronics Group
SEZ:	Special Economic Zone
SOE:	State-owned Enterprise
SPA:	State Pharmaceutical Administration
SWOT:	Strengths, Weaknesses, Opportunities and Threats
TWMNE:	Third World Multinational Enterprise
TVEs:	Township and Village Enterprises
UNCTC:	United Nations Centre on Transnational Corporations
UPS:	United States Pharmacopoeia

**PART I**  
**RESEARCH BACKGROUND**



# CHAPTER 1 INTRODUCTION

## 1.1 Research Background

This chapter reveals the reasons for the author to research competitive advantage, corporate strategy and the internationalisation of Chinese manufacturing firms. It identifies the research objectives, research scope and the significance of the study. The overall layout of the thesis is also reviewed in this chapter.

## 1.2 The Internationalisation of Firms from Third World Countries

In the last three decades or so, more and more firms from the Third World have internationalised. Some of them (eg, the major trading companies of South Korea) have become amongst the largest firms in the world (Table 1.1). Developing countries as a whole now account for a larger share of the world's stock of outward FDI, rising from 1 per cent in 1960 to more than 3 per cent in 1991 (see Table 1.2).

Table 1.1 The World's 500 Largest Industrial Corporations

Year	Number of Firms from LDCs	Number of Firms from Developed Countries	Total
1977	23	477	500
1987	34	466	500
1991	37	467	500

Sources: The Fortune Global 500 (various issues)

Table 1.2 Stock of Outward FDI (1960--91)

Year	World Stock of FDI (US\$ mn)	Developing Countries (as % of world Total)	Industrial Countries (as % of world total)
1960		1.00	99.00
1975		2.30	97.70
1980	536	2.86	97.14
1985	58,292	2.19	97.81
1986	93,767	2.05	97.95
1987	139,629	1.85	98.15
1988	171,567	3.55	96.45
1989	216,767	4.38	95.42
1990	237,471	3.77	96.23
1991	181,365	3.15	96.85

Sources: Based on UNCTC (1990, 1988), IMF (1992).

### 1.3 The Internationalisation of Chinese Firms

Although a handful of Chinese service organisations (eg, Bank of China and the 12 national foreign trading companies) had small scale outward FDI before the 1980s, outward foreign direct investment by Chinese manufacturing firms only began as recently as 1979 when economic reforms and the Open Door Policy were initiated (Huang et al, 1991; Ye, 1992). Although other developing countries (eg, Argentina, Brazil, Hong Kong, India, the Philippines, Singapore, South Korea, Taiwan) may have firms with earlier experiences of outward foreign investment, the development of Chinese outward FDI is faster, and at a larger scale, than that of these countries at their initial stage of outward investment (Ye, 1989). By 1992, China had approved a total of 4,117 foreign subsidiaries and joint ventures in more than 120 countries (People's Daily 1993, February, 16). China has probably overtaken Brazil and India in terms of outward FDI, becoming one of the few major outward investors from the Third World (see Table 1.3).

Handwritten note: *Handwritten*

Table 1.3 FDI from the Third World (selected countries)  
(1959-91, US\$ mn)

Year	Brazil	China	Singapore	S. Korea	Taiwan
1959-79	n.a.	--	n.a.	n.a.	59.26
1976-79	n.a.	--	734.21	23.05	n.a.
1980	n.a.	--	961.85	21.10	42.11
1981	177.0*	--	998.63	40.08	10.76
1982	336.0*	40.0*	1242.20	129.37	11.63
1983	171.0*	87.0*	1329.23	113.16	10.56
1984	42.0*	131.0*	1428.15	56.97	39.26
1985	81.0	629.0	1343.57	117.16	41.33
1986	143.0	450.0	1546.19	171.99	56.91
1987	138.0	645.0	1762.80	332.72	102.75
1988	175.0	850.0	1782.08	153.11	218.74
1989	523.0	780.0	3148.06	324.98	930.97
1990	665.0	830.0	4448.70	891.24	1552.21
1991	n.a.	913.0	n.a.	n.a.	1656.03

NB: (a) \* millions of SDRs;

(b) Data regarding outward FDI from Hong Kong and India are not available.

Sources:

- (i) Brazil: IMF Balance of Payments Statistics Yearbook (various years);
- (ii) China: China Statistical Yearbook (1987, 1991); IMF: Balance of Payments Statistics Yearbook (Various years);
- (iii) Singapore: Singapore Department of Statistics (1992, 93), Singapore Investment Abroad, 1976-90; Singapore Investment Abroad, 1990;
- (iv) S. Korea: Korea Statistical Yearbook (1991); Bank of Korea (1993);
- (v) Taiwan: Investment Commission, Ministry of Economic Affairs (August, 1991).

## 1.4 Research Gap

The last two decades have witnessed an upsurge in research on the internationalisation of firms from Third World countries. Researchers have so far concentrated their interest on Hong Kong (Busjeet 1980; Chen 1981, 1983; Lecraw 1981; Wells 1977, 1978; Young & Hood 1987), Singapore (Agarwal 1985; Chia 1984; Fong & Komaran 1985; Mirza 1986; Lim 1983; Lee 1993), South Korea (Escho 1985; Han & Brewer 1987; Jo 1981; Kwag 1987; Kumar & Kim 1984, 1992; Levy 1988; McDermott 1990; McDermott & Young 1989; Min & Brewer 1987), Taiwan (Escho 1985; Levy 1988; McDermott 1991; Ting 1982; Ting & Schives 1981) and India (Agarwal & Weekly 1984; Busjeet 1980; Escho 1985; Lecraw 1977; Lall 1983, Lall 1986), although some Latin American countries (eg, Katz and Kasacoff (1983) on Argentina, Villela (1983) on Brazil) and the Philippines (Telentino, 1990)) have also received attention. State-owned MNEs from both the market economies and socialist countries in Eastern Europe had received much less attention (eg, Walters & Monsen, 1979; McMillan & Warnock, 1985; UNCTC, 1986).

The internationalisation of Chinese firms has so far received scant attention despite its increasing importance as a Third World investor and its MNEs being state-owned enterprises. So far only two papers have been published on the theme of China's *outward* FDI. The first by Shih (1984) coincided with the emergence of China's outward FDI and it restricted its focus to China's FDI in Hong Kong. Since the publishing of that paper, China's investments in Hong Kong alone have developed significantly and merits reassessment, not to mention the development of Chinese outward investments elsewhere uncovered by the paper at all.

The other paper by Ye (1992) was based on a very small scale survey of 37 companies based in the cities of Shanghai, Beijing and in the province of Fujian. Although his findings have shed some light on the motives of FDI from China and the competitive advantages of Chinese MNEs, the paper was neither comprehensive nor methodologically flawless. For example, the Chinese government only allows a limited number of *state-owned* firms to engage in outward FDI (see Chapter 4), whereas only six out of Ye's sample were state-owned. It was not clear whether his sample included the Chinese subsidiaries and/or joint ventures of foreign MNEs.

Detailed statistical data regarding China's outward FDI is not been made available from the home country. The accuracy of the aggregate outward FDI data disseminated periodically by the Chinese government has to be questioned. For instance, while data disclosed by China's Statistical Bureau suggests that outward FDI amounted to US\$3,354 million during the period 1985-89 (China Statistical Yearbook, 1991. p.580), the Ministry of Foreign Economic Relations and Trade reports outward FDI of only US\$1,789 million by 1992 (People's Daily 1993, February, 24). Both of these sources contradict the estimate of the Hong Kong & Shanghai Bank, which suggests that China's investment in *Hong Kong* alone amounts to more than US\$12 billion by 1992 (Hongkong Bank Economic Report, February, 1993). As this researcher found out during interviews with case companies, Chinese firms do not always report their outward investment activities.

### **1.5 The Research Problem**

Since the late 1980s, the increasing scale of outward foreign investment from China has led to a policy debate inside China. The primary question arose as to whether outward FDI represented an outlay of hard currencies earned by exports. A second question concerned whether there is any reason why Chinese firms should invest overseas, and a third question concerns whether Chinese firms are able to invest overseas profitably. A fourth and interesting question is put forward by the Ministry of Foreign Economic Relations and Trade (MOFERT). While MOFERT encourages the internationalisation of China's foreign trade companies (FTCs), which are under its own administration and co-ordination, it questioned the necessity of manufacturing firms going international (see various issues of discussion papers of the Centre for Multinational Enterprise Research, China). Nonetheless, as many large and medium-sized state-owned manufacturing firms in China have been granted greater management autonomy (including direct import and export authority), they have become increasingly important in China's outward FDI. Thus it seems important to examine the rationale for FDI from these firms' perspectives.

## **1.6 The Research Objectives**

Given the research difficulties (see Chapter 6), this research attempts to address the questions of capabilities and the motives of Chinese state-owned manufacturing firms' internationalisation from a corporate strategy perspective. To this end, the research seeks to meet the following research objectives:

- a). To reveal how the evolution of home country environment (i.e., Porter's national competitive diamond) has influenced the creation and nature of competitive advantages of the Chinese firms;
- b). to examine how corporate strategies of Chinese firms have changed in response to the development of their international resources and capabilities and the changes in the domestic and international markets;
- c). to ascertain the impact of corporate strategy upon the internationalisation of Chinese firms, including their motives, method and modes of their foreign entry.

## **1.7 Research Methodology**

To meet these research objectives, ten propositions have been developed from an integrative analytical framework, which served as a guide to the researcher's fieldwork. Between April and June 1992, the researcher carried out case studies of five companies (i.e., Shougang, Baiyunshan Enterprises Group, Northeast Pharmaceutical Factory, Shenzhen Light Industrial Group, and Shenzhen Electronics Group) in China. Primary data were gathered through in-depth interviews with senior managers of the five case companies, which were supplemented by secondary data, including the companies' internal reports, research papers and press reports as well as official reports.

## **1.8 Method of Analysis**

As case study method usually embraces multiple levels (units) of analysis, the basic unit of analysis is the individual case companies, and their individual FDI projects and

individual products are often singled out for analytical purpose. The data collected is analysed mainly by "pattern-matching" and comparative methods (Cook and Campbell, 1979; Yin, 1984, 1987). In addition to these two methods, explanation-building modes of analysis is also used to draw inferences of the complex inter-dependent and interactive relationships among variables studied in each case.

## 1.9 Scope of the Study

This research focuses on the internationalisation of five of China's large state-owned manufacturing firms (i.e., Shougang, Baiyunshan, Northeast Pharmaceuticals, Shenzhen Light Industrial Group, and Shenzhen Electronics Group). It covers the evolution of their competitive advantages and corporate strategies in response to the economic reforms and Open-door Policy inside China and changes in international markets, and reveals their motives for internationalisation from a strategy perspective.

The focus of this research on the manufacturing sector is based upon the following considerations:

- (i). since most theories of MNE or the internationalisation of the firms were developed based upon the experiences of manufacturing firms from industrial and newly-industrialised countries, a focus on Chinese manufacturing firms in the research will make the findings of this research more comparable to existing empirical research;
- (ii). the internationalisation of Chinese services firms (eg, the 12 national FTCs, Bank of China, and the People's Insurance of China) can be explained by their monopolistic advantages in their respective industries or segments (Huang et al, 1991; also see Chapter 4), the explanation of the internationalisation of China's manufacturing firms is far more complex. Indeed, the concentration ratio in China's manufacturing sectors is very low (see Chapter 4);
- (iii). manufacturing sectors have attracted the largest proportion of China's outward FDI outside Hong Kong and Macau. FDI in production facilities is increasing faster than other types of FDI (eg, services) (The People's Daily,

1993, February, 16).

### **1.10 Significance of the Study**

The main contribution of this study will be the empirical evidence gathered from the five company case studies. It is expected that the findings on the impact of evolving corporate strategy upon the internationalisation behaviour of individual Chinese firms will add empirical evidence to the existing literature in international business and strategy management.

Secondly, since this research uses the case study method, it is, in itself, a methodological contribution to the existing knowledge of the FDI phenomenon. There have been a large number of empirical works devoted to the analysis of aggregate and quantitative data about contemporary MNEs.

Thirdly, as the existing literature in the fields of International Business tends to focus primarily upon the achievements and problems associated with China's trade and inward FDI, it is anticipated that this empirical research will help redress the academic imbalance between China's inward and outward FDI.

Fourthly, as the Chinese firms under investigation are all state-owned companies, the findings from this research will enrich our knowledge of state-owned MNEs, which have been given relatively scant attention vis-a-vis their private counterparts.

Lastly, as the Chinese government gradually relaxes its control over its state-owned firms, including their overseas direct investments, it is anticipated that more and more state-owned firms, and even collectively-owned and private ones, will become interested in internationalisation. The findings in this research will make a useful contribution to government policy-makers in formulating macro-policies towards China's outward FDI and assist corporate decision-makers in their formulating corporate and internationalisation strategies.

In terms of the theoretical contribution, this research will shed light on the role of corporate strategies in the inter-nationalisation process of the firm. Specifically, this research will demonstrate how an international strategy plays an intermediate role



between the corporate competitive advantage and the internationalisation of the firm.

### **1.11 The Limitations of the Study**

As with any other qualitative approach, findings from case studies, irrespective of the sample size (i.e., the number of the cases studied), are not based upon statistical analysis of aggregate data, and thus can not be generalised statistically to a large universe. Neither is it possible to generalise from one case to another.

In other words, this case study approach only permits one to generalise, within the context of the research problem focused in this research, a particular set of empirical evidence on the impact of external environmental changes upon the evolution of corporate competitive advantages and corporate strategies of the Chinese manufacturing firms to a broader body of knowledge. The findings from this research are indicative instead of conclusive. They might be treated as exploratory results for future statistical generalisation with a larger sample of firms.

### **1.12 The Organisation of the Thesis**

This thesis falls into four parts.

Part I includes Chapter 1, which introduces the research background, research problems and objectives, assesses the significance and limitations of the study. Main terminologies are defined as well in this chapter.

Part II (Chapters 2 through to 6) deals with theoretical and methodological issues. Chapter 2 reviews the literature on the internationalisation of firms and foreign direct investment (FDI) from an economics, behavioural and business strategy perspective. It also attempts to demonstrate what (selected) previous empirical studies of developed country MNEs have revealed about the competitive advantages of firms. Conclusions are drawn from literature review as regards sources and nature of competitive advantages of the MNEs.

Chapter 3 reviews theories and empirical evidence of the so-called unconventional

MNEs (i.e., MNEs from the Third World countries and state-owned MNEs) from both market economies and (former) socialist countries.

Chapter 4 overviews the evolution of the Chinese economy and its impact upon the behaviour and competitive advantages of Chinese state-owned firms. It also discusses the differences and similarities of China and other LDCs (including India and the four "Tigers") and how these difference and similarities will influence the creation and nature of competitive advantages of their firms, corporate behaviour and thus their propensity to engage in foreign direct investment.

Chapter 5 synthesises the literature and proposes an integrative strategy framework for analysing the competitive advantages and internationalisation of the firm. This framework is then contextualised with the characteristics of China's national diamond and its state-owned enterprises. Ten propositions are derived from the framework to explain firstly their competitive advantages and corporate/business strategies, secondly the relationships between their corporate/business strategies and internationalisation behaviour, including motives for, methods and modes of foreign entry.

Chapter 6 discusses alternative research methodologies. Firstly, it assesses the respective strengths and weaknesses of quantitative and qualitative methods. Secondly, it demonstrates the need to use case study as appropriate qualitative method in this research. Thirdly, it presents the case selection criteria and process. Finally, it reports implementation of the case study method.

Part III presents empirical evidence from a series of case studies. Chapters 7 through to 11 present the case studies of five manufacturing firms (i.e., Shougang Corporation, Baiyunshan Enterprise Group, Northeast Pharmaceutical Factory, Shenzhen Municipal Light Industrial Group, and Shenzhen Electronics Group). Each chapter has a case study of one company. It presents the background of the case company, its recent developments, the characteristics of its managerial behaviour, its corporate strategy and the details of its internationalisation in terms of exporting and FDI. The ten propositions derived from the literature review and framework are discussed in the light of the case company's experience in creating its competitive advantage, internationalisation of its activities and the development of its corporate strategy. Thus the concentration on the propositions ensures that the five case studies

have a common focus.

Part IV contains the final chapter, which summarises the theoretical and methodological contribution of the thesis and discusses the limitations of this research. It also suggests some areas for further research.

The Structure of the thesis is summarised in Figure 1.1.

### **1.13 Terminology and Definitions**

#### **(a). Competitive Advantage:**

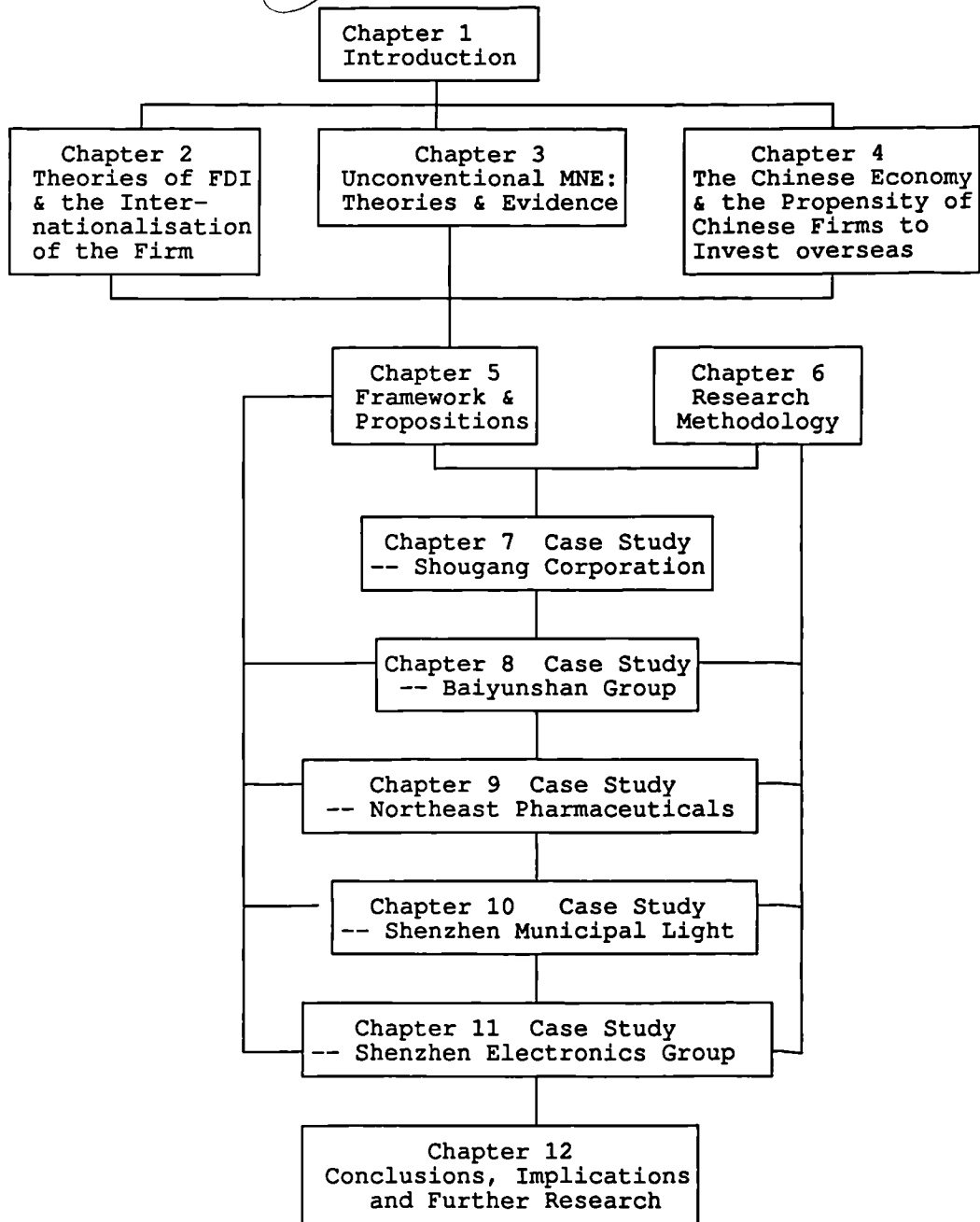
There is no common meaning for "competitive advantage" (Day & Wensley, 1988). Sometimes it is used interchangeably with "distinctive competence" to mean relative superiority in skills and resources or privileged access to them. For instance, competitive advantage is sometimes referred to firm-specific advantage which stems from some proprietary characteristics of the firm (Dunning, 1979, 1988; Kogut, 1985). A variant of this version of competitive advantage is a firm's privileged access to, or possession of, some (tangible or intangible) assets, which are denied to other competitors (Casson, 1990).

Another widespread meaning of competitive advantage refers to what are observed in the market -- positional superiority, based on the provision of superior value to customers or the achievement of lower relative costs, and the resulting market share and profitability performance (Porter, 1980; Philips et al 1983; Luchs, 1986; Gale and Buzzell, 1989). These two generic competitive strategies, i.e. cost leadership (thus price competitiveness) and differentiation (Porter, 1980, 1985, 1990) will be called positional advantages.

In this thesis, competitive advantage is an aggregate term to denote a firm's resources and capabilities to create a superior market positions and achieve superior competitive and financial performance than its competitors.

(b). Foreign Countries: Because of the issue of Hong Kong and Macau being colonised by Britain and Portuguese respectively, and current separation of Taiwan from mainland China, there are definitional complications. For analytical purposes,

Figure 1.1 The Structure of the Thesis



Source: Author

Hong Kong, Macau and Taiwan are treated as overseas countries, and the investments of mainland Chinese firms in these regions are considered as overseas investments and trade with these regions as foreign trade. So Chinese firms' exports include those to Hong Kong, Macau and Taiwan.

(c). Foreign Direct Investment (FDI): FDI is an investment in a venture by a firm in another country where it has effective control over the venture.

FDI from China: refers to investment by Chinese firms in overseas countries and Hong Kong, Macau, which leads to control by the Chinese parents. Whereas it is perfectly clear that a wholly-owned overseas subsidiary, especially manufacturing one, is a direct foreign investment, it's arguable how much share stake in an overseas joint venture by a partner ensures effective control of the venture. Throughout this research, 25 per cent is the threshold for an investment to be qualified as FDI.

The Ministry of Foreign Economic Relations & Trade (MOFERT), which oversees China's foreign trade and inward as well as outward FDI, does not distinguish direct investment from portfolio investments. Instead, it differentiates non-trading investments from trading investment projects (eg, sales offices abroad).

(d). Multinational Enterprise (MNE): An MNE is defined as a firm that owns (in whole or in part), controls and manages income-generating assets in more than one country (Hood & Young, 1979. p.3).

(e). State-owned Enterprise (SOE): An SOE is defined as a firm that is owned and run by the state.

(f). Internationalisation of the Firm: The inter-nationalisation of the firm has been conventionally defined as the developmental process of increasing involvement in international business (Young et al, 1989. p.3). Here "involvement" may take the form of exporting, international licensing, technology transfer, joint ventures and strategic alliance, wholly-owned subsidiaries.

(g). Motives for FDI: Motives for FDI refer to the reasons why a particular investment project is undertaken in a particular host country by an MNE. While an investment project could be motivated by a number of factors, usually there is one

predominant or a few main considerations behind the FDI. The main motives for FDI can be categorised as resource seeking, market seeking, efficiency seeking, strategic asset seeking, and others (see Appendix 1).

## Appendix 1. The Categories of FDI Motives

1. Resource-seeking FDI. Such FDI is undertaken to enable the MNE to acquire particular resources at a lower cost in the host country than at home country. Depending the resources sought, this type of FDI can be further subdivided into physical resource- (eg, minerals, timber) seeking, labour-seeking and technology and management skills-seeking.

2. Market-seeking FDI: This type of FDI is undertaken in order to supply goods or services to markets in the host and/or adjacent countries, or to protect and exploit its existing markets (thus usually export-replacing). This type can be also subdivided into four categories:

- a. following the suppliers or customers that have set up foreign production facilities;
- b. localisation of production;
- c. production and transaction cost considerations;
- d. as part of globalisation of production and marketing strategy.

3. Efficiency-seeking FDI: This type of FDI is undertaken to rationalise the structure of established resources-based or market-seeking FDI so that the MNE can benefit from the common governance of geographically dispersed activities. According to the specific purpose, such FDI can be undertaken:

- a. to take advantages of the differences in the availability and cost of traditional factor endowment in different countries;
- b. to take advantages of economies of scale and scope, and differences in consumer tastes and supply capabilities.

4. Strategic Asset-seeking FDI: This type of FDI is undertaken to promote long-term strategic objectives -- especially that of sustaining and advancing international competitiveness of the parent.

5. Others. In addition to the above four major categories of FDI, FDI can sometimes be made for other motives:

- a. **Escape Investment:** such FDI is made to escape restrictive legislation or macro-organisational policies by the home government;
- b. **Support Investment:** such investment is made to support the activities of the rest of the MNE (eg, trade-related FDI);
- C. **Passive Investment:** the minority partners who have very weak or passive control over the joint ventures (eg, the acquisition of prestigious real estate in the US by some Japanese MNEs who do not participate effectively in control of the acquired properties).

Sources: Based on Dunning, (1993) (pp.57-63)



**PART II**

**THEORETIC AND**

**METHODOLOGICAL FOUNDATIONS**

## CHAPTER 2

# THEORIES OF FOREIGN DIRECT INVESTMENT AND THE INTERNATIONALISATION OF THE FIRM

### 2.1 Introduction

Many theories have been expounded by economists and scholars from other disciplines to explain the emergence and development of MNEs. Each of these has contributed, to a varying degree, to the development of our knowledge of MNEs and provided an analytical framework for the inter-nationalisation of firms. However, all the existing theories have their limitations and drawbacks (Cantwell, 1991; Itaki, 1991; Marcharzina & Engelhard, 1991; Buckley, 1990, 1987; Mainardi, 1987; Casson, 1986; Kojima & Ozawa, 1984; Aggarwal, 1982; Gray, 1982; Calvet, 1981; Hood & Young, 1979), as firm and its external environments change, and the interactions between the changing environment and its strategic and operational responses compel scholars to monitor and restructure continually their thinking (Dunning, 1990). Thus the objectives, and determinants of FDI and other foreign entry modes, as well as timing of foreign entry have become so complex that any single theory of the MNE and the inter-nationalisation of the firm has become increasingly insufficient.

This chapter sets out to review the existing theories of the MNE and the internationalisation of the firm, assess their contributions and shortcomings in terms of their applicability and relevance to the diverse FDI phenomena. It also attempts to demonstrate the linkages between the internationalisation of the firm and its strategic behaviour, which in turn is related to the evolution of its competitive advantages, and the comparative advantages of home and host countries. Major empirical studies pertaining to the testing of each of these theories are also reviewed. After reviewing the economic theories of the MNE and the behavioural theories of the internationalisation of the firm, the business strategy perspective on the internationalisation of business is also reviewed.

## 2.2 The Mainstream Economic Theories of FDI

Several major economic theories have been developed, from macro, meso and micro perspectives to explain the emergence and development of international production financed by FDI, although they seem to have focused on different issues and questions (Cantwell, 1991). Each of these economic theories is reviewed in the chronological order of their conceptualisations.

### 2.2.1 The Industrial Organisation Approach (1960)

This approach to explaining FDI began in 1960 with Hymer's seminal doctoral thesis on American FDI overseas, primarily in Europe. Hymer suggests that a firm must have some kind of monopolistic advantage to enable it to offset the costs associated with its operations abroad, where the environment is different from the home country. FDI thus represents the transfer of such monopolistic advantages (eg, superior product knowledge, business techniques, marketing skills) to the host country(ies) where the investing firm still retains its control over the use of such advantages. Under the assumption of market imperfections, FDI enables the firm having such advantages to maximise economic rent from using them across countries. In other words, the firm internalises or "supersedes" the market for the use of its advantages abroad (Hymer, 1960).

Kindleberger (1968) further develops Hymer's idea, identifying the particular monopolistic advantages that could be exploited via FDI by a firm. These include its advantages in goods market (eg, brand names), in the factors market (eg, patented technologies, special marketing skills), external or internal economies of scale arising from vertical or horizontal integration, and government's discriminatory policies in favour of or against the firm.

This approach has treated the MNE as an instrument of monopolistic exploitation of its advantages in an imperfect market. It takes a firm's monopolistic advantages for granted and as constant, without elaborating how the firm gains such advantages and how such advantages evolve as the firm's external environment changes. Its applicability, at best, is limited to the resources-based, efficiency and market seeking types of FDI. Strategic asset seeking and other types of FDI as well as two-way flows

of FDI between countries can not be explained by the approach (Cantwell, 1991; Calvet, 1981).

The treatment of ownership advantage as monopolistic also caused confusion, because in Hymer-Kindleberger's framework ownership advantage should be thought as oligopolistic rather than monopolistic in nature (Cantwell, 1991). Moreover, it does not take strategic factors of the firms into its conceptualisation, nor does it say anything about the comparative advantages of home and host countries. Thus it fails to point out where the investing firm will locate its FDI. In this connection, Vernon's product cycle theory represents a major advancement in the thinking of FDI phenomenon.

### 2.2.2 Product Life Cycle Theory (PLC) (1966)

The Product Cycle Theory was proposed by Vernon (1966, 1979) sheds light on the dynamics of the internationalisation process of the firm. In this respect, he moves away from the static approach by explaining the successive stages of a product's life.

Instead of taking as given the advantages enjoyed by the firm, he suggests that whereas business opportunities are assumed to be open to all, how far individual entrepreneurs in practice grasp them depends upon specific considerations such as geographical proximity to such opportunities and the ease of communications. Therefore entrepreneurship and the country environment determines which firm in which country/ies (ie, the USA in PC Mark I; and the USA, Europe and Japan in PC Mark II) will be able to take the opportunities, leading to product innovations, which is the key competitive advantage in Vernon's analysis (Vernon, 1966, 1979).

Vernon further suggests that the location of production of the innovated product follows its life cycle. The factor endowments, the consumer demands and market structure in the USA are all conducive to the aspiring entrepreneur (and his firm) to introduce product innovation. Thus the initial production (at the introduction stage) of the new product is located in the USA. Foreign markets will be served via exporting. Later on (at the growth stage), as foreign demands grow to sufficient quantity and as local firms begin to produce the product by imitation, the firm will invest and produce the products in the large markets while smaller markets will continue to be served via

exports from home country. As the product becomes more standardised (at maturity stage), production in the home country might be replaced and the proportion of its foreign production increases, more foreign markets are served by foreign affiliates. Finally at the decline stage, as competition from foreign firms intensifies and as foreign countries' (eg, LDCs) comparative advantages (in factor costs) become more apparent, the firm shifts its total production overseas in order to minimise production costs, and all markets (including home country) are served by foreign production.

Empirically, the PLC model was applied to explain post World War II USA FDI outflow to Europe (PLC Mark I, Vernon, 1966), and the result was quite supportive. Hafbauer (1966), Hirsch (1967) and Wells (1972) have provided supporting empirical evidence to the PLC model. However, as differences in income levels and thus demands and in factors costs between Europe and Japan on the one hand and the USA on the other declined or disappeared, and as the existing MNE further spread their international or even global production and marketing networks, the PLC model faces a series of new challenges: MNEs increasingly introduce their new products simultaneously instead of sequentially in many markets, not only the increasing number of European and Japanese firms become MNEs, but firms from developing nations have also started to invest overseas. Accordingly, the PC model was updated (ie. PLC Mark II, Vernon, 1979) to take Europe and Japan, along with the USA as the home countries which provide both stimuli to innovations and initial location of production of the innovated products. Several authors have extended the PLC model to investigate the FDI by the UK (eg, Stopford, 1974, 1976), Continental European (Franko, 1976) and Japanese (Yoshino, 1976) firms. And the results of these empirical studies do suggest the importance of locational advantages of home and host countries in shaping the industrial and geographical distribution of FDI. More recent empirical work (eg, Mullar-Sebastian, 1983) has shown mixed results for the PLC model.

The PLC theory contains dynamic elements in terms of the creation of competitive advantage (ie, innovation) and the evolution, and timing of the firm's production and market serving methods (exporting and FDI). External environment (eg, demand stimuli, technology leads or lags and factor conditions in both home and host countries, as well as foreign competitors) has also been taken into account, but not in sufficient depth. Noteworthy is that in PLC theory the home market plays a dual role: the source of stimulus for the innovating firm, and the preferred location for the actual

development of the innovation.

However, PLC is basically a cost-minimisation theory for the innovating firm, it fails to explore the possibility of licensing as the best cost-effective method of exploiting the innovation by the firm (Giddy, 1978; Clegg, 1986). Its explanatory power is limited to foreign investment by some firms. It has little to say on the expansion of existing investment by the firm, or resource-based, and strategic asset seeking foreign investment (Dunning, 1993). Giddy (1978) argues that FDI in raw material industries seems to have nothing to do with the product life cycle. Despite competitive behaviour (eg, oligopolistic reaction) has been incorporated in a later refinement of the PLC theory (Mark II) (Vernon, 1979), its consideration on strategic issues and the characteristics of the firms is far from satisfactory. Thus the model is not a general theory of international involvement, and indeed its limited relevance has undoubtedly waned, admitted Vernon himself (Vernon, 1979).

### 3.2.3 Currency Premium Theory (1970)

The Currency Premium Hypothesis, proposed by Aliber (1970, 1971), suggests that the pattern of FDI can be explained by the existence of different currency areas. Some currencies are stronger and more stable (and thus "harder") than others at a point of time and the market is subject to a bias in evaluating the currency premium on weaker currencies. Firms in harder currency areas are able to obtain cheaper credit and then capitalise the earnings on their FDI in softer currency areas at higher rates than local firms in host countries. This theory was applied to explain the US FDI into Europe in the 1950s and 1960s. The recent increase of flow of FDI from Japan, South Korea and Taiwan into the USA can be seen as supporting evidence to this theory because the Japanese Yen, Korean Won and New Taiwan Dollar have been continuously appreciated against the US dollar in the last few years.

Some empirical studies in the 1970s (Alexander & Murphy, 1975; Kohlhagen, 1977; Logue & Willet, 1977; ) obtained supporting evidence for Aliber's theory, while other studies at the same period and thereafter have demonstrated that the devaluation of currency a country did not attract an inflow of FDI (eg, Scaperlanda, 1975; Boatwright & Renton, 1978; Gray, 1982; Hunanuntathan & Sachamarga, 1982; McMlain, 1983), which denied the explanatory power of the theory proposed by

Aliber.

However, its explanatory power has been further challenged by cross-investments between currency areas, and by FDI of a country into another belonging to the same currency area such as US dollar or sterling area. For example, the US investment in Hong Kong can not be explained by Aliber's theory because of the fixed exchange rate between Hong Kong and US dollars.

It has not relevance at all to the recent surge of FDI from China because the Chinese currency Renminbi has been devaluating against all major hard currencies since mid 1980s.

At both industry and firm levels, the theory is virtually irrelevant because it can not explain why not all the firms in the same strong currency area (a country) will become MNEs.

Obviously, an MNE can create or maintain a competitive edge over a uni-national firm by virtue of its ability to dominate its geographically dispersed assets and goods in different currencies. However, a firm's competitive advantage may be attributed to its ability to gain cheaper or privileged access to capital to finance its operations or expansion, rather than due to the existence of different currency areas (Hood & Young, 1979; Aggarwal, 1980; Gray, 1982; Dunning, 1988).

Given the existence of different currency areas, Aliber's theory fails to demonstrate why foreign involvement should take the form of FDI rather than portfolio investment, which could be a better instrument for geographical and sectoral diversification and quick liquidation in different currency areas. Thus in many respects Aliber's theory can be regarded as an extension of portfolio theory to incorporate market failure rather than a theory of FDI per se (Dunning, 1990). Therefore, differential currency premiums are not sufficient to explain either the cause or the direction of FDI at country, industry and firm levels.

#### 2.2.4 Product Differentiation Theory (1971)

This theory was proposed by Caves, who found a correlation between the extent of

product differentiation and the proportion of firms in an industry having invested overseas. According to Caves (1971, 1974, 1979), FDI was caused by product differentiation. He views FDI as either horizontal or vertical integration by the firm. Firms undertake vertical FDI overseas in order to avoid oligopolistic uncertainty in sourcing raw materials and create barriers to entry for potential competitors, while the motive for horizontal FDI arises from product differentiation. FDI in host countries can insulate the differentiated products from exact imitation by patents or high costs of imitation, trade marks, differences in sales terms and conditions.

Empirical evidence has been gathered to test Caves' hypothesis. Studies on the US FDI in the UK and Canada (Horst, 1972; Dunning, 1973; Orr, 1973; Bauman, 1975; Buckley & Casson, 1976; Bergester, Horst & Morgan, 1978; Baldwin, 1979; Lall, 1980) have generally revealed the association of product differentiation (approximated by high proportion of advertising expenditure in sales, and R & D intensity) and multinationality of firms, although some of these studies also find out that the multinationality of firms is also correlated to economies of scale (approximated by higher capital intensity), the size of firm, managerial resources and skills (approximated by higher proportion of non-operative personnel) and market structure (oligopolistic, approximated by higher market concentration). The consistently high incidence of multinationality of firms in the industries (eg, automobiles, consumer electronics durables) characterised by extensive product differentiation also seems to support Caves' hypothesis.

Despite this supporting evidence, product differentiation theory remains descriptive, ambiguous and even irrelevant to the FDI reality from individual firm's perspective. Because it does not say why firms should invest in product differentiation which can be quite risky, it can not predict which firms are more likely to differentiate their products and thus become MNEs. It lacks clarity in the direction of causality in the research findings obtained by Caves, Horst, Wolf, and others (Hood & Young, 1979). For instance, it could be argued that large firm size stimulates diversification and multinationality, but equally plausibly, size may be the result of the past expansion (via organic growth or even mergers and acquisitions) rather than the stimulus. Furthermore, instead of suggesting that R & D intensity encourages multinationality, it could be the case that the greater the firm's existing foreign involvement, the higher the prospective return on R & D, since the results can be spread over more markets. Thus increased internationalisation could encourage higher R & D intensity, rather



than simply vice versa. Another shortcoming of Caves' hypothesis is that he neglected cost implications of investing and producing overseas. Moreover, Caves paid no attention to the strategic behaviour of the firm and the macro-environment in which the firm is operating. Thus the firms are assumed to be insensitive to changes in the external environment (including the comparative competitive advantages of home and host countries), and FDI decision by the firm is thus directionless. The fact that many developing country firms with no evident product differentiation advantage have already invested directly overseas (see Chapter 3) also challenges the relevance of Caves' theory.

### 2.2.5 Oligopolistic Reaction Theory (1973)

The Oligopolistic Reaction Theory, proposed by Knickerbocker (1973), suggests that FDI is the result of firms' oligopolistic reaction. Based on the data on 187 American MNEs, he found a coincidence in the timing of these firms' FDI in foreign countries, which he interpreted as the oligopolistic firms' attempt to counter any advantages that the first investing firm may derive from its FDI by following it with their own FDI in order to maintain an equilibrium. Thus firms tend to follow their leader to invest overseas in industries characterised by oligopolistic market structure.

The studies by Wilkins (1974), Gramham (1975, 1978) and Flowers (1976) lend some support to the hypothesis, although the relationships among such variables as profitability, market structure and foreign investment decisions are subject to different interpretations. For instance, foreign investment behaviour may not be oligopolistic in nature but rather is simply an acknowledgement by other firms in the industry that the first investor possesses some advantages in market intelligence (Buckley & Casson, 1976, 1991; Aggarwal, 1980). More recently, studies by Archer (1986) seem to support the hypothesis, and Japanese firms' entry into the European industries (eg, TV sets, video recorders, cars and photocopiers) also demonstrated a 3-5 year bunching characteristic (JETRO, 1991). Nonetheless, Knickerbocker's hypothesis shed some light on the impact of market structure and industry characteristics on the pattern of FDI, and the theory is very straightforward.

Although this theory has the virtue of simplicity, it fails to explain why the first foreign investor should undertake FDI in the first place. Many cost-minimisation FDI,

rationalised FDI and resource-seeking FDI can not be explained by the theory. Moreover, it does not explain why some (US) industries have witnessed a higher degree of FDI than others. Knickerbocker (1973) himself explicitly admitted that his oligopolistic theory provides only a partial explanation of FDI. Thus his theory has only limited, if any, explanatory power.

Like the product differentiation theory and Hymer-Kindleberger's industrial organisation approach, this oligopolistic reaction hypothesis fails to point out the possible direction of foreign direct investment, because of its lack of consideration of comparative advantages of home and host countries and the cost consequences of such investment overseas. It is possible that comparative advantages of home and host countries, instead of oligopolistic reaction of firms, have mainly determined the pattern of outward FDI. For example, the Japanese outward FDI in the 1960s and 1970s was directed in industries (eg, resources-based sectors and labour-intensive industries) where Japan is comparatively disadvantaged, to countries having advantages in these sectors (Kojima, 1978; Ozawa, 1979) (See Section 2.2.6 on Trade-oriented FDI Theory).

Although it addresses the strategic issues (oligopolistic/ competitive strategy), the theory fails to take into account other, and perhaps more important, strategic issues (eg, corporate objectives and strategy, marketing and production strategy) (see Section 2.4.). The fact that FDI occurs in both global (where eg, automobile, aerospace), international industries, and multi-domestic industries (Porter, 1990) challenges the relevance of the theory because not every of all these industries can be considered as oligopolistic.

#### 2.2.6 Trade-oriented FDI vis-a-vis Anti-Trade-oriented FDI (1975)

Some Japanese writers (Kojima, 1975, 1978; Ozawa, 1979) postulated that FDI can be categorised into two types: one is trade-oriented, represented by Japanese FDI abroad, and the other is anti-trade-oriented, typified by US FDI abroad. The Japanese type of FDI is said to be trade promoting because it is complementary to trade in that it strengthens the comparative advantage of trading countries. More specifically, in the case of less developed countries, FDI should provide capital, management skills so as to activate previously unexplored resources. This process requires continuous

upgrading of the industrial structure of both home and host countries to "harmonise" trade between them. The earliest Japanese outward FDI in the 1960s and early 1970s in resource industries was typified as trade-oriented as it complemented the Japanese shortage of resources at home. On contrary, the US type of FDI is "anti-trade-oriented" because it disregards the comparative advantages of home and host countries.

Trade-oriented FDI theory forces researchers to pay attention to the evolution of comparative advantages of home and host countries and its impact on the direction of FDI. It is, however, basically normative and descriptive in nature. The pattern of Japanese FDI it envisaged in the 1960s and 1970s may be due to a series of "fortuitous circumstances" such as a strong domestic demand, with less scope for FDI in some sectors, concentration of Japanese FDI on labour-intensive offshore production in Southeast Asia. The explanatory role of this theory has been challenged because of its "too simplistic frame reference" and a relative uncritical acceptance of the neoclassic assumption of perfect competition (Gray, 1982).

Trade-oriented FDI theory is also basically a theory for resources-based or cost-minimisation FDI. The Japanese recent FDI, especially its investment in the developed countries (eg, the USA, UK, Germany), in the last decade has refuted the prescription of the Trade Oriented Theory because market-oriented reasons and strategic motives are more important than resources-seeking or cost reduction in such FDI (The EEC, 1991; Morris, 1988; Kujiwa, 1986). The more recent establishment of Japanese R & D centres in the EEC and USA has cast further doubt on the relevance of the theory. It can not easily encompass intra-industry investment (Dunning, 1991).

Finally, the theory ignores firm-specific factors (including ownership advantages and strategic issues) all together in its FDI conceptualisation. For example, the evolution of a country's economic system may cause changes of corporate strategic behaviour, and FDI (initial and/or rationalised) might result from corporate strategic responses to such evolution (Porter, 1990; Dunning, 1990) (See Section 2.4).

### 2.2.7 The Internalisation Theory (1976)

The Internalisation Theory has its roots in the transaction cost theory which was first

proposed by Coase in the 1930s. However, in the 1970s Buckley and Casson applied transaction cost theory to FDI, giving it a new conceptualisation -- internalisation theory.

According to the Internalisation Theory, the market for key intermediate products such as knowledge, marketing and management expertise are imperfect, thus linking different activities through market solutions involves significant time lags and hence transaction costs. As a result, firms are encouraged to replace these external markets with their own internal markets for these products. The internalisation of markets across national boundaries leads to FDI, and this process continues until the benefits and costs of further internalisation are equalised at the margin. The benefits of internalisation include avoidance of time lags and bargaining and buyer uncertainties, minimisation of the impact of government intervention through transfer pricing and the ability to use discriminatory prices. On the other hand, internalisation results in greater administrative and communication costs.

Internalisation theory (Buckley & Casson, 1976) takes knowledge as the main competitive advantage which encourages a firm to undertake FDI. Within the theory there is a creation of knowledge where firms invest in research in much the same way as for any investment project. Because research is particularly risky, it remains unexplored why firms make such a risky decision to invest in research. Buckley and Casson argue that it is not the possession of a unique asset per se that gives a firm its advantage, rather it is the process of internalising that asset as opposed to selling it to the market that gives the firm its unique advantage.

But if internalisation can benefit a firm so much, then why do only some firms undertake such internalisation ? The factors distinguishing the firms internalising markets from those which do not, must be more than simply the willingness of the firms. In other words, there is a difference between the willingness and capability to internalise (Dunning, 1983). Indeed, Buckley et al (1991) admit that the selection of an appropriate foreign market serving strategy (eg, exporting, licensing or fdi) designed to enhance and protect the competitiveness of the firm is dependent on an amalgam of firm-specific factors (eg, the nature and "uniqueness" of the firm's *competitive advantage*, and resource availability ), industry-specific factors and location/country specific factors (p.37). Nonetheless, to make the theory dynamic, more attention must be paid to the "generation, dissipation and the form of use" of

competitive advantage, such as innovation and entrepreneurship (Buckley, 1988, Cantwell, 1991).

Another drawback of the Internalisation theory is that it has tended to take location advantages and technological advantages as given and exogenous (in order to focus attention on the form of linkages between plants) (Cantwell, 1991). Thus the analysis employed by internalisation theory is static rather than dynamic. For instance, it does not fully explore the impact of changes in environmental and firm-specific factors on a firm's choice of governance mode through time (Hill & Kim, 1988). Moreover, strategic or management decision-making issues are ignored all together by the Internalisation theorists (Kindleberger, 1988). Hence, the theory can not point out how the evolution of comparative advantages of nations will affect the emergence of MNE via FDI, what will be its strategic responses to such evolution (Kojima, 1982), and where the firm will internalise takes (especially on the issue of recipient host country of FDI) (Clegg, 1987), which firms are more likely to become an MNE. Even the keenest advocates have recognised the need to incorporate strategic and management decision-making into the development of the theory (Buckley, 1983, 1987, 1988; Casson, 1987, 1990).

Thirdly, the theory pays little attention to the impact of internal control costs on the MNE's choice of governance mode (Hill & Kim, 1988). The internalisation theory assumes that wholly-owned overseas production is more efficient than joint ventures, which in fact may not always be the case (Young et al, 1989).

The empirical verification of the internalisation theory is difficult, if not impossible (Aggarwal, 1980). Buckley (1988) also admits the difficulty in operationalising the theory into testable hypothesis. The theory is criticised for not being applicable in the short-term and especially to FDI by smaller firms operating in one or two foreign countries. The statistical tests done so far under very simple assumptions only lead to the conclusion that the process of internalisation is concentrated in R & D intensive industries, a conclusion that is subject to different interpretations (eg, the Product Differentiation Theory, and to a lesser extent, Product Cycle Theory) (Aggarwal, 1980, see Section 2.2. 9 on empirical evidence).

### 2.2.8 The Eclectic Paradigm (1977--93)

The Eclectic Paradigm, developed and refined by Dunning (1977, 1984, 1988, 1993), combines elements of different approaches to international production. Dunning suggests that the propensity of a firm to engage in FDI depends on three main determinants.

Firstly, the firm must possess competitive or monopolistic advantage which its competitors do not possess. Dunning calls this an "ownership or firm-specific advantage". He further distinguishes two types -- asset and transaction -- ownership advantages. The former arise from the proprietary ownership of specific assets (eg, a patented process or product technology) which other firms do not possess. The latter mirror the capacity of MNE hierarchies vis-a-vis external markets to capture the transactional benefits (or reduce the costs) arising from the common governance of a network of these assets, located in different countries (Dunning, 1988).

Secondly, it must be in the best interests of the enterprise to transfer its ownership advantages across countries within its own organisation, rather than sell them or the right to their use to another firm. This is the internalisation advantage. Dunning contends that the "greater the perceived costs of transactional market failure, the more MNES are likely to exploit their *competitive advantage* through international production rather than by contractual agreements with other firms" (Dunning, 1988, p.3).

Buckley (1985) and Casson (1987) argue that the failure of international intermediate product markets is both a necessary and sufficient condition to explain the emergence of MNEs. Dunning refutes this on two grounds. He (1983) suggests that firstly, there is a need to distinguish between asset generation or acquisition, and asset usage through internalisation and secondly, it is "logically correct to distinguish between the capability of MNEs to internalise markets and their willingness to do so" (p.3). The latter (ie. willingness to internalise markets) explains the choice of a hierarchical rather than external market route to transfer ownership advantage, the former (capability) why they are exploited by one group of MNEs as opposite to any other or firms indigenous to the country of production. In other words, ownership advantages are only a necessary condition for establishing and preserving international production (Cantwell, 1989).

Thirdly, it must be in the firm's best interests to exploit its competitive advantage in conjunction with the indigenous resources of foreign countries rather than at home. This explains why an overseas investment is located in a particular host country.

Therefore, under the auspice of OIL paradigm, the greater the ownership advantages a firm has over foreign firms, the higher the propensity for it to internalise the advantages. And the more beneficial it is for the firm to exploit its advantages by using foreign country-specific endowments rather than those available locally, the more likely the firm will become an MNE.

Dunning further elaborates the other alternatives (eg, exporting and licensing) to the internalisation route (ie, FDI) in exploiting the advantages abroad. The Three Advantages in Dunning's eclectic paradigm are demonstrated in Figure 2.1.

Dunning's eclectic paradigm forces researchers to take a comprehensive viewpoint of the determinants of international business involvement by firms. As a wider analytic framework, the eclectic paradigm also requests researchers to question why a given economic activity is undertaken wholly internal to the firm via FDI, the external market via exporting, or in a combination of the two via licensing. Compared with the Internalisation theory, the eclectic paradigm is able to predict the direction in which internalisation may take (Clegg, 1987).

However, critics have suggested that it is tautological to include both ownership advantages and internalisation advantages as necessary conditions for FDI because the former already contains the latter (Casson, 1986, 1987; Buckley, 1988; Itaki, 1989, 1991).

Moreover, the size, complexity and scope of the Eclectic Paradigm make it almost impossible for researchers to verify satisfactorily and empirically. Another problem with the paradigm is that it may degenerate into a checklist against which researchers display data, and the causality and inter-relationships between numerous factors that lead to (FDI, licensing, exporting, etc) may be obscured or ignored (Lecraw, 1984). Corporate strategic issues such as corporate responses to risks and uncertainties are hardly taken into account in the OIL paradigm (Mainardi, 1987; Kindleberger, 1988; Macharzina & Engelhard, 1991). Moreover, the paradigm takes competitive or firm-

Figure 2.1 The Eclectic Paradigm of International Production

<p><b>1. Ownership-specific Advantages</b> (of enterprises of one nationality, or affiliates of same, over those of another)</p> <p>(a) Property right and/or intangible advantages Product innovations, production management, organisational and marketing systems, innovatory capacity; non-codifiable knowledge; "bank" of human capital experience; marketing, finance, know-how, etc.</p> <p>(b) Advantages of common governance</p> <p>(i) Which those branch plants of established enterprises may enjoy over de novo firms. Those due mainly to size and established position of enterprise, e.g. economies of scope and specialisation; monopoly power, better resource capacity and usage. Exclusive or favoured access to inputs, e.g. labour, natural resources, finance, information. Ability to obtain inputs on favoured terms (due, e.g. to size or monopolistic influence). Exclusive or favoured access to product markets. Access to resources of parent company at marginal cost. Economies of joint supply (not only in production but in purchasing, marketing, finance, etc. arrangements).</p> <p>(ii) Which specifically arise because of multinationality. Multinationality enhances above advantages by offering wider opportunities. More favoured access to and/or better knowledge about international markets, e.g. for information, finance, labour. etc. Ability to take advantage of geographical differences in factor endowments, markets. Ability to diversify or reduce risks, e.g. in different currency areas, and/or political scenarios.</p>	<p><b>2. Internalisation incentive advantages</b> (i.e. to protect against or exploit market failure)</p> <p>Avoidance of search and negotiating costs To avoid costs of enforcing property rights Buyer uncertainty (about nature and value of inputs, e.g. technology, being sold Where market does not permit price discrimination Need of seller to protect quality of products To capture economies of interdependent activities (see 1/(b) above) To compensate for absence of future markets To avoid or exploit government intervention (e.g. quotas, tariffs, price controls, tax differences, etc.). To control supplies and conditions of sale of inputs (including technology) To control market outlets (including those which might be used by competitors) To able to engage in practices, e.g. cross-subsidisation, predatory pricing, etc. as competitive (or anti-competitive) strategy</p> <p><b>3. Location-specific variables</b> (these may favour home or host countries).</p> <p>Spatial distribution of inputs and markets. Input price, quality and productivity, e.g. labour, energy, materials, components, semi-finished goods Transport and communication costs. Investment incentives and disincentives (including performance requirements, etc.) Artificial barriers to trade in goods. Infrastructure provisions (commercial, legal, educational and transportation). Psychic distance (language, cultural, business, customs, etc., differences) Economies of centralisation of R &amp; D, production and marketing</p>
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Source: Dunning, J. (1981) International Production and the Multinational Enterprise Allan & Unwin, London



specific advantage for granted and is thus static. For example, like the internalisation theory, it offers little guidance as to the path or process and timing of the internalisation of firms (or of countries).

Despite the sophistication of the Eclectic Paradigm, its explanatory power is still challenged by the changing and complex FDI phenomenon. Its explanatory power at micro-economic (firm) level seems to be troublesome. Thus Dunning argues that his eclectic paradigm should be regarded as a framework for analysing the determinants of international production (at macro or country level) rather than a predictive theory of the multinational firm (Dunning, 1988, 1991, 1993). He further warns:

"No single theory can be expected to encompass all kinds of foreign production satisfactorily, simply because the motivations for and expectations of, such production vary so much. The variables necessary to explain import-substituting investment are likely to be different from those which explain resource-oriented investment, and both are likely to be different from those which explain rationalised investment" (Dunning, 1991. p.124-5).

### 2.2.9 The Empirical Evidence of Competitive Advantage

In parallel to the theoretical development on the determinants of FDI and MNEs, economists have attempted to identify the characteristics of MNEs and/or industries with extensive outward FDI. Some of the major empirical studies and their findings are summarised in Table 2.1. These studies seem to highlight the association between multinationality and technological advantages (approximated by R & D and advertising intensity, economies of scale, proportion of non-operative staff).

Though the association between multinationality and technological advantage is established, there has been some ambiguity in the direction of cause and results (Hood & Young, 1979). For instance, it could be argued that large firm size stimulates diversification and multinationality, but equally plausibly, size may be the by-product of expansion rather than the cause. Moreover, instead of suggesting that R & D intensity encourages multinationality, it could be considered that the greater the firm's existing foreign involvement, the greater the prospective return on R & D, since the results can be spread over more markets. Thus increased internationalisation could encourage higher R & D intensity, rather than simply vice versa. higher advertising

intensity than local rivals in the host market may be the necessary promotion action rather than the cause of FDI in that country.

Moreover, some recent empirical studies have also pointed out that some MNEs have invested and established their R & D centres in the USA, UK and continental Europe in order to seek or improve, rather than exploit, their technological advantage.

Table. 2.1 Technological Advantage and Outward FDI  
(Empirical Evidence from Developed Countries, selected studies)

Author(s) (Year)	Sample	findings
Hymer (1960/76)	US firms	Higher R & D intensity and capital-intensity was related positively to multinationality of firms
Caves (1971)	US firms	Industries characterised by a high extent of product differentiation (proxied by R & D and advertising intensity) tended to have more foreign affiliates
Vaupel (1971) Vernon (1971)	the largest US firms	MNEs were more diversified in terms of product structure, tended to be larger, more profitable, more advertising- and research-intensive.
Knickerbocker (1973)	187 large US firms	The entry of US firms into foreign markets (via FDI) was bunched in time, and the industries with extensive outward FDI were characterised by high market concentration and a high intensity of R & D, and extensive product differentiation.
Orr (1973)	US firms	US and foreign control of Canadian industries was significantly higher in sectors characterised by high advertising intensity, high capital requirements and for capital-intensive firms
Buckley & Casson (1976)	170 non- US firms, 250 US firms	Higher R & D intensity and capital-intensity was related positively to multinationality of firms
Parker (1974)		The degree of multinationality was associated with technological advantage for US and European MNEs (but not for Japanese MNEs)
Dunning (1974)	US affiliates in the UK	US affiliates were more capital-, R & D- and advertising-intensive than host country counterparts.
Buckley (1977)	16 manufacturi ng industries	FDI was positively related to the relative strengths of R & D activity in the home country

Swedenborg (1979)	Swedish firms	R & D intensity was a positive and significant determinant of the outward FDI by Swedish firms.
Cantwell (1987)	German and Japanese firms in 12 selected manufacturing firms	Relative number of patents of German and Japanese firms was positively and significantly related to their share of total foreign production in their industries.
Clegg (1987)	US, UK, German, Swedish and Japanese firms	R & D expenditure was the most positively significant determinant of outward FDI for US, Swedish and West German MNEs. But it was negatively and significantly related to Japanese outward FDI, negatively but insignificantly related to FDI from the UK.
Pearce (1989)	The largest industrial firms	R & D intensity of the US firms was significantly and positively related to their propensity to undertake outward FDI. Research intensity had significant impact on the outward FDI by European firms (except British ones)
Kogut & Chang (1990)	Japanese FDI in the US	Japanese investors had a higher R & D intensity than their counterparts in the US

Sources: Compiled by the author

### 2.3. The Behavioural Perspectives: The Stages of Development Model

Unlike the economic theories reviewed above which usually treat exporting as an alternative to FDI, some marketing researchers, using the behavioural theory of firm and the theory of growth of the firm, focus their analysis on the increasing international involvement by a firm along its internationalisation process. Three models of the stages development have emerged in the literature: the export development, the stages of internationalisation and the network theory.

#### 2.3.1 The Export Development Model (1971-81)

The export development model was proposed by several authors with slightly different versions (see Table 2.4). The model attempted to explain the behavioural

determinants of increasing export involvement of firms.

This model tends to treat export decisions as managerial innovation, pushed by a set of internal (eg, management's outlook and international experience) and external factors (eg, unsolicited export orders). However, since these authors hardly moved beyond active or committed export stage, the model has very little relevance to the MNEs that have invested and produce abroad.

### 2.3.2 The Nordic Model

Another model of internationalisation process moves beyond the exporting stage to foreign investment by a firm. The sequential-type of internationalisation process had been envisaged earlier by Vernon (1966) within his PLC Model. The PLC model (see Section 2.2.2) traces the development of the product from its initial development and subsequent sale in the home market through to exporting and eventual manufacturing in an overseas subsidiary. Knickerbocker (1973) extended the analysis by identifying the roles of agents and sales subsidiaries as separate stages in the process, but it was the Nordic studies (Johanson and Vahlne, 1977; Olson and Weidersheim-Paul, 1978) that gave this sequential-type model a firm empirical base.

Based upon the evidence of a few large Swedish manufacturing firms' experiences, several authors have attempted to conceptualise the development of exporting and overseas investment as an incremental stagewise process. The model suggests that entry into exporting is commonly reactive, with initial exports targeting the psychologically closest country (Johanson & Vahlne, 1977; Olson & Weidersheim-Paul, 1978). This model has been extended to include multinational manufacturing operations. A further expanded model (Cavusgil, 1980; Young et al, 1989) views the internationalisation process as consisting of four stages:

- a). Experimental involvement stage: when a firm starts to export at a marginal and intermittent scale;
- b). Active involvement stage: when the firm begins to systematically explore export opportunities in a number of markets. An export marketing department may be set up.

Table 2.4. Stages of Export Development

Bilkey & Tesar (1971)	Cavusgil (1980)	Czinkota (1982)	Reid (1981)
1: Management is not interested in exporting	1: Domestic marketing: The firm sells only to the home market	1: The completely uninterested firm	1. Export Awareness: Problem of opportunity recognition, arousal of need
2: Management is willing to fill unsolicited orders, but makes no effort to explore the feasibility of active exporting	2: Pre-export: The firm searches for information and evaluates the feasibility of exporting	2: The partially interested firm	2. Export intention: Motivation, attitude, beliefs, and expectancy about export
3: Management actively explores the feasibility of exporting	3: Experimental Involvement: The firm starts exports on a limited basis to some psycho-logically close country	3: The experimental firm	3. Export Trial: personal experience from limited exporting
4: The firm exports on an experimental basis to some psychologically close country	4: Active involvement: Exporting to more new countries -- direct exporting -- increase in sales volume	4: The experienced firm	4: Export Evaluation: Results from engaging in exporting
5: The firm is an experienced exporter	5: Committed Involvement: Management constantly makes choices in allocating limited resources between domestic and foreign markets	5: The experienced small exporter	5: Export Acceptance: Adopting of exporting/rejecting of exporting
6: Management explores the feasibility of exporting to other more psychologically distant country		6: The experienced large exporter	

Source: Andersen, O. (1993)

c). Committed involvement stage: when the firm has a long term commitment to international marketing, with the establishment of foreign licensing and production facilities.

d). Global involvement stage: when the firm's international involvement is so high that it begins to coordinate its widely spread sourcing, manufacturing and marketing activities on a global basis.

This incremental stagewise development process evolves in an interplay between the development of knowledge about foreign markets and operations on the one hand, and an increasing commitment of resources to foreign markets on the other. This model is said to be able to explain two patterns in the internationalisation of the firm. One is that the firm's involvement in foreign markets develops according to an establishment chain: at the start of the process, the firm has no regular export activity, occasional exports take place via independent representatives, later exports become regular and sales subsidiaries are set up to handle exports, eventually foreign manufacturing may follow. This sequence of stages indicates an increasing commitment of the firm's resources to foreign markets.

Another pattern is that the firm enters new markets with successively greater psychic distance which is defined in terms of factors such as differences in language, culture, political systems etc, which disturb the flow of information between the firm and the market (Vahlne & Wiedersheim-Paul, 1977).

A similar version of internationalisation process was envisioned by Ohmae (1985, 1987), who presented a model of evolution of manufacturing MNE in a five-stage process: export -- direct sales and marketing -- partial foreign production -- new foreign investment -- regional or global integration. However, no specific empirical study has been undertaken to verify Ohmae's model.

One of the strengths of the stages of development model (Nordic Model) is its dynamism at the firm level. It has considerable merit, particularly as it describes the initial stages of entry into foreign markets. For market-seeking FDI, it predicts the direction of exports and FDI, ie, towards the country the firm feels closest psychologically in its early stages of internationalisation.

However, the model remains too deterministic, over-simplistic and lack of explanation (Young et al, 1989) because it did not consider the industry-specific factors (eg, competitors), firm-specific elements (eg, costs and risks of production abroad, product adaptation) and corporate strategic issues. The impact of evolution of comparative advantages (eg, infrastructure provisions, market size, government policies, and incentives for inward investment) of home and (possible) host countries on the process of internationalisation of the firm has been ignored all together. Because foreign market conditions (except psychic distance) and industry-specific factors are ignored, the original Nordic Model also fails to consider other alternatives of serving foreign markets (eg, licensing) (Young et al, 1989).

For example, in the high-tech industries, the high costs of R & D and engineering calls for an acceleration of internationalisation process; the short product life cycle requires simultaneous marketing efforts in many markets; the education level of entrepreneurs (especially those with international experience) may help overcome some psychological barriers to foreign markets (Young et al, 1989). Indeed, as the world becomes more homogeneous, the explanatory value of psychic distance tends to decrease (Melin, 1992).

As a result, its explanatory power is limited to the early stages of internationalisations of firms, and some export-replacing investments. Indeed, the model has been accused of being descriptive rather than explanatory.

The empirical evidence confirming the prediction of the stages model comes mainly from studies on the experiences of Scandinavian firms (Johanson & Weidersheim-Paul, 1975; Johanson & Vahlne, 1977; Loustarinen, 1979, 1982, Larimo, 1985). Some studies of exporting, and/or entering foreign markets via acquisition by firms from USA, Japan, Australia and Turkey (Buckley et al, 1979, 1982; Buckley & Robert, 1982; Cavusgil & Godiwalla, 1982; Wells, 1984; Hood & Young, 1985) confirm that commitment and experience are important factors explaining international business behaviour, indicating that firms usually undertake FDI after a period of exporting.

However, other empirical studies (Hood & Young, 1983; Bureau of Industry Economics, 1984; Millington & Bayliss, 1990) have denied the generalisability of the Nordic Model. In a sample of 140 American and Continental European subsidiaries in

the UK, Hood & Young found that 44 per cent of their parents had no prior involvement in the UK market (Hood & Young, 1983). Another study of Australian MNE's overseas subsidiaries reveals that 39 per cent of 228 FDI cases had not pre-existing host-country presence (Bureau of Industry Economics, 1984). Millington and Bayliss (1990) in a study of 90 British MNEs found that 20 per cent of them had no previous experience of foreign markets, 58 per cent leapfrogged from licensing, direct export or indirect exporting via agent to manufacturing subsidiaries.

### 2.3.3 Network Theory (1984)

Another development in explaining the internationalisation of the firm is the so-called Network Approach (Imai, 1984; Johanson & Mattsson, 1984, 1987). This approach is developed by some Japanese and Swedish researchers who examined distribution (systems), internationalisation of industrial firms (processes), and industrial purchasing and marketing behaviour (interaction).

According to the Network Approach (Imai, 1984; Johanson & Mattsson, 1984, 1987), the industrial system (or the market) consists of firms engaged in production, distribution and use of goods and services. Such a system or the market is considered as a network of relationships between firms as suppliers, distributors and/or clients of goods or services. Such relationships are competitive and complementary. They are also cumulative and changing. The boundary of such network relationships depends on the transaction costs and benefits associated with being dependent upon resources controlled by other firms.

According to the Network Approach, the internationalisation of a firm means that the firm establishes and develops positions in relation to its counterparts in foreign networks. This can be achieved (1) through establishment of positions in relation to counterparts in national nets (markets) that are new to the firm, ie, *international extension*; (2) by developing the positions and increasing resource commitments in those nets abroad in which the firm has already had positions, ie, *international penetration*; and (3) by increasing co-ordination between positions in different national nets, ie, *international integration*. Therefore internationalisation of firm is a process by which the firm's network positions are established and changed across border.



The Network Theory contains certain dynamic elements as it emphasises the interdependence and interaction of firms. Cultural influence on FDI, which has hardly been incorporated in conceptualisation of other theories of MNE (with the exception of the Nordic Model), may be easily embraced by the network theory. For example, Casson and Cox (1992/93) demonstrate that transaction costs can be substantially lowered in case of family networks based upon trust. And they have identified three cases of such family networks facilitating international expansion of business enterprises:

- a). a dispersed extended-family group used to provide an international network based upon trust and consensus decision-making (as in the case of the origins of Glaxo);
- b. A network in which small-scale family firms comprise the individual atoms, enabling horizontal co-ordination between them based upon ethnic and regional links that allow economic functions to be organised at very low transaction costs, as in the case of the Overseas Chinese;
- c. A large scale hierarchical organisation utilising existing cultural norms relating to the concept of family links in order to produce an integrated networks based upon family-type authority/loyalty rather than managerial controls as in the case of the Japanese Zaibatus and Sogo Shosha.

Whereas economic theories tend to treat inter-firm relationships as formal dyadic, short-term and combative, the network approach views them as custom-related, multi-faceted, long-term and co-operative. Thus it could be more useful in explaining inter-firm collaborations (eg, strategic alliance, joint ventures) than other theories.

However, the Network Theory is still in its infancy (Dunning, 1993) and its full contribution in terms of its explanatory power of a firm's internationalisation has yet to be seen and assessed. Furthermore, the importance of strategic intent of firms in internationalisation has been neglected in the theory. So have the factors distinguishing which firm will be the first to internationalise. Many important external variables (eg, other sources of firm-specific advantages rather than networking, government policies, the stage of development of the countries) have not been incorporated in the approach. Thus it is difficult now to ascertain whether the network

Theory can be developed into a general theory of internationalisation of firm.

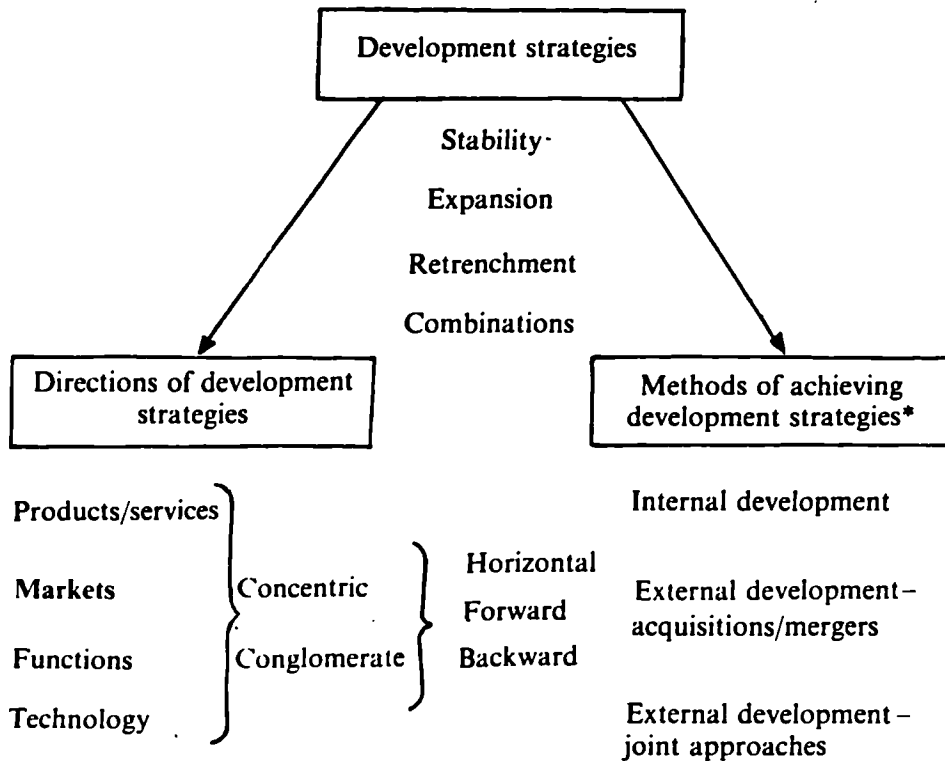
## **2.4 Business Strategy Approach**

Business strategy refers to "a deliberate choice by entrepreneurs or managers of firms to organise the resources and capabilities within their control (ie, the competitive advantages) to achieve an objective or set of objectives over a specified time period" (Dunning, 1993. p.186). The making of strategic decisions is usually based on the assessment of strengths, weaknesses of the firm's resources and capabilities and the opportunities and threats brought by the changing internal and external environments (ie, SWOT analysis) (Ansoff, 1965; Learned et al, 1965; Loustarinen, 1980, Porter, 1980, 1985). Thus in strategic decision-making process, a large number of factors are been taken into account by management.

In search of a number of corporate objectives (eg, stable expansion, sales maximisation, profit maximisation), a firm may face multiple choice in terms of the development strategies, the directions of development (such as products, services) and the methods of achieving these development strategies (eg, acquisitions, joint ventures) (Young et al, 1989). Moreover, it is possible that while some firms may choose one development strategy, or one direction within the selected strategy or one method of achieving the chosen strategy, others may have chosen several directions of development strategies and multiple methods of achieving these strategies. For a firm that aims to achieve stable expansion, there are several alternative strategies that can be chosen and pursued sequentially or simultaneously (see Figure 2.2.).

Whether a firm chooses to pursue a single or multiple expansion routes including internationalisation depends upon the firm's perception of its internal and external environment, its confidence in its resources and competitive advantage and the entrepreneur and/management's attitude to and propensity to take risks as well external opportunities and threats. Thus inherent in the strategic decision is the consideration of a large set of variables.

Figure 2.2. Development Strategies of the Firm



\*For retrenchment strategies the development approaches would include liquidation or sell-out and divestment.

Source: Young et al (1989). p.7.

Most researchers have viewed MNE corporate strategy along two major dimensions, namely product diversification and international market diversification (Stopford and Wells, 1972, Danniels et al, 1984, Egelhoff, 1988, Habib and Victor, 1991). These two dimensions were identified to capture MNE diversification strategy in terms of products and markets. A third dimensions -- operation -- should also be added as an essential intermediate link between product and market components (Loustarinen, 1980). Thus product-operation-market specification sets the scope for search of an internationalisation strategy.

At early stage of internationalisation, a firm usually has no predefined holistic strategy to guide its internationalisation within the potential product-operation-market scope (Loustarinen, 1970, 1980; Schwendiman, 1971, 1973). This is especially true in cases where a particular export operation for a particular product is initiated by an agent in a particular foreign country.

Young (1988) argues that skills and knowledge in the company increase as the internationalisation process proceeds; this offers the basis for the company to diversify its internationalisation further in the later stages of the process. Kogut (1983) contends that while the possession of superior intangible assets may give rise to the initial act of foreign investment, once established abroad the advantages of multinationality per se (ie, those gained from the spreading of environmental risks and the common governance of geographically diversified activities) become more important. MNEs operating in a variety of environments are exposed to multiple stimuli which enable them to develop competencies and learning opportunities not open to domestic firms (Kugot, 1987; Bartlett & Ghoshal, 1988, 1990).

Stopford (1972) has suggested that as a firm's international involvement deepens, corporate strategies will change, so will organisation structure, which in turn will reinforce or improve management efficiency and foster greater degree of multinationality or rationalisation of international operations. Thus MNE organisation structure evolves from international division, to product divisions (regardless of location), to regional divisions (manufacturing is concentrated in home country and host country/ies that have large market and/or have large neighbouring markets) and to a mix of product and area diversification.

Some studies even show that the speed of internationalisation is related to the firm's experience at domestic market (Franko, 1983; Hedlund & Kverneland, 1984). This domestic experience, once learnt and accumulated, becomes knowledge and competitive advantage for later exploitation overseas. Moreover, the increasing number of managers and technical staff who have foreign education and/or employment experiences, improved communication and exchange of management knowledge across countries may help firms accelerate the pace of their internationalisation.

The strategic approach becomes especially relevant to a firm that has large involvement in international business (Young, 1987). Young et al (1989) argue that while a number of the factors involved in the choice of foreign market serving methods are evolutionary in nature, items such as policy changes would produce discontinuities in the operating environment and could thus require a fairly immediate response in terms of the internationalisation methods used. As such, a company's

development overseas may be expected to be subject to breaks in sequence, the jumping of stages or indeed the reliance on only one or more strategic routes. Millington and Bayliss (1990) also suggest that international experience and formal strategic planning act as substitutes for market experience, enabling firms to leapfrog the incremental process within markets.

The widening strategic options open to firms require a reappraisal of the received theories of MNE activity in a number of ways. Thus any future modelling of MNE activity must pay more attention to strategic-related variables (Dunning, 1993a). The full incorporation of strategy-related issues into a general theory or paradigm of MNE or FDI activity has yet to be accomplished (Dunning, 1993).

## **2.5 The Role of National Competitive Advantage**

The foregoing and fragmented literature suggests that a very broad range of issues have had an impact on the emergence and development of MNEs, including their strategic behaviour. Among the salient issues touched by various theories is the role of national characteristics. It seems that national competitive advantage serves as the determinants of corporate competitive advantage (Porter, 1990. see Figure 2.4.). For example, Vernon (1966) attributed US firms' product innovation capability to the large US market with high-income customers. The ease of communications in the US also helped American firms to identify new market potential and thus to innovate. Thus Porter (1990) suggests that the creation and sustainability of corporate competitive advantages arises from four broad and inter-related attributes which constitute the "diamond of national advantage": firm strategy, industry structure and rivalry; factors conditions; demand conditions; related and supporting industries. This model shows that these four facets of the diamond and the interaction between them vary between countries, and suggests that the principal ways in which countries may improve their competitiveness are to upgrade the quantity and quality of their resources and capabilities and to utilise them more efficiently.

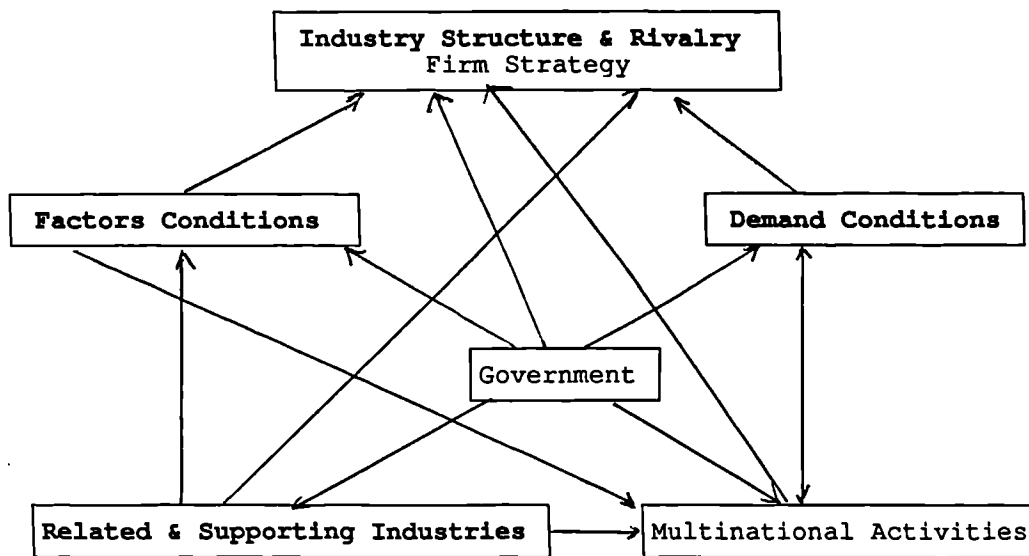
However, Porter's diamond model is essentially a framework for assessing *industry* competitive advantages of nations rather than *corporate* competitive advantages, and criticised for its failure to take into fuller account the role of foreign and indigenous MNEs and the role of government (Dunning, 1992).

For example, the competitive advantages of the UK auto industry largely depend upon foreign MNEs rather than its own indigenous firms. The case of Singapore may be more illustrative of the role of foreign MNEs in its national economic development (Mirza, 1987; Chia, 1988). During 1980 and 1992, foreign MNEs accounted for 78.5 to 89.3 per cent of investment in Singapore's manufacturing sector (Lee, 1993), and in 1990, they accounted for 61 per cent of employment, 76 per cent of value-added, and 91 per cent of exports in the island's manufacturing, commerce and services sectors (Economic Planning Committee, Singapore, 1991). In fact, MNEs have an impact upon three facets of the diamond -- industry structure and rivalry (and thus firm strategy), demand conditions, and related and supporting industries. Thus it is sensible to add multinational activities as the fifth facet of the diamond.

Moreover, the role of government may be more complex than suggested in Porter's model. Governments can influence all the five facets of the diamond through its investment projects (eg, in infrastructure and education), economic and industrial policies, and as purchasers and suppliers. And above all, governments set the "rules of game" for competition, the central thrust in Porter's model (Dunning, 1992). In addition, Porter's neoclassic economic approach to competition also contradicts his earlier writings when he advises firms to seek attractive industries where there is a minimum of competition defined by the five forces (competitor rivalry, bargaining power of suppliers, bargaining power of customers, threat of new entrants and threat of substitution) (Porter, 1980, 1985).

The determinants of industry competitive advantages of nations can be summarised in the six facets (see Figure 2.3).

Figure 2.3. Industry Competitive Advantage of Nations



Source: Dunning (1992), "The Competitive Advantage of Countries and the Activities of Transnational Corporations", in Transnational Corporation Vol.1, No.1. pp.135-168.

The competitive advantage of nations not only influence the creation of corporate competitive advantage and thus corporate strategy (from home country and firm perspectives) but also have an impact on the location of FDI (from host country perspective). For instance, the demand conditions in the USA, Europe and Japan stimulate firms in these countries to innovate new products (Vernon, 1967, 1979), while industry rivalry and structure determine the opportunities suitable for horizontal, vertical integration and diversification strategies of firms (Buckley, 1990). The latter point also illustrates that internalisation advantages are also being influenced by comparative advantages of nations (Dunning, 1990). The activities of MNEs will in return change the configuration of national competitive advantage (Dunning, 1992).

Thirdly, the evolution of national diamond may provide direct stimuli (pushing and pulling factors) for outward FDI by firms. For example, currency appreciation, increasing labour and other operating costs, the shortage of labours at home may have an immediate effects upon the competitive advantages of firms and thus their business strategies, encouraging outward their FDI.

Thus the competitive advantage of the nation has a major impact on the propensity of the its firms to generate and sustain certain types of competitive advantages. Dunning (1993) contends that the propensity of firms of a particular nationality to engage in FDI will vary according to the specific characteristics of their home country and the country/ies in which they propose to invest and produce, the range and types of products (including intermediate products) they intend to produce, and their underlying management and organisational strategies. Table 2.3 lists some selected firm-specific competitive advantages and characteristics of home country favouring such advantages.



Table 2.3. Selected Corporate Competitive Advantages and Country-specific Characteristics Likely to Generate & Sustain Them

Firm-Specific Advantages	Country Characteristics Favouring Such Advantages
1. Size of firm (eg, economies of scale, product diversification)	Large & standardised markets; liberal attitude towards mergers and acquisitions, conglomerates, industrial concentration
2. Management of organisational expertise	Availability of managerial manpower; educational & training facilities (eg, business schools). Size of markets, etc; making for (1) above. Good R & D facilities
3. Ability to create, acquire and upgrade	Government support for innovation. Availability of clusters of complementary industries, skilled manpower and in some cases of local materials
4. Labour and/or mature, small-scale intensive technologies	Plentiful labour supplies; good technicians. Expertise of small firm/consultancy operation. Favourable work ethos and industrial relations
5. Product differentiation, marketing economies	National markets with reasonably high income; high income elasticity of demand. Acceptance of advertising and other persuasive marketing methods. Sophisticated and demanding purchasers
6. Access to domestic markets	Large markets. No government control on imports. Liberal attitude to exclusive dealings
7. Ability to foresee & take advantage of global production and marketing opportunities	An outward-looking economic strategy. Willingness to be economically interdependent
8. Access to, or knowledge about natural resources	Local availability of resources encourages export of that knowledge and/or processing activities. Need for raw materials not available locally for domestic industry. Accumulated experience of expertise required for resource exploitation/processing

9. Capital Availability and financial expertise	Good and reliable capital markets and professional advice
10. Entrepreneurial drive and vision	A commercial ethos conducive to risk taking and start-up of small enterprises. A favourable tax and legal environment
11. Ability to adjust to structural change	First-class information acquiring and transmission facilities; and mobility of complementary assets
12. As it affects various advantages above	Role of government and relationship with enterprises. Incentives to create advantages. A systemic strategy towards inward and outward direct investment

Source: Dunning, (1990)

## 2.6 Concluding Remarks

This chapter has reviewed economic theories of the MNE and the behavioural theories of the internationalisation of the firm. Recent development from strategic perspectives has also been discussed. While each of the theories reviewed has made contribution to our understanding of the emergence and development of the MNE, an integrative analytic framework has yet to be developed from corporate strategy perspective.

From the above literature review, the following conclusions can be reached:

a). The Nature of competitive advantage. Numerous competitive (or ownership-specific) advantages have been suggested by the theories of the MNE: oligopolistic market structure and behaviour (Hymer, 1960; Kindleberger, 1969; Caves, 1971, 1982, Vernon, 1971), differentiation (Caves, 1971, 1982), financial and monetary factors (Aliber, 1971), including access to cheap capital and diversification investments (Grubel, 1968; Rugman, 1976, 1981) and access to raw materials (Lall & Streeten, 1977).

b). Sources of competitive advantages. The home country provides the primary source of competitive advantages of firms. The national diamond of home country provides opportunities and threats that enable and/or compel firms to create competitive advantages in technology, management and marketing, etc. The PLC theory illustrates the point.

c). Home country diamond and corporate strategies. The home country diamond not only influences the creation of competitive advantages, but also (consequently) impacts upon the corporate strategies in terms of product and market diversifications, in which the internalisation analysis can play an important role. The industry structure and rivalry, for instance, has a decisive impact upon corporate strategy in terms of integration and diversification.

d). The evolution of home country diamond vis-a-vis international markets (especially host country diamond) can create opportunities and threats that call for changes of corporate or business strategies. Some changes are incremental, but in many instances dramatic.

e). The management and strategies are important in the internationalisation of firms in that opportunities and threats created by environmental changes have to be perceived by the management who are mainly responsible for formulating strategy to match corporate resources with opportunities. (Geographical) market orientation of the management can influence the focus of their attention in search of opportunities and in allocating corporate resources, which in turn could determine the internationalisation process of the firms. The technological advances in communications have made it much easier for management to broaden their business horizons beyond their national boundaries and to identify business opportunities in the international markets.

f). The evolving corporate or business strategies, reflecting the match of perceived corporate resources and capabilities and market opportunities and threats, thus influence the objectives, methods and modes of foreign entry by the firms. It is assumed that firms will take the methods and modes of foreign entry that take full advantages of its corporate resources and capabilities and foreign market opportunities to fulfil its entry objectives.

g). The process of the internationalisation of the firm. The behavioural theories

suggest that the firm tends to increase its international involvement incrementally, usually starting from indirect export to direct export, and then to the establishment of foreign sales subsidiaries and eventually foreign manufacturing. Its foreign involvement usually begin with nearby countries with similar cultures and with countries it has established network relationships. However, such an incremental approach has gained only limited empirical support.

Having reviewed the general literature on FDI and the internationalisation of the firm, the following chapter will examine the theories and experiences of MNEs from the Third World and of state-owned MNEs.

## **CHAPTER 3**

### **UNCONVENTIONAL MNEs: THEORIES AND EVIDENCE**

#### **3.1 Introduction**

FDI by developing country enterprises is not a new activity. Hong Kong firms have been investing and operating overseas since the last century, and in the 1920s Argentinean firms had invested in neighbouring countries. The 1960s and 1970s saw the first surge of outflows of FDI from many developing countries (eg, Argentina, Hong Kong, India, and other countries) (World Bank, 1989). The 1980s and early 1990s saw the emergence of (even considerably large) MNEs from South Korea, Taiwan, Singapore as well as Hong Kong. MNEs from LDCs continued increasing their overseas presence throughout the 1980s and early 1990s, although their impact in international business remains very limited, compared with that of MNEs from developed countries (see Table 1.1. and Table 1.2.).

MNEs emerging from the Third World and socialist countries may differ in a number of important ways from their counterparts from industrial countries (see Section 3.2.) and thus deserve attention from researchers (Wells, 1978, 1981, 1983; Giddy & Young, 1981; Dunning, 1984, 1993). This chapter reviews the theories specifically developed to explain the internationalisation of firms from less developed countries (LDCs) and the empirical evidence of the Third World MNEs within the analytic framework developed in the last chapter.

#### **3.2 Conventional and Unconventional MNEs: A Comparison**

MNE theories developed by 1980 tended to focus on the explanation of the emergence of MNEs from developed countries, especially those from the USA and Europe. These theories and empirical findings suggested that these conventional MNEs tended to have competitive advantage in product differentiation, brand names, marketing and more general managerial skills, unique technologies and privileged access to finance due to capital market imperfections (Giddy & Young, 1981). These MNEs also usually emerged from oligopolistic, technologically advanced industries.

Thus emphasis was put on technologies derived from intensive R & D, large size of firm, as well as high degree advertising intensity (see Chapter 2, especially Section 2.2.9).

Emerging MNEs from the Third World do not conform to the profile of conventional MNEs from developed countries. The major differences in the characteristics of conventional and unconventional MNEs are summarised as follows (also see Table 3.1):

Table. 3.1 A Comparison of Conventional & Unconventional MNEs

Characteristics	Developed Country-based MNEs	Developing Country-based MNEs
Size of overseas Subsidiaries	Large	Small (With notable exceptions from Korea)
Technology Intensity	R & D intensive, advanced technology sectors (eg, automobile, chemicals, petroleum)	Low technology, labour-intensive sectors (eg. clothing & textiles, basic household goods, simple food processing) (With some recent exceptions from the four Tigers)
Industrial Clusters	Oligopolistic industries with high market concentration at home country	
Product Features	Heavily advertised, differentiated products.	Undifferentiated products (with only some recent exceptions from Korea)
Main Recipients of Their FDI	Developed countries with similar level of per capita income	Poorer and neighbouring countries
Main Form of Foreign Involvement	Wholly-owned subsidiaries	Joint ventures

Source: derived from Wells (1978, 1983); (Giddy & Young, 1981); (Lall, 1983)

a. The overseas subsidiaries of developing country-based MNEs are relatively small (eg, Lecraw, 1977, 1981; Busjeet, 1980; White, 1980; Wells, 1978, 1983, 1983; Lall, 1983) (see Section 3.2.2);

b. MNEs from LDCs tend to concentrate on low-technology, labour-intensive, undifferentiated products (Lall, 1983, Wells, 1983). For example, in a study of foreign subsidiaries located in Mauritian and Philippine export processing zones during 1970-78, Busjeet (1980) found that the average capital-labour ratio in Mauritius was US\$2,100 per worker for affiliates of developing country-based MNEs and US\$4,400 per worker for affiliates of industrialised country MNEs, and in the Philippines, the figures were US\$1,500 per worker and US\$9,300 per worker respectively. In Han & Brewer's study (1987) of Korean MNEs, they also found that Korean technology involved in FDI tends to be labour-intensive, Kumar & Kim (1992) found that despite a surge of Korean FDI in the EC, most Korean products sold in the Single Market had to use distributors' brands (see Table 3.4).

c. FDI undertaken by these unconventional MNEs tends to flow to the poorer and smaller neighbouring countries (Wells, 1977, 1981, 1983; Lall, 1984; Lecraw, 1984). For example, between 1965 and 1978, 99 per cent of Argentine and 95 per cent of Chilean investment was in other Latin American countries. White (1981) found that FDI flows from higher income and larger Latin American countries (eg, Argentina, Brazil and Mexico) to smaller and lower-income countries like Ecuador, Paraguay and Uruguay. East Asia attracted 71 per cent of accumulated FDI from the four East Asian NIEs (UNCTC, 1983; Dunning, 1986). The major exception is India which had only 15 per cent of FDI stock by 1980 located in South Asia (Lall, 1983). Han & Brewer (1987) also found that Korean FDI tended to flow to lower-income countries.

d). joint ventures are frequent (although effective control is probably retained by the investing firm in the most of cases) (Wells, 1978, Giddy & Young, 1981). For instance, in a study of 602 subsidiaries of the Third World MNEs, only 57 were wholly owned. This is in sharp contrast to the pattern of US MNEs, which wholly own almost 66 per cent of their manufacturing subsidiaries abroad (Wells, 1983). For the Korean MNEs, if only the manufacturing sector is included, less than 10 per cent of their overseas ventures are wholly owned (Monkiewicz, 1983). In the case of

Mexico, MNEs from Latin America controls only 36 per cent the capital of their foreign ventures. In Ecuador in 1974-75, Latin American investment had in 42.5 per cent cases some local equity participation (Monkiewicz, 1983).

The salient differences between conventional MNEs from the developed countries and developing country-based unconventional MNEs lead some authors (Lecraw, 1981; Lall, 1983; Wells, 1983; Min & Brewer, 1987; Kim & Lyn, 1990) to question the applicability of "conventional MNE theories" to the unconventional MNEs, although many authors (Giddy & Young, 1980; Dunning 1984, 1988, 1990; Bodywyn, 1986) argue that conventional MNE theories only are adequate and sufficient, if applied carefully, to explain the emergence of unconventional MNEs.

Three theories have been proposed to explain the FDI undertaken by MNEs from developing countries. These include Dunning's investment development cycle (1981, 1985, 1988), Wells' small-scale technology hypothesis and Lall's adapted technology theory.

### **3.3 The Theories of MNEs from LDCs**

#### **3.3.1 Investment Development Cycle**

According to Dunning (1981, 1986, 1988, 1993), a country's propensity to engage in outward FDI depends upon the following variables:

- i). its stage of economic development (measured by per capita income);
- ii). the structure of its domestic factor endowments and markets;
- iii). its political and economic systems;
- iv). the degree of transactional market failure of intermediate products; and
- v). the extent, and the form of its economic, political and cultural interface with other countries (the economy in question must be an open one).



Thus Dunning suggests that as a country's economy enters a new stage of development, it is likely to experience a change in its position in terms of inward, outward and net outward FDI. It is hypothesised that most very low income countries attract little or not inward investment and undertake no outward investment. Middle income developing countries attract considerable amount of inward investment but engage in only a modest amount of outward FDI. While industrialised upper income countries attract large amount of inward FDI and were becoming quite important outward investors. A few very rich developed countries will have substantial amount of both inward and outward FDI, the most rich will become attract more inward FDI than its outward FDI. This is illustrated in Table 3.2.

Table 3.2 Stages of Development Cycle

Stage of Development	1	2	3	4	5
Level of Per Capita Income	Lowest	Low	Medium	High	Highest
Inward FDI	Nil or low	Low	High	Very High	Substantially high
Outward FDI	Nil or low	Nil or low	Low	Very high	Very high
Net Outward FDI	Nil or negative	Nil or negative	Negative	Balanced or positive	Negative

Source: Adapted from Dunning (1981, 1986, 1988).

To link this investment development cycle with the eclectic paradigm and the evolution of comparative advantages of nations, Dunning (1982, 1985, 1993) suggests that as a country progresses towards a higher stage of economic development, its "OLI" configuration will change, thus stimulating the creation of firm-specific competitive advantages (therefore making some of its firms able to compete successfully in international markets), locational advantages (as a host country to inward FDI) and internalisation advantages (thus fostering outward FDI).

This investment development cycle is an aggregate and dynamic model to explain the changing international direct investment position of countries at different stages of development. It can be particularly relevant to the timing of outward FDI undertaken by developing countries.

Longitudinal studies covering countries at different stages of development are required to verify the validity of the model. But lack of reliable and comparable data hampers such undertaking. The few limited exploratory studies (Dunning, 1986; World Bank, 1989; Toletino, 1992) have failed to provide satisfactory statistical support for this model (Dunning, 1993).

Like the eclectic paradigm, this investment development cycle model is less relevant to the emergence and development of FDI from firm perspective since firm-specific strategic factors, the timing and other modes (rather than FDI) of international involvement by individual firms are not incorporated in the model. Within the model, the interaction between the firm-specific advantages and locational advantages of countries has not been explicitly explored, though it has been recognised that both of them have an impact on the country's position in international investment (Dunning, 1993). Moreover, the investment cycle theory can not explain the distinctive characteristics of the MNEs from LDCs (see Section 3.2.). For example, the theory can not explain why MNEs from the Third World prefer joint ventures to wholly owned subsidiaries in host countries. Thus a more dynamic model is still required.

### 3.2.2 Small-scale Technology Theory (1977-83)

Wells' (1977, 1983) hypothesis about Third World MNEs focuses upon the characteristics of LDC home market and their impact on the competitive advantages of MNEs from LDCs. One particular feature in LDCs that gives their firms a competitive edge is the small size of the markets for most manufactured goods. Entrepreneurs in LDCs have a special propensity to respond to that characteristic. Thus small-scale technology is developed in response to small markets. Such technology is not only labour-intensive, but also flexible in terms of using parts and components from different sources, being capable of producing a range of goods at low volume and using local inputs of varying quality. This type of technology gives LDCs MNEs competitive advantage because it can be easily exploited in the poorer

host countries where labour is abundant and cheap, the market is small, and quality of materials varies from time to time. Thus MNEs from LDCs can successfully compete with MNEs from developed countries and local firms which do not have the technology required to produce goods.

Apart from the small-scale technology advantage, MNEs from LDCs also enjoy a competitive edge in the provision of ethnic products to the ethnic communities in the host countries. Their procurement of local materials (which depends upon the flexibility of their technology), the low costs of expatriate managerial and technical staff, give LDC MNEs additional competitive advantages over MNEs from developed countries (Wells, 1983).

Several studies have confirmed the relative small size, and higher labour intensity of both parent firms and overseas subsidiaries of LDC MNEs. Lecraw (1977) found that LDC MNEs' subsidiaries in Thailand were of smaller size than that of their developed country counterparts. The size of overseas subsidiaries of MNEs from Southeast Asia was substantially smaller than that of the counterparts from industrialised countries (Lecraw, 1981). In Nigeria, textile plants owned by firms from other LDCs were in most cases smaller than the subsidiaries owned by European, Japanese or American MNEs (Nambudiri, 1980). This was also the case of foreign owned subsidiaries in Indonesia (Wells, 1973). White (1980) reported a similar result as regards the MNEs from Latin America. Busjeet's (1980) study of foreign subsidiaries in Mauritius and the Philippines also revealed a similar pattern. Ting & Schives (1981) in their two case studies of Taiwanese MNEs found that both firms undertook little R & D, but they succeeded in making suitable adaptation in the original technologies imported from developed countries, and the possession of the adapted technologies gave them a competitive edge in foreign markets.

The theory proposed by Wells shows the interaction of competitive advantages of MNEs from LDCs and the home and host country characteristics. However, the variables included in his hypothesis are too limited. The explanatory power of this theory, if any, is limited to market seeking investment and resources seeking FDI. It can not explain strategic asset seeking and efficiency seeking investments. Besides, the strategic behaviour of firms in LDCs is hardly taken into consideration.

The empirical evidence of the size of overseas subsidiaries also needs to be interpreted carefully, because MNEs from industrialised and developing countries tend to be engaged in different sectors, and labour and technology intensity may vary one sector from another. For example, textile industry, where MNEs from LDCs tend to invest heavily, is more labour-intensive than auto industry which is dominated by MNEs from a few developed countries and requires a larger amount of capital. Thus it is mistaken to compare the average size of FDI projects across different industries. Even for investment projects in the same industry, the relative size may be related to the late entry into host country market or lack of marketing economies, rather than the small-scale nature of technology itself. Moreover, the casual empiricism used by Wells on which the small-scale advantage argument is based may be misleading -- there must be concrete evidence to show that firms from LDCs have made major technical efforts to down-scale so that they gain the so-called descaling advantage through the process (Lall, 1983).

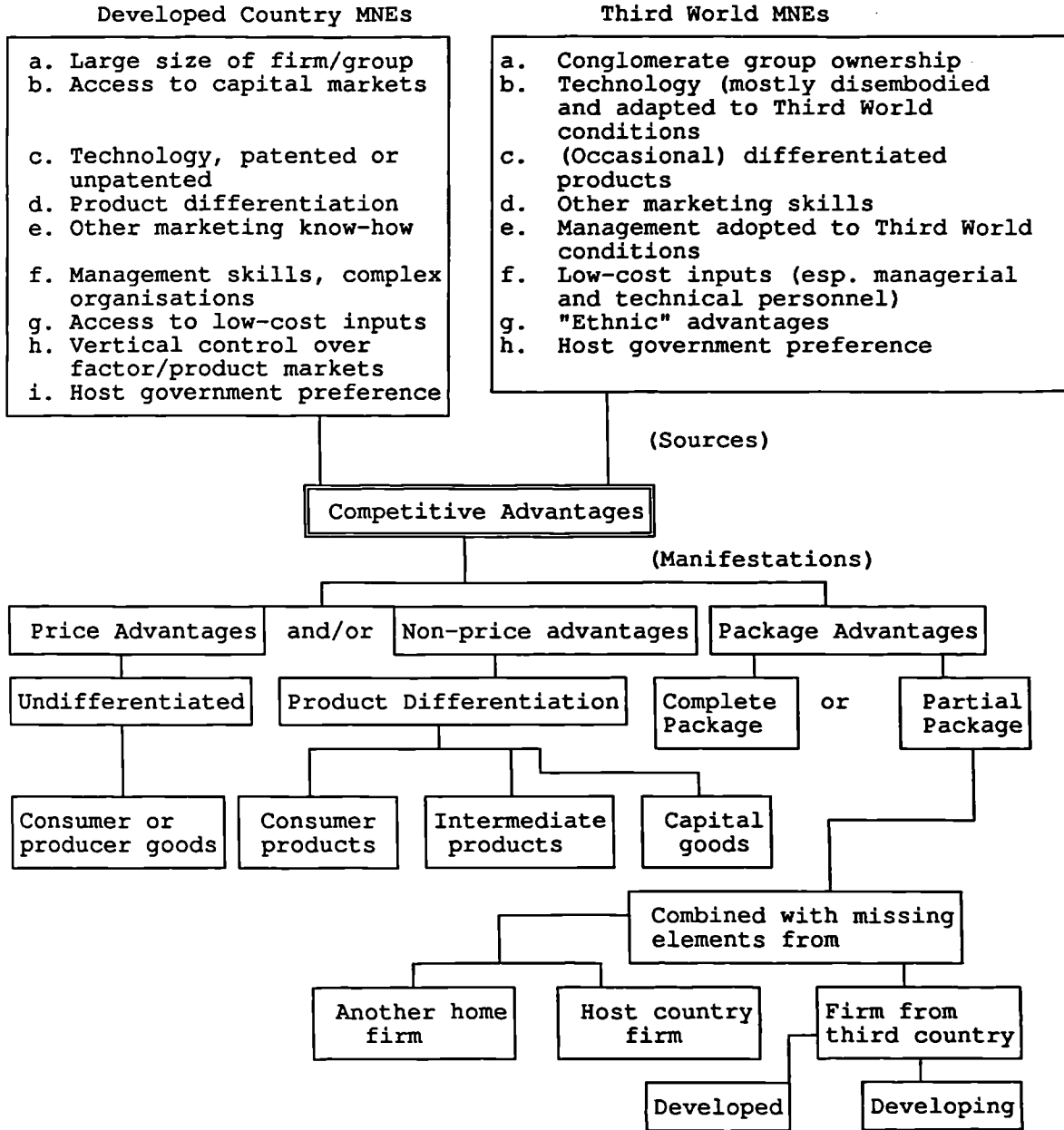
### 3.3.3 Technological Adaptation Theory (1983)

Lall (1983) proposed a technological adaptation theory for MNEs from LDCs. Based upon the experiences of Indian MNEs, He contends that developing countries are able to engage in outward FDI because their firms have accumulated technology/ techniques imported from advanced countries. This technology/ technique is further adapted to the small markets of the less developed home countries. Thus the technological advantage of MNEs from LDCs is created through the process of imitation, improvement, basic design and innovation (Lall, 1983). Hence it is reasonable to observe the differences in the sources and manifestations of competitive advantage possessed by conventional and unconventional MNEs (see Figure 3.1).

Where Lall differs from Wells is that while Wells' hypothesis depends very much upon the small scale manufacturing advantage, Lall argues that LDC MNEs have several sources of competitive advantages, including technology (mostly disembodied and adapted to Third World conditions), and management (also adapted to Third World conditions). The latter is strongly supported by low cost inputs (especially managerial and technical personnel). He also suggests that LDC MNEs occasionally have advantages in product differentiation and ethnic ties in many host countries.

Figure 3.1

Sources and Manifestations of Competitive Advantage of MNEs



Source: Lall (1983). p.7

Lall's model also recognises the impact of home country characteristics on the generation of firm-specific competitive advantages and the later use of them overseas. However, the theory fails to take strategic issues and other firm-specific characteristics (except conglomerate ownership) into full account, thus it can not explain why certain firms in a Third World country are able to generate their competitive advantages and thus become MNEs while other can not.

Nonetheless, since technological advantage has been suggested to have played an important role in the emergence and development of MNEs from LDCs, it seems imperative to look at the findings of some major country studies of the Third World MNEs.

### **3.4 The Nature of Competitive Advantages of MNEs from LDCs: Empirical Evidence**

Since late 1970s and early 1980s, many studies have been undertaken to examine the Third World MNEs, mainly from Hong Kong, Taiwan, South Korea, Singapore, India and some Latin American countries. The empirical evidence demonstrates that there are certain competitive advantages associated with the international companies from these countries. According to Wells (1978, 1983), Giddy & Young (1981) and Lall (1983), the ownership-specific advantages possessed by the Third World MNEs can be summarised as follows:

- a). Production experience and know-how in manufacturing certain products which are not in sufficient demand to support local production in the host countries that are often poorer than the home country;
- b). Skills in adapting machinery for low volume production and in designing machinery to permit more flexible usage;
- c). Skills in adapting product designs to particular geographical and climate conditions and the availability and cost of local raw materials into domestic consumer tastes;
- d). Lower costs of managerial and technical personnel from these home

countries than that from developed nations, which enable the Third World MNEs to be competitive in price vis-a-vis developed country MNEs. Setting up (overseas projects) costs for Third World MNEs are also lower, and the flexible organisation structure of LDC MNEs may further provide advantage in cost;

e). General production and marketing skills facilitating the manufacture of quality, reliable, low cost products.

The experiences of MNEs from Hong Kong, Taiwan, South Korea, Singapore and India are summarised (see Table 3.3.). These studies generally shed some light on the nature of competitive advantage of LDC MNEs.

Table 3.3 The Nature and Sources of Competitive Advantage of Third World Countries

Home Country	Hong Kong	Taiwan	South Korea	Singapore	India
Positional Advantage	Low price, Improved quality	Low price, low quality; non-standardised products	Low price; standardised products	Low price, low quality	Low price
Production technology	Imported & modified		Imported, modified & improved process technologies; labour-intensive		Imported, improved, modified, labour-intensive.
R&D				Little	
Marketing	Skilled		Skilled		
Management	High quality & low cost			Low costs	
Labour			Low costs	Low costs	Low costs
Others			Suitable operating technology	Dynamism, flexibility, local familiarity	Ethnical ties; adaptability to local conditions
References	Chen (1981), Wells (1977, 1978), Young & Hood (1985)	Ting & Schives (1981) Escho (1985), Levy (1988),	Jo(1981), Kumar & Kim (1984) Escho (1985) Kwag (1987) Levy (1988)	Chia(1984) Agrawal (1985) Fong & Komaran (1985) Mirza(1986) Pang (1986)	Lecraw (1981) Agrawal(1984) Lall(1986)

Source: Author

### 3.4.1. Positional Advantage (Generic Strategy)

It has to be admitted that there has been no much research done focusing on the strategic behaviour of MNEs from the Third World. However, previous research has revealed evidence as regards the positional advantages of the Third World MNEs in the international markets, especially in the host country markets. As Wells (1983) suggests, the Third World MNEs have a set of competitive advantages, namely small-scale manufacturing, local procurement and special products, and access to markets. This observation is further supplemented by cross examination of the five country studies in terms of the nature of the Third World MNEs. The positional advantage of the Third World MNEs lies in low price and improved quality of their products. When their motives for FDI are examined (see Table 3.4), such positional advantage becomes more obvious because many Third World MNEs are investing in host countries in search of low labour and operating costs, to avoid cost-increasing measures (eg, tariffs) imposed by host countries and/or product destination countries and/or to avoid trade restrictions (eg, import quotas).

Third World MNEs generally do not compete with developed country MNEs on product differentiation or advertising. As Lall (1986) contends, "while advertising, product differentiation and brand name promotion have been an important source of comparative advantage for MNEs in the host country environments, very few LDC MNEs have been able to build develop strong trade names for their products. Still fewer have been able to build a successful international strategy around differentiated products" (p.5). According to Lall, the Third World MNEs "tend to concentrate in industries in which marketing, brand names and advertising are not essential components", and it appears that even those exceptional Third World MNEs that do exist in advertising-intensive industries base their marketing strategy on price rather than product differentiation or sales promotion" (pp.5-6). (Wells, 1983 ).

However, more recent studies of MNEs from NIEs, especially South Korea (McDermott and Young, 1989) and Taiwan (McDermott, 1991), have indicated that some of the Third World MNEs have begun to improve their positional advantage considerably in the product differentiation and product quality dimensions. For instance, South Korean electronics MNEs and Taiwanese computer MNEs are revealed to have some differentiation advantage. Meanwhile the cost/price



competitiveness has become less important to them than before. On the other hand, MNEs from NIEs have not yet challenged the dominance of product differentiation by developed country MNEs. A study of 27 Korean subsidiaries in the EC revealed that Korean firms still relied much on distributors' brand names in the EC (Kumar & Kim, 1992. see Table 3.4.)

Table 3.4. Proportion of Korean Products Sold under Buyers' Brands in the EC

Product	Percentage of Korean products sold under buyers' brands
Television	55
VCR	65
Micro-ovens	80-85
Refrigerators	55
Stereo equipment	90

Source: Kumar & Kim (1992). p.196

### 3.4.2 Sources of Technological advantage

Chapter 2 has indicated the association between technological advantage and the multinationality of firms from the industrial countries (see Table 2.2.). Furthermore, the technological advantages of industrial countries' MNEs usually are revealed (or thought) to have resulted from their own R & D and innovations. Researchers usually do not question whether these MNEs have ever imported technologies from other industrial countries.

However, in search of the sources of the Third World MNEs' technological advantage, researchers have enquired whether these MNEs have imported and modified technologies from the more advanced countries. And all the Third World country studies have shown that their MNEs have imported, modified and improved (mainly process) technologies and equipment (Table 3.3). The capability of the Third World MNEs to develop or adapt imported technologies to developing country

markets (eg, de-scaling, tropicalising) has been emphasised by Wells (1978, 1984), White (1980) and Lall (1983).

Indeed, through this process of importing, modification and improvement, they have created their own competitive advantage in technologies and many of them have become able to export their modified and improved technologies and equipment (usually in the form of machinery) to the host countries and convert such machinery into equity investment.

### 3.4.3 Other Competitive Advantages

In addition to the aforementioned technological advantage, MNEs from LDCs have competitive edge in costs, conglomerate ownership and marketing advantages.

a. **Cost Advantage:** The importance of cost advantage for LDC MNEs can not be overstated, as indicated in the preceding section. The sources of cost advantage of MNEs from the Third World countries include the production of mature or standardised products (which requires little R & D efforts), low cost of managerial and technical expatriates, cheaper supplies from home countries. Cost advantage could also arise from belonging to a large conglomerate (Lall, 1983; Kumar & Kim, 1992).

b. **Conglomerate Advantage:** Most overseas subsidiaries and affiliates of Korean, and to a lesser extent Indian and Latin American firms belong to large "Chaebols" or conglomerates. The broad information base of parent conglomerates could reduce transaction costs of its overseas affiliates. The overseas affiliates could also avail of its large capital base and credit potential of their large parent conglomerates and thus gain advantages over local competitors. The competitive advantage accruing from conglomerate ownership is supported by White's (1980) research on Latin American MNEs, Lall's (1983) on Indian MNEs and Kumar & Kim's (1992) study of Korean MNEs' European affiliates.

Another ownership pattern is that most MNEs from the Third World are owned, controlled and managed by individuals or related families (Busjeet, 1980). In a sample of 31 Hong Kong, Indian and other Asian MNEs, only one firm had a professional top

management team effectively "divorced from" the private owners. This familial ownership pattern seems also applicable to the Korean chaebols and many Taiwanese MNEs (McDermott, 1990; McDermott & Young, 1989).

### 3.5 The Motives for FDI from the Third World

From Chapters 1 and 2, it has argued that there are diverse motives for FDI, depending upon the perceived market opportunities and constraints, corporate strategy and/or functional strategies as well as alternative methods of serving the foreign markets. Thus it is possible that motives differ from one investment project to another, and from one firm to another. The market orientation of an overseas manufacturing subsidiary certainly has a major impact on the motives of the FDI project (Reuber, 1973). As Busjeet (1980) suggested, "in case where the parent company had undertaken various foreign investments, each motivated by different reasons, the motivations for each investment were considered separately" (p.42), and "there were a few cases where the actual market orientation differed from initial one. It is assumed that motivation is best understood by considering the initial market orientation" (p.43).

In a broader sense, the motives for FDI are determined by the (nature of) competitive advantages of the investing firm, its corporate strategy and country strategy, its stage of internationalisation, and the comparative advantages of both home and host countries.

Motives for FDI by MNEs from the Third World are complex and diversified (Monkiewicz, 1983). In fact all types of FDI suggested by Dunning (1993) can be found among developing country-based MNEs (see Table 3.5), although it seems that market seeking and resources (natural resources and cheap labour) seeking investments are relatively more important for the time being.

One recent study of 31 MNEs from NIEs (World Bank, 1989) revealed that five major forces motivated the outward FDI flows from the NIEs:

- a. currency appreciation in the home country;
- b. increase in real labour costs at home;

- c. attempts to gain access to major markets;
- d. seeking competitive advantage by upgrading technology and improving industry reputation; and
- e. procurement of raw materials.

Table 3.5 The Motives for FDI from LDCs

Country	Hong Kong	Taiwan	South Korea	Singapore	India
Main contribution to FDI project		Used machinery; Cash plus new machinery (later on)	Process technologies from both parents and developed countries		Plants & machinery from parents
Main Recipient Country/ies		USA (to 1985)			Malaysia/S.E.Asia (1983)
Motives of FDI	Access to low-cost labour; risk-diversification; Access to third country markets	Access to markets	Protect & expand export markets; Assure raw materials supply; seeking low cost labour	Seek new markets & investment opportunities; diversification	Defending export markets; circumventing home country restriction
Main rivals in host country markets		local firms, developed country MNEs			Developed country MNEs
Main Benefits of FDI		Promotion of exports	Export promotion, return on investments, fresh business opportunities		
Main Sectors		Manufacturing	Natural resources; trading		Manufacturing
References	Busjeet(1980) Chen(1981) Lecraw (1981)	Chen (1988)	Kumar & Kim (1984); Han & Brewer (1987)	Fong & Komaran (1985)	Lecraw(1977), Busjeet(1980), Agrawal (1981), Lal(1986).

Source: Author

All these factors, except raw material procurement, distinguish the recent wave of NIE outward FDI from the first surge of developing country FDI in the 1960s and 1970s (World Bank, 1989). Thus it is arguable that the evolution of these NIE has influenced the competitive advantages of firms based in these countries and motivated them to invest overseas.

In terms of strategic issues, the same study (World Bank, 1989) suggested that many NIE MNEs have dual strategies -- investing in OECD countries to upgrade technology and circumvent trade barriers, and investing in lower cost developing countries as export platforms. NIE MNEs concentrated their developing country FDI in Asia, mainly China, Thailand, Malaysia, and Indonesia because of:

- a. macro-economic and political stability;
- b. geographical proximity and familiarity;
- c. labour cost, supply and quality;
- d. ethnic and cultural ties;
- e. favourable investment incentives.

This shows that the host country characteristics do influence the inward FDI from NIE MNEs. Moreover, NIE MNEs have different FDI strategies for different clusters of host countries.

Ethnic and cultural connections are particularly worth mentioning as regards FDI from the Third World. It seems that ethnic and cultural ties have an important impact on the location of FDI from overseas Chinese firms (especially in Hong Kong, Singapore, Taiwan, Malaysia, Indonesia, Thailand and the Philippines) (Chen, 1983, 1984; Wells, 1983; Lecraw, 1985; World Bank, 1989; Asian Business, 1992, August 12) and Indian MNEs (Lall, 1983, 1986; Lecraw, 1985). The "pan-Chinese connections" or Guanxi may help explain why overseas ethnic Chinese MNEs concentrated their outward FDI in East Asia, and they intend to remain there. For example, the Chinese diaspora have accounted for as much as 80 per cent of a total of US\$50 billion inward direct investment in China (Time, 1993, May 10. p.28, Financial Times 1992, October, 25; also see Chapter 4). The ethnic and cultural ties are so strong that "virtually every (overseas Chinese owned) factory in China has some family connection to explain its location" (Time, 1993, May 10. p.28). Patrick Wang, a Hong Kong businessmen with extensive investment in China, reveals that Guanxi or connections "are always useful in China", and "one gets a lot more information if you know the right people. Access to information is explicitly linked to guanxi networks. Information is held within the network and exploited for profit" (Financial Times 1993, July 7. p.3).

Similarly, Indian MNEs tend to locate their overseas FDI in South Asia and Africa where ethnic Indian community has a strong presence (Wells, 1983; Lall, 1986). However, Korean MNEs behave differently because they lack an ethnic network but are assisted by a global chaebol information network. Therefore, Korean MNEs have expanded far beyond Asia to Latin America, Africa and Europe.

The importance of ethnic and cultural ties in the location decisions by MNEs from the Third World, however, may have been overestimated. Without other country-specific comparative advantages rather than ethnic and cultural ties of these host countries, it is highly questionable whether they would attract so much FDI from NIE MNEs. Moreover, the nature of competitive advantages (eg, labour-intensive, low technology, cost-based competitiveness) of NIE MNEs may dictate that these advantages are best exploited in developing rather than developed countries.

### **3.6 State-owned MNEs**

There are two types of state-owned MNEs. The first type includes those from non-socialist market economies which are wholly or partially owned by the governments or government agencies of their home countries. The second type of state-owned MNEs are those from (erstwhile) socialist countries. This section reviews these two types of state-owned MNEs in turn.

#### **3.6.1 State-owned MNEs from Market Economies**

State-owned MNEs were a spreading phenomenon until mid-1980s. Table 3.6. indicates the increasing presence of state-owned firms and state-owned MNEs among the largest 200 industrial firms outside the USA between 1965 and 1985. The increase of state-owned MNEs prior to 1985 was caused by three major factors. Firstly, a spate of nationalisation of private firms, particularly in the UK and France in the 1970s, led the increase of number of state-owned firms, many of which were large or became large MNEs. Secondly, governments increased their interest and direct stake in strategically important and rapidly growing industries such as aerospace, oil products and motor vehicles. Thirdly, the Third World countries began to develop their own MNEs, many of which were (and still are) wholly or partially owned by the governments. For instance, according to a study of MNEs from developing countries, out of 580 their subsidiaries for which relevant information has been collected, 118 (or 20.3 per cent) were state-owned firms and 87 (or 15 per cent) were owned by a mix of private and public partners (Svetlicit, 1983). In 1990, 11 of the 20 largest enterprises from the Third World countries were state owned (South: A Survey of the

Top 300 Companies from the Emerging World. 1991, August).

Table 3.6 The Increasing Presence of SOEs and State-owned MNEs in Non-socialist Countries Outside the USA (1965-86)

Year	(a). Number of SOEs among the 200 largest industrial firms outside the USA	(b). Number of State-owned MNEs among (a)
1965	19	n.a.
1975	29	9
1985	38	18

Source: Dunning (1993) p.49-50

There are many differences between state-owned enterprises and their private counterparts in terms of objectives and performance as well as the management autonomy (Blanc & Dosage, 1987, see Table 3.7).

Table 3.7 A Comparison of SOEs and Private Enterprises

Type of Firms	State-owned Enterprises	Private Enterprise
Objectives	Corporate and state objectives are mixed.	Corporate objectives are separate from state objectives.
Performance	They are generally less efficient, profitable. Lack of accountability.	They tend to be more efficient and profitable than state-owned firms. Accountability to shareholders.
Management Autonomy	State intervention is prevalent in their decision-making.	Less state intervention in their decision-making. Thus they have greater management autonomy.

Source: Walters & Monson (1979); Nielson (1980); Rugman (1983); Shirley (1983), Blanc & Dosage (1987)

Compared with private firms, state-owned firms face at least four sets of additional

barriers to internationalisation (O'Brien, 1983; White, 1983). First is a traditionally inward looking domestic orientation of many state-owned firms which were frequently set up to resolve some problems of a domestic scope. Secondly is their frequent association with military sector which makes their overseas venture a matter of national security. Third is their frequent operation under monopolistic conditions at home which makes them reluctant and unexperienced in competitive overseas environment unless they join another state monopoly abroad. Fourth is their pronounced risk averting attitude that makes them rather routine paths than setting new ways (such as venturing abroad).

Despite these salient differences and difficulties facing state-owned firms going abroad, the internationalisation of state-owned firms is interpreted as a mere "imitation" of their private counterparts (see Genarme, quote in Blanc & Dosage, 1987). Thus the large size of state-owned firms is seen as a sufficient competitive advantage, very much like their private counterparts, for them to become MNEs. A desire for more management autonomy, which can be accomplished by operations overseas where the state has relatively little influence on them, motivates them to invest overseas (Marois, 1977, quote in Blanc & Dussage, 1987).

Another groups of researchers suggest that state-owned firms can become MNEs because of "unfair" competition. Lamont (1979) argues that state-owned firms are unfair competitors because of their collusion with the shareholder -- state. Walters & Moses (1979) and Nielson (1980) list several competitive advantages of state-owned enterprises that are hardly available to their private counterparts, including less requirements to produce profits or pay dividends, lower investment and export financing costs, lower or no domestic taxes, purchase and sales preferences from government, information reporting, trade, and burden of proof regulatory advantages. These (mainly cost-based) competitive advantages help state-owned firms to overcome cost disadvantages of investing and operating overseas.

Empirical research is not sufficient to assert the validity of the above mentioned two hypotheses. But they are unlikely to give a satisfactory explanation of the emergence and development of state-owned MNEs. Low cost may not be the only competitive advantages that enable state-owned firms to go multinational. It is suggested that in addition to state ownership, the characteristics of home and host country environments, industry-specific factors, and firm-specific advantages (especially



strategic behaviour) of state-owned firms would have influenced the emergence and development of state-owned MNEs. Moreover, the aforementioned theories say nothing about the objectives, timing and modes of the foreign entry of state-owned firms.

### 3.6.2 Socialist MNEs

In the early 1960s, there were 40 equity ventures of enterprises from socialist countries in market economies, and most of them had been established in the inter-war period to obtain access to foreign market in a view to promoting trade in goods and services (International Management 1980, December).

During the 1970s and 1980s, the number of such ventures, range of activities and geographical areas entered have all been increasing. By the end 1979, firms from Comecon countries had established 115 affiliates in the West, and about 400 in developing countries.

By 1983-84, the aggregated book value of FDI from socialist countries (ie, Eastern Europe and former Soviet Union) was estimated to be US\$900 million -- US\$1 billion (US Department of Commerce, 1984; McMillan, 1985). Chinese enterprises only began their foreign direct investment from 1979 (Ye, 1992) except a handful of foreign trade companies and Bank of China.

In 1991, the number of MNEs from Central and Eastern Europe was estimated at 300 (UN, 1992) while China recorded some 553 outward investors (Dunning, 1993). By 1991, Comecon countries had set up 1249 foreign subsidiaries and joint ventures with a total of authorised capital of US\$1.2 billion (see Table 3.8).

Of the 1,249 FDI projects, 863 were located in developed countries. USSR accounted for the bulk (about 65 per cent) of the total amount of FDI capital (US\$1.1 billion) recorded by 1989 (East-West Business Directory, 1990/91; Economou, 1990). By 1992, China had recorded 4,117 outward FDI projects (including joint ventures and wholly-owned subsidiaries) with a total value of US\$1.85 billion (People's Daily, 1993, Feb. 25. p.1; also see Chapter 1.).

Table 3.8 FDI from Comecon Countries (by 1991)

Home Country	Number of FDI Projects	Value of FDI Projects (US\$1,000)
Bulgaria	96	54,363
Czechoslovakia	129	98,819
Hungary	197	134,487
Poland	204	146,125
Romania	80	93,126
USSR	220	699,470
Yugoslavia	321	n.a.
Total	1,249	1,226,480

Source: East-West Business Directory (1991/92)

No particular theory has been propounded to explain the emergence of socialist MNEs. The few empirical studies tend to focus on the motives of their foreign investment and sectoral distribution of such investment, rather than their capability to engage in foreign value-added activities (see McMillan, 1980; 1983; 1985; United States, Department of Commerce, 1984).

The sectoral distribution of FDI from Comecon countries suggests that in market economies vast majority (96 per cent) of foreign investment from Comecon countries was directed to service industries, especially in import-export trade and related marketing functions (East-West Center, 1990).

This was explained by the institutional factor, ie, especially established foreign trade organisations have been typically the only firms permitted to engage in foreign trade and hence in the overwhelming bulk of foreign value-added activities (The CTC Reporter, 1987; UNCTC, 1988). In another words, most of other types of firms in these Comecon countries lack management autonomy to engage in either foreign trade or foreign direct investment. From a broader perspective, the macroeconomic environment in (Comecon) socialist countries has been a major barrier for their firms, especially manufacturing firms, to internationalise their operations (International Management 1980, December; Fonara & Collins, 1990).

Thus for MNEs from socialist countries, particular attention has to be paid to the following factors (see Otta, 1991):

- a). a sellers' market in the domestic market (which will encourage firms to concentrate on the domestic instead of international markets);
- b). the inconvertibility of the local currency (which will prevent outward FDI projects that need capital outlays in hard currencies);
- c). the relatively low level of development (Fontara & Collins, 1990) (which means firms from these countries have rather limited competitive advantages);
- d). the institutional constraints (eg, the monopoly of foreign trade companies in international business involvement);
- e). the less outward oriented macro-economic policies pursued by the home government (which hampered the formation of an international outlook of managers and gaining international experiences);

Little is known about the strategic behaviour of socialist MNEs and their competitive advantages. The impact of home and host country environments is hardly incorporated into the studies of MNEs from the Comecon countries. Thus it seems imperative that future research on state-owned MNEs should focus on firm-specific variables (eg, competitive advantages, strategic behaviour) and the interaction of the home and host country characteristics (including state-ownership) and the generation and use of firm-specific advantages, and the internationalisation of these state-owned firms.

The foregoing discussions suggest that to examine the internationalisation of state-owned MNEs, the analytic framework suggested in Chapter 2 needs to incorporate a consideration of an impact of state-ownership and macro-economic environment of home country on the objectives of the firms, their competitive advantages and strategies.

### **3.7 Competitive Advantage of Nations: A Third World Perspective**

Chapter 2 has argued that the home country provides the primary source of competitive advantages of firms (Vernon, 1966, 1979; Caves, 1972; Porter, 1990;

Dunning, 1992, Hu, 1992). Wells (1978, 1982, 1983), and Lall (1982) have also linked the technological and other advantages of TWMNEs to their home country conditions. Is it possible to apply the diamond model to assess the competitive advantages of the Third World countries ?

The Third World consists of a large number of countries, which are diverse in many important aspects (eg, political and economic systems, levels of economic development, economic and industrial policies, population, the role of government and the interdependence with the international markets). Thus one has to be very cautious when applying the diamond model to the Third World countries. For example, political stability can not be taken as given in the assessment of competitive advantage of the Third World countries, even in the more advanced Third World countries like Hong Kong, South Korea, and Taiwan. Another difficulty in applying the diamond model is that many Third World countries have been undergoing radical political and economic changes (eg, Eastern Europe, ex-Soviet Union, and China), which make it difficult, if not impossible, to apply the diamond model to them. For example, competition (which underlies the model), was almost non-existent in these former centrally planned economies until recently. Even now, the role of market forces and competition has been limited and/or distorted for various reasons.

A third factor is the differences in the degree of openness of the Third World economies, which vary from highly open (eg, Hong Kong and Singapore) to highly autarkic (eg, North Korea). Thus it is perhaps useful to incorporate the ESP (environment-system-policy) paradigm (Koopman and Montias, 1971) with the diamond model when examining the dynamics of the competitive advantages of the Third World countries (see Dunning, 1993).

### 3.8 Conclusions

From the ongoing discussions it has been shown that there exist salient differences between MNEs from industrialised countries and those from LDCs. These include the relative small size of subsidiaries, low technology intensity of MNEs from LDCs, their more frequent use of joint ventures instead of wholly-owned subsidiaries in foreign involvement, their concentration in low technology industries and in poorer neighbouring countries.

Three theories have been compounded to explain the emergence and development of MNEs from LDCs. The empirical evidence indicates that the nature of competitive advantage of LDC MNEs is usually cost based rather than product differentiation oriented, and their motives for FDI are revealed to be market or resources seeking rather than strategic asset or efficiency seeking.

On the sources of competitive advantages of MNEs from LDCs, studies have indicated that their technological advantage usually originated from modified (or improved) technologies imported from developed countries to the conditions of the home country. Thus small-scale production, adaptivity to cheap and unreliable materials available in host countries, and labour-intensive technologies are highlighted as their prime sources of competitive advantages. These advantages, combined with the cheap managerial and technical staff, make the Third World MNEs quite competitive on price in international markets. Their heavy reliance on price competitiveness and lack of product differentiation by Third World MNEs have been pointed out as their distinctive characteristics as compared to their developed country counterparts. The nature of such competitive advantages can be explained by the national diamond (especially demand conditions) of home countries. And the evolution of home country diamond (eg, the shortage of labour, currency appreciation, increasing labour and other operating costs) provides direct pushing effect upon the firms to invest overseas.

The very few studies on the development and characteristics of state-owned MNEs from both the market economies and socialist countries show that these type of MNEs usually enjoy cost advantages because of their state ownership, and a desire for more management freedom leads them to expand operations overseas where the state has little or no control. Socialist MNEs from Comecon countries have concentrated in service sectors, especially in import-export trade and related activities, a characteristic related to the monopoly of foreign trade companies in foreign trade and foreign value-added activities.

In view of these theories and empirical evidence, it seems important to explain FDI by Third World MNEs from socialist countries by emphasising upon the following features:

- a. the impact of development of home country economy on the generation (sources) of competitive advantages of firms from Third World countries;
- b. the impact of home country market size and relative low level of technological competence on the nature and creation of competitive advantages of firms from Third World countries;
- c. the impact of state-ownership on the generation and use of competitive advantage of state-owned MNEs;
- d. the influence of institutional factors on the management autonomy of state-owned firms from socialist countries, and thus
- e. the impact of such institutional factors on the objectives, modes and timing of entry into foreign markets by state-owned firms from socialist countries.

Having reviewed various theories of MNE and the internationalisation of the firm, and compared the experiences and characteristics of conventional MNEs (ie, those from industrialised countries) with these of unconventional MNEs (ie, those from less developing countries and state-owned MNEs), next chapter will look at the dynamics of the competitive advantages of the evolving Chinese economy and their likely impact upon the creation of corporate competitive advantages of Chinese state-owned enterprises, their corporate strategies and thus their propensity to engage in outward FDI.

## CHAPTER 4

# THE CHINESE ECONOMY & THE PROPENSITY OF CHINESE FIRMS TO INVEST OVERSEAS

### 4.1 Introduction

The previous two chapters have established that the evolution of home country diamond influences the propensity of its firms to invest overseas in three basic ways. Firstly, the home country diamond provides the primary stimuli for firms to create competitive advantages. Secondly, the evolution of the home country diamond may present new opportunities and threats, which, together with corporate competitive advantages, compel firms to change corporate/ business strategies accordingly. Thirdly, the evolution of home country diamond may provide immediate pushing factors that encourage firms to invest overseas.

This chapter will discuss the evolution of the Chinese economy in the past 15 years and then compare the similarities and differences in national diamonds between China on the one hand and India and the four "Tigers" (ie, Hong Kong, Singapore, South Korea and Taiwan) on the other, assessing how these national diamonds and their evolution influences the creation of corporate competitive advantages, corporate/business strategies and present pushing factors that determine the propensity of their firms to internationalise and especially to engage in outward FDI. India and the four "Tigers" are chosen for comparison because they have been the most important Third World outward investing countries (see Table 1.3.) and subject to extensive research (see Chapter 1).

### 4.2. The Evolution of the Chinese Economy

The People's Republic of China was established in 1949 by Mao Tsetung and his Communist supporters. The early years of the Maoist period (ie, the 1950s) witnessed the establishment of the primacy of the state over the economy and centralisation of economic control at the national level. By the 1960s the state industries had been in firm control of the economy (see Table 4.1). The economic activities were severely

disrupted by two major mass movements (ie, Greater Leap-forward in 1958, and the Cultural Revolution during 1966-76).

Table 4.1 Gross Output Value of Industry (1949-90)  
(by different ownership, at current prices)

Year	Total (RMB 1 mn)	State Owned (%)	Collective Owned (%)	Individual Owned (%)	Other Ownership*(% )
1949	14,000	26.25	0.5	22.97	50.28
1950	19,100	32.68	0.78	26.31	40.23
1952	34,900	41.54	3.26	20.57	34.63
1957	70,400	53.77	19.03	2.95	26.37
1962	92,000	87.80	12.2	0	0
1965	140,200	90.07	9.93	0	0
1970	211,700	87.61	12.39	0	0
1975	320,700	81.09	18.91	0	0
1980	515,426	75.97	23.54	0.02	0.5
1985	971,647	64.86	32.08	1.85	1.21
1990	2392,436	54.60	35.62	5.39	4.38

\*Figures of 1949-57 refer to enterprises of state and private joint ownership and enterprises of private ownership.

Source: Based on China Statistical Yearbook (1991) (State Statistical Bureau of the People's Republic of China). p.356

Although the problems confronting the Chinese economy in the late 1970s were related to the dramatic shifts in economic policies that had previously taken place, they were in many respects similar to the problems encountered by other centrally planned economies dominated by the state industries and state-owned enterprises (SOEs) (eg, overstaffing and inefficiency in industry, an emphasis on product quantity and not quality, and isolation from foreign competition). These failings were exacerbated by biases against individual incentives, markets, and labour specialisation.



In industry, there was effectively no link between individual productivity and remuneration because, under the so-called "iron rice bowl", SOEs provided life-time employment, and differences in wages were small, primarily reflecting seniority. The labour market was virtually nonexistent as a result of rigid restrictions on the geographical mobility of labour, the assignment of jobs to labour market entrants, and the system of life-time employment under which enterprises provided housing, pensions, medical care and other forms of welfare benefits. Other markets, most notably financial markets, were also almost entirely absent (World Bank, 1989, 1991).

In late 1978, China announced a programme to reshape its economy. Since then, economic reforms involved the relaxation of direct planning controls, the decentralisation of economic decision-making, increased reliance on market forces in setting prices and output, the development of non-state-owned economic entities, and an opening of China's economy to the outside world. The transition from a centrally planned economy to a "socialist" market economy was eventually institutionalised by the 14th Communist Party Congress in 1992 and the People's Deputy Congress (ie, the Chinese Parliament) in 1993.

#### 4.2.1 Rural Reforms and Township & Village Enterprises (TVEs)

Restrictions on nonagricultural activities in the rural areas have been relaxed since 1979, and township and village enterprises (TVEs) in these areas have been allowed to sell their products at market prices. As a result, a large number of TVEs were established or expanded (see World Bank, 1989). These TVEs absorbed significant amounts of the surplus labour that emerged as agricultural efficiency increased following the implementation of the household responsibility system. Competition in input and output markets is generally tougher for the TVEs than for state enterprises and their budget constraints are harder, reflecting their less easy access to subsidies and credit. Consequently, they have proved to be more flexible and more responsive to changes in market conditions than state-owned enterprises. Productivity of these TVEs has been hampered, however, by dated technology and uneconomic scales of production that reflected the community orientation of TVEs.

Nevertheless, the TVEs have made an important contribution to China's development by providing competition for state enterprises and creating an environment for the

development of entrepreneurial expertise (World Bank, 1991). Between 1978 and 1992, TVEs and their employees have increased substantially (see Table 4.2).

Table 4.2 The Growth of TVEs in China (1978-92)

Year	Number of TVEs (million)	Number of People employed by TVEs (million)
1978	1.5	28
1990	19	98
1992	n.a.	100

Source: The Economist (1992, Nov. 28);  
People's Daily (1993, Jan. 16)

In 1978, there were 1.5 million TVEs employing 28 million people. In 1992, there were over 100 million people working for TVEs, more than those working for state enterprises. The industrial output of these TVEs has been growing by an average of nearly 30 per cent a year for more than a decade, and their exports have been growing by 65 per a year since 1985. In 1992, their exports amounted to US\$20 billion, accounting for 23.5 per cent of China's total exports (People's Daily 1993, Jan. 16) (Table 4.3).

Table 4.3 TVEs' Exports (1985-92)

Year	Exports by TVEs (US\$ bn)	Total Exports from China (US\$ bn)	TVEs' Share in China's Total (%)
1985	3.9	27.35	14.26
1986	4.5	30.94	14.54
1987	5.1	39.44	12.93
1988	8.0	47.52	16.84
1989	10.1	52.54	19.22
1990	12.5	62.06	20.14
1991	--	71.91	--
1992	20.0	85.00	23.5

Source: Lardy (1992); China Statistical Yearbook (various issues);  
People's Daily (1993, February, 16).

#### 4.2.2 The Reforms of State-owned Enterprises (SOEs)

Prior to the economic reforms of 1979, SOEs were centrally controlled via the Five-Year plans and annual plans, leaving enterprise managers little or no room for initiative with respect to production, pricing, marketing, and investment. State enterprises transferred all their profits to the state, while losses were covered by budget subsidies. Investment funds and some working balance were provided to the enterprises through the government budget in the form of grants, and the banking system supplied additional working capital. Wages were paid according to a centrally approved wage scale, and age was a major determinant of wage differences among workers. Under this system, enterprises were not held responsible for their financial results; instead, their main responsibility was to fulfil quantitative output targets set by the plans. Enterprise managers thus had little incentive to improve efficiency and productivity.

The focus of enterprise reforms was on increasing incentives by enhancing the enterprises' decision-making authority and by providing them with greater financial resources, while making them more responsible for their own profits and losses (Harding, 1987; World Bank, 1989). Following some experimentation, the government in 1983 initiated a changeover on a national scale from profit transfers to income taxation, and by 1986 profits of almost all enterprises were subject to taxation rather than being remitted to the government. Since 1986, the government has attempted to reduce government intervention in the daily management of the enterprises through the introduction of a contract responsibility system (CRS) for medium- and large-sized enterprises, leasing arrangements for smaller ones, and to a very limited extent the establishment of joint stock companies. By 1988, nearly 90 per cent of medium- and large-sized enterprises had signed management contracts<sup>1</sup>. These contracts specify targets for expected performance of the enterprises, quotas for output to be sold at state-fixed prices, and obligations to the government, generally in the form of taxes. Leasing arrangements have been generally used for

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<sup>1</sup>The contracts are between enterprise management and the level of government responsible for the enterprise. The central government is responsible for many of the largest state enterprises, but most state enterprises are responsible to governments at provincial, municipal and county levels.

smaller enterprises in the services sector. The leasee is entitled to all income left over after payment of taxes and the leasing fees.

A new national bankruptcy law was enacted in 1986 and came into effect in June 1989. It contains provisions allowing state enterprises to go bankrupt in cases where such firms suffer serious losses and can not repay debt because of poor management. While enterprise or their creditors can apply for bankruptcy proceedings, the consent of the governmental department supervising the enterprise is required. Thus far, however, the authorities have been reluctant to allow the provisions of the bankruptcy law to be fully implemented because of concern about massive unemployment. Consequently, few state-owned firms have been declared bankrupt and liquidated despite many of them suffering from heavy losses and being unable to pay their debt<sup>2</sup>. Instead, forced mergers are more acceptable to both enterprises and governments in charge of them. During 1989 and 1991, there were 124 cases of state enterprise bankruptcy. In the first six months of 1992, however, there were 117 cases of bankruptcy of state firms, and there were nearly 10,000 forced mergers of state enterprises (China's Economic Structure Reform 1993, No.1).

In line with the increase in management autonomy granted to enterprises, the scope of mandatory planning was significantly reduced. The proportion of fixed investment by state enterprises financed through the state budget declined sharply, falling from 60 per cent in 1978 to about 14 per cent in 1988, as enterprises were allowed to retain a portion of their earnings. At the same time, the number of products that were allocated through the output plan declined from about 250 items in the early 1980s to approximately 20 items in 1988 (World Bank, 1991). In addition, a smaller portion of the production of these items is under direct central control, although this development has been partly offset by greater control of local authorities over allocation. But despite the reduced scope of planning controls, the bulk of production of important intermediate products, including steel, coal, petroleum, and electricity

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<sup>2</sup> By the end of 1980s, a particular phenomenon, called triangle debt among firms in China, had developed into a national crisis. Triangle debt occurs when firm A is indebted to firm B, which is indebted to firm C, and firm C is indebted to firm A. Because a very large number of state firms produced products unsaleable in the marketplace, they are thus unable to pay their suppliers. The State Council set up a committee in 1990 to discharge the triangle debt clearance at national level.

remains under central and local government control.

While reforms contributed to a pickup in the growth of output by state enterprises, their share in total industrial production fell from 81 per cent in 1978 to 60 per cent in 1987, and to slightly more than 50 per cent in 1991 (World Bank, 1990; The Economist 1991, Nov.). This reflects a greater dynamism of non-state sectors (including TVEs, individually owned firms, private firms, and foreign-owned firms) and the substantial problems that continue to restrict the efficiency of state enterprises. The limited duration of management contracts (usually three to five years) creates incentives for management to focus on short-term rather than long-term profit maximisation. Marginal tax rates vary substantially across enterprises and costs differ because of unequal access to raw materials at state-fixed prices. These factors together with price controls and variable access to cheap credit and budgetary subsidies have distorted production and investment decisions. In addition, even under the CRS, government interference in the management of enterprises, including over the quantity and composition of production and employment decision, remains significant (World Bank, 1991).

#### 4.2.3 Management Autonomy of State Enterprises

State enterprises have been playing an important (albeit declining) role in the Chinese economy. They account for, though 2.5 per cent of all firms in China, 45.6 per cent industrial output and more than 60 per cent tax revenue to the state (Yao, 1992). However, from the discussion of the previous paragraph, it is clear that SOEs in China have far less management autonomy, bearing far more financial burdens of the state and their employees. They are more restrained by state planning.

To gauge the characteristics of SOEs in China, perhaps it is useful to compare them with foreign companies in China (see Table 4.4).

Table 4.4 SOEs & Foreign Firms in China

	Foreign companies in China	SOEs
Taxation	33 per cent income tax	55% income tax; 15% tax for energy & key construction fund; 10% tax for budgetary adjustment fund. Total taxation: 70 per cent
Management autonomy	Full management autonomy in hiring & firing, procurement, production, sales, etc.	Limited autonomy in these aspects.
Employee retirement	Most employees are young. So foreign companies have little retirement pension burden.	SOEs are responsible for employee insurance, retirement pension.
Import and export autonomy	Can export their products. Can import materials & equipment needed for production, Need no import or export licenses. Can be exempted from import (and export) duties. Can retain all foreign exchange earnings.	Need import or export licenses; most SOEs need to use agents (no direct import and export autonomy); only part of foreign exchange earnings can be retained; permission needed to use the retained foreign exchange earnings.
Personnel Mobility	Little restrictions on sending personnel abroad	Permission needed to send personnel abroad.

Source: Zhang, Jinyuan (1993) The Economy of Special Economic Zones No.2.

#### 4.2.4 The Reforms of the Pricing System

Prior to 1979, most prices were controlled by the state and changed only infrequently.

As a result, domestic prices reflected neither relative scarcities nor price on international markets. Price reform measures implemented since 1979 have involved both administrative price adjustments and price stabilisation. The former began with a large increase in state agricultural procurement prices in 1979, followed by increases in consumption prices of nonstaple foods. Subsequently, a number of further price adjustments were made for grains, textiles, petroleum products, transport services, and major nonstaple foods, such as eggs, pork, and vegetables.

Price stabilisation began with the introduction of two-tier price system. This system was first introduced in the rural areas where farmers sold their output up to a quota amount to the state at fixed prices and then were allowed to sell above-quota to the state at negotiated prices or on the free market. Selected state enterprises were also permitted to sell a portion of their output of certain products at negotiated prices on an experimental basis. Nevertheless, until 1984, the retail prices of most important consumer goods and industrial raw materials and the procurement prices of major agricultural commodities continued to be set by the state.

Following the expansion of the decision-making power of state enterprises in 1984, the two-tier price system was extended to a wide range of products. At the same time, the prices of other products were allowed to be freely set or negotiated within state-established guidelines (ie, state guidance prices). Enforcement of price guidelines generally has been left to the local authorities and the flexibility in pricing of goods subject to guidelines varies across regions. In general, however, "guided" prices have tended to be more closely in line with market prices. The share of goods subject to mandatory planning and state fixed prices was reduced from two thirds of total retail sales in 1978 to about one third in 1988. Similar proportions of 1988 retail sales took place at market places and "guided" prices. The remaining controls, however, have been reflected in production bottlenecks in such areas as energy and transportation. By 1990, the prices of more than half of consumer goods and agricultural produce were determined by market forces (see Table 4.5).

Table 4.5 Pricing Pattern in China (1979--90)

Type of Products	Price Decided by	1979	1990
Consumer Goods	Mandatory plan	97.3%	29.7%
	Guidance plan	0	17.2%
	Market	3.0%	53.1%
Industrial Goods	Market	n.a.	36.8%
Agricultural Produce	Market	n.a.	52.2%

Source: People's Daily (1991, Sept. 19)

### 4.3 The Open-Door Policy

The aim of the Open-Door Policy was to reverse the isolationist foreign economic policy pursued in the 1960s and 1970s. China's Foreign economic sector (eg, foreign trade, inward and outward investment) reform has facilitated the modernisation of China's economy and in the process has had a substantial impact on its structure. With the liberalisation of the foreign economic sector, exports have diversified and grown rapidly, tripling in relation to GNP to about 25 per cent during the period 1980-1992. The reform of foreign economic sector has also made possible the inter-nationalisation of a limited number of Chinese industrial firms.

#### 4.3.1 Foreign Trade System Reforms

Prior to 1978, China's foreign trade was handled exclusively by 12 state-owned foreign trade companies (FTCs)<sup>3</sup> organised along product lines, each having a

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<sup>3</sup> These 12 national trading companies are: China National Chemicals Import and Export Corporation (Sinochem), China National Metals & Minerals Import & Export Corporation (Minmetals), China National Textiles Import & Export Corporation, China National Cereals, Oil & Foodstuff Import & Export Corporation, China National Native Produce & Animal By-products Import & Export Corporation, China National Machinery and Equipment Import & Export Corporation (CMEC), China National Light Industrial Products Import & Export Corporation, China National Arts & Crafts Import & Export Corporation, China National Technology Import & Export Corporation, China National Electronics Import & Export Corporation, China National Medicines & Health Products Import & Export



monopoly in its area. Levels of exports and imports each year were set and controlled in the context of a central planning system, administered by the Ministry of Foreign Trade (MFT) (to become Ministry of Foreign Trade and Economic Relations, or MOFERT). Once the plan was made, the FTCs implemented it under the direction of MFT (and later MOFERT), purchasing goods for export and selling imported goods at their domestic prices. Financial losses incurred were covered by budgetary grants; profits were remitted to the state. By conducting trade through the FTCs, the tradable goods sector of the domestic economy was effectively insulated from the rest of the world, and the trade plan provided a direct means of centrally controlling China's balance of payments (World Bank, 1991).

In 1979, the leadership decided that China could not modernise itself rapidly unless it expanded its economic relations with the rest of the world. Through exposure to competition from foreign firms, the efficiency of China's tradable goods sector could be improved and greater access to advanced technologies could be provided. In reforming foreign trade, the government followed a strategy similar to that used domestically: control over trade was decentralised, and entities engaged in foreign trade were given greater discretion and made responsible for their financial performance.

As part of the reforms, the structure of the plan was changed substantially and the influence of local governments and enterprises in determining it was increased. The plan was revised to consist of two parts: the command plan and the guidance plan. The former establishes mandatory levels for the volume of exports and imports of key commodities, while the latter assigns targets for the value of exports and imports of certain products to local governments and FTCs that have considerable flexibility in determining how to achieve the targets. Over the years, however, the number of products subject to mandatory and guidance planning has been reduced significantly.

As the role of the trade plan has decreased, direct control over exports and imports has been exercised increasingly through a licensing system. The number of items subject to licensing has varied over time depending upon developments in China's balance of payments and, more recently (particularly with regard to export licensing),

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Corporation, and China National Foreign Trade  
Transportation Corporation (Sinotrans).

depending upon whether there are adequate domestic supplies. At the end of 1988, exports of 165 products required (quantitative) licenses, while 53 types of products were subject to formal permission. 10 items were prohibited from exporting.

Competition in the foreign trade sector was increased through the abolition of the monopoly powers of the central FTCs and by allowing provincial authorities to establish their own trading companies. Also steps were taken in 1984 to make FTCs responsible for their financial performance and to begin to pay taxes instead of remitting their profits to the state. At the same time, the "agency system" was established under which FTCs, on behalf of domestic firms, conduct trade transactions for which a fee is charged. In 1988, most local branches of national FTCs were made independent entities responsible for their financial results. The operation of the agency system was extended, and a number of domestic industrial enterprises were authorised to engage directly in foreign trade. These developments increased the extent to which changes in international prices were passed through to domestic prices of imported goods and to exporters. By September 1992, 650 large and medium-sized state enterprises had been authorised to engage directly in foreign trade (People's Daily 1992, Sept. 19). They represent, however, only a small proportion (7.7 percent) of large and medium-sized SOEs (8,400 in 1992) in China. In other words, most of the large state enterprises (3518 in total by the end of 1991) have not been given autonomy to conduct direct import and export (People's daily 1992, Sept, 18).

In 1991, further reform in foreign trade was implemented to make FTCs fully accountable for their financial performance by withdrawing export subsidies (Xiao & Ye, 1992).

The decentralisation of foreign trade system has stimulated local governments and enterprises themselves to increase their exports. During 1978 and 1992, exports from China increased by eightfold, from US\$9.745 billion to US\$85 billion (see Table 4. 6). In 1992, China overtook Taiwan, South Korea and Spain and became the 11th largest trading nation in the world (Financial Times, 1993, February, 16).

The product structure of China's exports has also changed, reflecting increasing sophistication of Chinese products. In 1980, manufactured goods accounted for 50 per cent of China's total exports. By 1992, they accounted for 79.94 per cent (People's Daily 1993, Feb. 9; Financial Times, 1993, Feb. 16). While China's success

in exporting manufactured goods owes much to cheap labour costs -- textiles and footwear account for one third of 1992's exports of US\$85 billion -- exports of machinery, electronic products and transport equipment are the fastest growing areas (Financial Times, 1993, Feb. 16). In 1985, China exported US\$1.6 billion worth of machinery and electrical products, accounting for only 5.85 per cent of total exports. Their share grew to 23 per cent (US\$19.5 billion) in 1992 (People's Daily 1993, Feb. 16). The sectoral composition of China's exports for the first nine months of 1991, for which detailed data were available, is depicted in Table 4.7.

Table 4.6 China's Foreign Trade (US\$ billion)  
(1950-92)

Year	Total	Exports	Imports
1950	1.135	0.552	0.583
1960	3.809	1.856	1.953
1970	4.586	2.260	2.326
1978	20.638	9.745	10.893
1981	44.022	22.007	22.015
1982	41.606	22.321	19.285
1983	43.616	22.226	21.390
1984	53.549	26.139	27.410
1985	69.602	27.350	42.252
1986	73.846	30.942	42.904
1987	82.653	39.437	43.216
1988	102.784	47.516	55.268
1989	111.678	52.538	59.140
1990	115.413	62.063	53.350
1991	135.170	71.910	63.260
1992	165.630	85.000	80.63

Source: China's Customs Statistics, Vol.4. 1991; The People's Daily (Overseas Edition) (January 18, 1992. p.1, 1993, January 8); China's Foreign Trade (1986)

Table 4.7 Manufacturing Exports from China  
 (Percentage, January-September 1991)  
 (Total Exports US\$49.5 bn)

Sector	Share (%)
Mechanical & Electrical Products	19.4
Garments	13.8
Food & Animal Products	9.8
Textiles	6.2
Petroleum	5.6
Footwear	4.0
Toys	2.8
Subtotal	61.8
Others	39.2

Source: The Far Eastern Economic Review 30 Dec. 1991. p.3

The growing competitiveness of Chinese firms in international markets is also reflected in their increasing outward technology transfer (see Table 4.8) as well as their starting to exports high-tech products (computers and communication products, biological products, aerospace and aviation products, electronics products, etc) (see Table 4.9).

Beginning in 1980 with 4 technology transfer projects worth US\$1.2 million, China had by 1989 recorded more than 700 cases of technology transfer worth more than US\$2.4 billion, and the recipients of its technologies included both developing countries as well as developed nations such as the USA, Germany, Switzerland, Japan and Australia. In 1989 alone, there were more than 160 technological transfer projects worth US\$800 million. In the first nine months of 1992, China exported technologies worth US\$1.4 billion, an increase of 56 per cent over the same period in 1991 (People's Daily 1992, 1st February; December, 22).

In 1992, exports of high-tech products increased by 38.8 per cent to US\$3,996 million, accounting for 4.7 per cent of China's total exports, up from 4 per cent in 1991 (see Table 4.9).

Table. 4.8 China's Outward Technology Transfer  
(1980-92)

Year	Number of Technology Transfer Cases	Total Value of Technology Transfer (US\$ million)
1980	4	1.20
1989	160	800.00
1991	462	1,300.00
1992*	n.a.	1,400.00

\* January to September

Sources: People's Daily (1992, February, 1st; December 22).

Table 4.9 China's Exports of High-Tech Products (1992)

Category	Export Value (US\$ mn)	As % of Total
Computers & Communication Products	1,900.0	47.5
Biological Products	551.4	13.8
Aerospace & Aviation Products	379.6	9.5
Electronics Products	367.6	9.2
Other High-tech Products	791.2	19.8
Total	3,996.0	100.0

Source: People's Daily (1993, April, 13. p.1).

#### 4.3.2 Inward Foreign Direct Investment

In a sharp contrast with previous policies, China began in 1978 actively to pursue foreign capital through opening the economy to direct investment. Inward direct investment was viewed as a way to avoid incurring an unduly heavy foreign debt burden and as an effective means of transferring foreign technology to China. Initially, it was envisaged that foreign investment would be restricted to particular organisational structure (primarily joint ventures), certain types of activities and

particular areas of the country (initially the four Special Economic Zones (SEZs) of Shenzhen, Shantou, Zhuhai, Xiamen and later on Hainan) (World Bank, 1991). These SEZs were patterned after the exporting processing zones that had been established in other Asian countries and offered preferential tax and tariff rates and tax holidays. In 1984, it was decided to promote foreign investment on a wider geographical basis and 14 coastal cities were permitted to offer tax incentives similar to those offer by the SEZs. Now foreign firms are permitted to invest in any province in China. Over time, the government has become less concerned about the ownership structure of foreign investment enterprises and have since 1983 allowed wholly foreign-owned subsidiaries to be set up.

China has achieved considerable success in attracting foreign investment, although there were increasing complaints from foreign investors that the investment environment in China was not favourable (World Bank, 1991). Between 1978 and 1991, there had been 37,189 foreign subsidiaries and joint ventures (22,791 equity joint ventures, 8,497 contractual joint ventures and 5,901 wholly-owned subsidiaries) approved by Chinese authorities, 16,000 of which were already in operation by 1991 (The People's Daily (Overseas edition), 1992, January 27). In 1992 China attracted 53,712 new foreign investment projects, more than the accumulated figure for the previous 13 years (The People's Daily, 1993, February 9, p.1). The value of China's realised inward FDI is depicted in Table 4.10.

Table 4.10 China's Inward FDI (realised) (1978-92)

Year	FDI (US\$ mn)
1979-81 (Average)	373.56
1982	649.27
1983	915.96
1984	1,418.86
1985	1,956.15
1986	2,243.73
1987	2,646.61
1988	3,739.66
1989	3,773.45
1990	3,754.87
1991	4,370.00
1992	9,000.00

Source: China Statistical Yearbook (various issues);  
People's Daily (1993, February, 9).

Overseas Chinese MNEs are particularly active investors in China, which has been frequently attributed to their cultural and ethnic ties there (see Chapter 3). Firms from Hong Kong, Macau and Taiwan accounted for 62.4 per cent of total realised inward FDI in China during 1979 and 1992 (see Table 4.11)

Foreign subsidiaries and joint ventures in China have made an increasing contribution to the Chinese economy, especially to China's exports (Table 4.12).

Table 4.11 Foreign Investment in China  
(by Country of Origin, Utilised, 1979-92)

Home Country	FDI in China (US\$ bn)	As % of China's Total Inward FDI
Hong Kong & Macau	21.1	57.3%
Japan	3.9	10.5%
USA	3.2	8.7%
Taiwan	1.9	5.1%
Germany	0.5	1.4%
Others	6.3	17.0%
Total	37.0	100.0%

Source: China's Ministry of Foreign Trade and Economic Cooperation (MOFREC), quoted in *Financial Times* (1993, July 7).

Table 4.12 Foreign Firms' Contribution to China's Exports

Year	Exports (US\$ bn)	Increase (%) over the Previous Year	As Percentage of China's Total Exports
1985	0.3	--	1.10
1986	0.5	66.67	1.62
1987	1.2	140.00	3.04
1988	2.5	108.33	5.26
1989	4.9	96.00	9.33
1990	7.8	59.18	12.57
1991	12.1	55.13	16.83
1992	17.3	42.98	20.35

Sources: Based on *The People's Daily* (1991, September, 20; 1992, January, 18; 1993, February, 9); Lardy (1992).

The economic reforms and the Open-Door Policy have produced fundamental

changes in the Chinese economy. With the role of state planning and control diminishing, the market forces and competition have become increasingly important in the economy. Chinese SOEs have encountered competition not only among themselves but also from TVEs and foreign firms. With greater management autonomy than ever before, SOEs have also become responsible for their behaviour and performance. This has made it possible to compare the national competitive diamond of China (see Table 4.13) with that of India and the four "Tigers" and their respective impact upon their firms' propensity to internationalise.

Table 4.13 The Comparative Advantages and Disadvantages of China & Chinese State Manufacturing Enterprises

National Advantages		National Disadvantages	
a:	large & fast growing domestic market;	a:	Uncertain economic policies & unstable economic development
b:	Rich in natural resources;	b:	Low level of per capita income & hence low level of consumption;
c:	A large pool of cheap scientific & technological personnel;	c:	Fragmented domestic market by regional & ministerial protectionism, and thus
d:	Plenty of labour;	d:	High transaction cost between suppliers-buyers;
e:	Increasing investment of foreign MNEs;	e:	Insufficient infrastructure;
f:	Entrepreneurial ethos;	f:	Lack of managerial personnel;
g:	Willingness of people to reform and open the economy;	g:	Insufficient legal framework;
h:	A comprehensive industrial structure;	h:	Disadvantaged treatment by some leading trading countries (eg, the USA)
i:	A large network of overseas Chinese business communities		
Advantages of State Enterprise		Disadvantages of State Enterprises	
a:	Government protection;	a:	Limited management autonomy;
b:	Privileged access to domestic low-cost supplies;	b:	Heavy financial burden;
c:	Large stock of accumulated technological personnel;	c:	Lack of market orientation;
d:	Some experience in adapting imported equipment to the conditions of domestic market;	d:	Lack of international experience;
e:	Relatively large size	e:	Strong competition from foreign firms and TVEs in domestic market
		g:	Lack of product differentiation

Source: Summarised by the author



#### **4.4 National Diamonds and Propensity of Firms to Invest Overseas: A Comparison**

Having discussed the evolution of the Chinese economy in the past 15 years, this section will attempt to compare the similarities and differences in national diamonds between China on the one hand and India and the four "Tiger" and assess how their national diamond influence the behaviour of their firm, especially their propensity to invest overseas. This comparative analysis attempts to evaluate the impact of each facet of the national competitive diamond (Figure 2.3) of these six countries upon the propensity of their firms to engage into foreign direct investment.

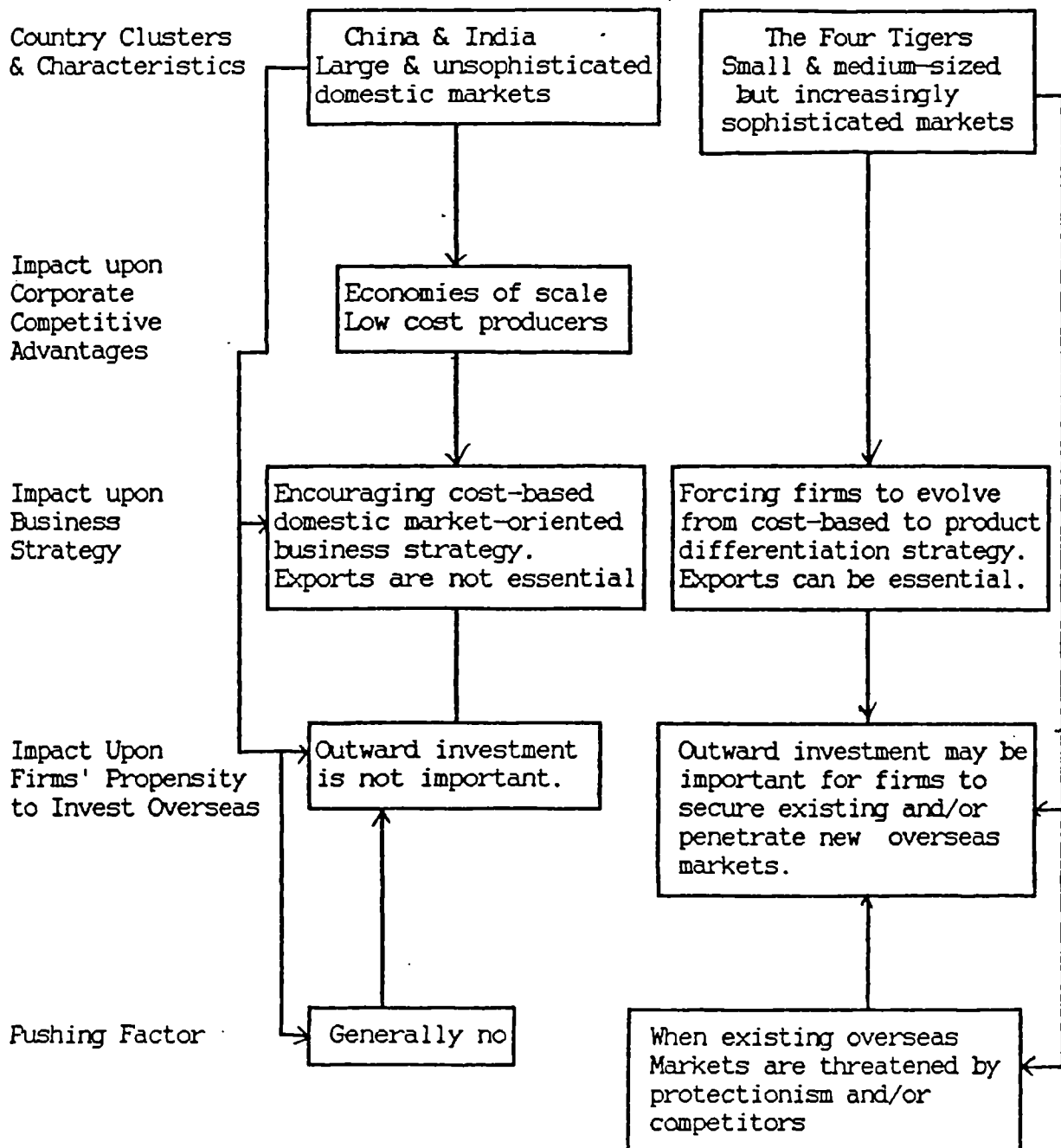
##### **4.4.1 Demand Conditions**

China shares a number of similarities with India, it differs from the "four tigers" in demand conditions. Both China and India, with the largest and second largest number of consumers, have the two biggest markets in the world. However, with an average per capita income of less than US\$500, the majority of the consumers in China and India are not very demanding, which stimulate their manufacturers to focus on a low-cost strategy instead of product differentiation. The big and unsophisticated domestic markets, characterised by weak competition and heavy intervention from the governments in China (see the previous section) and India (Financial Times 1993, September, 24 "IMF--World Economy and Finance"; September 30, "India Survey"), also facilitate a domestic market orientation of most of their firms.

In contrast, the four tigers are small (ie, Hong Kong and Singapore) and medium-sized markets (ie, Korea and Taiwan). Thus many of their firms have had an international market orientation from their onset, and more have become highly dependent upon the international markets. Furthermore, the consumers of the four "tigers", are far better off with their average per capita income ranging from US\$5,000 to US\$12,000 and still rising fast, and thus are becoming increasingly demanding, forcing their manufacturers to evolve from low-cost producers to product differentiators. The product quality improvement capacity gained in this developmental process can help the firms of the four "tigers" to improve their international competitiveness. Thus while the smallness of the markets in the four tigers encourages the internationalisation of their firms, the big domestic markets in

China and India, together with their rich natural resources, have encouraged these two nations to pursue self-sufficiency development strategies, in which their firms are generally domestic market oriented. The likely impact of national factor conditions of the six countries in question is depicted in Figure 4.1.

Figure 4.1 Demand Conditions and the Propensity of Firms to Invest Overseas



Source: Author

#### 4.4.2 Factor Conditions

On factor conditions, China and India resemble each other but differ from the four "Tigers" in natural resources endowments and human resources as well as factor-creating mechanisms.

a). Natural resource endowments: Both China and India are strong in natural resources (eg, minerals, energy and timber), coastal lines and ports. Ironically, both of these two countries have failed to developed their natural resources-based industries to their full advantage. And the abundant resources had actually contributed to self-sufficiency development strategies pursued by the two countries until very recently, which have hampered the formation of an international outlook of their firms.

The four "Tigers", on the other hand, lack natural resources with the exception of their geographical locations (eg, ports), which has made their development heavily relied upon the international markets for the supply of their resources. Indeed, lack of natural resources has motivated many firms to undertake resource-seeking FDI abroad. The Koreans had been particularly active overseas investors in natural resource exploration and development in other countries.

b). Human resources: China and India, with the largest and second largest population in the world, also have the largest and second largest labour pools. However, with literacy of 73 per cent (China) and 48 per cent (India) (Financial Times 1993, September 24), the quality and structure of the human resources in these two countries are questionable. Although India has a lower literacy than China, it does have a better supply of well educated managers and technocrats, especially those with English language skills due to its disproportionate investment in higher education and colonial influence (Financial Times 1993, September 30).

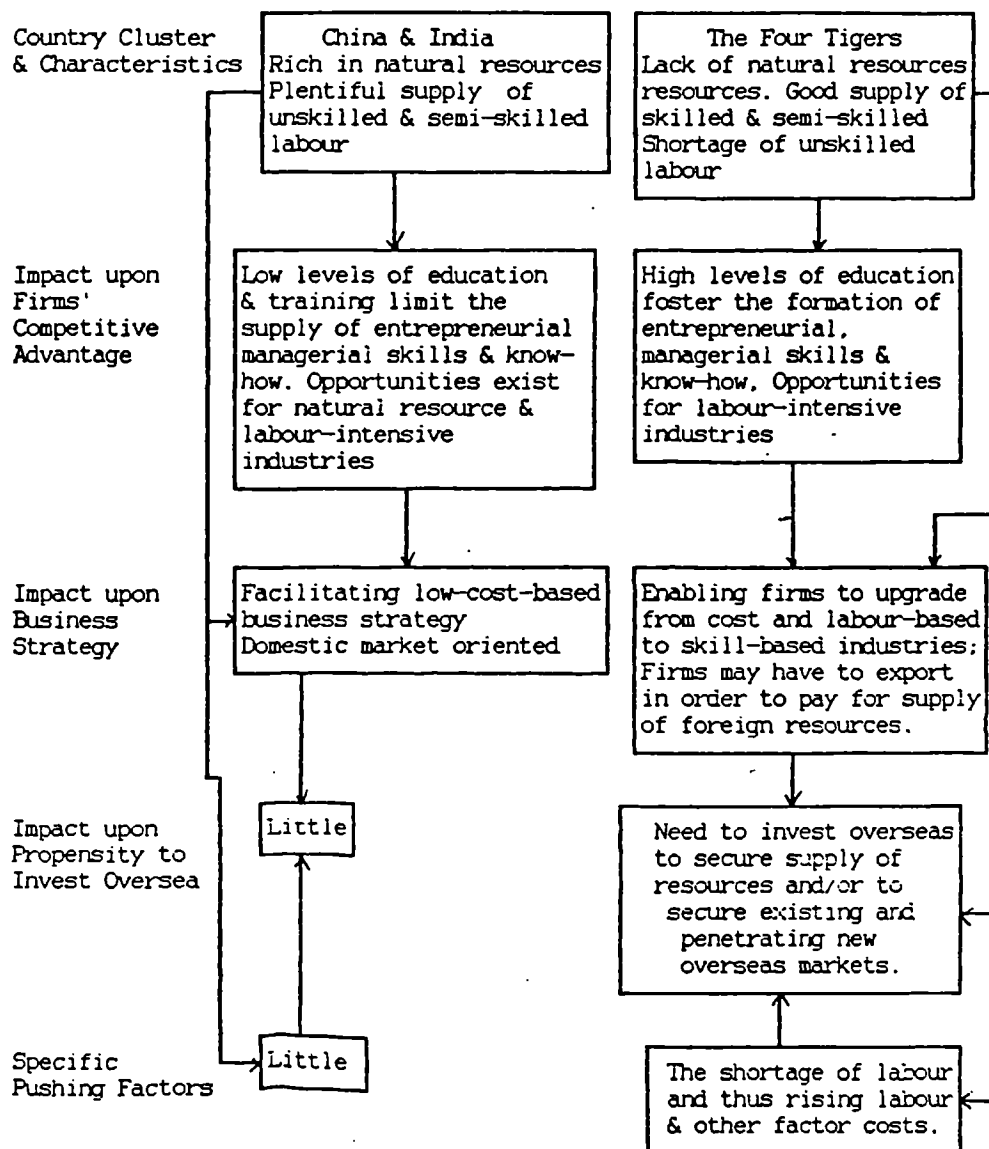
The four tigers, each with very high level of literacy and education, have better and well motivated workforces. For example, 36 per cent of Korea's high school graduates went to universities and colleges in 1987 (Porter, 1990). Supplementing the domestic higher education are a large number of students who train abroad. Many students from the four "Tigers" have attended top universities in North America and Europe, which contributed to the ultimate formation of a class of entrepreneurs, engineers and scientists with an international outlook and experiences (Porter, 1990;

McDermott, 1991), which is favourable to the internationalisation of the firms (Young et al, 1989).

From the late 1960s onwards, the labour shortage has become apparent first in Hong Kong and then in the other three "tigers", especially in the 1980s, which has compelled many of their firms to locate their manufacturing facilities overseas. In the 1960s, Hong Kong textile firms were thus among the first firms from the Third World to invest in Singapore (which had then a lower level of development with lower labour costs and plentiful supply of unskilled and semi-skilled labour) (Busjeet, 1980).

The impact of factor conditions of the six countries upon the propensity of their firms to engage in outward FDI is depicted in Figure 4.2.

Figure 4.2 Factor Conditions and the Propensity of Firms to Invest Overseas



#### 4.4.3 Related and Supporting industries

Both China and India have a comprehensive industrial structure, ranging from basic and heavy industries, to light and consumer industries as well as aerospace and nuclear industries. This industrial structure, together with a rich natural resources endowment, had led these two countries to pursue a self-sufficient development strategies (such as import substitution), resulting in an overall domestic orientation of their firms. The major problems with both China and India are the inadequate infrastructure (in power supply, transportation and telecommunications) and red tape and corruptions associated with their heavy bureaucracy.

The four tigers, due to lack of natural resources (except their geographical locations in case of Hong Kong and Singapore, and to a lesser extent Taiwan) and the small size of their markets, have concentrated on a fewer number of industries. Thus their reliance on foreign supplying and related industries is inevitable. However, the four economies are far better off than China and India in infrastructure and public services.

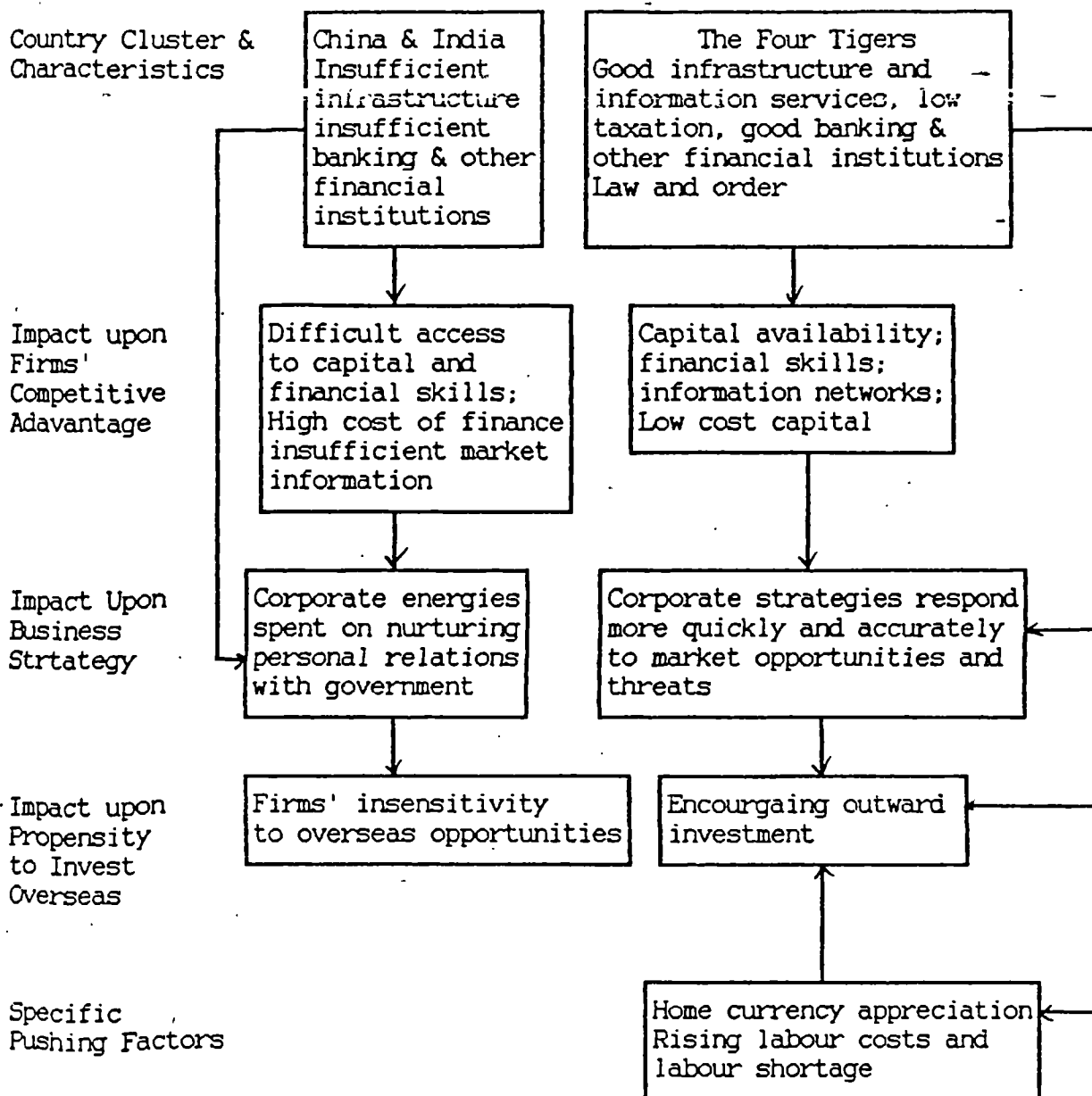
Financial industries are particularly important in their impact upon the competitive advantages of firms, their possible business strategies and their propensity to invest overseas. China and India have rather rudimentary banking and other financial industries, limiting their firms' access to capital and financial skills, whereas the four tigers have relatively advanced financial markets, with Hong Kong being a regional capital and financial centre in the world, which provide their firms easy and cheap access to capital and financial expertise, risk protection and market information (Dunning, 1980). The impact of these home country characteristics upon the propensity of firms from these countries is summarised in Figure 4.3.

#### 4.4.4 Industry Structure and Rivalry

The six countries differ remarkably in this respect. While South Korea has a highly concentrated and competitive market (Porter, 1990), with the 11 biggest chaebols contributing to major slice of its GNP (McDermott, 1989), the Chinese market has been very decentralised, with the largest 100 industrial firms contributing to less than 15 per cent of its GDP in 1991 (People's Daily 1993, April 24). As revealed previously, competition has been particularly weak in the Chinese market due to the

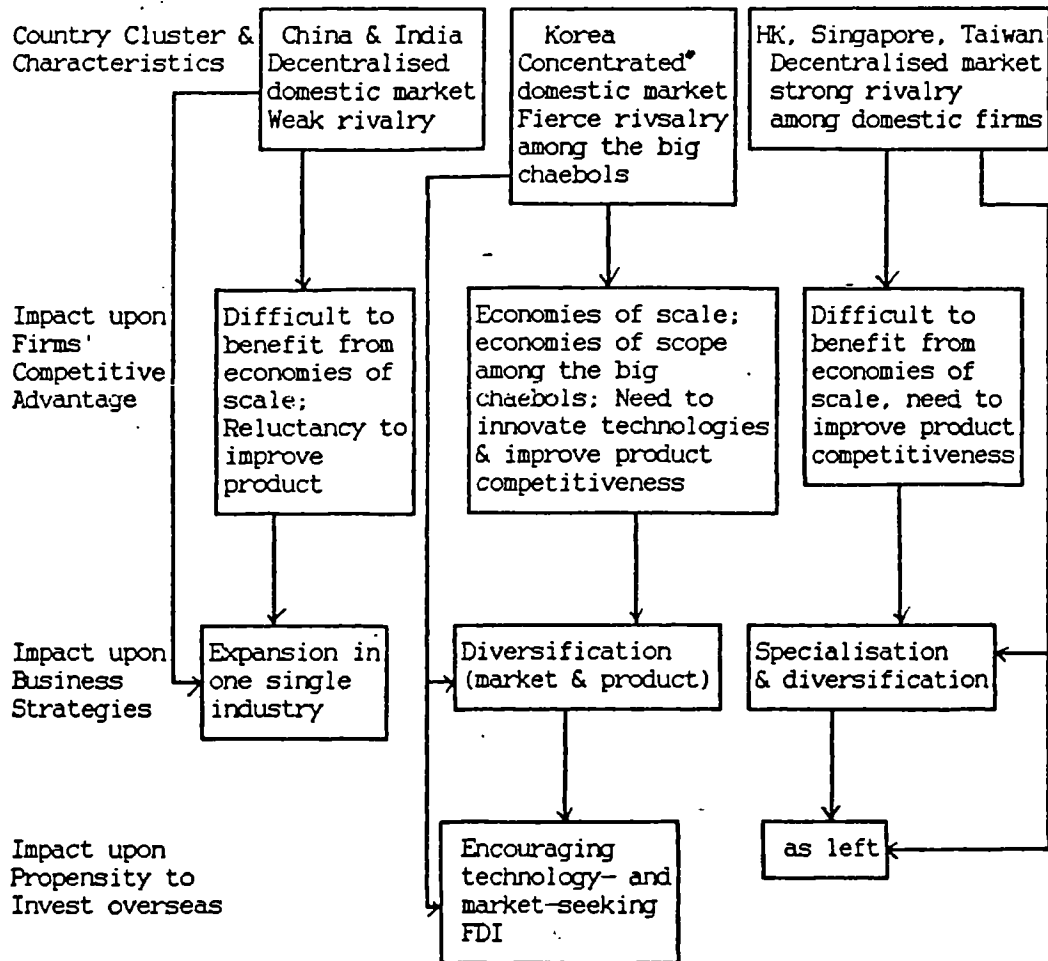
ministerial and regional protectionism and remaining role of central planning until recently. Moreover, the Chinese domestic market, similar to the Indian market, remains largely insulated from the international competition by the home government's restrictive trade policy. Thus lack of fierce competition in the Chinese and Indian domestic markets has led to the reluctance and consequent inability of their firms to innovate products, upgrade technologies and market their products and services aggressively in the domestic as well as international markets.

Figure 4.3 Related & Supporting Industries and the Propensity of Firms to Invest Overseas



Source: Author

Figure 4.4 Industry Rivalry and the Propensity of Firms to Invest Overseas



Source: Author

Hong Kong, Singapore, Korea and Taiwan have had capitalist market economies for decades. Although Korea has the most interventionism government amongst the four tigers, its government has encouraged competition among its firms, especially among the big chaebols not only in the domestic but also in the international markets. This competition creates continued pressure to invest, improve productivity, and introduce new products. The presence of committed Korean rivals mitigates any tendency for firms to compete solely on the basis of low Korean labour costs (McDermott, 1989;

Porter, 1990; The Economist, 1993, November, 2-8). Hong Kong has a non-interventionist government with a free trade policy, forcing Hong Kong firms to face domestic and international competition. Both Singaporean and Taiwanese governments have been playing a rather indirect role in their economies and encouraging competition amongst their firms and foreign firms. Facing increasingly fierce rivalry and demanding consumers/ customers, more and more firms from the four tigers are beginning to differentiate their products and services, with the Korean chaebols and some Taiwanese firms having gone the furthest (McDermott & Young, 1989; McDermott 1990), although they still lag behind their global competitors (Kumar, 1991).

#### 4.4.5 The Role of Foreign MNEs and Inward FDI

The four tigers have had a rather liberal policies toward inward investment by foreign MNEs. Hong Kong and Singapore have been the foremost among less developed economies in welcoming inward FDI and foreign MNEs. Foreign MNEs have since 1980 contributed to more than three quarters (and as high as 89.3 per cent in 1990) of Singapore's annual investment in the manufacturing sector (Ng, 1993). Hong Kong does not have official records of inward or outward FDI, but it is widely speculated that inward FDI and foreign MNEs have been playing a similar role in Hong Kong as in Singapore (Hong Kong Bank Economic Report, 1992, January).

Taiwan also has had a liberal policy toward inward FDI and foreign MNEs since the first inward FDI case was recorded in 1964. Foreign investors are entitled to the same incentives and privileges as local investors, and they are allowed full ownership of their Taiwan operations, with all net profits and interest earnings being remittable. With this liberal foreign investment policy and a fast growing domestic market, there was a substantial increase in the volume and value of inward investment, especially during the 1980s. By August, 1990, Taiwan had recorded a total of 5,620 cases of inward FDI worth US\$12.5 bn (McDermott, 1990).

Korea has been more cautious than the other three tigers in its inward investment policy. It welcomes inward FDI in selected industries.

As seen in the last Chapter, China did not welcome foreign investment until 1979.

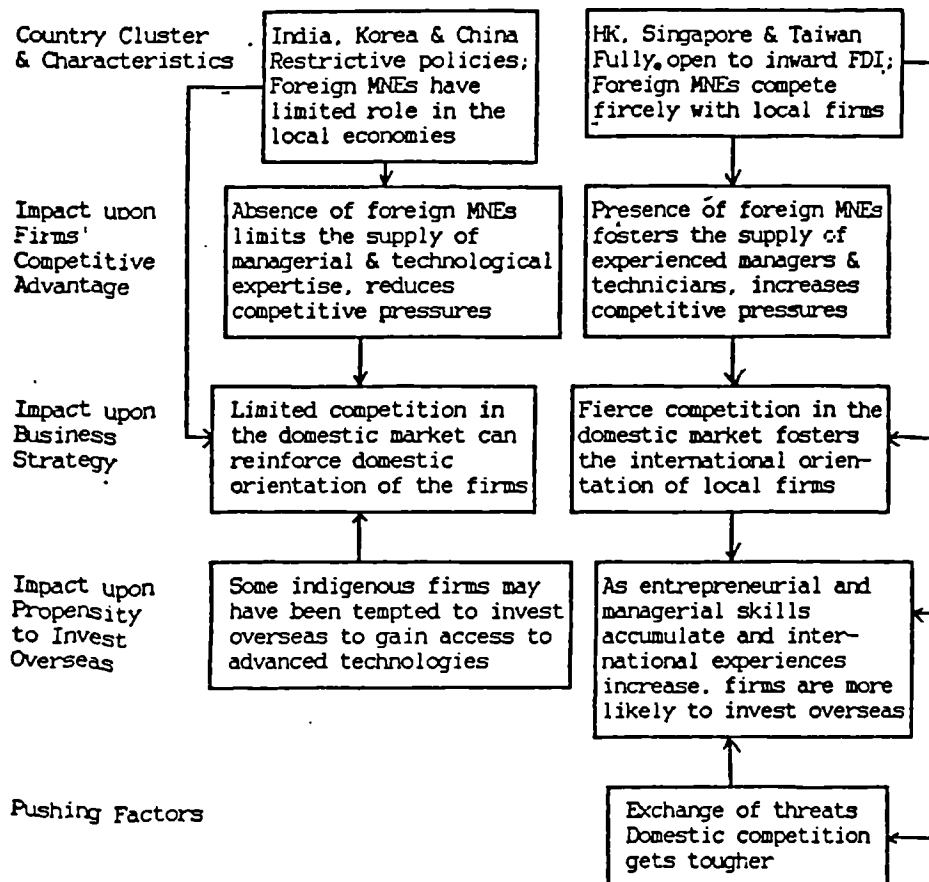


Since then, its policy toward inward FDI and foreign MNEs has become increasingly liberal. Foreign investors are entitled to financial and other incentives and privileges, which are not available to local firms. Foreign investors are also allowed full ownership of their Chinese operations, and their profits and earnings can be remitted. More and more sectors have now been open to foreign investment. With this liberal policy and the potential of a huge market with population of over 1.1 billion people, foreign investment has been increasing fast, especially in the past three years.

In comparison, India has perhaps the most restrictive foreign investment policy. Foreign investors are not allowed majority ownership until 1991, and many sectors in the country remain closed to foreign investors.

As inward FDI and foreign MNEs can have substantial impact on the local economy, what is particularly important here is that foreign MNEs can help local employees (through direct employment and demonstrating effects and business links with the host country suppliers and clients) learn advanced management skills and knowledge, facilitate an international outlook among the local people, especially those employed in managerial positions.

Figure 4.5 Inward FDI and the Propensity of Firms to Invest Overseas



Source: Author

#### 4.4.6 The Role of Government

The government has direct influence upon the propensity of national firms to invest overseas in three ways: national economic development strategies, policies of national firms' overseas investment and state intervention into enterprise activities (especially the activities of state-owned firms as would-be and/or existing MNEs).

##### A). National Economic Development Strategies

With the exception of the Hong Kong government which has had a *lassie faire* policy toward economy, government has been playing a very important role in China, India and other three tigers. The governments in these five economies have been playing (albeit declining) role in the economy through their five-year and annual plans, state-owned industries and enterprises and other macro-economic controls (eg, foreign exchange regulations) and administrative measures (eg, India's *licensē raj*). The late 1970s and 1980s had witnessed liberalisation of the Korean and Taiwanese economies, with their governments relinquishing much of their control in the economy (see McDermott & Young, 1989; McDermott, 1991).

The governments in Korea, Singapore and Taiwan had been pursuing successful exports-oriented economic development strategies, which have transformed these economies (plus Hong Kong as well) not only into status near developed nations, but also into the world's top 15 traders. Their interdependence with the world economy and long-standing experiences in international trade have produced a large number of entrepreneurs and managerial cadre with an international outlook.

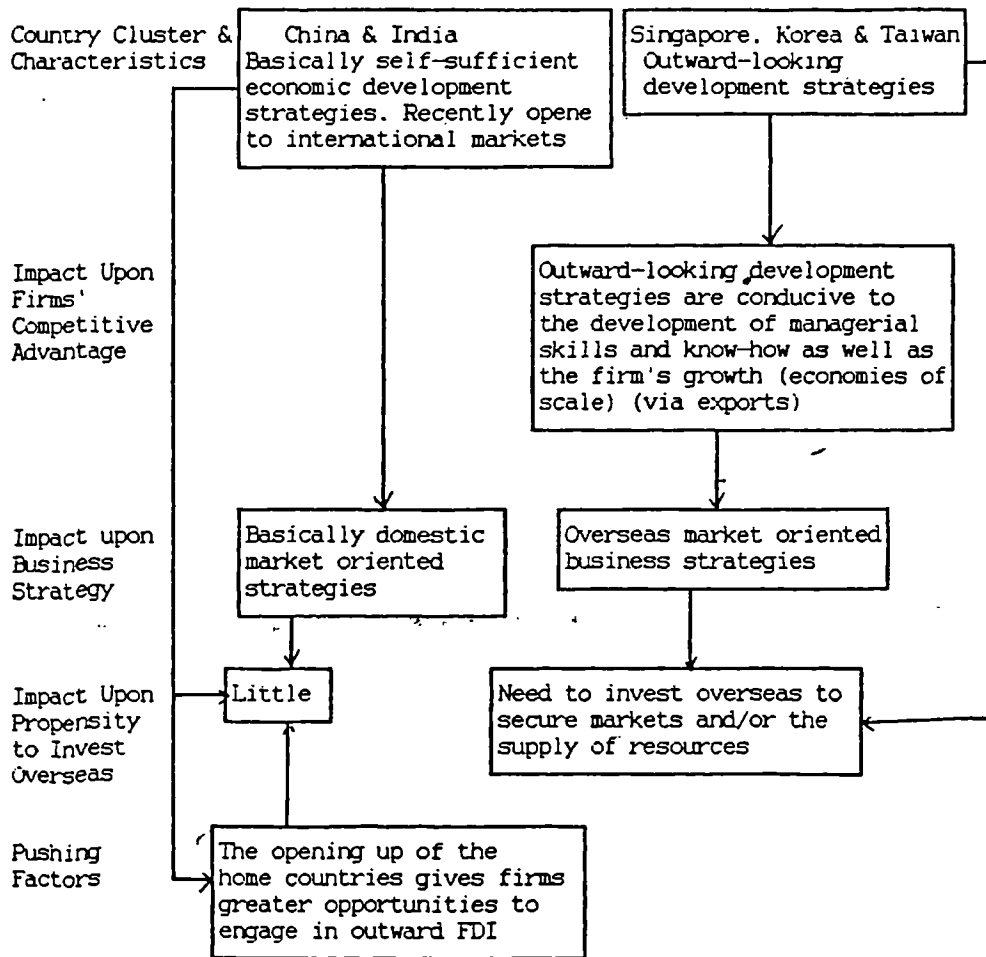
In the previous section, it has been argued that the Chinese government had virtually controlled the whole economy between mid-1950s and 1979 through its central planning (the five-year plans and annual plans) and the dominance of state-owned enterprises. The last 15 years have witnessed a liberalisation of the Chinese economy with market forces playing an increasing role at the expense of the central planning, with the domestic market opening up to international competition and investment. Nonetheless, China still has to liberalise its foreign trade and foreign exchange policies.

Although China has never had an anti-monopoly legislation, its excessive number of industrial ministries have had effective monopoly over the sectors under their respective administration. Although the reforms implemented so far have made possible for a firm in one industry to enter into another, the bureaucratic hurdles are sometimes too time-consuming and frustrating because various ministries still control the allocation of resources at state determined prices (which are lower than market prices) and access to certain privileges. Another factor that fragments the domestic market in China is the regional protectionism, which has been most obvious at provincial borders. Some provinces have erected road barricade to prevent the movements of goods and raw materials from and to other provinces (The Economist 1993, April, 23). Recent calls for an inter-regional trade legislation have highlighted the seriousness of the problem in China. Thus the ministerial and regional protectionism has effectively restrain the expansion opportunities in China.

Although India is not a socialist country, it had pursued a self-sufficiency economic development strategy for 40 years since its independence in 1947. After 4 decades of avowed economic self-reliance, India is opening up to the outside world by cutting import duties, reforming the exchange rate and promoting exports and inward foreign investment in the late 1980s. India has also been attempting to free the economy through liberalising trade rules, reducing the public deficit and introducing a market-based foreign exchange rate. The "license raj", a panoply of industrial control, under which virtually every corporate decision needed bureaucratic sanction, has now been abolished, so has the anti-monopoly legislation, which had in effect restricted the expansion potential of large industrial firms of the country (Financial Times, 1993, September 24; 30) and compelled many of them to invest overseas in order to expand in the past two decades (Lall, 1980, 1986).

The likely impact of national economic development strategies of the six countries concerned upon the propensity of their firms to invest overseas is depicted in Figure 4.6.

Figure 4.6 National Economic Development Strategies and the Propensity of Firms to Invest Overseas



Source: Author

### B). Foreign Investment Policies

The governments of the Korea, Singapore and Taiwan have all become supportive to their firms to invest overseas, especially in recent years.

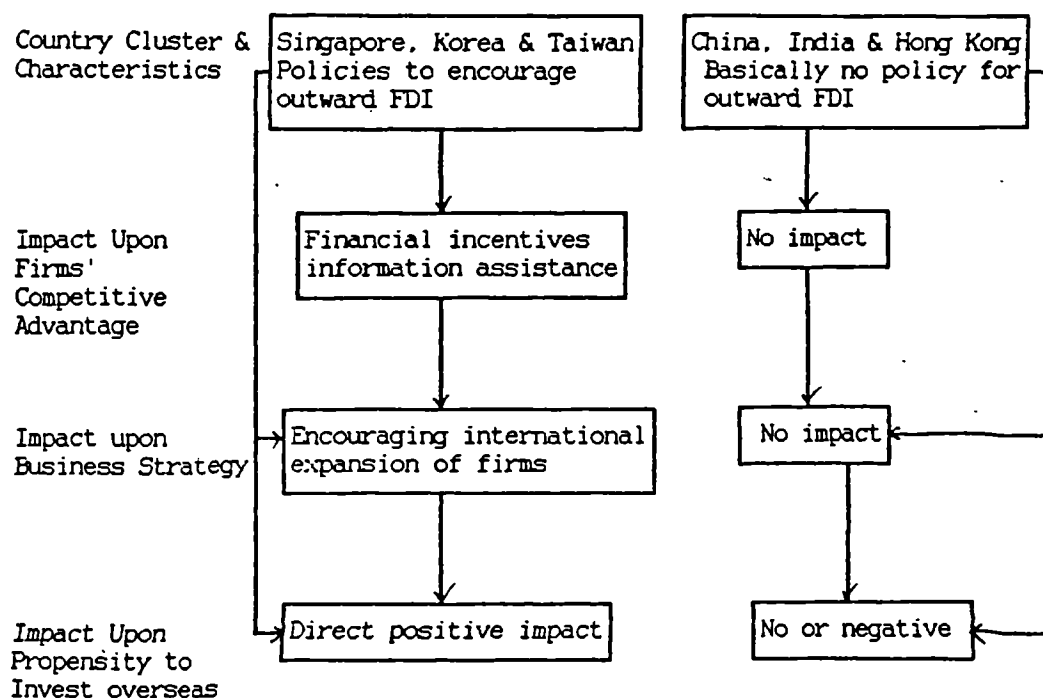
In the case of Singapore, the government has in recently years been encouraging Singaporean indigenous firms to invest overseas. It has set up several schemes (eg, International Direct Investment Incentive; Feasibility Study Grant) to support the internationalisation of its firms (Ng, 1993). The Korean government has been known to support financially and administratively its chaebols in their domestic development and competition and international expansion (McDermott & Young, 1989). These supports have played definitely a positive role in pushing the Korean chaebols to invest and compete overseas. The Taiwanese government has also become

increasingly supportive to the internationalisation of its firms, especially at their exporting stages through the programmes provided by its China External Trade Development Council (CETRA), although it has a wary attitude toward Taiwanese firms investing in mainland China.

India does not have a supportive policy toward the outward FDI of its firms, but the recent changes in its trade and foreign exchange policies will make outward investment easier than before (Financial Times 1993, October 24).

China's Ministry of Foreign Economic Relations and Trade has been calling for the internationalisation of some selected firms, notably the former 12 national TFCs. But there has been not concrete foreign investment policy laid down. As for manufacturing firms, the ministry is still suspicious of their capability to undertake outward FDI profitably (The Chinese Centre for Multinational Enterprise Research Reports, 1992). Thus it remains unclear whether or not the Chinese government is actually supporting the outward investment of its firms. Nonetheless, the open-door policy has made possible the internationalisation of some Chinese SOEs, including those in the manufacturing sector.

Figure 4.7 Foreign Investment Policy & Outward FDI



Source: Author

### C). Government Intervention

The six countries differ significantly as regards their governmental intervention into the operations and management of their firms. On the one extreme is the Chinese government, which has direct control over and intervenes very frequently the operations and management of its state-owned firms. On the other extreme is Hong Kong, whose non-interventionist government has adopted a *lassie faire* policy towards its industries and firms, leaving the market forces to play their full role. India is perhaps somewhere near China, with the Indian government having a direct control and impact upon the public sector, which absorbed 44 per cent of gross domestic capital formation, used 46 per cent of the capital stock, and accounted for 27 per cent of the country's GDP (Financial Times 1993, September, 30). Korean government's intervention into the economy comes largely from its regulations and enforcing the competition among its big chaebols. The governments of Singapore and Taiwan have gradually reduced their direct intervention into the economy, including the role of their state-owned firms. Perhaps in the middle of the two extremes stands the Korean government, which has played a relatively heavy and important role in the economy. Apart from substantial investment in education and infrastructure, efforts to promote exports, the Korean government has also intervene directly in individual industries (Porter, 1990). For instance, its financial and administrative supports are critical to the rapid rise of the big chaebols.

The impact of government intervention into the operations and management of firms is basically upon the development of entrepreneurial skills, managerial skills and know-how (see Dunning, 1980; Porter, 1980, 1985, 1990). With the exception of the Korean government which has enforced competition among its domestic firms, particularly the big chaebols (McDermott & Young, 1989; Porter, 1990), governmental intervention in the other countries has usually limited the role of market forces and competition, reducing the opportunities for genuine entrepreneurs and competent managers to emerge and develop.

## 4.5 Conclusion

In this chapter, the extended national diamond model and the integrative analytical framework developed in Chapter 3 have been used to compare the impact of the

evolution of home country diamonds of China, India and the four "Tigers" upon the competitive advantages of their firms, their business strategies and thus their propensity to engage in foreign direct investment.

The big and unsophisticated domestic markets in China and India have prevented the Chinese and Indian firms from innovating and upgrading technologies and marketing skills. They have also been compelled to adopt strategies based upon low costs rather than product differentiation. Therefore, both the Chinese and Indian firms have had limited rationale to pursue an international market-oriented strategy, which has reduced their propensity to engage in outward FDI. In contrast, the relatively small markets of the four "Tigers", have compelled many firms from these economies to pursue an international business strategy, in which outward FDI may be an important part. The increasing difficulties with rising labour and other operating costs and the shortage of labour in the four "Tigers" have also pushed their firms to locate labour-intensive activities overseas.

In conclusion, while the changes in demand conditions, factors conditions and the governmental policies in the four "Tigers" have been conducive to the internationalisation of their firms, the restrictive policies in India and de facto ministerial and regional protectionism and other market imperfections in China have served as pushing factors behind their firms to internationalise. As for China, the reforms have to certain extent liberalised its state-owned firms (ie, allowing them a greater management autonomy) and the open-door policy has them exposed to the opportunities and threats in the international markets. Some of the Chinese state-owned firms have responded positively with drastic strategic changes from a domestic market orientation to international market orientation.

Overall, it can be concluded that the national diamonds of the four Tigers have had a strong and positive impact upon the development of competitive advantages of their firms, fostering the firms from these economies to adopt international markets-oriented business strategies, and thus increasing their propensity to invest overseas. The national diamonds of China and India have had limited and/or negative impact upon propensity of their firms to engage in outward investment, although in the case of China, the recent reforms and open-door policy have at least made possible for some of its SOEs to invest overseas.

## CHAPTER 5

### FRAMEWORK AND PROPOSITIONS

*"The widening strategic options open to firms require a reappraisal of the received theory of MNE activity in a number of ways. .... Any future modelling of MNE activity must pay more attention to strategic-related variables. .... The full integration of strategic-related variables into a general theory or paradigm of MNEs or MNE activity has yet to be accomplished" (Dunning, 1993. p.93).*

#### 5.1 Introduction

The various theories of FDI/MNEs reviewed in Chapters 2 and 3 have introduced a large number of variables both endogenous and exogenous to the firm to explain the conditions, motives, direction, timing and path of internationalisation of firms. However, no single theory has been able to explain all kinds of FDI. The economic theories of FDI have been static, cost-oriented, taking no consideration of strategic and management decision-making issues. The process model has ignored the cost implications of internationalisation, and overlooks the impact of evolution of comparative advantages of nations and industry-specific issues on the timing of internationalisation. Moreover, the strategic issues (eg, how the evolution of corporate strategies will influence the geographical market orientation of the firms and the speed of internationalisation) are ignored all together in the process model. The strategic approach to the MNE on the other hand so far fails to consider the impact of company idiosyncrasies (eg, the origins of the firms, the sources of competitive advantages, the orientation and entrepreneurship of the top management), apart from external environments upon the formulation and/or evolution of their corporate strategies.

Thus to explain FDI satisfactorily needs an integrative strategic approach to the internationalisation of firm. Following the previous chapters on literature review, this chapter attempts to synthesise the literature and put forward a strategy-oriented integrative analysis framework for the internationalisation of the firms. This framework incorporates strategy formulation and implementation process into the economic and behavioural approaches, which will enable the researcher to examine the internationalisation of the firm from a multi-dimensional and integrative strategy



perspective.

## 5.2 Strategy Approach Revisited

Although the home country diamond influences the creation and sustainability of corporate competitive advantages (Porter, 1990; Dunning, 1992, 1993; see Section 2.5) (ie, resources and capabilities), and the home country may provide the primary source of competitive advantages of MNEs (Hu, 1990), the management of the firms must perceive these resources and capabilities and take them into the formulation and implementation of corporate/business strategies. Also the market opportunities and threats existing in the home country and international markets must be also perceived by the management and taken into their decision-making. The evolution of comparative advantages of countries, once perceived as business opportunities and threats by the management, will stimulate the management to adjust their corporate/business strategies. Thus it is plausible that corporate/business strategies play an intermediate role between the corporate competitive advantages and the internationalisation of the firm.

While it is possible that a firm takes no strategic guide to internationalisation at early stages, especially at the early exporting stage (Loustarinen, 1970, 1980; Schendiman, 1971, 1973), as internationalisation proceeds, an international or even global strategy is likely to emerge because of:

- a). increased skills and knowledge enabling it to diversify further (Young, 1987);
- b). increased contribution of international involvement to its overall revenue;
- c). the need to coordinate its dispersed operations across countries so as to benefit from the multinationality advantages (Kogut, 1983, 1985a, 1985b);
- d). the need to reform organisation structure in order to reinforce or improve management efficiency and foster greater degree of multinationality or rationalisation of international operations (Stopford, 1972; Jansson, 1989);
- e). environmental factors encouraging outward-oriented vis-a-vis domestic expansion (eg, the pulling factors and pushing factors). As the international markets have become increasingly integrated and even globalised through the production, marketing and procurement networks of the existing MNEs and inter-firm trade, no firm is totally insulated from international competition and

influence (Porter, 1986). With the ease of transportation and communications brought by the advances of technologies, firms have become increasingly aware of development and changes in the international markets;

- f. managerial factors encouraging an outward-oriented development strategy (eg, formal strategic planning enabling firms to scan international market opportunities more systematically, international experiences of top managers at the firm, see Millington & Bayliss, 1990; also see Aliber, 1966).

By studying the internationalisation of three experienced Swedish MNEs (ie, Tetra Pak, Alfa-Laval, and Atlas-Copco), Jansson (1989) has shown that their globalisation is the results of their intended international strategies. And their subsequent investments become more direct and swift as required by these strategies.

However, Johanson and Vahlne (1992) have argued that internationalisation or foreign entry decisions can not be made strategically, as they see internationalisation as purely an evolutionary reaction in response to the changes of international market networks. While some strategies demand substantial changes in business policy and new orientations in products, markets and operations, and thus require dramatic changes in the deployment of corporate resources, many other strategic changes are incremental and responsive to the evolution in corporate competitive advantages and external environment. Indeed, strategy formulation (eg, SWOT analysis, be it formal or informal) involves consideration of how to utilise these market opportunities and corporate resources to achieve corporate objectives. The strategy could be reactive, proactive or neutral (Glaister & Thwaites, 1993), depending upon the perceived corporate competitive advantages and the complexity of environment. And strategy implementation will deploy corporate resources and capabilities to exploit the perceived opportunities in the market(s) or market niches, including foreign markets. It is usual that the strategy being implemented needs some adjustments or even radical changes in response to the developments in the firm's internal and external environments.

Having argued that internationalisation could be strategic in nature, especially when the firm has a high degree of international involvement (Young, 1987), it is further argued that the motives for, the modes and methods of foreign entry are linked to the international corporate strategy. This international strategy defines the motives for, the mode and method of each foreign entry. While a sequential evolution of foreign

entry methods (eg, from exporting to sales subsidiaries, or from joint venture to wholly owned subsidiaries) may reflect a cautious managerial style, some environmental changes (eg, acquisition opportunities) may necessitate immediate and bolder actions to be taken by the firm. In addition, international markets usually provide opportunities and threats suitable for different market entry methods and modes. For instance, licensing would be preferred to FDI and exports if some host countries' regulations or political risks inhibit the formation of majority-owned joint ventures and wholly owned subsidiaries, and when transport or tariff barriers make exports difficult (Contractor, 1985). For example, Pilkington Bros plc, the world's leading float glass manufacturer, had licensed its processing technology to more than 100 production lines in the world. When it entered the Chinese market in the early 1980s, it changed this licensing-only policy and set up a minority-owned joint venture using its innovated technology, in response to the country's ever-increasing market demand and joint venture regulations then (Huang & Gallo, 1989).

The diversity and changes in the international environment usually provide different opportunities suitable for different market entry objectives, entry methods and investment modes, firms, especially those with substantial international experiences and a high degree of internationalisation, are stimulated to adopt a portfolio of different entry methods and modes for multiple-objectives. Thus as internationalisation proceeds, a firm is more likely to use more entry methods rather than simply replace one method (eg, FDI) with another (eg, exports).

Lastly, the results of internationalisation (the degree and scope) will in return bring additional competitive advantages (ie, multinationality advantages) to the firm (Dunning, 1981, 1988; Kogut, 1983; Ghoshal, 1987). Recent contributions to the literature on the determinants of MNE activity have increasingly distinguished between the initial act of FDI and sequential investment. Kogut (1983) persuasively argued that although the possession of superior intangible assets may give rise to the initial act of foreign production. Once established abroad, the advantages of multinationality per se, ie, those gained from the spreading of environmental risks and the common governance of diversified activities in dispersed locations, become more significant. Kogut (1987) also relates the international strategy of MNEs to the sources of these sequential advantages and to their learning experiences in coordinating domestic and foreign production because "learning by doing" contributes to management development (Margerison, 1980; Margerison & Kakabadse, 1986;

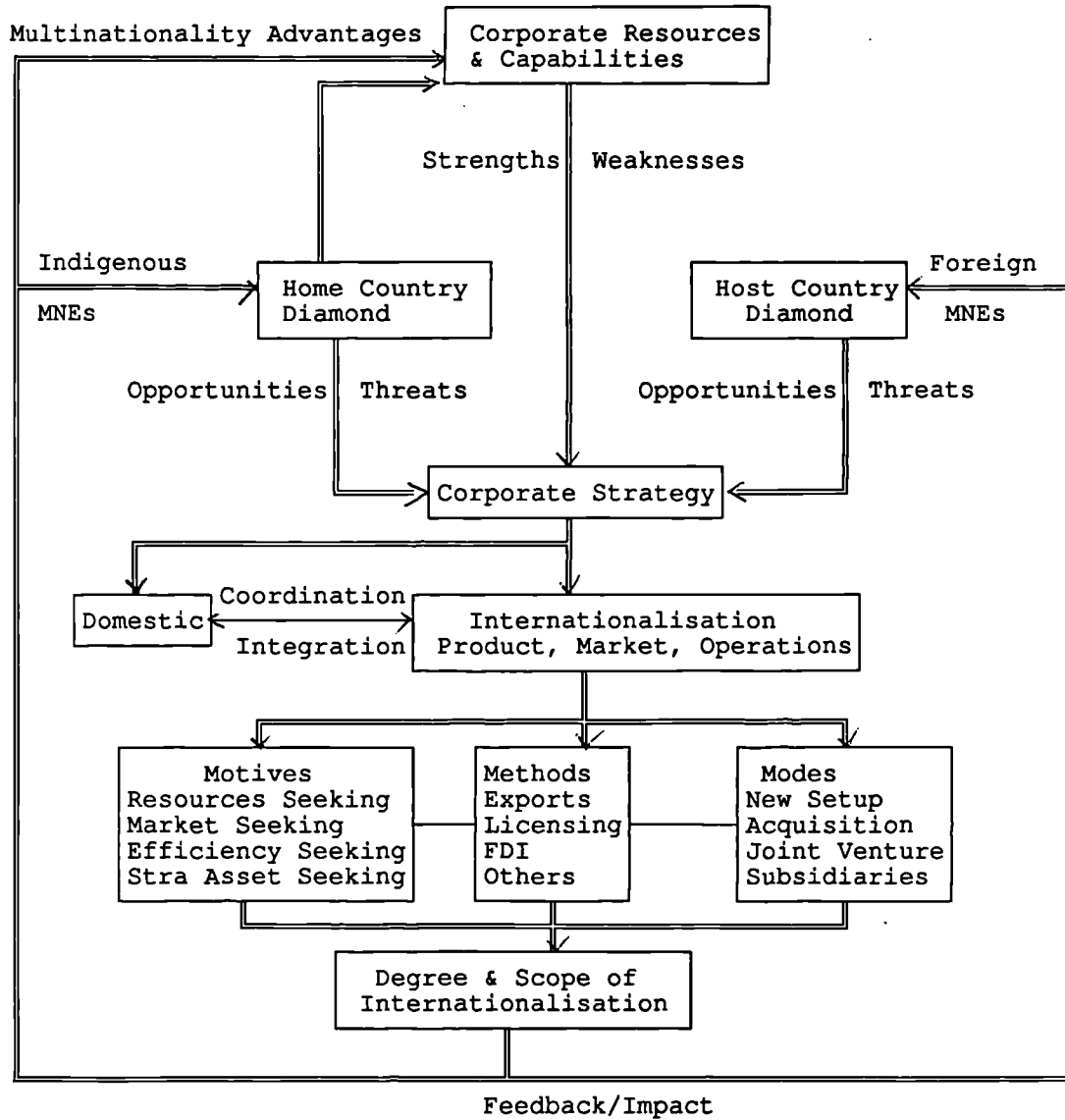
Janaka, 1989). On similar lines, Bartlett and Ghoshal (1987) have asserted that MNEs operating in a variety of environments are exposed to multiple stimuli which enable them to develop competencies and learning opportunities not open to domestic firms. Thus for an MNE, its multinationality advantages have become an additional and powerful determinant of its subsequent strategic evolution, including further internationalisation or globalisation. Thus the distinction between initial competitive advantages and multinationality advantages per se is very important. For example, while large MNEs with substantial multinationality advantages are able to formulate and implement global strategies, the uninational firms and companies at early stages of internationalisation can hardly think globally (Young, 1987).

### **5.3 An Integrative Strategy Framework**

Having argued that corporate/business strategies are formulated in response to the perceived corporate competitive advantages and market opportunities and threats, including those in the international markets, and that corporate/ business strategies play an increasingly important role in the internationalisation of the firm as the process proceeds, an integrative strategy framework is now proposed to explain the dynamics and interactions of the home country diamond, corporate competitive advantages, corporate/business strategies, and the internationalisation of the firm.

Figure 5.1. demonstrates that when the focus of analysis is on individual company rather an industry or country, it is vital to link motives, the ways (methods) the firm approaches and serves foreign markets, and timing of its entry into foreign markets and location of its outward FDI with the corporate/ business strategy, which in turn is determined by the perceived opportunities and threats in the domestic and international markets and corporate resources and capabilities.

Figure 5.1. An Integrative Strategic Framework of the Internationalisation of Firms



Source: Author

## 5.4 A China-specific Model of Internationalisation

Having reviewed the theoretical and empirical literature on MNEs from both developed and developing countries as well as the changing Chinese economy, the comparative advantages and disadvantages of China and its state enterprises, this section will attempt to apply the proposed integrative framework to explain the competitive advantages and internationalisation of the Chinese firms.

Chapter 4 has indicated that China has a relatively low level of per capita income (US\$380 by direct Yuan-dollar conversion, or US\$1,700 by PPP conversion). Thus it is appropriate to consider China from a Third World perspective. The internationalisation of Chinese firms is hence expected to be similar to that of their counterparts from other less developed countries such as India, Brazil, and, to a lesser extent, the four NIEs (ie, Hong Kong, Singapore, South Korea and Taiwan). However, China differs from India and these four "Tiger" in that it is in a transition from a centrally planned to a market economy. Thus there are considerable differences in the characteristics of the national economies between China on the hand and India and the four "tigers" on the other. These similarities and differences are supposed to impact upon the behaviour of their firms, their corporate strategies and their internationalisation.

It has also been shown, in the last chapter, that the Chinese economy has been open to the rest of the world since 1978 and thus become increasingly exposed to international markets. For instance, foreign trade accounted for nearly 40 per cent of GDP by 1992 (see Chapter 4). On the other hand, the trajectory of China's economic and social development in the past four and half decades differs substantially from many of these LDCs and also from its former socialist counterparts in Eastern Europe (The Economist 1992, November 23; Financial Times 1993, May 24).

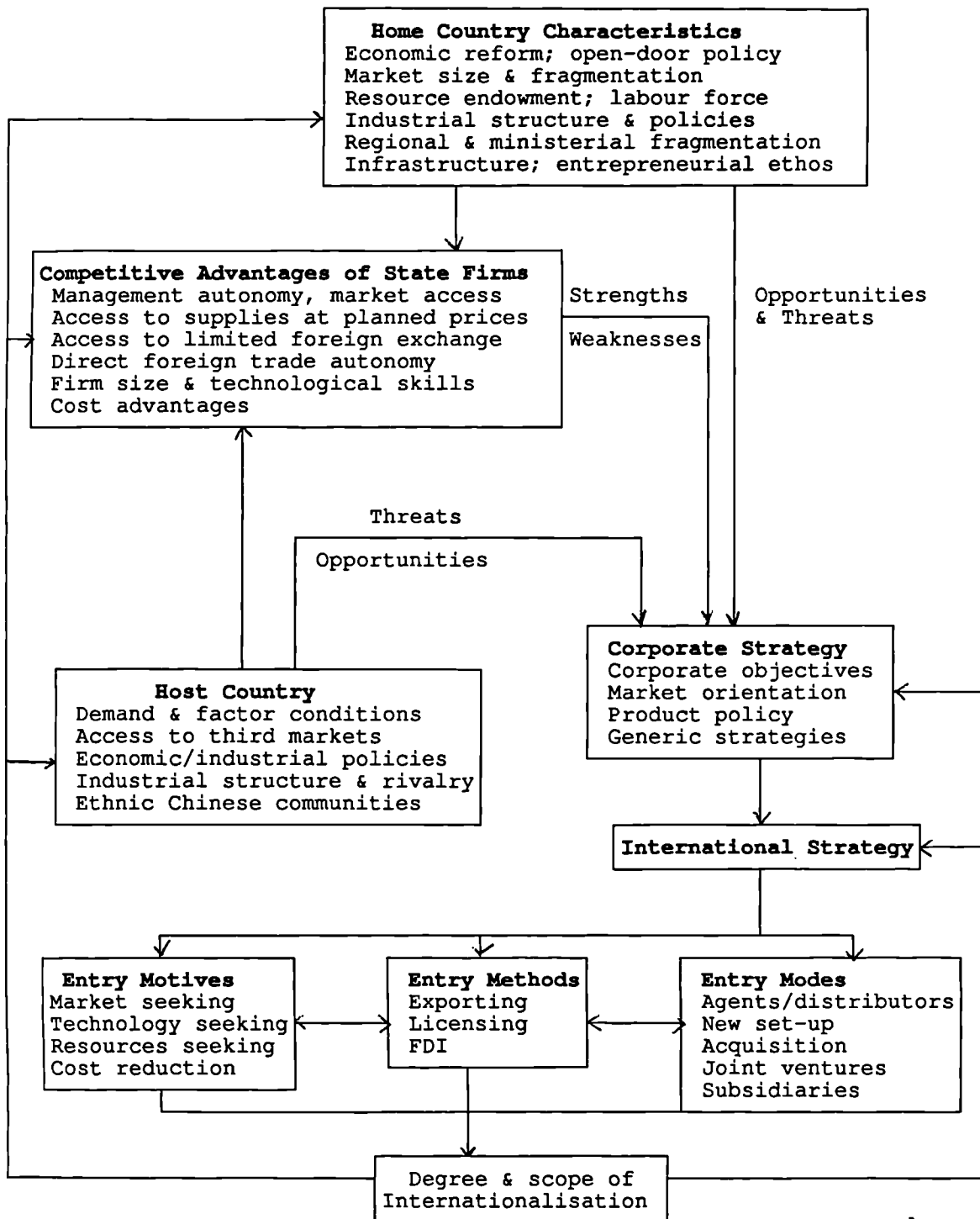
At the firm level, the major differences between Chinese MNEs and their counterparts from other LDCs are that almost all Chinese MNEs are state enterprises, which may differ from their private counterparts in terms of corporate objectives, management autonomy, access issues, etc (see Chapter 3, Section 3.6.1. and Chapter 4, Section 4.5.2.).

As Dunning (1988, 1990, 1993) and Porter (1990) have argued, the home country-specific characteristics (eg, the level of its economic development, the size of its market, the quality and quantity of its labour force, industrial policies and overall economic development strategy, market structure and rivalry, etc) have a direct impact on the creation of corporate competitive advantages. In other words, the home country provides the primary source of competitive advantages of its MNEs (Hu, 1992). Home countries also have an impact on the corporate strategies of firms because strategies are basically formulated upon the perceived strengths and weaknesses in the resources and capabilities within the firms and opportunities and threats of the firms' external environments, including international markets.

In the case of China, the declining but still predominant importance of state ownership of large industrial and service firms is still quite evident in the Chinese economy. Moreover, (only a limited number of) state-owned firms have been allowed to engage in direct exports and undertake outward FDI from China. Thus the internationalisation of Chinese firms has reflected the impact of transition from a centrally planned economy to market economy. And it is the relaxation of China's external economic sector and decentralisation of foreign trade decision-making power that makes possible the internationalisation of Chinese firms (see Chapter 4).

To incorporate China's macro-economic characteristics and its institutions with the micro-level entities -- state enterprises -- into the internationalisation framework of Third World/Socialist firms, a model for the inter-nationalisation of Chinese state manufacturing firms has been developed (see Figure 5.2).

Figure 5.2 A Chinese Model of Internationalisation



Source: Formulated by the author



## 5.5 Propositions and Supporting Literature

From the China-specific model of the internationalisation of the firm, the following propositions can be generated and supporting literature for them be reiterated in view of the research objectives:

Proposition 1. The competitive advantages of Chinese MNEs are likely to be influenced by the characteristics of the home country diamonds.

The importance of home country diamond in the creation of competitive advantages of firms has been suggested by several authors (eg, Dunning, 1988, 1990, 1993; Porter, 1990; Hu, 1992). Other researchers have revealed the impact of home country diamond and its evolution upon the creation of specific competitive advantages. For example, Vernon's (1966, 1979) PLC theory suggests that product innovation advantages of the US and subsequently European and Japanese firms are largely determined by the demand conditions and their evolution of their respective home countries.

The competitive advantages of the Third World MNEs in small-scale technology (Wells, 1977, 1979, 1980, 1982) and adapted process technology (Lall, 1982) are also related to the characteristics of the demand conditions of their home countries. Moreover, their disadvantages in product innovation and differentiation, product branding, advertising and economies of scale can be attributed to the home country diamonds (especially their relatively undemanding customers and consumers, and weak technological base, etc).

As China resembles India in many respects in its national diamond (see Chapter 4), it is expected that China's national diamond will stimulate the Chinese firms to create competitive advantages similar to those possessed by their Indian counterparts.

Moreover, as the Chinese economy is still in transition from a command to market economy (see Chapter 4), some firms may have become privileged in such a transition. For instance, some SOEs have greater management autonomy (including direct import and export autonomy) than many others.

Proposition 2. Chinese manufacturing MNEs are likely to have some technological advantage prior to their inter-nationalisation.

As discussed in Chapter 2 on MNEs from developed countries, numerous ownership-specific competitive advantages have been suggested by MNE theorists: product innovation (Vernon, 1966, 1974, 1979); technology and product differentiation skills (Caves, 1971, 1982); oligopolistic market structure and behaviour (Kindleberger, 1969; Caves, 1971, 1982; Vernon, 1971; ); excess managerial capability (McManus, 1972; Wolf, 1977); financial and monetary factors (Aliber, 1970, 1971), including access to cheap capital and raw materials (Lall & Streeten, 1977).

Technology advantage has also been singled out as an important characteristic of LDC MNEs (see Chapter 3), although the nature of such advantage is suggested to be special. Wells (1977, 1981, 1983, 1984) argues that LDC market induces firms to develop flexible, small-scale, labour intensive processes and products, and to find ways to substitute available local inputs for imported ones. Thus LDC MNEs have developed a competitive edge over MNEs from industrial nations because their technology is more appropriate to the host countries which bear social and economic similarities to their home countries. Similarly, Lall has suggested that firms in LDCs have developed (through their own research efforts) or adapted imported process technology to the home country conditions. Such technology developed or adapted in developing country conditions is more applicable, than that available from industrial countries, to host countries which are usually also in the Third World. Chapter 3 has summarised empirical evidence in relation to such contention (see Chapter 3, Sections 3.2.2, 3.2.3. and Table 3. 2).

Proposition 3. Chinese MNEs are likely to have experienced an incremental internationalisation process, namely from indirect exporting (and importing), to direct exporting, to overseas sales offices and eventually to overseas manufacturing.

Chapter 4 has argued that prior to 1978, the 12 national FTCs had the monopoly of foreign import and export activity in China. Manufacturing enterprises were granted import and export autonomy in the 1980s. And only those manufacturing firms with significant exports have been authorised to engage directly in import and export, as well as foreign investment. Similar institutional arrangement has been evident in the

former Soviet Union and other Eastern European socialist countries (see Chapter 3, Section 3.6.2.). Thus from such an institutional perspective, the Chinese manufacturers have to experience an indirect export stage.

The literature has shown mixed evidence on the evolutionary nature from direct exporting to the establishment of overseas sales offices and manufacturing entity (see Chapter 2). Because Chinese manufacturers were insulated from international markets prior to their direct export and import autonomy, they are expected to lack international marketing experiences, not to mention international production. Thus the establishment of manufacturing facilities is expected to come last in the process of their internationalisation.

Proposition 4. Chinese MNEs may have no initial strategic plan for internationalisation. But as their internationalisation deepens, they are likely to have formulated and been pursuing internationalisation either as their corporate strategies or as one of the most important constituents in their corporate strategies.

It has to be admitted that so far strategic issues have not been fully incorporated into the thinking of MNE theories or internationalisation theories (Buckley, 1988; Dunning, 1988, 1990, 1993). In Chapter 2, it has been suggested that internationalisation (via exports, FDI or other cross-border contractual arrangements) may be viewed as the, or part of an, overall corporate growth/expansion strategy (Wolf, 1977; Luostarinen, 1980; Young, 1986; Young et al, 1989).

Luostarinen (1970, 1980) and Schwendiman (1971, 1973) argue that firms at their initial stage of internationalisation usually do not attach any strategic importance to it. The export marketing literature (see Chapter 3, Section 2.3.2) asserts that exports usually start with negligible or marginal resources and commitment from management, which can be interpreted as lack of strategic importance (Bilkey & Tesar, 1971; Cavusgil, 1980; Czinkota, 1982; Reid, 1981).

The increase of exports, especially growing contribution from exports to corporate revenue, as well as fiercer competition in international markets, will motivate management to increase strategic weight to internationalisation (Stopford, 1972). And the international experience accumulated in the past will assist the firm to take bolder steps to further internationalisation in the later stages (Young 1987). Thus an

internationalisation strategy will emerge as either the overall corporate expansion strategy or an important part of it.

In the case of China, like the former Soviet Union and Eastern European countries, manufacturers did not have the autonomy to engage directly in imports and exports, all their exports (if any) had to be handled by the 12 FTCs prior to 1979. Moreover, the central plans assigned quotas for exports to the manufacturing firms. Without any financial incentives, firms were just passive participants in the implementation of state exports plans. Even though exports might account for an important portion of their sales, these exporters would not take a strategic interest in exports because almost invariably they were preoccupied with the expansion of production. They certainly did not themselves assess market opportunities and threats in the international markets because they were insulated from the international markets by the nature of their indirect exports. Thus it is unlikely;y that they had formulated an internationalisation strategy.

The economic reforms and Open-Door Policy have introduced management autonomy to the firms and incentives to the exporters. The incentives came in different forms. Firstly, as despite the greater difficulties encountered by the Chinese firms in the international markets than in the domestic market, they usually prefer exports (if they can) to domestic sales. This is because a portion (from 15 per cent to 75 per cent, depending upon the location of the firms) of hard currencies earned through their own exports can be retained. The retained foreign exchange can be used by the exporters to import technology, equipment and materials, etc. The state simply does not have enough foreign exchange earnings to meet the demands of every state-owned firm. Thus instead of waiting for a limited allocation of foreign exchange from the state, firms turn to earn foreign exchange through their own exports. Secondly, the retained exchange earnings can be converted into Reminibi at a more profitable rate at the swap centres which were established since 1988 throughout China. The swap centres are China's official foreign exchange market where rate is much higher than the official rate and thus closer to that prevailing in the illegal black market. Thirdly, the exporters usually have greater bargaining power than non-exporters with local governments which have various incentives to increase exports from there localities. As exporters, these firms usually get privileges in the allocation of materials, the use of infrastructure (eg, transport, power), etc. Fourthly, prices of many products in the domestic market have been low either set artificially by the state

pricing control or forced by the competition among the domestic rivals which have been competing primarily on price rather than product differentiation. As shown in Chapter 4, as an important promotion and competitive tool, advertising only reappeared in China in 1979 and total expenditure on advertising in China still accounts for a smaller proportion of its GNP than that of many other LDCs such as India and Brazil. For all these reasons, exports are supposed to take a strategic momentum, especially when a firm has been given greater management discretion and when sales in the international markets account for an important proportion of its total sales. After all, it is now up to the firms themselves to penetrate and expand in the international markets.

Proposition 5. Internationalisation strategies, will not only speed up Chinese MNEs' internationalisation process but also influence their choice of foreign entry motives, methods and modes.

In Chapter 2, Section 2.4., it has been argued that strategic issues are inherently contextual (Pettigrew, 1989), and a large number of factors are been considered by strategic decision-makers (Dunning, 1993). SWOT analysis by strategic planners involves examining the internal strengths and weaknesses (in resources and capabilities, ie, competitive advantages) and external opportunities and threats (include both domestic and international markets). Thus MNEs from, for example, Asia-Pacific countries, will differ from their USA or German counterparts in corporate strategies (Buckley & Mirza, 1988, 1990), and indeed, MNEs from the same countries may pursue different strategies because of their different resources and capabilities, ie, firm-specific advantages and the perception of them. Hence it is expected that home and host country characteristics and firm-specific advantages determine the corporate and international strategies of Chinese MNEs.

Moreover, international strategic decision-making can substitute for market experience, enabling firms to leapfrog the incremental process (Millington & Bayliss, 1990). The formation and implementation of international strategies require changes in organisational structure so as to improve management efficiency and foster greater degree of multinationality (Stopford, 1972). Young et al also suggest that as policy changes (eg, international strategies vis-a-vis domestic strategies) bring discontinuities in the operating environment and thus require a quicker response in terms of the internationalisation methods used. Thus it is expected the formulating and pursuance

of an internationalisation strategy will speed up the internationalisation process of the firms.

Moreover, as a part of international strategy decision-making and implementation process, the firm will assess more regularly and systematically the opportunities and threats in the international markets and strengths and weaknesses in its internal resources and capabilities. Some opportunities (eg, an acquisition target, an emerging market segment) will be more likely to be exposed to a firm pursuing an internationalisation strategy than another firm oriented towards its domestic market. Also as a firm pursuing an internationalisation strategy usually has a fairly high degree and scope of internationalisation, its multinationality advantages together with its original competitive advantages will also enable it to take bolder steps in furthering its internationalisation. An MNE with a large number of overseas subsidiaries and joint ventures is more likely to coordinate activities of these subsidiaries and joint ventures (eg, transfer pricing) to maximise corporate benefits, sometimes at the expense of some overseas subsidiaries and joint ventures. Thus a firm pursuing a global strategy differs from a firm making an initial investment overseas in the motives, methods and modes of foreign entry (Young, 1987). Therefore, it is proposed that an internationalisation strategy will influence the motives, methods and modes of foreign entry of the firm.

Proposition 6. In terms of generic strategies, Chinese MNEs are likely to base their competition primarily upon cost advantages and thus enjoy price competitiveness in international markets.

According to Porter's (1980, 1985, 1990) classification of generic strategies, developed country-based MNEs are found to have been pursuing differentiation strategy (reflected in their heavier advertising, higher R & D intensity, product innovation, etc) (see Chapter 2, Section 3.2.9, and Table 3.2), while MNEs from the Third World competing on low costs and thus low price, rather than product differentiation, brand names or advertising in international markets (Ting, 1982; Lall, 1983, 1986; Wells, 1983; also see Chapter 3, Section 3.4.1 and Table 3.3.). The Korean chaebols, the largest and most powerful MNEs from the Third World (see McDermott, 1989), are still basically competing upon their price competitiveness in the international markets. Recent research of Korean MNEs in the EC suggests that cost advantage is very much the basic competitive weapon for them, which generally

neither possess the technology nor have the highly reputed brands or marketing expertise for focus strategies at specific market niches, at least in the EC (Kumar & Kim, 1992).

As Chapter 4 suggests, the centrally planned system had led to state enterprises in China to focus on product quantity rather than quality in the past, and the market orientation has yet to come to be recognised by China's state firms (Liu, 1990). There was virtually no advertising in China during 1952 and 1978. Advertising first appeared in Chinese media in 1979, and advertising fees, after 10 years of fast increase, amounted to US\$288 million, or less than 0.1 per cent in China's GDP, a ratio lower than that in India, Pakistan and many other developing countries in 1989 (Economic Reporter 1993, No.5).

The product rather than market orientation, the lack of technological leadership in most of the industries (see Chapter 4) and the low cost advantages in China are expected to lead to an emphasis on cost and price competitiveness of Chinese MNEs in international markets like their counterparts from many other LDCs.

Proposition 7. Imported but adapted technology is likely to be one of the main sources of technological advantages for Chinese MNEs.

In Chapter 4, it has been argued that imported but adapted technology has been an important source of advantage for Third World MNEs (Wells, 1977, 1979, 1981, 1983; Ting, 1982; Lall, 1983; World Bank, 1989; also see Chapter 3, Section 3.4.). This is expected to hold true for Chinese MNEs, especially when one considers the lack of technological leadership of most Chinese state enterprises (see Chapter 4).

Proposition 8. The main motives for Chinese firms to internationalise are to gain access to host country markets or third markets, or seek advanced technology of the host country. Escaping home country government interference is also likely to be an important reason behind their outward FDI.

In terms of motives for FDI, cost reduction and efficiency seeking may not appear to be important for Chinese MNEs. Although labour cost may not be the only cost factor taken into account by MNEs, it remains an important cost factor to many Third World MNEs investing in labour-intensive industries (see Chapter 3, Section 3.2.). Labour

costs and shortages have been an important pushing factor behind the internationalisation of firms from NIEs (ie, Hong Kong, Taiwan, Singapore and Korea) (World Bank 1989; see Chapter 3, Section 3.4.). However, labour costs in China are amongst the lowest and China has the largest labour pool in the world (see Chapter 4).

As for efficiency seeking (ie, rationalisation of FDI), Chinese firms began their outward investment as recently as 1979, and individual firms are not expected to have a large number of foreign subsidiaries, so rationalisation of their foreign facilities should be out of question.

Market seeking (to the host country and/or third country) and technology seeking FDI have been common motives for MNEs from the Third World (see Chapter 3, Table 3.4.). Most of LDC MNEs' investment in industrial countries are found to be oriented to the host country market while many subsidiaries of LDC MNEs located in the poorer developing countries are viewed as export platforms, aiming at third country markets. The low costs of the host countries, and their access to the third countries (usually developed countries) are the commonest two reasons why they have attracted export platform FDI (Busjeet, 1980; Chen, 1981; Han & Brewer, 1987). For example, Busjeet (1980) has shown that when import quota was imposed on Hong Kong by the UK in 1959, the US in 1961, Norway and Germany in 1962 had motivated a surge of outward FDI from Hong Kong to Singapore which faced no import quotas by these countries at the time. Chinese manufacturers not only face import quotas imposed by destination countries, but also export quotas in many products imposed by the Chinese government. Chinese FDI has been suggested to be mainly export promoting (Buckley & Mirza 1988, 1990).

Chapter 3 (Section 3.6.1.) has suggested that state enterprises usually lack full management autonomy. FDI is seen as one way for them to exercise management autonomy overseas where the home government has relatively little influence (Marois, 1977, quoted in Blanc & Dussage, 1987). In China, state-owned firms not only have relatively lesser management autonomy, but bear greater financial burden (see Chapter 4, Section 4.3. and Table 4.20). Internationalisation via foreign investment will thus not only give them a chance to exercise their management autonomy in their overseas affiliates but also reduce their financial bearing. Thus escaping home government constraints may have served as an important motivation for their internationalisation.



Proposition 9. Joint ventures are likely to be the main investment mode by the Chinese MNEs in their outward investment.

Much of the literature on MNEs from the Third World has pointed to the frequent use of joint ventures by LDC MNEs (Giddy & Young, 1981; Wells, 1981, 1983; see Chapter 3 Table 3.1.). Empirical evidence seems to be quite conclusive and supportive of this contention (see Chapter 3, Section 3.2.). For instance, in a study of 602 of foreign affiliates of Third World MNEs, only 62 were wholly owned subsidiaries (Wells, 1983). In the case of South Korea, less than 10 per cent of its manufacturing affiliates overseas were wholly owned by Korean MNEs (Monkiewicz, 1983). The importance of joint ventures rather than wholly-owned subsidiaries as a foreign entry mode for the Chinese MNEs is compounded by their lack of marketing and production experiences in the international markets. Thus it is expected that the Chinese MNEs will prefer joint ventures to wholly-owned subsidiaries in their outward investment.

Proposition 10. Chinese MNEs are likely to have enjoyed network advantage arising from their cultural ties with overseas Chinese communities and from their previous business relationships in their internationalisation process.

The network theory (see Chapter 2, Section 2.3.3.) suggests that relationship networks help a firm to internationalise its operations (Imai, 1984; Johanson & Mattesson, 1984, 1987). The locus of such networks helps explain the location of a particular overseas investment. For instance, the investment undertaken by overseas Chinese in the PRC is usually connected with their *guanxi* or connections arising from cultural and dialect ties in China (World Bank, 1989; Financial Times 1992, October 23, 1993, May 16). Similarly, the location of Indian outward investment in the India-subcontinent and Africa has also been attributed to the cultural affinity of overseas Indian communities, which enabled Indian investors to have a competitive edge over other investors (see Chapter 3).

Given that Chinese manufacturing firms do not have substantial direct international experiences and that there are large overseas Chinese communities all over the world, especially in the Southeast Asia, North America (see Chapter 4), it is expected that Chinese MNEs will take advantage of their cultural and ethnic ties with overseas

Chinese communities in their foreign investment.

## **5.6 Conclusions**

This chapter has, based upon the preceding three chapters, presented a China-specific Model of internationalisation of firms. Ten propositions have been put forward to suggest the likely answers to the research questions regarding the nature and sources of Chinese MNEs' competitive advantage, the impact of home country characteristics on corporate and international strategies of Chinese MNEs, their generic strategies in international markets, their motives for foreign investment and main mode of foreign investment.

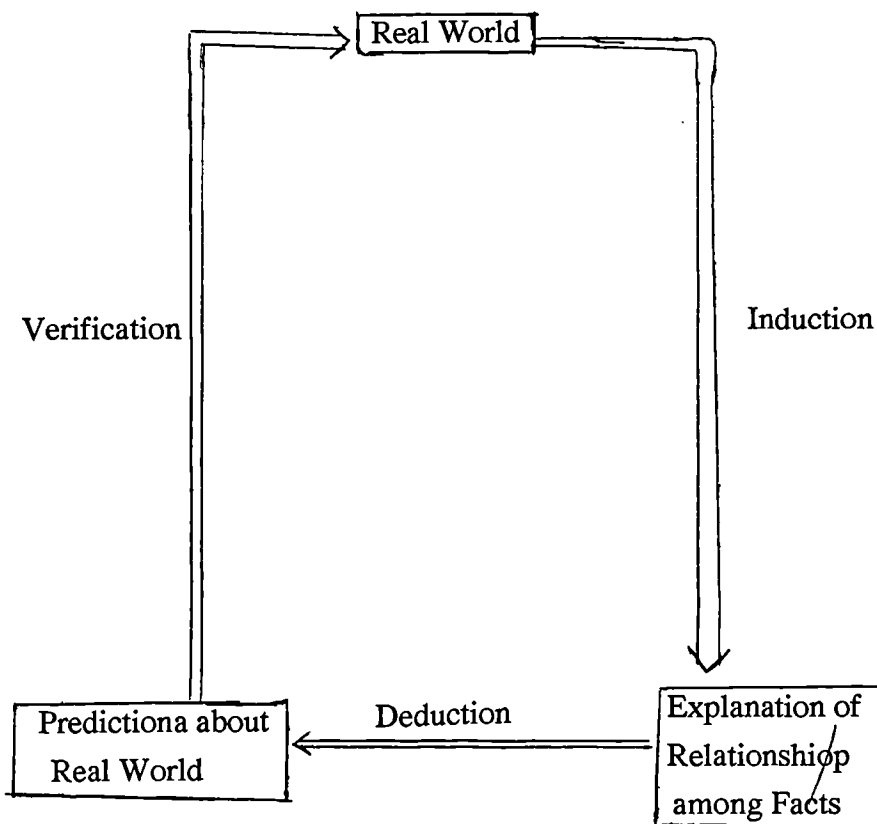
Having put forward these ten propositions, the next chapter will consider methodological issues and the selection of case companies.

## CHAPTER 6 RESEARCH METHODOLOGY

### 6.1 Introduction

There are two basic approaches to scientific inquiry: inductive and deductive. In fact they are the two stages of a complete process of scientific research (Cohen & Nagel, 1934). The relationship between different methods as they are called is presented in Figure 6.1.

Figure 6.1 A Model of Scientific Research Methods



Source: Cohen & Nagel, 1934

The philosophical arguments regarding the strengths and weaknesses of inductive and deductive research are beyond this thesis, though it might be said that qualitative research including case studies is generally of an inductive nature while quantitative methods via sample survey are of deductive-verification one ( Hypothetico-deductivism, as Pratt (1978) puts it; also see Esterby-Smith et al (1991) ). The philosophical distinction between quantitative and qualitative research is very important in judgement criteria of their soundness. For instance, as Ryan (1970) puts it:

"(Deductive) validity is universally held to be an all-or-nothing matter while inductive support is a matter of degree. In a deductive argument, it either is the case that the premises logically entail the conclusion and hence the argument is valid. There is no room for a half-way house, no possibility of an argument being 'fairly valid' or 'almost valid', or 'slightly valid', ie, there is no compromise between accepting and rejecting the argument. But in case of inductive argument, this is precisely what we can and often do. Inductive evidence for a generalisation can be better or worse evidence, fairly good or pretty bad, overwhelming and conclusive or weak and inconclusive. Here is the degree of support" (p.37).

( Data sought in empirical research can be classified into three types: exploratory, descriptive and explanatory (casual) (Babbie 1973, Green and Tull, 1978, Chisnall 1986). Consequently, research must be designed to contend with the nature of the data sought. There are broadly two types of research methods frequently employed by researchers: qualitative and quantitative methods. Each type of research method has its own advantages and disadvantages.) This chapter discusses the strengths and weaknesses of quantitative vis-a-vis qualitative research methods and the justification of using case study method for this research project. It reports the implementation of case study method in empirical undertaking by the researcher.

## 6.2 Quantitative Research Methods

### 6.2.1 Quantitative Methods and Their Strengths

The obvious benefit of quantitative data is that quantitative information is numerical in character, which makes statistical computing and comparisons easy. Moreover, quantitative data is standardised, visible and amendable to the tests of classical survey statistics (Cooper and Brantwaite, 1977). In general, sample size is larger and controlled in such a way as to be random and representative of the population from which it is drawn. This allows greater confidence in accepting the reliability (or generalisability) of the findings. Moreover, the advances made by quantitative researchers since the 1930s in translating theoretical concepts into research operations, gave greater scope for controlling construct and validity (Glaser and Strauss, 1967).

Easterby-Smith et al (1991) argue that in the case of quantitative methods and a positivist paradigm, they have the strengths of providing wide coverage of the range of situations and probably being fast and economic. Moreover, when statistics are aggregated from large samples, they may be of considerable relevance to policy decisions.

As there are well-documented guides for quantitative analysis and thus less room for subjective interpretation, the research findings' internal validity can be assessed more easily (Miles, 1979).

Since concepts under investigation have to be operationalised, quantitative methods are both specific and parsimonious (Hart, 1989). In addition, quantitative researchers, in attempting to explain the reasons for and the sources of observed events, assume a deterministic posture. The three characteristics -- specific, parsimonious and deterministic -- comprise the basis of scientific investigation (Babbie 1973).

These aspects taken together highlight the scientific rigour that accompanies the use of quantitative methods. In addition, where quantitative researchers have failed to provide adequate accounts of their approaches, there is a body of well-drawn guidelines to assist the reader in deciding on the quality of the research (Adams and Schaneveldt 1985).

## 6.2.2 Quantitative Methods and Their Weaknesses

Criticisms of quantitative methods seem to centre, not on the scientific content of the study, but on the nature of the data they provide. For example, it is often suggested that quantitative methods are able to investigate only the more rational aspects of behaviour and motivation, and therefore miss the subtleties and idiosyncrasies of individual or organisational behaviour (Cooper and Brantwaite 1977).

There seems to be a general disillusion with statistical data, on the grounds that it is superficial and often without theoretical direction (Glaser and Strauss, 1967; Mintzberg, 1979). In a similar vein, Van Maanen (1979) reiterates some of the problems that organisational researchers face:

"Our (quantitative) data manipulation techniques have become increasingly complex, mathematically sophisticated and governed by strict assumptions, but paradoxically, our interpretative frameworks which make such data meaningful have grown looser, more open-ended, fluid and contingent (p.522)".

Esterby-Smith et al (1991) suggest that quantitative methods tend to be rather inflexible and artificial and they are not very effective in understanding processes or the significance that people attach to actions. Moreover, they are not very helpful in generating theories. Because they focus on what is, or what has been recently, they make it hard for the policy-maker to infer what changes and actions <sup>then</sup> should take in the *future*. As Legge (1984) points out, they may only provide illusions of the "true" impact<sup>s</sup> of social policies, and most of the data gathered will not be relevant to real decisions although it may be used to support the covert goals of decision-makers.

Moreover, a general sentiment echoed throughout marketing literature is that quantitative methods -- surveys in particular -- are more inclined to describe and interrelate verbally expressed sentiments and beliefs rather than describe actual conducts. In short, they focus on what Ames (1970) entitles the "trapping" of behaviour, not its "substance".

A further weakness of quantitative methods is that content validity is nearly always

uncertain. Bonoma (1985) argues that even "precision in measurement (of quantitative data) often is obtained at the expense of the currency, contextual richness, or 'external validity' of the findings" and that "many interesting phenomena cannot be understood if removed from their social context" (p.199).

As Van Maanen (1982) summarises: "The sources of disenchantment (with quantitative/deductive tools) are many, but deserving of passing note are: the relatively trivial amount of explained variance, the abstract and remote character of key variables, the lack of comparability across studies, the failure to achieve much predictive validity ... and the causal complexity of multivariate analysis, which, even when understood, makes change-oriented actions difficult to contemplate" (p.13).

As for research on strategy issues, Aharoni (1993) highly criticises the uses of the quantitative methods. He argues that as strategy is inherently unique to each firm (as the term firm-specific advantage (FSA) implies), only longitudinal and case studies can help researchers to reveal the uniqueness -- and thus FSA, as he contends:

It is "rewarding to look for the unique and the different rather search for central tendencies in a population of firms. .... A cross-sectional analysis of firms may be very misleading. A longitudinal study of the outlier firm would identify not only the vision and the unique strategy but also the means by which it was made sustainable, and the dynamics of the shifts and changes" (p.43).

The last but not the least problem associated with quantitative methods, especially postal surveys, concerns the quality of the quantitative data collected. There is little guarantee that questionnaires are filled by the targeted respondents, whom the quality of the information required depends upon. Who knows whether it is the secretary or the targeted respondent answered the questionnaire. In case of research (eg, strategic studies) requiring information from multiple departments of an organisation, it is impossible to collect such information since a questionnaire is usually answered by a single person from an organisation.

### 6.2.3 The Uses of Quantitative Research Methods

Despite the aforementioned weaknesses of quantitative methods, it has been suggested (Hart, 1989) that quantitative methods are appropriate for testing hypotheses, synthesising a large number of variables to determine associations (and the strengths of these associations), controlling for construct validity, and controlling for reliability.

## 6.3 The Qualitative Research Methods

### 6.3.1 Qualitative Methods and Their Strengths

The strengths of qualitative methods are usually associated with the depth and richness of the data they provide. Miles puts it as "qualitative data are attractive for many reasons: they are rich, full, earthy, holistic, 'real'" (1979, p.590).

While quantitative data can be compared, tabulated and manipulated in various controlled or "objective" ways, qualitative data, especially in the social sciences, offers greater depth of understanding and meaning (Davis, 1976). Van Mannen et al (1983) suggest further that qualitative methods can provide "an array of interpretative techniques which seek to describe, translate and otherwise come to terms with meaning, not the frequency of certain naturally occurring phenomena in the social world".

Moser and Kalton (1971) argue that the primary advantage of qualitative methods is that they "dig deeper" and get a richer understanding than more formal techniques, namely quantitative survey methods. Esterby-Smith et al (1991) argue that qualitative methods have the ability to look at change processes over time, to understand people's meanings, to adjust to new issues and ideas as they emerge, and to contribute to the evolution of new theories. They also provide a way of gathering data which is seen as natural rather than artificial. Gordon and Langmain (1984) suggest that qualitative data collection offers the flexibility, creativity and depth to penetrate the superficial and develop the underlying issues into a non-numerical hypothesis.

The Marketing Research Society (MRS) study group (1979) makes the point that



often, information sought by marketing managers is often of a complex and subtle nature amenable to investigation by qualitative techniques.

Chisnall (1986) defines the essence of qualitative research as diagnostic, seeking to discover what may account for certain types of behaviour, seeking a deeper understanding of factors, sometimes covert, which influence decisions.

### 6.3.2 Qualitative Methods and Their Weaknesses

The overriding problem facing qualitative researchers is that methods of analysing qualitative data are not well formulated. Whereas quantitative data is associated with clear analytical conventions, the qualitative analysis is generally self-generated and controlled. As Miles (1979) puts it:

"how can we be sure that an earthy, undeniable, serendipitous finding is not, in fact, wrong?" (p.590).

Chisnall (1986) describes qualitative data as impressionistic and subjective. Other concerns about qualitative methods include the extent to which the data they generate are a). reliable, b). objective, and c). parsimonious; all three are important components of scientific enquiry (Babbie, 1973).

A number of practical issues may also be considered as weaknesses of qualitative methods. Qualitative data collection is labour intensive and requires skills (especially interpersonal and communication skills), if it is to be carried out correctly. It can be extremely time-consuming. Qualitative data itself is copious, comprising as it often does, of innumerable observations and recordings. The ensuing analysis -- unguided -- is lengthy (Hart, 1987). As Esterby-Smith et al (1991) put it:

"(Qualitative) data collection can take up a great deal of time and resources, and the analysis and interpretation of data may be very difficult, harder to control their pace, progress and end-points" (p.32).

### 6.3.3 The Uses of Qualitative Research Methods

According to Hart (1989), a qualitative method of data collection is appropriate for: traditional preliminary exploration; sorting out and screening behaviour; exploring complex behaviour; explanatory models of behaviour (grounded theory).

The last of these four is perhaps the most contentious because scientific theory by its very nature has to be general and this is an issue of considerable debate regarding qualitative methods. As Glaser and Strauss (1967) point out, however, it is the history of qualitative researchers and their use of data in a non-systematic way, non-rigorous way which has jaundiced many research views on qualitative data. Glaser and Strauss argue for qualitative data to be systematically obtained and analyzed, a point echoed by Miles (1979):

"the need to develop grounded theory usually exists in tension with the need for clarity and focus. .... a rough framework needs to be in place near the beginning of the work." (p.591)

## 6.4 The Case Research Method

### 6.4.1 The Definition of Case Study

A case study is an empirical inquiry that a). investigates a contemporary phenomenon within its real-life context; when b). the boundaries between the phenomenon and context are not clearly evident; and in which c). multiple sources of evidence are used (Yin, 1984. p.23). This definition summarises the operational characteristics of the case study.

Another definition of the case study method is that it is the basic descriptive material an analyst has assembled by whatever means available about some particular phenomenon or set of events using the material to infer theoretical principles. This could be compared with Mitchel's notion of case study as a detailed examination of an event (or series of related events) which the analyst believes exhibits (or exhibit) the operation of identified general theoretical principle. Thus the nature of case study has been shown by these two definitions to be descriptive, inductive and theory

generating.

#### 6.4.2 Reasons for Case Study

Yin (1984) argues that choosing a particular research strategy depends on three conditions: a). the types of research question, b). the control an investigator has over actual behavioural events, and c). the focus on contemporary as opposed to historical phenomenon. Additionally, Bonoma suggests that case study should reflect and be sensitive to the context within which management's acts occur and to the temporal dimensions through which events unfold. Yin's criteria for selecting research strategy are shown in Table 6.1.

Table 6.1 Relevant Situations for Different Research Strategies

Research Strategy	Form of Research Questions	Control over Behavioural Events ?	Focus on Contemporary Events ?
Experiment	How, Why	Yes	Yes
Survey	Who, What*, Where, How many, How much	No	Yes
Archival Analysis	Who, What*, Where, How many, How much	No	Yes/no
History	How, Why	No	No
Case Study	How, Why	No	Yes

\*"what" questions, when asked as part of an exploratory study, pertain to all five strategies

Source: Yin (1984). p.17

In addition to the kind(s) of questions being asked and therefore answers sought from the research objects, the current state of knowledge and the nature of the variables involved influence the choice of research method (Bennett, 1986/87). For instance, if little is currently known about the nature of the variables involved in the research problem, then it is likely that more qualitative, exploratory research methods will be needed. On the other hand, if there exists a rich literature about the variables involved,

it is then possible to isolate the key variables. This then determines the extent to which a hypothesis or hypotheses could be established and made available for testing. In this case, hypothesis-testing method using survey or experimental methods might be in need, which is subject to the nature of variables. Certain variables involved can be manipulated and measured to certain extent, which allows the use of hypothesis (hypotheses) testing. On the other hand, if the variables are hard to measure and manipulate, which is often true in business and management research, then the use of hypothesis (hypotheses) testing method is largely limited.

The paucity of literature about Chinese firms' behaviour and their strategies, competitive advantage and especially their internationalisation, dictates that this research is largely exploratory in nature. There are three major reasons why the case research method has been chosen.

First of all, as Esterby-Smith et al (1991) suggest, context, along with the researcher's personal preference and consideration of validity, reliability and generalisability, determine which research method is appropriate for a specific investigation (p.40). The macro-economic and institutional background of Chinese firms' internationalisation (Chapter 4) are dramatically different from that of not only developed countries whose MNEs' experiences led to the theorisation of internationalisation of firms (Chapter 2) but also other developing countries (Chapter 3). Furthermore, strategic issues are inherently contextual (Pettigrew, 1987, 1991), thus it is imperative to link the internationalisation of firms with their external and internal contexts. This calls for detailed case study (Pettigrew, 1987, 1991).

As demonstrated in Chapter 4, Chinese MNEs are state-owned, based in a developing socialist country which has been in a transition period from a centrally planned economy to market one and liberalised for less than one and half decades to the rest of the world. This fast changing external context largely constrains the direct applicability of MNE or inter-nationalisation theories drawn from the experiences of private companies from developed market economies. Therefore, this casts doubt on the meaningfulness of testing such theories in light of Chinese firms' experience. The three theories of developing country-based MNEs (see Chapter 3) can be best treated as partial explanation of internationalisation of firms. Thus the model suggested in Chapter 5 will be used as an analytic framework for the research, rather than the basis to operationalise the theories.

Secondly, related to the decades of isolation from world market and to the functioning of centrally planned economic system, the Chinese managers are not exposed to the management practices and management literature (Alder et al, 1990). Thus the researcher needs to communicate face-to-face with the managers in Chinese firms to gain an understanding of what they mean and perhaps explain what the research wants to know. This essentially excludes the usability of questionnaire-type survey and permits only in-depth interviews.

Thirdly, the paucity of statistical data of Chinese firms and detailed information regarding their foreign direct investment makes it impossible to draw a "representative" sample of the Chinese MNEs. To the researcher's knowledge, there has been no such a thing as the directory of Chinese leading exporters or foreign direct investors. And the accuracy of the total number of China's foreign direct investment projects and the total value of such projects have been doubted (see Chapter 4).

Furthermore, the lack of literature regarding the management and functioning of Chinese firms in general and their internationalisation in particular will also constrain the meaningfulness of using questionnaire survey of firms in China. The problems associated with using questionnaire survey in China are highlighted by the experience of Adler et al in their recent behavioural research of Chinese managers. Adler et al (1989), after conducting a quantitative survey in China regarding the behaviour of Chinese managers, suggest that using grounded theory or similar anthropological techniques are more appropriate in the research of Chinese companies and managers since "there are so profound differences in culture, history, politics and economic systems in China that western models can not be blindly applied in China"(p.72-73).

Having considered the exploratory nature of the study, the contemporary nature of the phenomenon, the lack of control by the researcher over the behaviour of the firms, and the paucity of statistical data regarding Chinese state firms, leading exporters or foreign direct investors, case study approach is chosen as the best available method for this research.

### 6.4.3 The Representativeness of the Cases

Since many, if not most academics engaged in empirical research, are particularly concerned about the validity of qualitative research, it might be necessary to discuss the validity, the representativeness of cases chosen for investigation, and the implications for validity of generalisations of findings based upon such cases.

In quantitative empirical studies, there is no doubt that the representativeness of the sample from the population is vital to the validity and reliability of statistical inferences. Representativeness of sample in qualitative research, especially case studies, has caused concern among many writers. In fact, the principal criticism of case studies is that they are unrepresentative: theoretical conclusions derived from case studies are not considered to be valid unless the cases can be demonstrated to be "typical" of the phenomena under investigation (Smith, 1989). According to positivistic viewpoints, qualitative research is fine in exploratory studies but quantification is necessary to establish the validity of anything.

However, concern with representativeness may be irrelevant. Some methodologists argue that the cases being studied need not be representative at the exploratory stage of research (ie, representativeness can be ignored temporarily but will be eventually attended to, if generalisations -- valid theoretical conclusions -- are to be drawn).

Others argue that case studies are an approach rather than a method (McLintock et al, 1979). It is a way of organising social data so as to preserve the unitary character of the social object being studied. Therefore, case studies can be employed with a positivist perspective. By incorporating elements of positivist research design (sampling, quantification), the researchers may absolve themselves from the charges that their cases are not representative.

The above two treatments of case studies (considering case studies as appropriate to exploratory research only or making the cases representative through the application of quantitative procedures), accept the epistemological requirements for representativeness. One may alternatively view it as absolutely irrelevant. There are two reasons for such argument. First, one may have different intentions when using case studies as opposed to survey research. If, for example, the purpose of research is description rather than correlation, then there is no need for representativeness.

Second, and perhaps more importantly, there is recognition that representativeness is irrelevant because it can be a spurious basis for claiming validity. As Worsley et al (1970) put it:

"The general validity of the analysis does not depend on whether the case being analyzed is representative of other cases of this kind, but rather upon the plausibility of the logic of analysis. The generalisability is of the same kind that enabled Sir Ronald Ross to announce the 'cause' of malaria when he found the malaria parasite in the salivary gland of a single female Anopheles mosquito in 1897" (p.112)

Mitchell (1983) has expanded on this argument showing that logical inference is epistemologically quite independent of statistical inference. He is not alone in recognising the distinction of statistical inference and logical inference and the independence of the latter from the former. Glaser and Strauss (1967), for instance, make the distinction between theoretical and statistical sampling:

"Theoretical sampling is done in order to discover categories and their properties, and to suggest the interrelationships into a theory. Statistical sampling is done to obtain accurate evidence of distribution of people among categories to be used in descriptions or verifications" (p.62).

According to Mitchell, therefore, statistical inference is "the process by which the analyst draws conclusions about the existence of two or more characteristics in some wider population from some sample of that population to which the observer has access", whereas "scientific or causal -- or perhaps more appropriately -- logical inference, is the process by which the analyst draws conclusions about the essential linkage between two or more characteristics in terms of some systematic explanatory schema -- some set of theoretical propositions". Such a distinction paves the way for illustrating the irrelevance of representativeness in case studies, because the analyst using this method is only concerned with logical inference. As Mitchell states:

"The process of inference from case studies is only logical or causal and cannot be statistical and extrapolability from any one case study to like situations in general is based only on logical inference. We infer that the features present in the case study will be related in a wider population not

because the case is representative but because our analysis is unassailable".

Silverman (1985) argues that the validity of case studies is not dependent on representativeness but on faultless logic. Therefore, selecting one case for study will not rest on how typical the case may be but on its explanatory power. Indeed, "deviant" cases may be chosen, as analytic induction suggests, to demonstrate the limits to generalisation reached by a possible representative sample. The presentation of the case will be limited to that material which most effectively reveals the theoretical principle investigated, for just as the "best" cases are employed, so are the "best" elements within each case.

As Kirk and Miller (1986) point out, the language of validity and reliability was originally developed for the use in quantitative social science, and many procedures have been devised for assessing different facets of each. There has been some reluctance to apply these ideas to phenomenological (ie, qualitative) social research because they might imply acceptance of one absolute (positivist) reality. Accordingly, reliability, validity and generalisability have different meanings in qualitative (phenomenological) vis-a-vis quantitative (positivist) research as Table 6.2 shows.

Table 6.2 Questions of Reliability,  
Validity and Generalisability

	Positivist Viewpoints	Phenomenological Viewpoints
Validity	Does an instrument measure what it is supposed to measure ?	Has the researcher got full access to the knowledge and meaning of informants ?
Reliability	Will the measure yield same results on different occasions (assuming no real change in what is to be measured) ?	Will similar observations be made by different researchers on different occasions ?



Generalisability	What is the probability that patterns observed in a sample will also be present in the wider population from which the sample is drawn ?	How likely is it that ideas and theories generated in one setting will also apply in other settings ?
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Source: Easterby-Smith, M. et al (1991) Management Research: An Introduction London: Sage Publications (p.41)

Finally, as Ryan (1970) argues, inductive evidence (including that from case studies) for a generalisation can be fairly good or bad, overwhelming and conclusive or weak and inconclusive, it is a matter of degree of support. This confines to the statement that inductive research is a matter of degree of support and there is no such issue of validity in inductive research.

For example, Chandler (1962) carried his seminal work on corporate strategy in only four firms but proposed important conclusions for generations of scholars to research (Aharoni, 1993). Case studies have proved very useful in generating theories in many other disciplines. It has also been suggested that Hippocrates built medicine on 7 cases, Freud established psychoanalysis based upon 5 cases, and Mintzberg built a theory of organisation on a few cases (Gummesson, 1991).

#### 6.4.4. The Number of Cases and Criteria for Case Selection

There is no optimal way to decide the number of cases (Smith, 1989). Many authors using qualitative methods and especially case studies have the experience that as each case progressed, as each interview was conducted, the data was conformed with expectations. This is common in qualitative research and is sometimes referred to as "saturation" of data (Glaser & Strauss, 1967). When saturation is achieved, the researcher may claim to have a sufficient number of cases.

In this research, it is decided that at least five companies will be studied, each with multiple interviews with senior managers from 3 different departments, namely, R & D, international division and general management. Should these five companies be not

enough to achieve "saturation" during the field study, additional companies will be studied on contingency basis.

As suggested in Chapter 4, data regarding Chinese outward FDI has been always scanty. It was originally planned to draw a sample from the population of Chinese overseas investing firms. However, no detailed information has been made available to the researcher as regards the investors (even the total number of such firms), industrial or regional distribution of such FDI projects. And the researcher's several attempts through direct correspondence with a director of the MOFERT (which has been in charge of China's inward and outward FDI) and other personal connections to obtain such information had resulted in vein. Lack of such data (the total population and the sectoral distribution of them) has made it impossible for the researcher to draw a representative sample of cases. Thus alternative method must be established to select case companies.

As the representativeness of the cases chosen is not relevant in this exploratory research, the companies were chosen according to the following criteria:

a. The case companies must be among the top 500 industrial companies in China by 1991 (see Administrative World Quarterly 1992, No.1). As Chapter 4 indicates, having direct export (and import) autonomy is the pre-requisite for any indigenous Chinese firms to invest overseas, and only about 650 large and medium-sized state industrial enterprises have been authorised to engage directly in foreign trade. But the list of these firms had not been made available to the researcher. Thus the researcher turned to the 500 largest industrial firms. Amongst these 500 industrial enterprises, the Chinese subsidiaries and joint ventures of foreign companies (17) were excluded from selection because this research concerns the internationalisation of indigenous Chinese firms, rather than the reinvestment of subsidiaries of foreign MNEs.

b. The case companies must also be among China's top 250 exporters in 1991 (see Administrative World Quarterly 1992 No.2). This criterion was set because in China exporters can only retain a small proportion (up to 15-25 per cent, depending upon the location of the firm) of their export earnings (in hard currencies), thus it is assumed that only large exporters can retain sufficient amount of their foreign exchange earnings to invest overseas, as the Chinese currency Renminbi has not been freely convertible to hard currencies.

c. The core business of the case companies must be in manufacturing. The criterion is set because the prime interest of the research concerns with the internationalisation of Chinese industrial firms, not the services ones, though it has been revealed that the latter, especially the 12 FTCs are important players in China's outward direct investment (see Chapter 4). The focus on manufacturing firms is necessary for comparative reason since the theories of MNE or the internationalisation of the firms are developed based upon the experiences of manufacturing firms from industrial countries and NICs.

d. The case companies must be indigenous Chinese firms. Some Sino-foreign joint ventures (eg, Huaxia Electronics Group) in China have invested overseas, but this research concerns only the internationalisation of Chinese indigenous firms, not subsidiaries of foreign MNEs in China.

e. The case company must have at least four FDI projects, and at least one of them must be in manufacturing. This criterion qualifies them as MNEs (see Chapter 1).

Having established these criteria, the researcher asked colleagues and researchers in China to identify qualified companies and obtain access to them. Thus from various sources of information (ie, People's Daily; Intertrade; etc), seven companies were identified as having met the above criteria and agreed to be interviewed.

The seven case companies were Baiyunshan Enterprise Group (Baiyunshan in brief), Northeast China Pharmaceutical Factory (Northeast in brief), North China Pharmaceutical Factory, Shenzhen Electronics Group (SEG), Shenzhen Municipal Light Industrial Group (Municipal Light in brief), Shougang Corporation and Wanbao Electric Group. The North China Pharmaceutical Factory and Wanbo Electronics Group were eliminated from our case report because of the saturation of information after the other five companies. As a result, five case companies are reported here and their brief profile is shown in Table 6.3.

The five case companies are among the most developed manufacturing multinationals emerging from the People's Republic of China (PRC). Shougang is amongst the largest ten companies in China by total sales and profits before tax. Along with SEG and Municipal Light, it has been among the largest manufacturing exporters in China

since 1988. The two pharmaceutical companies, Baiyunshan and Northeast Pharmaceuticals are the largest two firms in the industry in terms of turnover. While Baiyunshan has diversified into electronics, food, garment, toys and real estate and other industries, Northeast Pharmaceuticals remains mainly rooted in the pharmaceutical industry.

Table 6.3 The Profile of the Five Case Companies

(1991)

Company	Shougang	SEG	Municipal Light	Baiyunshan	Northeast Pharmaceutical
Date of Establishment	1919	1986	1984	1973	1946
Location of HQ	Beijing	Guangdong	Guangdong	Guangdong	Shengyang
Core Business	Steel	Electronics	Bicycles	Pharmaceutical	Bulk drugs
Turnover (US\$ mn)	1,772.80	498.00	288.96	246.60	79.51
Exports (US\$ mn)	210.20	300.00	208.05	14.55	48.50
Exports as % of Turnover	12.2	60.2	72.0	5.9	61.0
Profits (US mn)	483.53	43.07	n.a.	15.14	n.a.

Source: Author

The characteristics of the five case companies seem to suggest that they are unlikely to be representative of the Chinese manufacturing firms. For instance, it has been revealed that Chinese outward FDI has spread to a wide range of manufacturing

sectors (Li, 1992) and these five case companies constitute only four industries, namely electronics, pharmaceuticals, steel and light industry (specifically bicycles). But again given the lack of reliable and detailed data on the overall FDI from China, it is difficult to ascertain to what degree that these case companies are representative of all Chinese manufacturing MNEs.

## **6.5 The Implementation of the Case Study Research Strategy**

The research could be divided into four stages including design, data collection, data analysis and case presentation.

### **6.5.1 The Research Design**

This stage consisted of exploring, clarifying the nature of the project, researcher questions and objectives, reviewing literature, proposing an analytic framework (model) and formulating propositions. Topic guide for data collection was also developed. The topic guide (see Appendix 4A) was the operationalisation of the ten propositions derived from the literature review. However, the nature of the topic guide was basically open-ended, allowing the researcher to derail from the guide and explore any important issues into detail. A set of questions were designed and answers sought from the case companies.

Many authors favour unguided data collection in qualitative research (see, for example, Glaser and Strauss, 1967, Van Maanen, 1982, p.16), but it could be very ineffective and inefficient for an unexperienced researcher using qualitative method. But this researcher believes that it is important to have a common focus across all case studies, and to do so, a topic guide will be and indeed proved very useful.

Additionally, the sources of data are also decided at this stage. In this research project, the sources of data included primarily interviews with senior managers of the case companies and secondarily companies archives like annual reports and publicised information.

### 6.5.2 Data Collection

It was proposed that data will be collected from a variety of sources. Although interviews would be the main source of data, data from other sources such as financial data (budgets, operating statements, financial performance), market performance data, and market and competitive data, in addition, archives including business plans were also collected wherever they were available to the researcher.

(Interviews were conducted with managers of 6 case companies between April and June 1992. Interviewees included the senior managers) in three departments: international division (or import and export department), corporate development, and R & D. Access to chief executive officers was sought for interviews as well. This resulted in 16 interviews (see Appendix 4B). All interviews were conducted in Mandarin Chinese) and cassette recorded. (They were translated in English and transcribed. The data from other sources were also ~~be~~ translated into English wherever necessary and possible.)

### 6.5.3 Data Analysis

Qualitative data analysis is usually seen as very problematic since there is no guideline available for the researchers. In this research project, the researcher decided to ~~wx~~ pattern-matching and comparative analysis as the two basic methods of analysis in the case study.

Pattern-matching, according to Yin (1984), involves the comparison of patterns or propositions derived from literature with that emerging from the empirical data. The ten propositions (Chapter 5) derived from literature chapters (2, 3 and 4) are compared with and thus verified by the experiences of our five case companies.

Comparative analysis depends upon the comparison of one group of objects with another in certain attributes, behaviour, etc. This method is used in our analysis to distinguish the case MNEs with uni-national Chinese firms in the same industries. Comparisons were also made between case companies.

Another mode of analysis, explanation-building, was also used but to a very limited

degree. This mode of analysis is of particular use in explaining the differences between the propositions (theoretical or predicted patterns) and the empirical patterns.

Our case study approach encompasses multiple levels of analysis (FDI project, product, firm, industry and country). Although the focus of this research is on the corporate level, multiple levels of analysis are necessary to give the contextual accounts (country and industry) and exemplar accounts (product and individual FDI project).

#### 6.5.4 Case Presentation

Each case company was presented separately. Given the complexities of the nature of the variables involved and paucity of the literature on Chinese companies regarding their behaviour and their international business activities, plus the dramatically different context in which Chinese firms' internationalisation took place, it is preferred to have each case company presented separately. This allowed a detailed account on the relationship between competitive advantage, corporate strategy and internationalisation of firm as well as the context in which the case companies' internationalisation took place.

So the structure of each case report consists of introductory remarks about the history of the case company, its present development, the creation of its competitive advantage and formulation of its corporate strategy, its inter-nationalisation experience, and the verification of propositions.

#### 6.5.5 Reliability Considerations

Because interviews were conducted in Mandarin Chinese and translated into English, it was possible that meanings of the interviews and information revealed by the respondents got distorted or lost. To ensure that the case analysis was as accurate and reliable as possible, the researcher intended to send a copy of case analysis to one of the interviewees in each case company. However, because case analysis was written in English, and the English proficiency of all the interviewees (except the Vice President of NorthEast Pharmaceutical) is rather low, it would be impossible for them to read

and comment on the case studies written in English. Instead, the research wrote the excerpt of the case studies in Mandarin and sent to them for comments.

(As the researcher had established rapport with the interviewees, feedback on the case studies was quickly sent back) Except in case of Shougang where the respondent added more information about the company's new acquisition in Hong Kong after the interviews, the other four respondents were satisfactory about the case analysis. Three of them even asked whether, when and where the case studies about their companies would be published. The positive feedback from the case companies can be treated as a reliability test of the case studies.

## **6.6 Concluding Remarks**

It has been argued in this chapter that there is actually no optimal research method for all the research situations in business studies. Both quantitative and qualitative research methods have their respective strengths and weaknesses, to some extent they are best seen as complementary in a full circle of research enterprise. The choice of a particular research method for a specific research topic depends upon a set of factors including the richness of the literature regarding the phenomena under investigation, the accessibility to the population of the objects, the context-object relationship, etc.

It is also demonstrated that it is best to use case research method at present to investigate the competitive advantage and internationalisation of Chinese manufacturing firms. Based on five criteria, five Chinese firms were chosen as case companies and access to them sought for collecting primary and secondary data.

A four-stage case research strategy has been designed and implemented to investigate five companies in China for the research purposes.

The implementation of the case study approach consisted of developing interview guide from literature review, which was basically open-ended, data collection through personal interviews and other sources, the analysis of data through pattern-matching, comparative analysis, and to a lesser degree content analysis and explanation-building, and the style of case presentation.



## Appendix 6.1. Interview Guide

Briefing the research project and the purpose of the interview.

1. Could you please tell the background, history and recent development of your company?
2. Maybe you can tell me in what circumstances your company started to look overseas in terms of exporting, and perhaps importing, and investment.
3. Could you tell me in detail about your company's exporting and foreign investment ? For exporting, please be precise about the date of your first export, and the circumstance in which you started to export, the development of your exporting activities. For FDI, please be as detailed as possible regarding the location, the name, the date, the nature of the business, the motive(s), the scale of each of your FDI project. If it is a joint venture, please tell me your partners to the venture and why the partner was chosen.
4. Do you think your company have any competitive advantage or strengths over other firms that enabled it to export and invest overseas ? If so, what are these strengths ? Could you give me some specific data (eg, R & D scale, percentage of professional and technical staff, advertising, or any other data) showing such strengths ?
5. How did your company created such competitive advantage ?
6. In what way these advantages are related to your company's ability to export and invest overseas ?
7. What is your company's current corporate strategy ? How the corporate strategy evolved in the past 15 years ? And why the current strategy is formulated and pursued ?
8. Do your company has a strategy for internationalisation ?  
Could you tell me the main content of such strategy in terms of goals, measures, geographical markets, etc ?

9. Or does your company has any strategic consideration for internationalisation ?  
Why ?

10. What do you seen your company in international markets ? In another words what are the basic competitive weapon(s) of your company in international competition ?  
What are the major competitors of your company in your major markets ?

11. Ask for more written materials.

## Appendix 6.2. Interviewees and Their Positions

### 1). Shougang (Capital Steel) (Beijing)

Hu Hao, Senior Manager for Recruitment (Foreign Experts Section), Human Resources Department (28, April, 93)

Zhang Yan, Director, International Operations (29 April, 93)

Kong Rong Ping, Vice Director, International Operations (29 April, 93)

### 2). Baiyunshan Enterprise Group (Guangzhou)

Chen Jian Zhou, Vice President (11 May, 93)

Lin Bao Hong, Director, Pharmaceutical Machinery (9 May, 93)

Mr Chen, Vice Director, Import/Export Company (9 May, 93)

### 3). Shenzhen Electronics Group (Shenzhen)

Li Jin Qiu, Vice President, International Operations (16 May, 93)

Li Ping, Director/Senior Economist, Development Strategy Office (18 May, 93)

Wang Shou Ren, Deputy Director, Strategic Research Division  
(17, 20 May, 93)

### 4). Shenzhen Light Industrial Group (Shenzhen)

Mr Lai, Chief Executive Officer (22 May, 93)

Ling Zao Wei, Deputy Manager, Business Development Dept. (22 May, 93)

Shang Shu Hua, Senior Economist, Business Development Dept. (27 May, 93)

Yang Fan Bo, Deputy Manager, Development Dept. (27 May, 93)

### 5). Northeast China Pharmaceutical Company (Shenyang)

Zhao Jiquan, Senior Consultant (Ex-vice president) (18 June, 93)

Zhang Shi Xin, Vice President (18 June, 93)

Sun Yuan Ren, Manager, Export Dept. Import/export Company (18 June, 93)

**PART III**  
**EMPIRICAL EVIDENCE &**  
**CASE STUDY SERIES**

## CHAPTER 7 CASE STUDY -- SHOUGANG CORPORATION

### 7.1 Company Background

The roots of Shougang Corporation date back to the formation of Yanshan Iron & Steel Mill in 1919. By 1949 when Mao Tse Tung's communists gained power and the Kuomintang government fled to Taiwan, Shougang was already one of the largest industrial establishments in China. During the next 30 years, it pursued a strategy of concentric diversification, which saw the company transformed into a major iron and steel complex. By 1980, Shougang's output stood at 1.55 million tons of steel and 2.94 tons of iron, but an internal and external environment analysis led management to conclude that the company had failed to achieve its full potential. However, the economic reform introduced in 1979 provided Shougang, for the very first time, the scope to maximise its performance.

### 7.2 Contract Responsibility System and Shougang's Development

The first major change was the introduction of the so-called Contract Responsibility System (CRS), a Chinese version of Management by Objectives (MOB). The essence of the contract is that:

"During the contract term from 1981 through 1995, Shougang must turn over to the state a fixed amount of profit, which is progressively increasing at 7.2% annually based on the 1981 figure. In case of deficit or having a profit less than required to turn over to the state, Shougang must make up with its own funds. Extra profit is retained by the company, which will be distributed to production development, employees' welfare, wages and bonuses at the proportion of 60%, 20% and 20%. No investment funds are available from the state for Shougang, it must raise funds for development by itself" (Beijing

Review 1992).

Shougang's contract with the central government has enabled it to retain a significantly higher proportion of its profit than any of other state-owned large enterprises (see Chapter 4), and have relatively greater management autonomy. In addition, Shougang's contract is of considerably long-term (15 years, instead of 5 years for most of other SOEs in China, see Chapter 4), which has made it imperative for Shougang to balance between its short-term benefits and long-term interest.

Talking about Shougang's CRS, it is important to appreciate the role of Mr Zhou Guanwu, Chairman of Shougang's Management Committee. With a military background, Mr Zhou has been working with Shougang since the early 1950s. With determination, drive and entrepreneurship, Mr Zhou has turned Shougang, laughed as "the metallurgical museum" for its technological backwardness and outdated equipment in 1979, into a modern, fully integrated conglomerate in a decade. His entrepreneurship has led his inclusion in "Who Is Who of the World" (Cambridge Press) in 1991.

With CRS in place, Shougang has developed very quickly throughout the 1980s even though it was denied financial aid from the state. It recorded the largest increase in steel-making capacity (181%) among the big steel-works in China (Table 7.1) and outperformed its domestic rivals (see Table 7.2; The People's Daily 1992. July 13. p.1). Both turnover and profit before tax have increased steadily since 1981 (see Table 7.3). In 1991, its total sales reached 9 billion yuan (RMB) (equivalent to US\$1.6 billion), it ranked as the fourth largest industrial enterprises in China (People's Daily 1992. June 4. p.1 ).

During the 1980s, it entered a new phase in its strategic development and pursued instead a strategy of conglomerate diversification, entering 13 other industries, including mining, electronics, shipping and ship-building, mining, construction and machinery, and food. The next industry it will entered is banking. It now consists of 9 companies, 98 factories, and 15 joint ventures in China.

Table 7.1 Top Ten Steelmakers in China, 1980-90

Company	Steel (mn tons)			Iron (mn tons)		
	1990	1980	Growth (%)	1990	1980	Growth (%)
Anshan	7.71	6.97	10.6	7.41	6.70	10.6
Wuhan	4.74	2.78	70.5	4.51	3.44	31.1
<u>Shougang</u>	<u>4.36</u>	<u>1.55</u>	<u>181.3</u>	<u>3.58</u>	<u>2.94</u>	<u>21.8</u>
Baoshan	3.87	0	--	3.30	0	--
Baotou	2.52	1.23	101.6	2.51	1.28	96.1
Benxi	2.37	0.90	163.3	2.75	3.10	(13.0)
Ma'anshan	2.04	1.09	87.2	2.24	1.78	25.8
Penzihua	1.91	1.62	17.9	2.29	1.95	17.4
Taiyuan	1.79	1.15	55.6	1.33	0.92	44.6
Tangshan	1.58	1.15	37.4	0.69	0.19	263.2
Chongqing	--	0.62	--	--	0.49	--

NB: Figure in bracket represents decrease in production.

Source: Based on Beijing Review (1991) Vol. 35, No.25. p.17

Table 7.2. Financial Performance of Chinese Big Eight Steelmakers (1981-1990)

Company	Increased Profit (accumulated) (Rmb m)	Total Investment on Fixed Assets* (RMB m)	Rate of Return (%)
<u>Shougang</u>	<u>7,747.11</u>	<u>3,638.52</u>	<u>212.92</u>
Wuhan	6,889.73	3,727.42	184.84
Taiyuan	2,029.11	1,287.65	157.58
Baoshan	1,724.37	1,403.87	122.83
Ma'anshan	1,627.98	1,837.66	88.59
Benxi	1,927.61	3,242.53	59.48
Penzihua	1,494.07	2,686.04	55.55
Anshan	3,690.39	8,197.98	45.02
Total	27,128.37	26,021.67	104.25 (Average)

\* Fixed asset investment refers to the sum of capital investment and investment on technological innovations.

Source: Adapted from Zhou (1991) (ed) Reform at Shougang (Vol. 2). Economic Press, Beijing. p.143

Table 7.3. Shougang's Corporate Performance  
(1978-1991)

Year	Turnover (RMB m)	Profit before Tax (RMB m)	Exports (US\$ m)
1978	n.a.	376.92	0
1981	n.a.	536.86	n.a.
1985	2,745.91	1,113.66	n.a.
1986	3,244.39	1,338.62	n.a.
1987	3,841.76	1,593.10	9.88
1988	4,634.86	1,894.36	20.74
1989	5,441.04	2,257.98	56.15
1990	7,297.89	2,625.84	64.43
1991	9,000.00	2,595.00	210.20

Sources: Yang (1991), "The Effects of Contract Responsibility System at Shougang" in Zhengdi Magazine Vol.3; Shougang International Report (1992), Briefing on Shougang's International Operations; Zhou (1991) (ed) Reform at Shougang (Vol.2), Economic Press, Beijing

Shougang's development has been due to business expansion, including the internationalisation of its business. Exports increased steadily from US\$9.88 million in 1987 to US\$210.2 million in 1991 (see Table 7.3), and 15 overseas subsidiaries and sales offices have been established in a number of countries and regions including the USA, Belgium, Hong Kong, the Caribbeans, and Southeast Asia (see Table 7.4).

How did Shougang manage to develop so fast in both domestic and international markets? The MNE literature suggests that a firm must have some kind of competitive advantage or ownership advantage to offset its disadvantages of being foreign in a host country market (Dunning, 1980; Hymer, 1960/76). So what are Shougang's competitive advantages and more importantly how did it create such advantages? The answer to these questions is provided below.



Table 7. 4. Shougang's FDI Projects (as of June 1992)

Host Country	FDI Establishment	Date and Method of Investment	Scale of Investment/Stake	Nature of Business
USA	Mesta Engineering Corp.	1987, Acquisition	US\$4.85, 70 per cent owned	Design, manufacture, market and instal iron and steel-making equipment
USA	Shougang Mechanical Equipment (Penns) Co. Ltd	1987, new set-up	US\$0.75 mn, 100 per cent	Holding company of Mesta Engineering Corp, trading.
USA	Guan America International Development Inc.	1991, new set-up	US\$0.82 mn, 100 per cent owned	Trading
USA	California No. 1 Steel Mill	1992, acquisition	US\$400 mn 100 per cent owned	Equipment to be dismantled and removed to China.
Turks & Caicos Island	Turks & Caicos Seafood Co. Ltd	1990, new set-up	US\$0.35 mn, 100 per cent owned	Food processing
Belize	Crown Americas International Development Co. Ltd	1991, new set-up	US\$1.2 mn, 82.5 per cent owned	Real estate development
Peru	Hierro Peru	1992, acquisition	US\$312 mn, 100 % owned.	To supply iron ore to Shou-gang (Qilu Mill), to manufacture and supply steel to the Latin American markets.
Belgium	Sales Office	1990	n.a.	Trading
Hong Kong	Shougang Holdings	1990	n.a.	Trading
Hong Kong	Tung Wing Steel	1992, acquisition	HKS239 mn. 76.8 per cent (together with Li Kashing)	Steel distribution.
Malaysia*	Two FDI projects	1992.	n.a.	Manufacturing & marketing
Indonesia *	Two FDI projects	1992	n.a.	Manufacturing & marketing

NB. The details of the newly approved (June 1992) four manufacturing establishments in Malaysia and Indonesia are not available.

Source: Author; Financial Times (1993, January, 14).

### 7.3 Superior Performance from Competitive Advantage

Shougang's superior financial performance results from its competitive advantage in technological innovations and renovations and its successful experience in adopting new technologies and processes. Profit (before tax) in 1990 increased by 2.249 billion yuan over that in 1978. The increment came from four aspects (see Table 7.5).

Table 7.5 The Sources of Shougang's Profit Growth  
(1991 vis-a-vis 1978)

Factor	Profit Growth	
	Value (Rmb mn)	As % of Total Growth
Improvement of Product Structure & Quality	818	36.4
Reducing Energy Consumption & Increasing Metallurgical Utilisation Factor	644	28.7
Increase of Sales of Iron & Steel Products	568	25.2
<u>Subtotal</u>	<u>2,030</u>	<u>90.3</u>
Diversified Businesses*	219	9.7
Total	2,249	100.0

\* In 1978, Shougang's all profits came from iron & steel products. By 1991, other diversified businesses brought it Rmb 219 million worth profits.

Source: Shougang R&D Company (1991), "An Analysis of Shougang's Financial Performance (1985-1990)" in Zhou (ed).

As can be seen from Table 7.5, the former three aspects (ie, the improvement of product structure & quality, reducing energy consumption & increasing metallurgical utilisation factor, and increase of iron & steel products) account for more than 90% of total profit increase, and they are dependent on "technological progress", a term widely used in China to describe technological upgrading through technological innovations, adopting new technologies, new processes, improving technological sophistication of equipment and increasing productivity. These are the competitive advantages of Shougang against its domestic and international competitors. As regards the latter, its additional competitive advantage lies with its inexpensive technological and managerial personnel and cheap labour, making it very competitive in price.

#### **7.4 The Sources of Competitive Advantages**

Unlike most other state-owned firms in China, Shougang under CRS became financially independent of the government. Thus its long term survival depends upon its capability to create sustainable competitive advantage against domestic and international rivals. In the last decades, Shougang succeeded in creating technological advantage through continuous investment in technological innovations and adopting new technologies and processes. Apart from its own innovations, it also imported advanced technologies and equipment from developed countries.

In early 1980, China's steel industry was rather backward by international standards. It was estimated that only 23.8% of steel-melting and 16.5% of steel rolling equipment in China reached international standards and for continuous steel casting, the figure was less than 20% (Beijing Review 1992). China lacked technologies and experience in manufacturing heavy metallurgical equipment. Therefore importing foreign advanced technologies and equipment became necessary for Chinese steel industry including Shougang.

Although Shougang was not eligible under CRS for state investment funds, it gave priority to technological innovation and imports of foreign technologies and equipment. From 1979 through 1990, Shougang invested a total of Rmb 4.42 billion yuan in 4036 technological innovation projects, 108 of which were key ones. Among the 45 key projects that each cost more than RMB 1 million (US\$250,000), 17 used

imported equipment and technologies. The imported equipment and technologies for these 17 projects accounted for more than 50% of foreign exchange expenditure by Shougang during the period. So importing activities in Shougang was centred on technological innovations.

During the Sixth Five-Year Plan period (1981-85), Shougang had lacked funds for large-scale production expansion and technological innovations, even though its production expansion fund which stood at Rmb 6 million in 1979 had grown to Rmb 185 million in 1985. During this period, Shougang relied on the initiative of its employees to make technological innovations, make full use of equipment, improve management efficiency and effectiveness in order to accumulate funds for large scale technological innovations and adopting new technologies. On the other hand, the company undertook a large number of small scale innovation projects that needed little investment but were able to produce a quick return on investment. In 1979, average investment for an innovation project was RMB 170,000 (US\$42,500). During 1981-85, average investment on an innovation project had increased to RMB 572,000 (US\$143,000).

With improved performance, Shougang was able to retain a large proportion of its profits, enabling it to increase further the scale of investment on technological innovations in the second half of the 1980s. Average investment in a single innovation project increased to RMB 2.848 million (US\$0.712 million). From 1985 on, it was able to undertake a large scale modernisation programme to adopt new technologies in its steel-making processes. These innovation projects have had a decisive impact, enhancing Shougang's technological advantage.

Shougang's enhanced technological advantage is reflected in a number of aspects. In the past decade, the company recorded 690 major research achievements, 442 of which won national and Beijing Municipal prize while 82 research achievements reached international leadership in their respective areas. Among Chinese firms, it has the largest number of patents (ie, 44) granted by the state. Some of the technologies (eg, top firing hot wind furnace, coal spraying technique) innovated at Shougang were exported to developed countries like the USA, UK and Luxembourg. By 1991, the company ranked first in 33 of the 55 technical and financial performance indices for iron and steel production nationwide. It also occupies a leading international position in terms of the grades of concentrates, the utilisation coefficient of the blast furnace,

the amount of coke used, the utilisation coefficient of the converter and energy consumption per ton of steel made.

Its steel-making equipment has been updated and the operating efficiency raised steadily. Labour productivity increased remarkably from Rmb 10,149 yuan per employee in 1978 to Rmb 36,511 yuan in 1988, an increase of 260%. If calculated at the rate of Rmb 600 yuan in the domestic market and US\$300 for per ton of rolled steel in the international market, then the 1988 figure for Shougang's labour productivity was US\$18,300 per employee, 8% to 113% higher than that of British Steel, Kloechner Co. of Germany, USI-NOR of France and about the same as that of Krupp and Thyssen of Germany. Profit per employee at Shougang increased by 474% between 1978 and 1988. In 1988, its profit per employee was higher than that of all developed country steel producers with the exception of Japan (Che, 1992, pp.23-25).

In the 1980s, with increased amount of retained income, Shougang was able to spend more than any other state firms in China to improve the quality of its employees. Through the recruitment of university graduates, training of staff at its own technical schools and Shougang University, the ratio of graduates from universities and technical schools increased from 5 per cent in 1979 to 46.91 per cent in 1991. For example, in the early 1980s, only eight people at Shougang then had knowledge about computers. By 1990, it had established an electronics company with 3,100 electronics technicians and professionals. And Shougang's electronics company had been successfully used in the automation (including computer software design, programming and trial operation) of 7 converters of United Steel (of the USA) and Geneva Steel Works.

## **7.5 The Formulation of Internationalisation Strategy**

By the end of the 1980s, Shougang had developed into a strong and fully integrated conglomerate in China with an extensive range of products, and one of the largest exporters in China. This internal development, coupled with rapid external changes in China's policies and economic environment and in international markets, called for a new corporate strategy in Shougang.

### 7.5.1 A SWOT Analysis for Shougang

Table 7.6 contains a summary of strategic analysis of Shougang.

Table 7.6 A SWOT Analysis for Shougang

STRENGTHS	WEAKNESSES
<ol style="list-style-type: none"> <li>1. Technological innovation &amp; adaptation capabilities;</li> <li>2. Financial resources;</li> <li>3. Highly motivated and well-educated employees;</li> <li>4. Greater management autonomy</li> <li>5. Economies of Scale and scope;</li> <li>6. Cost advantage</li> </ol>	<ol style="list-style-type: none"> <li>1. Over-reliance on steel sector and domestic market;</li> <li>2. Lack of internationally experienced personnel;</li> <li>3. Limited access to export quotas;</li> <li>4. Constrained allocation of foreign exchange;</li> <li>5. Restricted mobility of managers and technicians (across border);</li> <li>6. Lack of international reputation.</li> </ol>
OPPORTUNITIES	THREATS
<ol style="list-style-type: none"> <li>1. Growing demand for steel and other products and services in domestic market;</li> <li>2. The Open Door Policy allowing greater access to international markets;</li> <li>3. Cost advantages enabling Shougang to penetrate international products and services markets;</li> <li>4. The growing demand for steel plant modernisation in many developing countries.</li> <li>5. Takeover opportunities in the domestic and overseas markets</li> </ol>	<ol style="list-style-type: none"> <li>1. The large size of labour force requiring Shougang to expand fast;</li> <li>2. The increasing competition from foreign steel-makers in the domestic market;</li> <li>3. Unstable domestic economy and thus unstable demand;</li> <li>4. The fierce competition in world steel market;</li> <li>5. Reluctancy of Bank of China to back Shougang's international expansion.</li> </ol>

Source: Author (based on interviews)

## 7.5.2. Shougang's New Corporate Strategy

In 1990 Shougang had adopted an internationalisation strategy for its corporate development. The strategy of "increasing exports and becoming a leading multinational" has nonetheless focused only upon the development of its international business (see Table 7.7).

Table 7.7 Shougang's Corporate Strategy

Strategic Goals	<p>a: To become one of the 500 largest industrial MNEs in the world by 1995, with a total sales of RMB 20 bn (US\$4 bn), a quarter (US\$1 bn) of which will be exports and sales of overseas subsidiaries.</p> <p>b: To become a fully integrated conglomerate and world leader in steel production (20 mn tons) and exports by the year 2000. Exports and sales of overseas subsidiaries will increase to US\$5 bn, accounting for 50 per cent of Shougang's total sales (US\$10 bn) by the year 2000.</p>
Strategic Priority (international)	<p>a: Increasing exports, especially of high value added products (eg, complete sets of metallurgical equipment);</p> <p>b: Penetrating international metallurgical engineering markets;</p> <p>c: ten more foreign investment projects including acquisitions before 1995;</p>
Strategic Priority (Domestic)	<p>a: Construction of Qilu Iron &amp; Steel Mill (a joint venture between Shougang and Shandong Province);</p> <p>b: Establishment of Huaxia Bank (Shougang's wholly owned subsidiaries).</p>
Implementation Measures	<ol style="list-style-type: none"> <li>1. Geographical Markets: Focus on Southeast Asia, South Asia, the USA and Middle East markets;</li> <li>2. Product Diversification in Exports: Improve the product structure of export products. Increase the proportion of machinery and electrical products, especially the complete sets of equipment;</li> <li>3. Human Resources Development: Focus on the recruitment and training of staff for international operation;</li> <li>4. Organisational Structure: Three departments (ie, import and export, overseas engineering, and overseas industrial subsidiaries) will be the prime vehicles for international business.</li> </ol>

Source: Interviews; Company Internal Report (1992, January)

## 7.6 From Competitive Advantage to Internationalisation

Shougang regards importing as the initial phase of its internationalisation process. This is in contrast to the conceptualisation of the Nordic Model (Johnson & Vahlne, 1977), which suggests an incremental, evolutionary approach to foreign markets with companies gradually deepening their involvement, beginning with marginal and intermittent exporting. Shougang's perception has to be understood in the context of

Chinese economy and remarkable changes of the last decade, which have seen China transformed from a centrally planned and virtually closed economy to one which is mixed and open.

Under central planning, the government was responsible for all major decisions of Chinese state-owned firms (eg, sources of investment funds, raw materials procurement, personnel recruitment and the sales of products). In contrast, under the CRS, Shougang was free to raise funds for its investment, including generating foreign exchange for importing technologies and equipment. Thus, paradoxically, importing manifests a change in geographical market orientation, ie. from a purely domestic to an international orientation. International involvement has become one of Shougang's key corporate strategy for the very first time. In 1981, Shougang gained import and export autonomy, meaning that it can avoid using import/export companies for its international activities. In the past 12 years, Shougang spent US\$310 million on importing more than 600 foreign advanced technologies and equipment, including second-hand equipment.

Shougang has been able to expand rapidly into overseas markets, especially in the last five years (see Table 7.8.). In 1991 it was particularly successful in increasing exports over the previous year, and the target for 1992 is US\$350 million, an increase of 54.7% over 1991.

Table 7.8 Export Performance of Shougang (1987 - 1992)

Year	Total Exports (US\$ mn)	Increase (%)
1987	9.88	
1988	20.74	109.9
1989	56.15	170.7
1990	64.43	14.7
1991	210.20	226.2
1992*	350.00	54.7

NB: \* Figures for 1992 are projection.

Sources: Shougang Corp (R&D Company): (1992a, 1992b).



Based on its successful experience of exporting and a limited number of FDI projects, Shougang has formulated an internationalisation strategy, aiming at achieving foreign sales of US1 billion, accounting for 25% of its total sales (US\$4 billion) by 1995. In terms of FDI projects, it will set up another ten more overseas subsidiaries and joint ventures in foreign countries also by 1995. It aims to become one of the 500 largest industrial multinational corporations in the world by 1995. Such an explicit internationalisation strategy reflects Shougang's confidence in its competitive advantage in the international markets.

In recent years, Shougang's internationalisation process has changed significantly. Firstly, in the early 1980s, Shougang exported 15 manufactured products like pig iron, steel sheets and rods, casted steel, etc. Its diversification into other industries has seen the number of export products increase to 91, including chemicals, precious gas, construction materials, metallurgical products and machinery, electrical and electronics products, ships, etc. These products are exported to more than 20 countries. Asia has overtaken the USA as the largest export market for Shougang.

Secondly, *outward technological transfer* has begun to contribute to Shougang's revenue. As Shougang gained international leadership in some areas of the world steel industry, some of the applied metallurgical techniques and automation technologies developed at Shougang have been exported to a number of countries including the USA, Japan, UK, Luxembourg and many developing nations. In addition, Shougang has begun to provide technological training, design and consultancy services to many companies from overseas.

Thirdly, Shougang has a strategic goal of increasing the proportion of high-value added products (eg, machinery and electrical products) in total exports as steel products have little value added and their price is easily influenced by the changes in international market. To further capitalise on its advantages in design, manufacturing, instalment, technical training and quality after-sale services, it has decided to increase its exports of complete sets of metallurgical machinery and equipment. It has successfully designed, manufactured, delivered and installed a complete set of rolling mill for Master Steel-making Corp of Indonesia, earning the company US\$5.24 million. It has since won contracts to manufacture and install complete sets of metallurgical equipment for firms in Egypt, Syria, India, etc.

Furthermore, Shougang has explored opportunities in international engineering contracting and turn-key projects. Its successful experience in modernising steel-making facilities adds further competitive advantage to Shougang in this respect. Last year, Shougang was awarded two contracts to modernise existing steelworks and establish new steel mills in Peru and Iran, earning the company US\$9.25 million and US\$13.8 million respectively.

The last dimension in Shougang's internationalisation drive is overseas direct investment. By August 1992, it had set up 15 overseas subsidiaries and joint ventures, sales offices in the USA, Southeast Asia, the Caribbean, and Europe (see Table 7.4). It plans to set up a further ten more overseas subsidiaries and joint ventures by 1995.

### 7.7 Motives for Internationalisation

The literature on Multinational Enterprises from the Third World, or NIEs in particular, has suggested a number of reasons for a firm to go multinational through foreign direct investment, including seeking low (labour) production locations (Wells, 1977) and host government incentives (Baldwin, 1975), limited home market (Busjeet, 1980) and host country import quota restriction (Young & Hood, 1987), risk diversification (Busjeet, 1980). None of these reasons can satisfactorily explain Shougang's FDI.

Shougang's foreign investments are all located in developed countries or countries that have higher labour and other production costs than China, which denies cost consideration as a motivation for FDI. It is also hardly convincing that Shougang went to invest in these host countries because they provided an attractive incentives package. Thirdly, unlike MNEs from many other developing countries, Shougang is based in China where market potential is seen as the largest in the world, and import quota restrictions have not been a reason why Shougang invested overseas. Related to the last factor, Shougang's risk diversification is not an overwhelming explanatory factor in its FDI as risk can be effectively diversified through exporting.

In seeking to identify the motives for FDI by Shougang, clues may be found by analysing its desire for exporting. Its first exports, in the early 1980s, were tied to its desire to import technologies and equipment. Under the CRS, it was no longer able to

receive state funds including foreign exchange for investment. To generate foreign exchange for importing, it had to export as much as possible.

However, this reason had become less important by the late 1980s when the value of Shougang's exports exceeded that for imports (in 1987). Instead, exporting has become one important element in its internationalisation strategy. Certain factors have encouraged Shougang to pursue such a strategy through exporting. Firstly, domestic steel prices are subject to strict state control and are artificially low, but exports are exempt from state price control. For instance, price for rolled steel is about RMB 600 yuan (US\$100) a ton in China, whereas the price for the same product is US\$300 per ton in international markets. The state plan also demands that a fixed quantity of steel is sold in the domestic market. Companies can only export steel products once they have reached the level of domestic sales demanded by the state's quantitative plan. Shougang has to comply with this state plan until 1993 when it will be allowed to determine the level of output and where it is sold (Financial Times 1992, Nov. 11. p.29).

In the domestic market, state-owned firms in China encounter government interference, which limits management autonomy and initiatives and thus encourages internationalisation to escape these restrictions.

These problems are further complicated by the regional and ministerial protectionism which characterises the Chinese economy (see The Economist 1992, Nov. 28. "China Survey" p.8 for a description of inter-regional rivalry and regional protectionism; next chapter on Baiyunshan has a description of ministerial protectionism). Although Shougang has firms and factories in almost every province in mainland China, regional and ministerial protectionism makes it very difficult for management to coordinate Shougang's businesses in the different parts of China. Diversifying into foreign markets has thus become a substituting route for expansion and reduced its reliance on the domestic market opportunities.

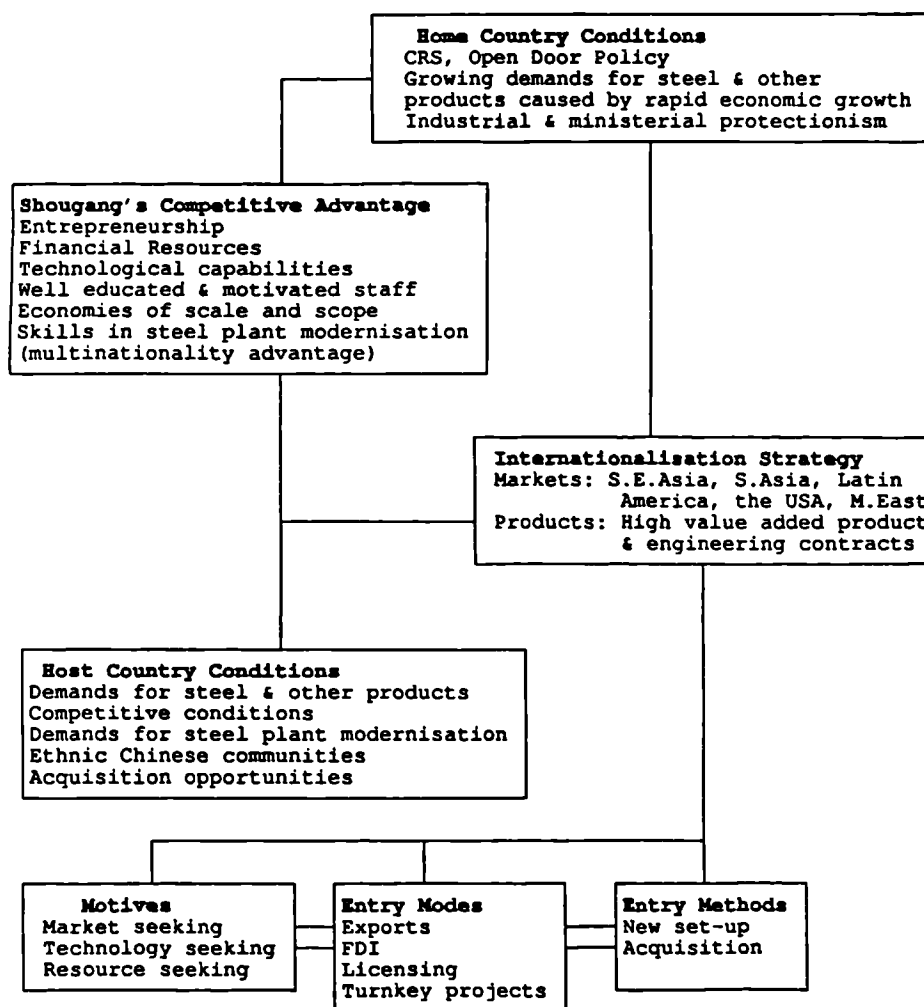
However, exporting has its own problems for Shougang. The government has allocated Shougang with a small export quota, and the company thus has to buy export quotas from other Chinese companies in order to further increase the proportion of its overseas business. In 1987, it spend US\$4.85 million to acquire a 70 per cent stake of Mesta International of the USA. Through Mesta, Shougang has been

able to access state-of-art technologies in the steel industry, and to bid for metallurgical engineering projects in developed countries.

## 7.8 Discussions & Proposition Verification

Shougang's experience, as presented in the foregoing sections, can be summarised as Figure 7.2. Having detailed Shougang's experience of creating competitive advantage and internationalisation, this section examines the relevance of the ten propositions derived from literature to Shougang's experience.

Figure 7.2. Shougang's Internationalisation Experience



Source: Compiled by Author

Proposition 1. The competitive advantages of Chinese MNEs are likely to be influenced by the characteristics of the home country conditions.

This proposition gains strong support from Shougang's experience. Shougang's competitive advantages, especially in technology innovation and adaptation, largely rest upon its greater management autonomy owing to the CRS, which is China-specific. Under the CRS, Shougang has made continuous improvements in technology, in which process it has created its own competitive advantage of upgrading steel plant. The CRS had also paved the way for Shougang to diversify into a wide range of industries. Moreover, the fast increase in demands for steel and other products provide opportunities for Shougang to increase production capacity in these sectors.

Proposition 2. Chinese MNEs are likely to have some technological advantage prior to and during their internationalisation.

Only scanty data for international comparison (see Section 7.3.) has been provided by Shougang. It has been indicated that by 1988 Shougang had become a leading steelmaker in China, being ranked first in 33 of the 55 technical and financial performance indices for iron and steel production nationwide. Internationally, its productivity for steel production had become quite competitive against some leading competitors such as British Steel, Kloechnner of Germany, USI-NOR of France and comparable with that of Krupp and Thyssen of Germany.

As foregoing sections have shown, Shougang's experience has largely affirmed this proposition. Although its expenditure on R & D has not been disclosed (R & D expenditure is scattered into capital investment, technological innovation fund, and research and development fund), its largest number of patents (excluding those obtained from Mesta Engineering Co. of the USA) amongst Chinese state-owned firms is indeed a better indication of technological advantage than R & D expenditure.

It is difficult to ascertain whether or not Shougang has the highest proportion of non-operative workers amongst Chinese steelmakers. However, 46.91 per cent of its employees are graduates from universities and technical schools, a ratio higher than that of any other large steelmakers in China. This higher ratio of university and

college educated employees may substitute for ratio of non-operative workers as an indicator of technological advantage. In addition, it has 72 research institutes and units, 29,235 professional and technical staff, accounting for 15.4 per cent of its total employees (190,000). The number of research institutes and units, number of professional and technical staff, and ratio of professional and technical staff are all higher than other steelmakers in China. All these indicators suggest that Shougang has technological advantage over its domestic competitors.

Shougang's scale of operation is not necessarily larger than its competitors. Its steel production ranked third in China in 1980-92. Iron output also ranked third during the period. However, the unit costs (production cost and overheads) of its iron and steel products (including pig iron, rolled steel, billets, drill steel and wires) has been consistently lower than that of its major competitors at home (Zhou, 1991. Vol.2. p.77).

In addition to technological advantage, Shougang has diversified into 16 industries, making it perhaps the most diversified manufacturing state-owned firm in China. This experience also supports the notion that MNEs tend to be more diversified than domestic firms.

Proposition 3. Chinese MNEs are likely to have experienced an incremental internationalisation process, namely from indirect exporting (and importing), to direct exporting, to overseas sales offices and eventually to overseas manufacturing.

This proposition has been partially confirmed by Shougang's experience. Shougang's exporting (and importing) activities date back to early 1970s. Its exporting activity then was indirect because it was handled by the state-owned China National Metallurgical Import and Export Company. Such indirect exporting by manufacturing firms in China prevailed because they were not allowed to export (and import) directly from overseas. Instead, the 12 state-owned FTCs and their provincial branches must be used as intermediaries. Chapter 2 has suggested that by 1978, 12 state-owned import and export handled 98 per cent of all China's foreign trade activities. Thus the lack of export autonomy before 1981 led Shougang to rely totally on indirect exporting.

Shougang's direct exporting started in 1981 when it started to implemented the CRS

and gained export (and import) autonomy from the state. Its wholly-owned import and export company (Shougang Branch of China National Metallurgical Import and Export Company) (now renamed as Shougang International Trading Corp.) was set up the same year and also started handling its own import and export activities.

Shougang's direct exporting had a slow start. Its export value did not reach US\$9 million until 1987, six years after the establishment of its import and export company. Since 1987, however, exporting business has been expanding very fast. By 1992, its exports reached US\$350 million.

Shougang's first FDI project, however, was not an overseas sales office. Instead, it was a takeover of 77 per cent stake of US engineering company (Mesta International) in July 1988. The outlay of this takeover was US\$3.4 million, quite a significant investment in comparison with its then foreign exchange revenue (US\$9.8 million in 1987 and US\$20.74 in 1988).

This leapfrog from exporting to overseas takeover be explained by Shougang's objective of the investment. This takeover was intended to acquire state-of-art design technology of steel-rolling and continuous casting for the parent company. Thus the market orientation was towards home country rather than host country. On the other hand, such a leapfrog also reflects Shougang's confidence in its own technological advantage.

Proposition 4. Chinese MNEs are likely to have no initial strategic plan for internationalisation. But as their internationalisation deepens, they are likely to have formulated and been pursuing international strategies.

The foregoing sections have suggested that Shougang's early exporting activity was only a part of state export plan. Before 1980, all state-owned firms had no more than a production plan derived from the National Economic Annual (or Five-Year) Plan. Exporting, if any, was a part of the production plan because all the firm was required to do was to produce the products, all other exporting activities were handled by import and export companies.

Since CRS was implemented and import and export company set up in 1981, Shougang's exporting has gained increasing strategic importance. As outlined before,

its strategic importance lies firstly in Shougang's desire for foreign exchange to upgrade its equipment through importing foreign technology and equipment, and secondly in Shougang's desire to become an internationally significant MNE, which has also led to the formation of its internationalisation strategy in 1990.

Shougang's internationalisation strategy has the ambitious objective of becoming one of the world's largest 500 manufacturing MNEs by 1995. Its target turnover by 1995 is Ymb 20 billion yuan (equivalent to US\$4 billion), with foreign sales of US\$1 billion, accounting for one quarter of its turnover. By the year 2002, its foreign sales target is US\$5 billion, accounting for 50 per cent of its turnover. In terms of foreign investment, it plans to set up ten more FDI projects in the next three years. Apart from sales and investment, its internationalisation strategy has also outlined its corporate structure, human resource development, corporate management, geographic market development and product diversification in view of increasing internationalisation.

Proposition 5. International strategies will not only speed up Chinese MNEs' internationalisation process but also influence their choice of foreign entry motives, methods and modes.

This has been confirmed from Sections 7.4. and 7.5. Shougang's internationalisation strategy has led to sharp increase of its exports, from US\$64.43 mn in 1990 to US\$210.20 mn in 1991 (see Table 7.8.), and US\$350 mn in 1992 (see Financial Times, 1993, February, 21). In terms of FDI, it had only 5 overseas FDI projects (Shougang Mechanical Equipment (Penns) Inc, Mesta Engineering Inc. Turks & Caicos Seafood Co, Shougang (Hong Kong) Holdings, and a sales office in Belgium) before 1990. Since 1990 when it started to implement internationalisation strategy, it had 8 new FDI projects in 1991 and 1992. In the first 6 months of 1993, it had made three more acquisitions in Hong Kong (Financial Times; Sing Tao Daily). Thus it seems true that Shougang had accelerated its process of internationalisation since it announced its internationalisation strategy in 1990.

Earlier international business in Shougang centred around increasing exports, earning more foreign exchange and getting access to foreign technology. However, the speeding up of Shougang's internationalisation process since 1990 has coincided with a re-orientation towards becoming a fully integrated conglomerate. FDI has new roles



to play. For instance, Shougang's acquisition of Hierro Peru aimed at securing supply of ore to Shougang's new 10 mn ton steel-making mill at Shandong Province and opening new markets for its metallurgical equipment and of course steel products in Latin America. Its acquisition of Californian No. 2 Steel Mill was a quicker and cheap way for Shougang to obtain modern steel-making equipment (with Shougang's innovation, the production capacity of the steel-making equipment dismantled from California will increase from 3 mn tons to 4.5 mn tons when installed at Shandong).

On the modes of foreign entry, it is expected that Shougang will become more aggressive in overseas acquisitions and takeovers. For example, in the bid to acquire Herrio Peru, Shougang had defeated a Japanese-Argentina-Brazil consortium. Its three new acquisitions in Hong Kong in 1993 have also proved its aggressiveness.

Proposition 6. The home and host country characteristics as well as firm-specific advantages are likely to have had a decisive impact upon the corporate and international strategies of Chinese MNEs.

From the ongoing discussions it may be self-evident that the strategy formulation has been largely based on SWOT analysis, which takes into account the home country and international market environments (including both opportunities and threats), internal strengths (resources and capabilities, ie, competitive advantage) and weaknesses. Shougang's internationalisation strategy has been the only one among the Chinese steelmakers, and it is not unrelated to Shougang's strengths against its major competitors.

The rapid economic growth in China should call for more steel products, this may explain why Shougang has been expanding its steel production capacity and aims at becoming a world leader in steel making by the end of the century. On the other hand, the characteristics of the Chinese economy (eg, regional and ministerial protectionism, export quota control, inconvertibility of the Chinese currency Renminbi) will also explain why an internationalisation strategy has its attraction to Shougang.

Proposition 7. In terms of generic strategy, Chinese MNEs are likely to base their competition primarily upon cost advantages in international markets.

This proposition holds true for Shougang's experience in its nature of competitive

advantage. The combination of low costs (and hence low price) and improved product quality makes Shougang competitive in international markets. The low costs of its products and services (for instance, engineering contracting) seems to have played an important role in Shougang's increasing export activity. To see how much cost advantage Shougang has over its international competitors, it only needs to compare (rolled) steel price in China and international markets. Rolled steel is a state controlled product in China, the price of which has been fixed at about RMB 600 yuan (US\$100) whereas international market price for the product is nearly US\$300. At only one third of international price, ie, RMB 600 yuan, Shougang still makes a handy profit.

Mr Zhang Yan, the director for international operations at Shougang, confirms the company's reliance on price competition. According to him, low cost has been the main advantage Shougang has over its international competitors in the steel and other products as well as engineering markets. On the other hand, he also suggested that technological expertise and reputation Shougang has gained in the 1980s help it enter and develop international markets.

Shougang's ability to develop international markets not only depends on its cost advantage and technological advantage, but also on its capability to gain government support and approval for its ambitious internationalisation strategy and diversification at home. First of all, not all large state-owned firms in China have the autonomy to engage directly in international business, as Chapter 2 has revealed. Shougang was one of the first manufacturing firms in China to be granted such autonomy (in 1981). Secondly, Shougang's close link with top leaders in the government helps it make full use of its management autonomy. For instance, in May 1992 Deng Xiaoping personally gave permission to Shougang to diversify into the banking industry and set up overseas establishment up to US\$30 million. He also allowed Shougang to sell its steel products at free market price in China from 1993 on.

Proposition 8. Chinese firms modified and improved technologies and equipment imported from developed countries in order to create their technological advantage.

This proposition has been confirmed by Shougang's experience. The foregoing sections have revealed that Shougang has spent hundreds of million dollars on importing technologies and equipment from developed countries. It has also made substantial effort to improve these imported technologies and equipment. As a result,

Shougang has become technologically competitive in international steel industry. Its technological advantage is more obvious inside China. According to Financial Times, Shougang is perhaps the only advanced steelmaker in China (Financial Times 1993. November 23).

Proposition 8. The main motives for Chinese firms to internationalise (invest overseas) are to gain access to host country markets and/or third country markets, or advanced technology of the host country. Escaping home government interference is also likely to be an important reason behind their outward FDI.

From the existing FDI projects undertaken by Shougang, market seeking is the main motives for FDI, although it must pointed that each project has its own objectives. For example, the acquisition of Hiero Peru was mainly for securing resources (iron ore), whereas the acquisition of Californian steel mill was for getting the equipment. The equipment acquired is moderately modern, but Shougang has full confidence in upgrading it and increasing its capacity by 50 per cent from 3 to 4.5 million tons of steel a year. The investment in Hong Kong and South East Asia was mainly for market penetration purpose.

Proposition 9. Joint ventures are likely to be the preferred foreign investment mode for Chinese MNEs.

As of 1992, out of Shougang's 10 FDI projects for which detailed data were made available, only 3 are joint ventures, and two of them (Mesta Engineering Inc of the USA, and Tung Wing Steel Co. of Hong Kong) were majority acquired by Shougang. Thus from Shougang's experience, it remains uncertain whether or not joint venture is a preferred mode of foreign investment.

Proposition 10. Chinese MNEs are likely to have enjoyed network advantage arising from their cultural and ethnical ties with overseas Chinese communities.

This has only been confirmed partially by Shougang's experience. While Shougang's entry into the USA and Latin America was almost totally unrelated to overseas Chinese communities, its entry into Hong Kong, especially the acquisition of Tung Wing Steel (as well as the three new acquisitions in 1993) and into South East Asia

can be viewed as related to ethnical affinity.

## **7.7 Summary and Concluding Remarks**

Shougang's experience illustrates the impact of China's economic reform and open-door policy upon state industrial firms. The CRS has made it possible for Shougang to retain a large amount of its profits to modernise its plants and equipment (via internal R & D and adopting foreign advanced equipment), and pursue a conglomerate diversification strategy in the 1980s. Shougang's improved technological capability improved its international competitiveness, resulting in substantial increase of exports.

The increasing international business activity and greater management autonomy have led Shougang exposed to increasing market opportunities in the domestic and international markets. Confident in its own competitive advantages, it formulated an internationalisation strategy for corporate development in 1990, which accelerated its international involvement in terms of exports, and foreign direct investment. It has also taken bolder modes of foreign entry (eg, acquisitions).

## **CHAPTER 8 CASE STUDY**

### **-- BAIYUNSHAN ENTERPRISE GROUP**

#### **8.1 Company Background**

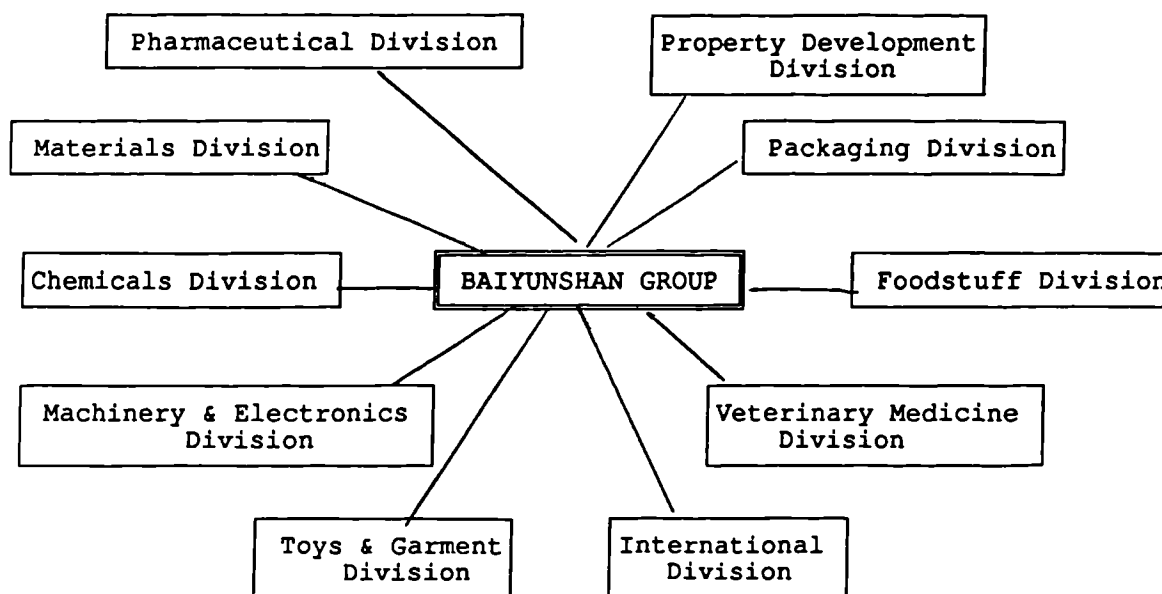
During the Cultural Revolution, millions of young graduates from middle (both junior and senior) schools in urban China were sent to the countryside to be "re-educated". In 1973, a traditional Chinese medicine doctor and 24 young people, sent from Guangzhou (the capital city of Guangdong Province), working at Baiyunshan Farm in the suburb of Guangzhou, set up a pharmaceutical factory -- Baiyunshan Pharmaceutical General Factory, which was the predecessor of Baiyunshan Enterprise Group (thereafter Baiyunshan in brief). In the first two years, the factory produced only one product -- andrographitis herb tablets. In 1975, Gan Mao Tea (a herbal medicine for treating cold) and Ke Te Ling (a medicine for treating cough) were successfully produced by Baiyunshan.

In 1976, Mr Bei Zhao Han was appointed as the Director of the factory when the factory was on the verge of closure because of poor management. Mr Bei set the guideline of "operating the factory based on advanced technology and strict management", which led to the exploration, training and utilisation of technologists, technicians and competent managers. In the same year, the injection workshop was set up and contract responsibility system (CRS) implemented. Since then, the factory has actively competed with the pharmaceutical rivals that were under the protection and control of the State Pharmaceutical Administration (SPA). Its turnover increased from RMB 20,000 (US\$540) in 1973 to RMB 1.4 billion (US\$246.6 million) in 1991. It has become one of the largest 200 industrial firms and the second largest pharmaceutical firm in the country. It has the largest capacity to manufacture finished pharmaceutical products in China. The considerable achievements made by Baiyunshan has won Mr Bei, Zhaohan one of "the Best Ten Public Servants" of Guangzhou City in 1986, and the "Economic Reform Stars" (Entrepreneurs) Prize (nationwide) in 1988.

Apart from pharmaceutical business, the company has in recent years diversified into related industries such as pharmaceutical raw materials, chemicals, medicinal aids and cosmetics and also unrelated sectors, for example, electronics, food, garment, toys,

packaging products, printing, real estate and business services (see Figure 8.1.). The firm has developed into a company group with more than 8,000 employees, 68 subsidiaries and branch factories. In 1991 it had exports of US\$14.55 million to more than 20 countries. By July 1992 it had set up one joint venture in Hong Kong and Mauritius and had a wholly-owned subsidiary in Canada and Japan each. In addition, it has 10 joint ventures in China with overseas investors' equity participation. Details on the recent performance of Baiyunshan Group are shown in Table 8.1.

Figure 8.1 Baiyunshan Group's Business Portfolio



Source: Author

Table 8. 1 Baiyunshan's Corporate Performance (1987-91)

Year	Turnover (Rmb m) (US\$ m)	Exports (US\$ m)	Exports as % of turnover	Profits (RMB m)(US\$ m)
1987	300 (104.7)	6.70	6.4	40.00 (13.96)
1988	533 (144.0)	8.64	6.0	59.72 (16.13)
1989	617 (137.2)	11.94	8.7	64.72 (14.39)
1990	800 (169.4)	10.50	6.2	52.33 (11.08)
1991	1,384 (246.6)	14.55	5.9	82.00 (14.61)

Sources: Introduction to Baiyunshan Enterprise Corporation (1991, 1987); Baiyunshan (1992) The Route to Success (Vol.3),p.11

## 8.2 Baiyunshan's Marketing Orientation

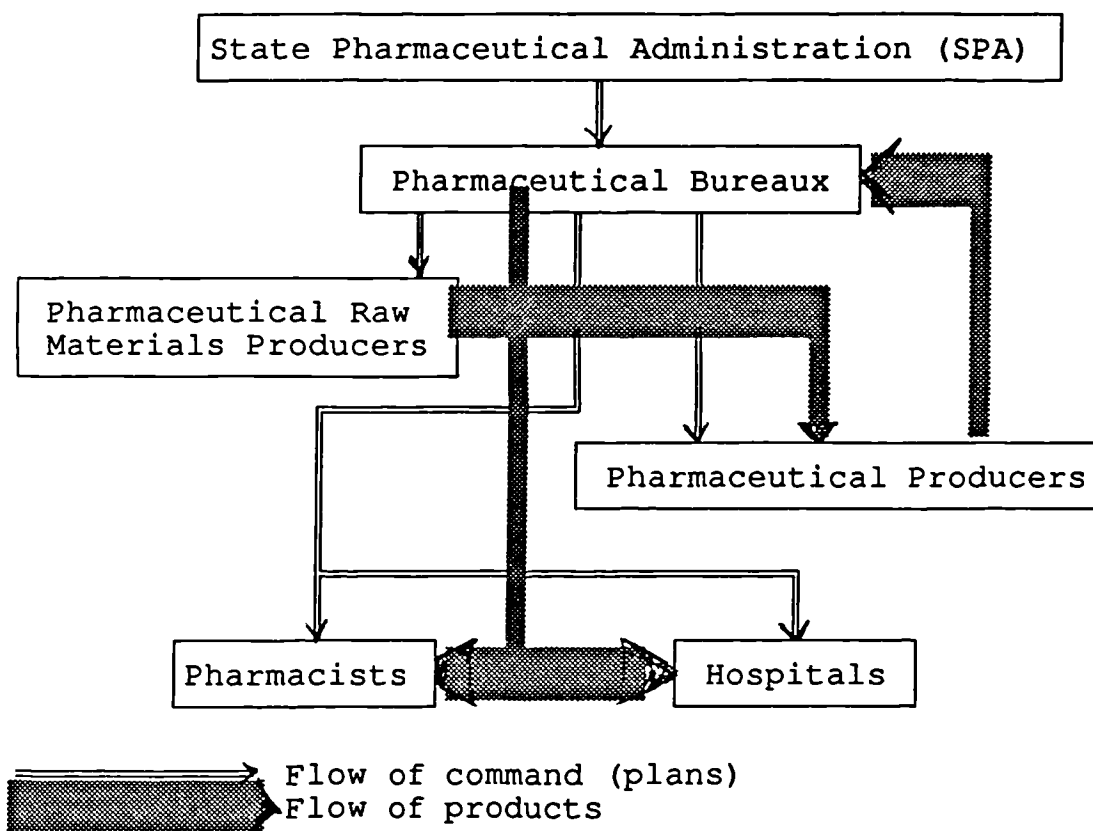
### 8.2.1 The Characteristics of Pharmaceutical Marketing

Marketing of pharmaceutical is different from marketing of other consumer products. The marketing of (ethical) pharmaceutical is characterised by the unusual split of the buying decision-maker (ie. the physician), the consumer (ie. the patient) and the payer (ie. usually the state) (Taggart, 1988). This feature means that the most effective promotion tools for ethical drugs marketing are personal contacts with medical practitioners by the representatives of pharmaceutical firms and advertising in medical professional journals (Taggart, 1988). However, for proprietary (over-the-counter or OTC) drugs, marketing may be quite similar to other consumer products.

In China, the bulk of pharmaceutical consumption is concentrated in urban areas where people tend to be more health conscious than their counterparts in the countryside. Employees in state-owned enterprises and government organs are reimbursed their health care costs by their employers. The sales of pharmaceutical in China is characterised by distribution channels which are owned, and controlled by the state watchdog, the State Pharmaceutical Administration (SPA). State-owned pharmaceutical producers sell their products to state-owned pharmaceutical

distributors (provincial and lower level pharmaceutical bureaus) all over China, which in turn supply the products to state-owned pharmacists and hospitals. The SPA plays a very important role in controlling producers, distributors and their activities through its annual, five-year plans, investment projects and coordination of other activities (see Figure 8.2.).

Figure 8.2 Pharmaceutical Distribution in China



Source: Author



## 8.2.2 Baiyunshan's Marketing Activities

Baiyunshan's entry into the pharmaceutical industry was not anticipated and welcomed by the SPA because it was not a firm under SPA's administration. Instead it belongs to a state-owned farm which is under the administration of the Agriculture Ministry.

Because Baiyunshan was set up without SPA approval, it has been operating more or less like an independent private company. It must procure raw materials and market its products by itself since neither its raw material needs nor its products were contained in the state pharmaceutical supply and sales plan, and no state purchasing departments were mandated to buy pharmaceutical from Baiyunshan. On the other hand, the SPA did not interfere with Baiyunshan's operations. Thus Baiyunshan has never been absorbed into the mainstream planning and administration of SPA.

Facing such a situation, Baiyunshan gradually formed a marketing orientation, establishing the strongest marketing force within the Chinese pharmaceutical industry. As vice-president Chen Jianzhou explains, "Baiyunshan would not survive if we failed to produce what the market needs. .... The products we manufacture here are demanded by our customers and clients. This makes it possible for us to break the (distribution) network of SPA". In addition, Baiyunshan was not in a position to get any financial support from the SPA, which means it must make a profit to survive.

As early as 1979 when economic reform just began in the rural areas of China, Baiyunshan had already set up 380 sales outlets throughout China and in the same year, the firm established an operating policy of "active marketing, superior product quality and services". Now the firm has more than 2,000 sales outlets in China.

The management has always emphasised that the most talented people should work in the marketing department: "only could they understand the market needs and market competition when they have direct experience of marketing", Chen Jainzhou, the vice-president suggests. Therefore, all new graduates recruited from colleges and universities are placed in the marketing department in their first few years at Baiyunshan and then transferred to other departments where their specialist capabilities can be best exploited. Most of the new recruits are from technological or

medical specialties. Their experience in the marketing department usually makes them pay more attention to market needs, quality, and competition as well as technological excellence. In addition to new entrants from universities and colleges, other recruits are subject to strict evaluation. No other firm in China has put more emphasis on marketing than Baiyunshan. Now the firm has four marketing departments and an import/export division.

### 8.2.3 Quality Products and Services at Baiyunshan

One of Baiyunshan's competitive weapons against its competitors in China is to provide quality services to its clients and customers. As early as 1982, Baiyunshan was the first and only Chinese pharmaceutical firm to provide "Five Guarantees" to national pharmaceutical wholesalers and retailers -- covering losses caused by: transportation, a fall in price, medicines passing expiry dates, medicines becoming obsolete, and medicines of inferior quality. Such practice won Baiyunshan enormous trust from its clients and customers throughout the country.

Within Baiyunshan's marketing function is a mail-order unit and a new medicines promotion unit. The mail order unit receives annually hundreds of thousands of letters requiring medicines. Staffed by senior medical doctors, the unit does not only post medicines but also provides health care suggestions to customers. In case the medicines are not available from Baiyunshan, the unit will do its best to get the medicines from other pharmaceutical firms in China for the customers. Here in Baiyunshan, "Quality first and Services first" is not a slogan but a practical guideline. The medicine promotion unit, established in 1987, hosted numerous new products seminars in 16 provinces and 30 cities, helped customers understand and use new medicines and sent free samples to many people. These activities won Baiyunshan an excellent reputation. In 1991, Baiyunshan was rated as one of the best known firms in China, and its public relations department won the Best PR Prize.

### 8.2.4 Corporate Image

Baiyunshan was the first Chinese firm to realise the importance of building up a corporate image and the first one in the Chinese pharmaceutical industry to launch a

TV advertising campaign for pharmaceutical products. It was also the first pharmaceutical firm in China to set up a public relations department to improve company image, and its budget for public relations is larger than that of any other Chinese firms (RMB 5 million each year in the last few years, now increased to RMB 10 million); Baiyunshan was the first firm in China to sponsor a national football team (the team was thus named after the firm); it was the first firm in China to set up a light song & dance ensemble ..... All these make Baiyunshan a well known name in China. Many patients request their physicians to prescribe Baiyunshan's ethical products while its OTC products are usually the best-sellers. No other pharmaceutical firm has ever enjoyed such a good reputation in the country.

### **8.3 The Creation of Technological Advantage**

#### **8.3.1. Technology (Hardware) and Product Quality**

When Baiyunshan was set up, it had just one piece of the most primitive equipment (a big pot) for producing one product -- a traditional Chinese herbal medicine. Mr Bei himself did not have the chance to receive university education during the Cultural Revolution, but he realises the importance of technology and the technical personnel in the firm. In 1979 he set the guideline of "reliance on technology and strict management" for the firm. To Mr Bei, technology comes from two interdependent aspects: hardware and software. Hardware refers to the advanced equipment while software mainly to the technologists and technicians who are capable of technological (process) and product innovations, and skilled workers who can manipulate the equipment very well.

To improve technological competence in terms of hardware, Baiyunshan invested heavily in technological innovation and importing advanced equipment and technologies from foreign countries. In 1981, it invested Rmb 2 million (US\$0.5 million) (from its retained profits) to upgrade its Tablets Workshop up to GMP requirements (an international manufacturing standard for pharmaceutical industry) in order to implement fully-closed, semi-sterilised production. In 1985, it spent US\$5 million to further upgrade the workshop through importing advanced equipment and technologies from abroad. As a result of absorbing and improving imported technologies and equipment, Baiyunshan owns the best processing lines in power-

injection, water-injection and soft-capsule production facilities among all Chinese pharmaceutical firms. It also possesses fully automated processing lines for water pills and tablets packaging facilities. In addition, it has more than 1000 sets of unit equipment and precise aids, 23 of which were imported from other countries in an investment worth RMB 40 million (US\$10 million).

### 8.3.2 Software Technology (R&D) and Innovations

Apart from investment in equipment and machinery, Baiyunshan set up a medical research institute in 1983. As Baiyunshan began to diversify into other businesses, it established a test centre with advanced precise instruments and equipment (imported) and seven other research institutes specialised in pharmacy, biochemistry, electronics, food, chemicals, which host a large number of medical experts, clinical doctors and scientists.

In addition to recruiting university graduates, Baiyunshan trained a large proportion of its employees up to university level. As a result, among the 8,000 employees in the Baiyunshan Group, 21 per cent of them are research scientists, technologists or technicians. This proportion is the highest amongst all pharmaceutical firms in China. Baiyunshan has made a decision to spend 1.5 per cent of annual turnover on research and new product development by these eight institutes. In addition, there is investment in fixed assets (instruments and devices) for the research institutes. In 1991, a total of RMB 20 million (US\$ 4.5 million) was invested in R&D. Recent hi-tech development strategy allocates a further RMB 200 million (US\$37 million) for research programmes on wide range of product areas like electronics and biochemistry.

### 8.3.3 Technological Advantages

Technological advantage has brought three major benefits to Baiyunshan: improved product quality, strong competitive edge in product innovations and an increased product range.

Product quality and safety is of paramount importance for any drugs producer. In the

early years of Baiyunshan's development, it lacked the ability to produce such products simply because its equipment was too primitive and there was no well-trained personnel except the traditional Chinese medicine doctor. Having imported advanced equipment, with a large technological and research force and a pool of skilled operative workers, it is now able to produce high quality products. Indeed, Baiyunshan's products, especially pharmaceutical, have the best quality image among Chinese pharmaceutical firms. This quality image has paid dividends. For example in 1989 it received one tenth of the total orders at the annual national pharmaceutical products exhibition, the most important yearly forum for pharmaceutical transactions within China. Purchasers were very satisfied with the quality of Baiyunshan's products and its product quality warrantee. In 1991 alone, more than 10 products from Baiyunshan won national, ministerial and Guangdong provincial quality prizes, vice-president Chen Jianzhuo explains..

Continuous investment in upgrading technologies and R & D provide Baiyunshan with an increasing number of new products. In 1991, Baiyunshan launched 130 new products (as compared to 43 new products launched in 1990), which accounted for 10.21 per cent of total revenue of the group company. It can now produce more than 200 pharmaceutical products including traditional Chinese medicines (herb) and Western medicines, plus more than 300 other products like electronics toys, garments, food, chemicals and pharmaceutical raw materials, etc. However, it has to be pointed out that China has only had a patent law since 1988, so before then innovating firms such as Baiyunshan were unable to protect fully their innovations including new pharmaceutical and thus failed to maximise profits from their new products.

## 8.4 Corporate Strategy

### 8.4.1 A SWOT Analysis for Shougang ?

The opening up of China to the outside world and economic reforms inside China in the 1980s had made it easier for Baiyunshan to increase its international involvement. For instance, importing and exporting had become easier than before, especially when the company was granted import and export autonomy in 1985. Baiyunshan's own import and export department was set up the same year. As Baiyunshan has gained more international experience, it has become more competent, than ever before, in

identifying international market opportunities, for example, the market demands for traditional Chinese medicines. Moreover, the reformed economic system has made it possible and easier for Baiyunshan to "diversify into many different industries", asserts Chen Jianzhou, vice-president of Baiyunshan.

However, the economic reforms and open-door policy have also brought increasing challenges to Baiyunshan. These include an upsurge of imports of pharmaceutical from abroad, and direct investment in China by foreign pharmaceutical MNEs (eg, Johansen & Johansen). The much debated GATT re-admission issue has also intensified the worries of Chinese pharmaceutical firms, because becoming a member of GATT means that "we must lower import tariffs for most of the imported goods, including drugs, which will intensify competition in the industry in our domestic market", explains vice-president Chen Jianzhou. Moreover, the adoption of the Patent Law in 1988 also meant that "Chinese pharmaceutical firms can no longer produce foreign invented drugs without paying for a licence from the inventor(s)", and "we (Baiyunshan) must catch up with these foreign MNEs in (process) technologies and in new drug inventions. Or we will lose our market (to foreign MNEs)", Chen reveals.

The rapid economic growth in China provides more opportunities to Baiyunshan. Some industries, for instance, cosmetics, were almost non-existent before the economic reforms started. Now as people have more disposable income, they have become more beauty conscious, especially for the young generations, and more health conscious. The population control policy (ie, one-child-per-family) pursued since 1980 has also created market opportunities for the manufacturers of children products (eg, toys, children's soft drinks). "All these favourable changes provide us opportunities to diversify further", says Mr Chen Jinzhou.

To grasp these opportunities and overcome the increasing challenges, a firm needs to have resources and capabilities. As section 8.2. has revealed, Baiyunshan's primary competitive advantages lie with its greater management autonomy, marketing networks inside China and good corporate image, richer financial and technological resources. Table 8.2 summarises Baiyunshan's competitive advantages and disadvantages, as well as the opportunities and threats in the domestic and international markets.

Table 8.2 A SWOT Analysis for Baiyunshan

STRENGTHS	WEAKNESSES
<ol style="list-style-type: none"> <li>1. Strong marketing advantages within China;</li> <li>2. Financial resources;</li> <li>3. High quality and well-motivated employees;</li> <li>4. Greater management autonomy than major domestic rivals;</li> <li>5. Economies of scale and scope</li> </ol>	<ol style="list-style-type: none"> <li>1. Lack of international brand;</li> <li>2. Lack of internationally experienced personnel;</li> <li>3. Lack of international marketing channels;</li> <li>4. Over-dependence upon domestic market;</li> <li>5. Very limited allocation of foreign exchange.</li> <li>6. Lack major drug innovation</li> </ol>
OPPORTUNITIES	THREATS
<ol style="list-style-type: none"> <li>1. The growing demand for pharmaceutical products in domestic market;</li> <li>2. Weak competition in the domestic market;</li> <li>3. Acquisition opportunities in the domestic market;</li> <li>4. Direct import and export autonomy (since 1985);</li> <li>5. Increasing market demands for traditional Chinese medicines in overseas markets;</li> <li>6. Market niches in Africa and other developing countries.</li> </ol>	<ol style="list-style-type: none"> <li>1. Increasing competition from foreign firms in China;</li> <li>2. Price control in China limits profitability of pharmaceutical products in domestic market.</li> </ol>

Source: Compiled from interviews

#### 8.4.2 Baiyunshan's Corporate Strategy

Based upon Baiyunshan's strengths and weaknesses, and the opportunities and threats existing in the domestic and international markets, Baiyunshan had formulated a corporate strategy, which is basically domestic market-oriented (see Table 8.3). Although this corporate strategy pays attention to the establishment of R & D centres abroad, these proposed centres are for defensive reasons (see Section 8.6).

Table 8.3 Baiyunshan's Corporate Strategy  
(1990-2000)

Strategic Goals	<ul style="list-style-type: none"> <li>a: To become the largest pharmaceutical producer in China, with sales of RMB 2.5 bn by the year 1995;</li> <li>b: Based upon pharmaceutical industry, to become a large conglomerate MNE before the year 2000, with total sales of in excess of RMB 10 bn.</li> </ul>
Strategic Priority (Domestic)	<ul style="list-style-type: none"> <li>a: Increasing the proportion of high-tech products;</li> <li>b. Increasing the capability of pharmaceutical production;</li> <li>c. Restructuring the corporate management;</li> <li>d. Strengthening the marketing networks in China.</li> </ul>
Strategic Priority (International)	<ul style="list-style-type: none"> <li>a. Establishment of R &amp; D centres in China and overseas;</li> <li>b. Setting up joint ventures overseas, including acquisitions.</li> </ul>
Implementation Measures	<ul style="list-style-type: none"> <li>a: Establishment of high-tech enterprises in bio-chemicals, computer software and their applications in pharmaceutical construction projects, semi-synthetic antibiotics engineering, etc;</li> <li>b: Acquiring some pharmaceutical firms in China;</li> <li>c: Divisionalisation;</li> <li>d: Establishment of R &amp; D centres in China and overseas (the USA, Australia, France, Canada and the UK);</li> <li>e: Setting up foreign subsidiaries.</li> </ul>

Source: Based on interview with Chen Jianzhou, vice-president of Baiyunshan.



## **8.5 Exports from Baiyunshan**

### **8.5.1 Initial Exports**

Baiyunshan received its first export order in 1976, the year when Mr Bei was appointed as the general manager of the firm. The order came from a Hong Kong pharmaceutical distributor, and three products (Gan Mao Qing, Ke Te Ling and Gan Faning) were exported to the distributor. These products were exported because they were "new products" albeit using traditional Chinese herbal medicine. While these export orders came from the Hong Kong agent, Baiyunshan could not export to the distributor directly. It had to export through the Guangzhou Branch of China National Pharmaceutical Import and Export Company, and this pattern of exporting continued for 10 years. In 1985, Baiyunshan became the first pharmaceutical firm in China to gain direct export (and import) autonomy, which meant it no longer had to rely on the Guangzhou Branch of the national pharmaceutical import/export company.

### **8.5.2 Reliance on Middlemen for Exports**

Baiyunshan's exports still rely heavily upon Hong Kong distributors. Given its price competitiveness and quality reputation, Baiyunshan might have more exports if it had its own marketing channels in the international markets. In addition, the world pharmaceutical market is dominated by the major multinationals that have well-established marketing channels and brand names, which Baiyunshan lacks. Mr Chen (Jr), an export manager at Baiyunshan maintains that it may take years or even decades for Baiyunshan to build up its own brand name and marketing channels in the overseas markets although the firm has been attempting to reduce such reliance.

It is very interesting that while Baiyunshan has the most powerful marketing capacity in the domestic market, it has very limited resources for international marketing. Apart from reliance on Hong Kong distributors, participating in international pharmaceutical trade fairs has also become important for Baiyunshan to get overseas orders.

### 8.5.3 Incentives for Exporting

Baiyunshan exports for three main reasons: firstly, it needs foreign exchange for importing pharmaceutical raw materials, technologies and equipment; secondly, exporting is more profitable than domestic sales and enhances the reputation of the firm; and thirdly, exporting can significantly reduce market risks through diversification of markets.

a). Before Baiyunshan established its own pharmaceutical raw materials base in 1987, it relied heavily on domestic and foreign suppliers for raw materials. As it is outside the state pharmaceutical plan, the SPA did not include Baiyunshan's requests for raw materials in its plans, and so major bulk drug producers were not mandated to supply Baiyunshan. Therefore Baiyunshan was unable to secure the supply of materials. Importing raw materials was an alternative, but the company needed to raise foreign exchange by itself. Exporting thus became necessary in the short term.

In seeking a long term solution, in 1987 Baiyunshan invested RMB 60 million (US\$15 million) to set up a pharmaceutical raw material base in China. It still has to import some proportion of required raw materials. In addition, importing foreign technology also needs foreign exchange, and it has always been very hard to get foreign exchange quotas, especially for a firm like Baiyunshan whose importing is not contained in state pharmaceutical plan. Without an allocation of foreign exchange, the firm would lack foreign exchange to pay for its imports.

b). Apart from a need to generate foreign exchange, other factors encouraged Baiyunshan to export. For instance, the Hong Kong distributors can pay a higher price because the price in Chinese domestic market is set artificially low by the state pricing plan, so exporting is more profitable. Furthermore, in China when a firm has large export volume and a large sum of foreign exchange surplus, it can have significant bargaining power with central and local governments. It can have privileged access to energy, water and other infrastructure facilities. In recent years, a company's foreign exchange surplus can be traded on the black or official market (the so-called Foreign Exchange Swap Centres), providing opportunities for further profitable dealings.

c). Thirdly, exporting is increasingly seen as a way to diversify market risk. This became very apparent in 1988-89 when the domestic pharmaceutical market was hit

by the government's austerity programme. For all these reasons, exporting is very important to any Chinese firm, but more important to Baiyunshan because it lacks the backing of the SPA.

Baiyunshan exports include finished pharmaceutical products and also pharmaceutical raw materials. Its electronics products began to be exported in 1989 to a number of countries, including the USA, Canada, Germany, France, UK, Belgium, CIS, Thailand, Singapore, Malaysia, Australia and Pakistan.

## 8.6 From Exporting to Direct Investment

Apart from exporting to overseas countries, Baiyunshan has set up establishments in Canada, Japan, Hong Kong and Mauritius (see Table 8.4).

Table 8.4. Baiyunshan's FDI Projects (as of July 1992)

Host Country	Name of Venture	Scale of investment	Main Business	FDI Objective(s)
Hong Kong	Fenhin Pharm. Co. Ltd:	US\$0.7 million Joint venture 50% stake	Packaging & distribution of pharmaceutical in Hong Kong & overseas	Attempting to gain control in overseas distribution
Canada	Baiyunshan (Canada) Ltd.	US\$ 1.56 million 100% owned subsid.	Final dosage processing and marketing in North America	Market seeking
Japan	San Ho Co. Ltd	US\$ 0.82 million 100% owned subsid.	The processing and marketing of Chinese food and drinks	Market seeking
Mauritius	Sino-Afro Pharmaceutical Venture	US\$ 2.2 million. 40% stake.	Manufacturing and marketing of pharmaceutical in Africa	Market seeking

Source: Author

The Hong Kong firm, China Fen Hin Pharmaceutical Co.Ltd, is a joint venture with Baiyunshan's long established partner in the territory. The Hong Kong firm has been Baiyunshan's export distributor for over a decade. Baiyunshan took 50% stake in Fen Hin, which is a packaging and distribution establishment.

This investment was undertaken to improve Baiyunshan's control over international marketing. And in one sense, it was a step towards reducing the role of the Hong Kong distributor and perhaps finally establishing its own export marketing arms. But Mr Chen, the manager for imports and exports at Baiyunshan, suggests that "setting up direct exporting relationships with overseas clients (ie, bypassing Hong Kong distributor) is very difficult, not only because we do not have enough people with substantial international sales experiences and language skills, but more importantly the group has been preoccupied with domestic expansion and diversification, (and thus) little attention is paid to international expansion". Fen Hin Co. Ltd has been packaging and exporting both traditional Chinese and Western medicines and raw materials for South East Asian markets and European countries.

Tracing the Hong Kong agent's re-exports to Canada, Baiyunshan gained access to its Canadian customers. In 1988 it set up a manufacturing subsidiary in Canada to serve the market. In addition to replace the role of the Hong Kong agent, Baiyunshan believes that the Canadian investment would bring it closer to its customers in North America, including those in the USA.

Baiyunshan's investment in Japan, San Ho Co. Ltd, is an establishment for processing food and drinks for the market. San Ho was set up to explore market opportunities in the Japanese market because Chinese food and drinks are not widely available there due to the perceived strong competition from Japanese producers. Baiyunshan's venture however, mainly provides a larger range of Chinese foodstuffs and drinks which give it a competitive edge against local rivals as well as China's producers seeking to penetrate the market.

The Mauritius investment is a joint venture between Baiyunshan, Northeast Pharmaceutical General Factory (another case company which will be discussed in the next chapter), and an undisclosed Hong Kong pharmaceutical distributor. Baiyunshan has 40% stake in the joint venture, using its pharmaceutical processing technologies. This investment project is seen as a way to penetrate the African market.

Vice president Chen Jianzhuo reveals that the group has plans to invest in Singapore and Thailand in the near future in order to safeguard and strengthen its presence in the Southeast Asian market. He explains that direct investment in overseas countries can benefit Baiyunshan, providing greater direct control of its international marketing efforts, reducing its reliance on overseas distributors. FDI also brings the firm closer to its overseas customers, resulting in better services. It thus help achieve market diversification. Given Baiyunshan's weakness in international marketing compared with its strengths in the domestic market, Chen further suggests that both export marketing and overseas investments in manufacturing should get more attention, be given strategic priorities in the coming years, with every effort made to integrate its overseas activities with its domestic ones.

### **8.7 Recent Corporate Development Strategy**

In less than 20 years, Baiyunshan has grown to become China's second largest pharmaceutical producer. Indeed, its total turnover (ie. including sales of non-pharmaceutical products) is double that of China's No. 1 pharmaceutical producer, Northeast Pharmaceutical Factory (see next case study chapter).

Although it has been exporting for more than a decade and has four overseas investments, international operations had been viewed until recently as periphery activities. Recent strategic development at Baiyunshan has focused upon the development of hi-tech products. This strategy puts FDI in overseas R & D centres in parallel to its domestic expansion in an increasing number of industries.

The focus of this new business strategy is the development in hi-tech areas like biochemical engineering, semi-synthetic anti-biotic engineering, computer applications in pharmaceutical industry, food additives, etc. The governments of Guangdong Province and Guangzhou (Canton) City have agreed to contribute some RMB 150 million to Baiyunshan's hi-tech research programmes. The firm itself will spend another RMB 50 million on them. Major research is expected to be completed within 3 to 5 years, through which Baiyunshan will become a hi-tech based firm, the only one in China's indigenous pharmaceutical industry. Included in this strategy, noticeably, is its plan to set up R & D establishments in the USA, Australia, France, Canada and

possibly the UK to undertake new product development. This is in addition to its ambition to set up similar research establishments in major cities in China, as well as its intention to set up strategic alliances with large multinationals for technological collaborations. The strategic importance of these proposed overseas R & D centres lies in Baiyunshan's desire to gain access to advanced pharmaceutical processing equipment and monitor advancement of the world's pharmaceutical research and applications. As vice-president Chen Jianzhuo explained: "We (the Chinese pharmaceutical industry) are behind the developed countries in pharmaceutical research and applications. But as China's pharmaceutical opens further to the international competition, I believe more and more large pharmaceutical MNEs will penetrate our domestic market. If we establish some R & D centres in these developed countries, it will be easier for us to follow up the development (of the industry). I also hope these centres can help us meet the challenges of technological and scientific developments in the industry and of foreign MNEs' increasing penetration of our domestic market".

Under the new strategy, Baiyunshan plans to increase its turnover five-fold by the year 2000. With 1992 turnover expected to reach RMB 2 billion (US\$370 million), Baiyunshan plans to reach total sales of RMB 10 billion (US\$1.85 billion at current exchange rate), with a profit of RMB 1 billion (US\$185 million), before the year 2000.

## **6.8 Proposition Verification**

Having outlined Baiyunshan's recent development and internationalisation experience, the ten propositions regarding Chinese MNE's competitive advantages and their internationalisation can be now verified and discussed.

Proposition 1. The competitive advantages of the Chinese MNEs are influenced by the characteristics of the Chinese national diamond.

There is no doubt about the impact of the national economy and its evolution upon the creation and nature of Baiyunshan's competitive advantages, particularly in the domestic marketing and in technological development. The industry structure and rivalry, the demand conditions, the supply and supporting industries and the role of

government (particularly the SPA) have all influenced the creation and nature of competitive advantages of Baiyunshan. The domestic pharmaceutical market structure and rivalry (under the control of the SPA) had forced Baiyunshan to establish its own distribution channels and marketing networks and compete fiercely with its domestic rivals. The weak competition and undemanding consumption in the domestic market had not stimulated Baiyunshan to innovate major drugs. As foreign pharmaceutical MNEs were allowed to enter the Chinese market only in the last few years, the Chinese firms including Baiyunshan did not feel much competitive pressure to improve their competitive advantages in the domestic market. The lack of supporting industries (notably the suppliers of technologically advanced pharmaceutical machinery and of pharmaceutical raw materials) had led Baiyunshan to import equipment from abroad and to integrate backwards to raw material production.

More notable is Baiyunshan's emphasis of management autonomy as a competitive advantage against its domestic rivals. This has to be understood in the Chinese context where SOEs have only limited management autonomy. Baiyunshan's origin (set up by a group of young people working in a farm) and subsequent development in the era of economic reforms and the Open-Door have made it possible for Baiyunshan to gain greater management autonomy, especially in diversifying into other industries and direct imports and exports.

Proposition 2. Chinese MNEs are likely to have technological advantage prior to their internationalisation.

This proposition is generally true for Baiyunshan. First of all, with 1,717 technical and research staff (by the year 1991), it has the highest proportion (21 per cent) of technical employees among pharmaceutical firms in China. Its expenditure on R & D (RMB 20 million, accounting for 1.5 per cent of annual sales in 1991) is also larger than any other pharmaceutical firm in China.

In terms of advertising intensity, it has the largest advertising (and Public Relations) expenditure among all Chinese firms and highest advertising intensity among Chinese pharmaceutical firms. It has the largest production capability for pharmaceutical products (final dosage forms) in China and thus enjoys economies of large scale. Furthermore, the firm is more diversified than any other pharmaceutical firm in China.

**Proposition 3.** Chinese MNEs are likely to have experienced an incremental internationalisation process, namely from indirect exporting, to direct exporting, to the establishment of overseas sales office and eventually manufacturing.

Baiyunshan's experience seems to confirm partially the evolutionary nature of internationalisation as envisaged by the Nordic Model (Johnson & Valhne, 1977). Initial exports came from an overseas (Hong Kong) distributor, and as the volume of exports increases, more importance is attached to international markets. FDI comes to play a part, first of all, in replacing the role of overseas middlemen and then in taking the opportunities arising in overseas markets through establishing local manufacturing facilities.

It should be pointed out that indirect exports began in 1976 and the firm relied on this method for 10 years. Indirect exporting was the only option because Baiyunshan did not have import and export autonomy until 1985. Thus gaining such autonomy was a prerequisite before Baiyunshan could switch from indirect to direct exporting. This evolution was only possible in the era of economic reform and open-door policy. This has clearly shown the impact of changing environment on the internationalisation of Chinese manufacturing firms.

Its first overseas investment, however, was not a sales office but a joint venture in Hong Kong to package and market its products outside China. Further leapfrogs are another two joint ventures in Japan and Mauritius and one wholly-owned subsidiary in Canada, all performing manufacturing activities. This is not in line with the Nordic Model of incremental internationalisation.

**Proposition 4.** Chinese MNEs may have no initial strategic plans for internationalisation. But as their internationalisation deepens, they are likely to have formulated and been pursuing internationalisation either as their corporate strategies per se or as one of the most important constituents of their corporate strategies.

As the foregoing sections have revealed, Baiyunshan's early exporting activity in the 1970s was not regarded as strategically important. However, since 1980 the importance of exporting had become clearer and greater as Baiyunshan needed foreign exchange to import foreign raw materials, technologies and equipment, as it had not been allocated any foreign exchange by the SPA. Thus increasing exporting



became an important element in Baiyunshan's corporate strategy.

Strategically Baiyunshan has been pursuing diversification (both industrial and geographical) since 1980. In terms of its industrial diversification, its businesses have diversified horizontally into chemicals and cosmetics, and vertically into raw materials production. The firm has also expanded into unrelated industries such as real estate, electronics, toys and garments. Geographically, it has expanded into an increasing number of countries, through exporting and direct investment. Figure 8.2. has depicted Baiyunshan's corporate development by 1992.

Within this context of Baiyunshan's corporate strategy, inter-nationalisation has its role (albeit rather limited so far). Exporting and FDI are seen as ways to diversify markets. Unlike SEG and Municipal Light (the last two case companies in this study) which concentrate on overseas markets, Baiyunshan had not given greater strategic priority to internationalisation than domestic expansion.

Its recent development strategy has attached high priority to the development of hi-tech products. Within this strategy is its intention to establish R & D centres in several developed countries to gain access to advanced technologies and monitor the progress in relevant scientific and technological areas such as bio-technology. These will help Baiyunshan to defend its position in the domestic market against competitive assaults of foreign MNEs. Baiyunshan's current corporate strategy is not pre-occupied with the internationalisation of its operations, although it plans to invest in Singapore and Thailand in the near future.

Although it is plausible to argue that Baiyunshan's internationalisation is not deep enough (with less than 10 percent of its products exported by 1991) to warrant its strategic focus upon the international markets, its recent interest in setting up R & D centres in the developed countries seems that it begins to take international (human resources as input) markets more seriously than before in its overall corporate strategy.

Proposition 5. Internationalisation strategies will not only speed up Chinese firms' internationalisation process but also influence their motives and choice of foreign entry methods and modes.

As Baiyunshan is still pre-occupied with conglomerate diversification in the domestic market, it really does not have an internationalisation strategy so far. It seems plausible to suggest that the lack of an internationalisation strategy at Baiyunshan may have in return contributed to its slow progress in internationalisation and also low degree of multinationality (with four outward FDI projects). As such, it is difficult to verify whether its motives and choice of foreign entry methods and modes have been influenced by its strategies.

Proposition 6. In terms of generic strategies, the Chinese MNEs are likely to base their competition primarily upon cost advantages and thus enjoy price competitiveness in the international markets.

It is true that Baiyunshan's main positional advantage in international markets is cost and thus price related. Several reasons are suggested for such a reliance on price competitiveness in international markets. First of all, because the company has not yet established an international marketing network, it depends heavily on foreign, especially Hong Kong distributors. This reliance on them largely limits Baiyunshan's bargaining power. Thus the price of its products has to be low enough to be acceptable to the foreign distributors. Secondly, although Baiyunshan has the best reputation and image as a pharmaceutical producer in China, it has not established an international brand, thus it is difficult for Baiyunshan to compete on anything else but price in international market. Thirdly, although the firm has invested heavily on R & D (by China's standards), it has not yet invented any major drug. Fourthly, low labour and other production costs make Chinese firms competitive in price in international markets. Such a cost and price advantage is not necessarily connected to economies of scale or productivity, but simply because they are located in China where labour and other operating costs are so low.

However, cost advantage does not necessarily lead to success in internationalisation. As for Baiyunshan, and indeed any other Chinese manufacturing firm, gaining export autonomy is the necessary condition for internationalisation. Otherwise, they can not go beyond indirect exporting through state-owned import and export companies. Secondly, in the case of Baiyunshan, its connection with its Hong Kong distributor helped it penetrate international markets. Its first export order came from the distributor, which also handles a large proportion of Baiyunshan's export activities now. The same agent has also become Baiyunshan's investment partner in Mauritius

and Canada. In this respect, the network theory seems particularly relevant to Baiyunshan's experience.

Proposition 7. Imported and adapted technologies is likely to be one of the main sources of technological advantages of the Chinese MNEs.

Baiyunshan's experience of creating competitive advantage mainly through absorbing and improving imported technologies and equipment is typical of Third World MNEs, like those from India (Lall, 1986; Wells, 1984). It has been revealed that Baiyunshan's first modern production line (a GMP production line) was established using imported technologies and equipment (costing it US\$5 million). However, it would be misleading to attribute Baiyunshan's creation of technological advantage solely to the importation and improvement of foreign technologies. The firm has made substantial effort in innovations and new product research and development. Its own technological capability has a decisive role in transforming the imported technologies into its own technological advantage. As a result, Baiyunshan has the largest finished drug production capacity among Chinese pharmaceutical firms.

Proposition 8. Market seeking and technology seeking are likely to be the main objectives for FDI by Chinese MNEs.

Three out of the four FDI projects undertaken by Baiyunshan are market seeking . Thus Baiyunshan's experience supports the proposition on the main objective of FDI by Chinese MNEs.

Proposition 9. Joint ventures are likely to be the main investment mode by the Chinese MNEs in their outward investment.

This is partially true of Baiyunshan's FDI experience. Out of its four FDI projects in Canada, Hong Kong, Japan and Mauritius, two (in Hong Kong and Mauritius) are joint ventures and the other two (in Japan and Canada) are wholly owned subsidiaries. While the involvement of the Hong Kong distributor in both the Hong Kong and Mauritius ventures can be explained by Baiyunshan's desire to maintain access (via the Hong Kong distributor) to the international markets where it has little direct experience, the Canadian subsidiary seems to suggest its intention to get rid of control by the intermediaries (including the Hong Kong distributor).

Proposition 10. The Chinese MNEs are likely to enjoy network advantages arising from their cultural ties with overseas Chinese communities and from their previous business relationship in their internationalisation process.

Baiyunshan's joint ventures (in Hong Kong and Mauritius) had the involvement of its long-standing Hong Kong distributor, in which case the ethnic factor does have played a role. However, neither the ethnical factor nor previous business relationship had been important in the establishment of its Japanese subsidiary in food processing and Canadian subsidiary in pharmaceutical manufacturing. In case of the Canadian subsidiary, although Baiyunshan knew that there was a market there for its products, its exports to Canada were previously handled by the state-owned China National Pharmaceutical Import and Export Company (Guangdong Branch) and the Hong Kong distributor, and Baiyunshan was effectively insulated from its ultimate Canadian clients. Thus it would be difficult to suggest that Baiyunshan had any network advantage in Canada prior to its investment in the country.

## **8.9 Conclusions**

This case study has shown that Baiyunshan's marketing orientation led it to succeed in the domestic market. Its management autonomy, resulting from being outside the SPA's control and protection, under Mr Bei's entrepreneurial leadership, laid the foundation for its market orientation. As a result of its success in the domestic market, Baiyunshan accumulated and retained an increasing amount of profits, which are used to invest in R & D, technological progress, advertising and public relations.

In pursuit of greater technological competitiveness and product diversification, Baiyunshan had imported and improved foreign technology and equipment, which led to the improvement of product quality, enlarging product range and thus enhancement of Baiyunshan's competitiveness in market. Baiyunshan created its own technological advantage though continuous investment in technological progress in an increasing number of product sectors.

Baiyunshan's experience has confirmed the proposition about the correlation between multinationality (degree of inter-nationalisation) and R & D intensity, advertising (and

PR) intensity, higher proportion of non-operative employees, and economies of large scale. The proposition that Chinese firms rely on imported technologies to create their own technological advantage has also been confirmed. Baiyunshan's internationalisation can not be explained from the corporate strategy perspective as it is at early stage of the process. The proposition about the Chinese MNEs' generic strategies of competing mainly on low cost and price has been strongly supported by Baiyunshan's experience, although this cost advantage serves only as a necessary but not sufficient condition for its internationalisation.

Baiyunshan's internationalisation experience has also partially confirmed the incremental process model, subject to the explanation of the Chinese context, namely whether or not, and when, a firm has been granted import and export autonomy. Because Baiyunshan did not have direct import and export autonomy when it began to export in 1975, it had to rely on another import and export company to export its products then. And the role of foreign distributors is still evident today. However, its leapfrog from exporting to the establishment of manufacturing facilities overseas (omitting the interval -- overseas sales office) is also observed, which limits the applicability of the incremental model to the case of Baiyunshan.

The motives underlying Baiyunshan exporting are very different from those typical of Third World firms. They are related primarily to the unique economic system in China. Baiyunshan's exports were necessary firstly for it to meet its foreign exchange needs for importing. Later on profit opportunities arose in exporting due to the higher price paid by overseas agents than domestic clients and because of the existence of dual exchange rates in China. Moreover, generating foreign exchange enhanced Baiyunshan's reputation and bargaining power in getting preferential treatment (eg, in access to the use of infrastructure) from local government. In common with MNEs from other Third World countries, Baiyunshan also has undertaken both exports and FDI in order to achieve geographical diversification and thus risk reduction. Until very recently Baiyunshan has not attached strategic priority to international markets.

Moreover, it seems that the industry characteristics (particularly the industry rivalry) have influenced Baiyunshan's business strategy. As vice-president Chen maintains, the industry has been very competitive and dominated by a few major multinationals in the international markets. Consumers in developed countries are very quality-conscious where their governments have enacted a series of quality standards and certifying

procedures (Taggart, 1988). The nature of the world pharmaceutical market, quality consciousness of consumers and quality control by governments have profound implications for Baiyunshan's internationalisation. Without an established international brand name or a patented pharmaceutical product, Baiyunshan's internationalisation is bound to be a slow process despite of its quality improvements at home. Interestingly, Northeast, another case company, has successfully avoided such difficulties and exports over 60% of its pharmaceutical products to overseas markets. The next chapter presents Northeast's internationalisation.

## **CHAPTER 9 CASE STUDY**

### **-- NORTHEAST PHARMACEUTICAL FACTORY**

#### **9.1 Company Background**

The previous chapter has detailed Baiyunshan's experience of creating competitive advantage, the evolution of its corporate strategy, and its internationalisation. This chapter focuses on the experience of another pharmaceutical firm -- Northeast China Pharmaceutical Factory (hereafter Northeast in brief).

Established in 1946, Northeast has been focusing on producing bulk drugs, intermediates and raw materials. Only since the 1980s has it begun to integrate forwards to manufacturing final dosage forms and recently backwards to raw material (chemicals) production. However, pharmaceutical intermediates and bulk drugs still represent Northeast's core businesses.

Northeast produces bulk vitamins, steroid hormones, antibiotics, sulfanilamides and other pharmaceutical intermediates as well as preparations. With a product line of 40 main bulk drugs and pharmaceutical intermediates as well as preparations (ie, raw materials), it is the largest organic synthetic pharmaceutical company in China. It has over 10,000 employees, 11 per cent of whom are engineers and technical professionals. Its operations in China comprise 4 subsidiaries, 3 branch factories, 12 bulk drug production plants, and 6 auxiliary workshops.

Northeast began exporting in the late 1960s. By 1984, total exports to 51 countries amounted to 5,242 tons of bulk drugs, worth US\$28 million and accounting for 40% of its total output. By 1991, over 60% of production was exported to 55 countries, earning it US\$48.5 million. In addition, it had set up sales offices in Hong Kong, London, Hamburg and plans to set up sales offices in Moscow and St. Petersburg. It already has joint ventures in Mauritius and in the USA and has plans to set up manufacturing establishments in Thailand and the Bahamas within next two years. Table 9.1 details Northeast's corporate development in the past five years.

Table 9.1 Northeast's Corporate Performance (1987-1991)

Year	Turnover Rmb mn (US\$ mn)	Exports (US\$ mn)	Exports as % of Turnover	Profits Rmb m (US\$ m)
1987	104.0 (36.31)	16.1	44.4	13.5 (4.7)
1988	187.0 (50.52)	24.5	48.5	15.2 (4.1)
1989	325.3 (72.33)	38.7	53.5	28.4 (6.3)
1990	364.2 (76.95)	43.4	56.4	30.2 (6.4)
1991	431.0 (79.51)	48.5	61.2	n.a.

Source: Northeast's Internal Report (1989, 1991)

## 9.2 The Sources of Competitive Advantage

### 9.2.1 Northeast's Generic Strategy

Northeast is one of the three key and large pharmaceutical firms (the other two being North China Pharmaceutical Factory and Xinhua Pharmaceutical Factory) under the administration of the State Pharmaceutical Administration (SPA). It is designated as a bulk drugs producer by the SPA. In the domestic market, its products which are highly regarded as quality products are distributed through the state planned and controlled distribution channels, mostly to other state-owned pharmaceutical (final dosage) producers. Its products and those of its rivals are subject to strict price controls imposed by the SPA. In this context, the level of competition in the domestic market is low and non-price based. Thus Northeast's positional advantage is best analyzed in its export markets where SPA's influence is minimal.

Northeast's main exports are bulk drugs and intermediates to foreign pharmaceutical MNEs, which process these to final dosage forms and market them. It enjoys a considerable cost advantage over international competitors due to low labour and other operating costs in China. Bulk drugs and pharmaceutical intermediates exported by Northeast are cheap in international market.

However, cost advantage alone does not make Northeast a successful exporter. Its quality reputation as well as large product range and large volume of production



contribute to its positional advantage in international markets.

It seems that Northeast uses a different competitive advantage for different markets. In developed country markets like the USA, Germany and the UK, it mainly exports bulk drugs and pharmaceutical intermediates to pharmaceutical MNEs like Bayer, BASF, Roche/Sapac, for further processing. The main competitive advantage of Northeast lies in the low price, reliable quality, large range, and quantity of its products. "For pharmaceutical MNEs, you need a large quantity (of bulk drugs and pharmaceutical intermediates), as they would not bother to order a small amount (of these bulk drugs)." And "quality must be competitive and assured while the price low. That's the way we deal with pharmaceutical MNE clients", explains vice-president Zhao Jiquan. "To make sure our (product) quality is up to international standards, our overseas clients come here very often to inspect our quality control and other quality assurance measures. They are very satisfied with our quality", he adds.

In contrast, in Southeast Asia and other developing countries, Northeast exports mainly finished drugs at a price low enough to be affordable by the majority of consumers there. "Market needs in these countries are very similar to those of the Chinese domestic market", explains Mr Sun, the manager for importing and exporting at Northeast (ie, the Shendong Branch of China National Pharmaceutical Import and Export Corporation). He also emphasises the importance of price competitiveness in the African market where people can not afford to buy more expensive branded drugs made by large pharmaceutical MNEs. Consumers there are less concerned with brands than with drug effectiveness in curing diseases. This view is echoed by Mr Zhao, the vice-president, who says that "in Africa, most of the ordinary people can only afford cheap drugs. Many drugs like penicillin and terramycin have been widely used for decades in China, whereas in Africa only a minority of population have ever used (them). We are able to provide cheap drugs (of these kinds) to the majority of the population in Africa".

Therefore it can be summarised that Northeast's main positional advantage in export markets are quality reputation and price competitiveness. Most of Northeast's exported products have achieved tough international quality standards such as those stipulated in the UK and USA pharmacopoeias. And at Northeast every effort is made to upgrade and improve product quality in line with changes in developed country markets such as the UK and the USA markets.

## 9.2.2 Technological Advantage in Bulk Drugs Manufacturing

As Northeast has been engaged in bulk drug production for four and a half decades, it has accumulated considerable experience in bulk drugs manufacturing. However, it and the rest of China's pharmaceutical industry remained very backward in terms of technological competence and equipment modernisation before the mid-1980s. Mr Zhao Jiquan (Vice-president) explains that because of thirty years isolation, the Chinese pharmaceutical industry had become very backward technologically and needed to upgrade its technologies and equipment. Northeast was no exception to that, despite being one of the largest three companies (it should be four, if Baiyunshan is included) in the domestic industry. Economic reform and the open-door policy (since 1979) has allowed the company to import technologies and equipment, and the company has taken the opportunity to catch up with international pharmaceutical standards (in terms of product quality, product range and productivity).

## 9.2.3 Foreign Technology and Equipment in Use

Importing technologies and equipment plays an important role in creating Northeast's competitive advantage. Zhao Jiquan, the vice-president and chief engineer, affirms the importance of foreign technology and equipment to the company. In the mid-1980s, the company spent millions of dollars (US\$14 million in total) on importing technologies and equipment from developed countries. This included a complete set of dextrose manufacturing equipment, major components of ethylene processing equipment, and a key component of a large-scale cyanidin manufacturing equipment. The company also imported advanced instruments and devices for quality control and R & D.

## 9.2.4 Quality Improvements

Imported technology and equipment has the potential effect of increasing productivity and improving product quality. As Mr Zhao asserts: "there are no substitutes for imported technology and equipment in improving product quality and increasing

productivity". ..... "It is obvious that developed countries are ahead of us in terms of technological capabilities and sophistication of equipment in pharmaceutical industry. It is not only wise but also vital for us to learn from them through adopting and digesting their technologies". The product range has been widened by imported technology and equipment. However, as Zhao elaborates, imported technology and equipment do not in themselves lead to an improvement of product quality and increase in productivity. Northeast does put emphasis on absorbing the imported technology and mastering the imported equipment. To do so needs a lot of skilled workers and above all a strong technological capability. Northeast's R & D personnel have made a critical contribution to both absorbing imported technology and equipment and new product development.

#### 9.2.5 In-House R & D

Northeast used to have the largest research unit among Chinese pharmaceutical firms. In 1956 its pharmaceutical research institute was transferred to Beijing and renamed the China National Chemical Research Institute, the predecessor of the present China National Chemical Research Academy. Since then Northeast has made great effort to rebuild a new research unit. Its Pharmaceutical Industrial Research Institute (PIRI) at its headquarters (Shengyang) is now staffed with 260 researchers, medical doctors and technicians, including 20 senior engineers, 76 engineers and assistant engineers. It has a six-storey laboratory of 6600 sq meters as well as a pilot plant with floor-space of 2200 square meters. The institute has excellent equipment and instruments, many of which have been imported. It has synthetic, biological, analytic and pharmaceutical labs and an information centre.

Since its formation in the late 1950s, the institute has recorded 70 major research achievements, including 30 that have won national, ministerial and municipal rewards. Northeast's PIRI has made an important contribution to the successful introduction of new, and quality products to the domestic market. In particular, it is the main body for tracing the international market quality standards like BP (British Pharmacopoeia) and USP (United States Pharmacopoeia). This is particularly important for Northeast because its products are to be further processed by major pharmaceutical MNEs in the developed countries where quality standards are increasingly stringent. Therefore, it is strategically vital for Northeast to ensure its quality standards reach or exceed the

strict pharmaceutical quality standards of the host countries where its major multinational clients are operating. Northeast's research institute has been particularly strong in introducing new quality standards and products of upgraded pharmacopoeias. Many of its products have won national and provincial quality prizes. Some of these quality prize-winning products are shown in Table 9.2.

Table 9.2 Quality Prizes Won by Northeast

Name of Product	Quality Standards	Awarding Authority
Amantadine	BP1980, USPXXI	SPA
Rifampin	BP1980, USPXXI	SPA
Sulphadiazine	BP1980	SPA
Dextrose	ChP1977	SPA
Hydrocortisone	BP1980, USPXXI	SPA
Prednisone Acetate	ChP1977	SPA
Piracetam		SEC
Fosfomycin		SEC
Fluocinonide	USPXXI	LP
Vitamin E	BP1980, USPXXI	LP
Ethambutol	BP1980	LP
Hydrochloride	BP1980, USPXXI	LP
Vitamin A	BP1980, USPXXI	LP
Vitamin B1	BP1980	LP
Hydroprednisone	BP1980, USPXXI	LP
Caffeine	ChP1985	LP
Berberine		
Hydrochloride		

NB: BP1980 (British Pharmacopoeia, 1980 edition), USPXXI (United States Pharmacopoeia, XXI edition), ChP1977/1985 (Chinese Pharmacopoeia, 1977 or 1985 edition); SPA (State Pharmaceutical Administration), SEC (State Economic Commission), LP (Liaoning Province).

Source: Northeast's Export catalogue.

The main objective of product development at Northeast is to ensure that its products are upgraded to international quality standards and to introduce new products innovated by itself or elsewhere. For instance, when foreign firms including large pharmaceutical multinationals have not been able to produce prostaglandins at a commercially viable rate, Northeast has already received new drug certificate for its

prostaglandins production. Many of the company's new products are the those developed in the late 1980s in the world pharmaceutical industry. Northeast has two basic policies for new product development. One is that the company has always four generations of new products at any given time -- one in production, one in standby for production, one in trial production and one in research and development. Secondly, new products are selected, researched, developed and manufactured at internationally competitive quality standards. By the nature of its bulk drug production and exporting mostly to foreign pharmaceutical multinationals, Northeast's new products therefore are aimed at being compatible with its overseas clients' product quality standards or even higher than expected by its clients.

### **9.3 Corporate Strategy**

It is perhaps most interesting to know that Northeast did not really have any explicitly written corporate strategy or policy. However, from the interviews with people in Northeast, especially, Mr Zhao, the vice-president and chief engineer, the following factors seem to have underpinned the company's current corporate strategy.

#### **9.3.1 SWOT Assessment for Northeast**

As an intermediate products producers, Northeast does not foresee any drastic changes in the demands for its bulk drugs pharmaceutical intermediates in both the domestic and international markets, especially as its major overseas clients are large pharmaceutical MNEs and it has capabilities to meet its clients' stringent quality and delivery requirements. Its ability to upgrade product quality and introduce new drugs not only boosts its confidence in maintaining these international clients but also encourages it to seek to integrate forward to the final dosage production in overseas markets. Some of its clients in the USA had already expressed intense interest in such joint ventures.

In the domestic market, the demands for raw materials and intermediates are likely to increase as the economy grows fast. However, the structure of demands for raw materials and intermediates is likely to change and become more favourable to Northeast due to its capability to upgrade quality to international standards. The

establishments of joint ventures in China by foreign pharmaceutical MNEs will also increase demand for raw materials and intermediates because they are more likely to purchase from China where sourcing costs are far lower than in the international markets.

The SPA administration may change, with pharmaceutical firms having more management autonomy. The control and coordination by SPA in the Chinese pharmaceutical sector will loosen or even disappear in the long term, which means that the industry rivalry in the domestic market will be intensified, not only amongst Chinese firms but also with the arrival of foreign MNEs. However, because Northeast is primarily a raw materials and intermediates producer, the economic reform (which means a decentralisation of decision-making power to firms from SPA and introducing industry rivalry) within the sector will not fundamentally change its market position. This is because "when competition is fully introduced into the (domestic pharmaceutical) industry, the rivalry will be more fierce among final dosage producers than among the raw materials and intermediates producers", says vice-president Mr Zhao Jiquan.

On the other hand, Mr Zhao also indicates that because of low pressures on Northeast, which is located in the interior China, people at Northeast are less enthusiastic to further enterprise reforms. "It's very hard to change our management practice in this part of China and especially in such a large state-owned firm like ours. .... And the pharmaceutical industry is one of the least reformed and opened sectors in China", says Mr Zhao. Mr Sun Weichi, the manager responsible for import and export at Northeast, has a similar opinion: "We are not managers but implementors of commands given by upper levels of governments (SPA and provincial pharmaceutical bureau). .... We have little management autonomy. What can we do?". Mr Sun gives an example about the lengthy bureaucracy Northeast had to pass through when it applied (to the SPA) to set up a joint venture in the USA.

Nonetheless, Northeast has indisputable strengths in product quality, product range, good reputation and good relations with its international clients. As one of the three key pharmaceutical firms under SPA, it also enjoys considerable financial and distribution support from SPA.

Its weaknesses lie in its reliance on a single industry, limited management autonomy,

lack of bargaining power against its international clients, and over-reliance upon state support (especially the support of the SPA).

A SWOT analysis for Northeast is presented in Table 9.3.

Table 9.3 A SWOT Analysis for Northeast

STRENGTHS	WEAKNESSES
<ol style="list-style-type: none"> <li>1. Economies of scale in synthetical drugs;</li> <li>2. Quality reputation in domestic and international markets;</li> <li>3. Capability to upgrade products;</li> <li>4. Good relations with major international clients;</li> <li>5. Government support;</li> <li>6. Cost advantage</li> </ol>	<ol style="list-style-type: none"> <li>1. Reliance on single industry;</li> <li>2. Lack of bargaining power against major international clients;</li> <li>3. Lack of capability to make final dosage products;</li> <li>4. Limited profit for intermediate products and raw materials;</li> <li>5. Reliance upon state allocation of export quotas and state plan for expansion;</li> <li>6. Limited management autonomy.</li> </ol>
OPPORTUNITIES	THREATS
<ol style="list-style-type: none"> <li>1. Forward integration;</li> <li>2. Domestic expansion opportunities;</li> <li>3. Diversification into related and unrelated industries;</li> <li>4. Growing demand for raw materials and intermediate products in both international and domestic markets.</li> </ol>	<ol style="list-style-type: none"> <li>1. Restrained management autonomy;</li> <li>2. government price setting;</li> <li>3. Increasing competition from domestic and foreign firms in China;</li> <li>4. Increasing competition from other Chinese firms in international markets.</li> </ol>

Source: Compiled from interviews

### 9.3.2 Corporate Strategy

According to the SWOT assessment for Northeast, it seems that the company will continue its current exports-based international expansion strategy in the near future. This is because "Northeast will continue to be a producer of bulk drugs and intermediates, so we have no particular reasons to spread our operations into many countries. .... As far as China can provide us with sufficient inputs (plants and chemical raw materials), we will continue to base our production of pharmaceutical raw materials and intermediates on China. China is important for us to maintain cost

advantage and price competitiveness", asserts Zhao Jiquan, the vice-president. On the other hand, in line with Northeast's domestic integration forward to final dosage processing, it will also continue to explore overseas opportunities in forward integration "with the approval of the SPA".

As one of the major pharmaceutical firms under the direct administration and control of the SPA, which has too many reasons to increase the exports of China's pharmaceutical products, Northeast has to accept the "guidance" export quotas from the SPA. Besides, it is more profitable to export than sell in the domestic market where pharmaceutical price is under government tight control and artificially low.

## **9.4 Internationalisation: Exports from Northeast**

### **9.4.1 Exporting Channels**

Northeast has been exporting since the late 1960s and by 1984 had exported some 40% of its total output. During that period, the main reason for exporting was that as the largest bulk drug producer, the company was required by the SPA to earn foreign exchange for the pharmaceutical industry.

Northeast's exports have always relied on China's pharmaceutical export/import companies and overseas agents. Before 1987, all its exports (and imports) were handled by the state-owned pharmaceutical import/export companies. Even though Northeast had established business relations with overseas agents, the import/export companies still had a role to play in channelling Northeast's products to overseas markets because Northeast was not allowed to export directly to overseas markets.

The company gained direct import and export autonomy in the late 1987 when it established an international trading company, Shendong Branch of China National Medicines & Health Products Import & Export Corporation. The formation of an import/export division has fostered the growth of Northeast's exports though the growth of exports handled by this division has slowed down gradually (see Table 9.4).



Table 9.4 Northeast's Exports (1988 -- 1992)  
(Through its Import/Export Division. US\$ million)

Year	Exports (US\$ mn)	Growth (%)
1988	15	
1989	20	33.33
1990	24	20.00
1991	28	16.67
1992*	30	7.14

NB: Figures for 1992 are export tasks assigned by Northeast to the import/export division.

Source: Based on interview with Mr Sun, Manager of Shendong Pharmaceutical Import & Export Company

Northeast's exports consist of two parts. While the import/export division handles the export of final dosage forms and a small quantity of intermediates or bulk drugs to small clients and customers or distributors, headquarters itself is responsible for the export of a large quantity of bulk drugs and intermediates to major pharmaceutical multinationals (eg, Bayer, BASF, Roche).

Table 9.4. shows that the growth rate of exports handled by the export division has declined, causing concern at Northeast. Mr Sun, the export manager, has admitted the difficulties in exporting final dosage forms to overseas markets because of high entry barriers (eg, the FDA's strict control in new drug certificate) and Northeast's lack of internationally experienced marketing staff. He explains that "competition in final dosage forms is very fierce in the developed country markets where most of Northeast' products are exported to" whereas exporting bulk drugs or intermediates is a cooperation rather than competition between Northeast and its overseas clients (major pharmaceutical multinationals). The difficulties are compounded by Northeast's lack of quality image as a final dosage forms producer in international markets although its product quality in raw materials and intermediates is well recognised by its overseas clients. The company has been long looking for opportunities to integrate downwards to finished drug production and marketing. Some of Northeast's overseas clients provided such opportunities and Northeast began to invest overseas.

Elsewhere (eg, in Russia and Southeast Asia), Northeast's exports consist of both intermediates and finished products, in which case, the company felt it necessary to set up sales offices locally to serve better local clients and customers and expand business.

#### 9.4.2 Motives for Exporting

Apart from being required by the SPA to export, Northeast has in recently years been motivated to export by a number of factors.

From Northeast's perspective, exporting has been attractive because it enhances the reputation of the company and its products. It has also increased the firm's bargaining power with the government. "In China, it is almost a standard practice that exporting firms (manufacturing firms) receive preferable treatment from the government: privileges in power supply, raw materials supply, investment funds, as well export subsidies". "As long as you export more and earn foreign exchange increasingly, you get benefits from the state", Sun said. For instance, exporters received state subsidies until 1991.

The 1980s added a new need by Northeast to generate foreign exchange for its own use: it wanted to import foreign technology and equipment. "As one of the three largest pharmaceutical firms under the SPA, we can of course get the foreign exchange from the state. But since we are able to export, we are allowed to retain part of the foreign exchange we earn, so we have foreign exchange to import technology and equipment. The more we export, the more we retain, and the more we can import". This mechanism obviously facilitated Northeast's desire to increase export.

Regional protectionism makes it difficult for Northeast to compete with local rivals in other provinces. Many local competitors are set up and protected by regional governments. Competition in China as a whole is intense because most competitors are competing on price, Mr Sun explains. In addition, the SPA has insisted that Northeast should focus on international markets rather than domestic market.

The most recent motive for Northeast's internationalisation is to diversify markets.

"we cannot rely on one market (domestic). If we diversify into overseas markets, we do not have to worry too much about demand changes in one (domestic) market. So it's worthwhile to take the risk of diversifying into foreign markets", says Zhao Jiquan. In addition, Northeast has the largest scale of production in many bulk drugs, and the domestic market is too small to absorb all its products.

## **9.5 Internationalisation -- Foreign Direct Investments**

Northeast's first manufacturing direct investment in the USA is its joint venture with Greenwich International Co. Ltd, which is an R & D based pharmaceutical company. Prior to the establishment of the joint venture, both parents had a business relationship for five years. While Greenwich had competitive advantage in pharmaceutical R & D, Northeast's experience lay in the manufacturing of quality and a wide range of bulk drugs. Northeast had been supplying Greenwich with its pharmaceutical intermediates and Greenwich further processed the intermediates into finished pharmaceutical products and marketed them. Satisfied with Northeast's product quality, range and quantity, Greenwich was the first to propose setting up a joint venture in the USA so that the supplying of the intermediates could be stabilised. Responding to the Chinese government's worry that such a venture might not be commercially viable given the fact the Northeast had no prior experience in direct manufacturing investment in developed countries, Northeast and Greenwich made a compromise. As a result, a joint venture by the two parties was set up in China first, and another one in the USA later. The USA investment cost US\$0.5 million (both parties have 50% stake) in 1991.

Another manufacturing investment is a joint venture by Northeast, Baiyunshan Enterprise Group and a Hong Kong firm in Mauritius. This joint venture was originally set up to target mainly the South African market where demand has been quite promising for Chinese pharmaceutical products and Northeast has been quite confident in its own competitive advantage in terms of product quality, range and price competitiveness. Most of the African market has pharmaceutical demands similar to those of China in the 1950s and 1960s. Many popular products like penicillin and terramycin which have been widely available in China for decades are only affordable by a minority of people in Africa. Most multinational pharmaceutical companies have neglected this poor market and their presence is particularly weak

there, leading to weak barriers to entry.

Northeast originally wished to set up a joint venture in South Africa because of its relatively high level of economic development among African countries. However, because China and South Africa did not have diplomatic relations until 1992, Mauritius was selected as a substitute location because of its privileged access to Commonwealth countries' markets including South Africa. Three parties set up a joint venture there with an investment of US\$2.2 million. While Northeast has a 30 per cent stake by contributing machinery, construction and decoration materials as well as pharmaceutical intermediates, Baiyunshan has a 40 per cent stake by providing technologies for final pharmaceutical processing and packaging. The Hong Kong partner holds another 30% equity share by contributing its expertise in marketing. After a lengthy delay because of government approval procedure, the venture was finally approved in 1991. With major site construction work has been finished, the installation of machinery and trial operation will commence in the second half of 1992.

Mr Zhao Jiquan, the vice-president for technologies and international business, suggests that the company has been thinking of setting up a joint venture in South Africa for serving the local market because of the improvement in diplomatic relations between China and South Africa since 1992. If that proposed joint venture is completed, the Mauritius operation will serve other African markets. This will need further coordination among and commitment by the three parties. Obviously more efforts will be needed for local marketing while keeping product price as low as possible so that more customers will be able to afford buying the venture's products.

Three local sales offices have been set up in London, Hamburg and Hongkong. These offices are intended to serve local clients and customers and expand business. These sales offices and the overseas manufacturing establishments consist of an international marketing network for Northeast. Further plans include sales offices in Moscow and St. Petersburg of CIS as well as manufacturing establishments in Thailand and Bahamas. There have been some negotiations, discussions about these four projects and decisions taken, but Northeast awaits approval from Liaoning Province or central government.

**Table 9.4. Northeast's FDI Projects  
(as of July 1992)**

<b>Host Country</b>	<b>Nature of the Venture</b>	<b>Main Business</b>	<b>Main Objectives</b>
<b>USA</b>	50-50% joint venture with Greenwich International Inc.	Final dosage form production of pharmaceuticals. Local marketing	Forward integration into final dosage processing & marketing
<b>Mauritius</b>	30% stake. Joint venture with Baiyunshan (40%) and a Hong Kong partner	Final dosage forms production of pharmaceuticals. Marketing in Africa & Middle East	Same as above
<b>UK</b>	Dongleng Pharmaceutical Co. Ltd	Sales office	In an attempt to set up a distribution channel
<b>Hong Kong</b>	Sales Office	Sales office for Southeast Asia	Same as above
<b>Germany</b>	Sales Office in Frankfurt	Sales office for Europe	Same as above

Source: Author

## **9.6. Discussions & Proposition Verification**

### **9.6.1 Proposition Verification**

The foregoing sections have detailed Northeast's corporate development, creation of competitive advantages and experience of internationalisation. This section discusses the relevance of the propositions to Northeast's experience.

**Proposition 1.** The competitive advantages of the Chinese MNEs are likely to be

influenced by the characteristics of the Chinese national diamond.

As the previous sections demonstrate, Northeast's primary competitive advantage in the manufacture of bulk drugs and pharmaceutical intermediates is indeed influenced by the industry structure and the role of the SPA. As the company is SPA's designated producer and exporter of bulk drugs and pharmaceutical intermediates, it had access to the SPA controlled domestic distribution channels and the state-owned exporting channel (ie, China National Medicine and Healthcare Import and Export Company). This has released Northeast from undertaking genuine marketing activities and enabled it to concentrate on the manufacturing, improve product quality and enlarge product range. Its economies of scale in the manufacture of synthetic drugs is also related to this factor. Apart from this influence, Northeast's continuous effort in product improvements and quality upgrading may be explained by the pressures from its demanding clients (major pharmaceutical MNEs), to which the company exports an increasing proportion (up to over 60 per cent by 1991) of its products.

**Proposition 2.** Chinese MNEs are likely to have technological advantage prior to their internationalisation.

Although Northeast's self assessment of competitive advantage is supportive to this proposition, namely, it has technological advantage against domestic rivals, the measurement of its technological advantage is not that straightforward.

The proportion of its technical employees (10 per cent) is not very impressive among pharmaceutical firms in China, and is only half of that of Baiyunshan (21 per cent, see previous chapter), but it has the second largest number of technicians and engineers, research scientists, after Baiyunshan. It can be further argued that while Baiyunshan has the largest number and highest ratio of technical staff, it may not be technologically stronger than Northeast in pharmaceutical industry, because it has spread its technical force into a large number of industries where it is involved, whereas Northeast has been concentrating its technical force in pharmaceutical industry. Anyhow, perhaps it is the quality, rather than simply the size, of technical employees that is more important in determining the technological advantage.

Northeast may have enjoyed economies of scale because it has the largest production capacity of synthetic drugs in China. As for advertising, its expenditure for advertising

and other promotional activities is negligible.

These indicators have suggested that Northeast's technological advantage is not as strong as that of Baiyunshan, but it has recorded the largest number of quality prizes won from central and provincial government. And its degree of internationalisation has been remarkably more significant than Baiyunshan. A comparative analysis of Baiyunshan and Northeast will be very interesting.

On the one hand, Baiyunshan has a lower degree of internationalisation than Northeast (the proportion of foreign sales is less than 10 per cent for Baiyunshan and over 60 per cent for Northeast, and the number of FDI projects is four for Baiyunshan and five for Northeast). On the other hand, the indicators of Baiyunshan's technological advantage is more obvious and overwhelming than that for Northeast. It has been shown in the last chapter that Baiyunshan has the highest proportion of non-operative employees, plus the largest R & D expenditure and advertising (and PR) expenditure among Chinese pharmaceutical firms. Why has Baiyunshan lagged so far from Northeast in terms of internationalisation ? Perhaps the different strategic orientation adopted by Northeast and Baiyunshan can shed some light on this puzzle.

Proposition 3. Chinese MNEs are likely to have experienced an incremental internationalisation process, namely from indirect exporting (and importing) to direct exporting, to the establishment of overseas sales office and eventually manufacturing.

Like Shougang and Baiyunshan, Northeast's experience has largely confirmed this proposition. But it is important that the firm's incremental internationalisation process should be interpreted in the changing environment inside China, especially the gaining of import and export autonomy by the firm at the era of economic reform and open-door policy. Similar to Shougang and Baiyunshan, Northeast's earliest exports dated back to the late 1960s when it lacked import and export autonomy. Its export activity was handled by the China National Medicine and Healthcare Import and Export Company. Northeast's indirect exporting, although accounting for as much as 40 per cent of its turnover (eg, in 1984), continued until 1987 when it was granted import and export autonomy and established its own import and export company.

Three overseas offices were set up (ie. in London, Frankfurt and Hong Kong) soon after Northeast gained foreign trade autonomy (with the establishment of its own

import and export department -- the Shendong Branch of the China National Medicine and Healthcare Import and Export Company), and they were followed by two joint ventures in the USA and Mauritius. This is typical of an incremental process of internationalisation.

Northeast's experience also seems to confirm the Network Approach in that its overseas distributor (in Hong Kong) and client (in the USA) initiated the two joint ventures in Mauritius and the USA respectively. While the Hong Kong distributor already had established marketing channels, its US client might prove extremely useful for Northeast to penetrate the final dosage forms markets in the USA. (Note that Northeast has already had established clients in the USA and Europe for its bulk drugs).

Proposition 4. Chinese MNEs have strategic plans for inter-nationalisation. But as their international involvement deepens, they are likely to have formulated and been pursuing an internationalisation strategy.

Northeast's experience does not provide direct verification of this proposition. On the one hand, its international market orientation has a rather long history of over 20 years. As the previous sections have revealed, Northeast was designated as a major exporter by the SPA in the late 1960s, thus early exporting from Northeast was hardly its strategic pursuit and choice. On the other hand, as exporting has accounted for an increasing and significant proportion of Northeast' turnover, and Northeast certainly could not afford failing to look strategically at export activity coordinated by the powerful SPA. Thus it is not clear whether or not Northeast had attached any strategic importance to its early exporting activity.

It has become clear, however, that in the 1980s internationalisation has been (gradually) accorded strategic priority at Northeast. Indeed, Northeast's internationalisation strategy can be identified although the company itself has never had a written strategic plan, as its management autonomy is still quite limited, and the company certainly does not want to offend the SPA. First of all, by 1984 exporting had accounted for 40 per cent of its turnover and thus merited strategic consideration. Secondly, gaining export autonomy in 1987 by Northeast further eased its international business activities, which made it possible for Northeast to export directly and undertake FDI overseas. Thirdly the attractions of and benefits brought



about by exporting have too much temptation for Northeast. Lastly, the demanding clients overseas have been the single most important factor pushing the company to improve product quality and enlarge product range, which in themselves give the firm a competitive advantage over its domestic rivals in the domestic market. Nonetheless, Northeast's inter-nationalisation strategy seems to continue to be export-based, instead of investing in overseas manufacturing.

**Proposition 5.** Internationalisation strategy will not only speed up the Chinese MNEs' internationalisation process, but also influence their motives and choice of foreign entry methods and modes.

Northeast's internationalisation strategy has indeed speeded up its international involvement, evidenced by the increase of the proportion of its exports from 40 per cent in 1984 to over 60 per cent in 1991. Moreover, as China still offers considerable cost advantage and capability for quality improvements, Northeast's internationalisation strategy is export-based instead of investing in overseas production, thus the focus of Northeast's corporate remains improving its export competitiveness in the international markets. Its investment in overseas marketing subsidiaries (in Hamburg, Hong Kong and London) aims clear to facilitate exports, while its investment in both US and Mauritius joint ventures can also be viewed as export facilitating because these two ventures need to import its pharmaceutical intermediates and bulk drugs for further processing.

**Proposition 6.** In terms of generic strategies, the Chinese MNEs are likely to compete based upon cost and price competitiveness in the international markets.

It is true, from Northeast's experience, that cost/price advantage is particularly important for the firm to penetrate overseas markets (bulk drugs in the first instance). Mr Sun, the manager in charge of Northeast's import and export department, argues that the bulk drugs produced by the firm are like standard commodities. For firms like Northeast which has large pharmaceutical MNEs as their clients, price concessions (sometimes substantial) are necessary because the MNEs are too powerful not only in terms of bargaining power but also their capability to produce the bulk drugs themselves. According to Porter's industry analysis model, this low price-based generic strategy is thus a result of bargaining power between the firm and its buyers.

To satisfy the needs of pharmaceutical MNEs, product quality is as important as price concessions, explained Mr Sun. The pressures for high quality come from both the nature of the pharmaceutical products and the desire of the MNEs to maintain their product differentiation and quality image. For instance, Northeast's MNEs clients used to send senior executives to inspect the processing equipment and quality control measures at Northeast in order to determine whether the firm had the capacity to produce high quality bulk drugs and raw materials.

Indeed, Northeast has exceeded the quality specifications of its clients, as Section 2 detailed. The firm has become so confident in its product quality that it believes that the high quality of its products (raw materials and bulk drugs) merits a higher price. This discrepancy between high quality and low price has been the major driving force in its determination to integrate forwards to the manufacturing of final dosage forms, despite of the high risks in marketing them.

Proposition 7. Imported and adapted technology is likely to be one of the main sources of technological advantage of the Chinese MNEs.

Northeast's experience of creating technological advantage through absorbing and improving imported technologies and equipment from developed countries seems very typical of Third World MNEs (Wells, 1979, 1984; Lall, 1986).

As Section 9.2. has shown, imported equipment and technologies are important for the creation of technological advantage at Northeast. These imported and improved equipment and technologies, used in production and quality control as well as research, are particularly important for Northeast to improve its product quality and range. However, it should be pointed that quality improvements at Northeast depend on not only these imported technologies and equipment but also its R & D efforts to upgrade continuously its product standards and quality management.

Proposition 8. The main motives for the Chinese firms to invest overseas are to gain access to host country markets or third markets, or seek advanced technology of the host country. Escaping home country government interference is also a likely reason behind their outward FDI.

As Northeast's strategy so far concentrates on exporting from China instead of

establishing overseas production network, gaining access to overseas markets is expected to be important than an MNE with extensive international manufacturing and marketing networks. Indeed, the motives of Northeast's three marketing subsidiaries in Hamburg, Hong Kong and London are clearly exports facilitating, even its two manufacturing joint ventures in Mauritius and the USA are also market seeking because the two ventures import pharmaceutical intermediates and bulk drugs from it. Thus this proposition is strongly supported by Northeast's evidence.

Proposition 9. Joint ventures are likely to be the main investment mode by the Chinese MNEs in their outward investment.

This proposition seems confirmed by Northeast's experience if its three overseas sales subsidiaries are not taken into account. In case of its US joint venture with Greenwich International, the main reason for joint venture instead of wholly owned subsidiary is that Northeast needs its American partner's expertise and channels in marketing of final dosage forms produced by the venture in the US market. Similarly, it has to rely on the Hong Kong partner to market pharmaceuticals (final dosage forms) produced by the Mauritius joint venture in the African market.

Proposition 10. Chinese MNEs are likely to enjoy network advantage arising from their ties with overseas Chinese communities and from their previous business relationships in their outward FDI.

Existing business relationship seems to be critical in the initiative and establishment of Northeast's joint venture with Greenwich International in the USA, while a Hong Kong pharmaceutical distributor has played an important role in establishment of its Mauritius joint venture. These network advantage is important in Northeast's two manufacturing FDI projects because they provide the critical expertise and channels in the marketing of final dosage forms the ventures produce, and Northeast itself lacks experience in marketing final dosage forms. As for the establishment of the three sales subsidiaries, however, the network advantage seems less evident although it can be argued that Northeast would probably have not set up these overseas offices without previous business relationships with local clients.

## 9.6.2 Motives for Internationalisation

The reasons for Northeast's internationalisation, however, may be very "Chinese". These include a desire to meet foreign exchange earning quotas assigned by the SPA and government planning organs, and a need to raise enough foreign exchange to import foreign technologies and equipment. Besides, a major exporter in China will receive preferential treatments from government like using infrastructure and utilities and thus enhance its bargaining power with government. In recent years, as Northeast has successfully imported and improved foreign advanced technologies and equipment, its production capability has been increased and thus domestic market has become relatively smaller for its products. Exporting has become thus desirable for it to diversify markets and reduce risk.

FDI is in a sense a way for Northeast to integrate its operations vertically into final dosage forms production.

## 9.6.3 Northeast with Baiyunshan: A Comparison

As pharmaceutical manufacturers, Northeast and Baiyunshan differ significantly in their corporate strategies and degree of internationalisation. A brief comparison of the differences between them will be useful.

a). Corporate Strategy. While Baiyunshan suffers little from government intervention and is responding to whatever profit opportunities arise by horizontal, vertical integration and diversification, Northeast has followed the intention of SPA whose version of "division of labour" has in effect limited Northeast's business scope to pharmaceutical industry. Only vertical integration (raw materials production and final dosage forms production) and horizontal integration (non-standard pharmaceutical machinery manufacturing) has occurred at Northeast. The result of the different business strategies pursued by Baiyunshan and Northeast is also distinctive. On the one hand, Baiyunshan has been very successful in overall development -- it has developed from a very small and insignificant pharmaceutical firm to the second largest drugs producer in China, and its turnover (thanks to its diversification) has more than double that of Northeast, the largest pharmaceutical firm in the country. On the other hand, Northeast has been more successful in penetrating foreign markets than

Baiyunshan. While Baiyunshan has less than 10% of its products exported, Northeast has exported more than 60% of its products to foreign markets.

2). R & D Concentration vis-a-vis Spreading. Related to business strategy, Northeast has been able to concentrate in one industry creating a strong technological advantage via absorbing and improving imported foreign technologies and equipment. This resulted in a steady upgrading of product quality which has become conformed with increasingly stringent international standards. Baiyunshan, on the other hand, has spread its technological force into a wide range of product and industrial sectors whose product quality may be as recognised as Northeast in international markets although it enjoys even better reputation than Northeast. However, this may be due to the different product segments Baiyunshan and Northeast are engaged in.

## 9.7 Conclusions

This chapter has detailed the creation of technological advantage by Northeast and its process of internationalisation. The five propositions have been discussed against Northeast's experience. Although all these five propositions have been supported by Northeast's experience, the interpretation should be cautious, especially in terms of Northeast's incremental process of internationalisation.

Although it can be said that Northeast has technological advantage such as a stronger technical force than the industry average, a comparison of the firm with Baiyunshan makes such a claim appear rather unconvincing. Yet Northeast has achieved a substantially higher degree of internationalisation than Baiyunshan. Such a paradox may have to be explained in terms of differential corporate strategies adopted by the two firms and SPA supports given to Northeast vis-a-vis virtually no such support for Baiyunshan. Another factor is that the two firms are in different segments of the markets -- while Northeast has been concentrating on the manufacture of raw materials and bulk drugs (hence cooperating instead of competing with large pharmaceutical MNEs in international markets), Baiyunshan's pharmaceutical products consist mainly of final dosage forms, which face fierce competition from large pharmaceutical MNEs in international markets. A particular strength Northeast has over Baiyunshan may lie in its ability to improve and upgrade its product quality and standards.

Northeast's experience has confirmed the notion that Chinese MNEs rely on cost/price competitiveness in international markets. However, the nature of its incremental internationalisation process should be viewed more cautiously. The next two case companies, Shenzhen Electronics Group (SEG) and Shenzhen Municipal Light Industrial Group (Municipal Light) will present more serious challenge to the notion of incremental internationalisation process.

## **CHAPTER 10 CASE STUDY**

### **-- SHENZHEN MUNICIPAL LIGHT INDUSTRIAL GROUP**

#### **10.1 Company Background**

The previous three chapters focused on the three "established" manufacturing firms (ie, set up prior to the era of economic reform and open door policy in 1979) and their experiences of creating competitive advantage, the evolution of their corporate strategy and their internationalisation. This chapter and the next, however, will instead demonstrate the experiences of two "newly" established (ie, after 1980) and external market oriented companies -- Shenzhen Municipal Light Industrial Group and Shenzhen Electronics Group respectively.

Shenzhen Municipal Light Industrial Group (hereafter referred to as Municipal Light in brief) is a large conglomerate based in Shenzhen, the most developed of the five Special Economic Zones (SEZs) in China. It is concentrated predominantly in light industry which consists of a large range of product sectors including bicycles, plywood, beer and foodstuff, printing and packaging products, paper & printing ink, insulating glass & zinc-aluminium alloy, enamelware, travelling products, plastic & bamboo products, domestic electrical appliances, batteries, handcrafts, garments and slippers, computerised knitted labels, and watches and clocks. Real estate development and tourism have been two recent additions to its business portfolio.

The group was formed in 1984 through the merger of eight small firms, which together had a total sales of less than Renminbi 10 million (US\$2.7 million) and exports of US\$0.44 million. It has grown rapidly to become a large conglomerate and one of the 20 largest exporters in China. By 1991 the group's domestic operations consisted of 23 wholly-owned companies, 46 joint ventures with foreign partners, and 27 joint ventures with indigenous partners. In terms of overseas direct investments, the group has set up 12 subsidiaries and joint ventures in the USA, Canada, France, Thailand, Australia, Hong Kong, and the Philippines. Total sales in 1991 reached RMB 1.4 billion (US\$290 million) while exports amounted US\$208 million, accounting for 72% of its total sales (see Table 10.1). Municipal Light's ratio of exports to its total sales has become the highest among the largest industrial

conglomerates in China.

Table 10.1 Municipal Light's Corporate Performance  
(1987 -- 91)

Year	Turnover (RMB m)	Exports RMB m (US\$ m)	Exports as % of Turnover
1987	241.38	146.90 (39.40)	60.8
1988	386.45	250.44 (75.19)	64.5
1989	423.59	274.68 (92.97)	64.8
1990	750.00	540.00 (149.58)	72.0
1991	1,400.00	1,008.00 (208.00)	72.0

Source: Yang (1992); data provided by Municipal Light's senior economist, Mrs Shang

## 10.2 Municipal Light's Initial Corporate Strategy

When Municipal Light was established in 1984, it had neither technological nor managerial strengths. The only advantage it had over other indigenous competitors was its location in Shenzhen SEZ which borders Hong Kong and where policies were more flexible and liberal. The top management decided to develop the company into an international market oriented one through the strategy of introducing foreign capital, technologies and management from foreign firms and associating with other Chinese companies. The group has been implementing a triple-pronged export-oriented strategy:

- a). Corporate growth and expansion should be achieved through increasing exports instead of domestic sales. All its subsidiaries, joint ventures must aim at maximising exports. In case of its joint ventures with foreign partners, the foreign partners are expected to provide international marketing channels to export all or most of the products from the venture(s);
- b). It is vital to introduce (import) technologies and equipment from abroad.



However, technologies imported must be advanced and appropriate so that the company's products will have strong competitiveness and adaptability;

c). All the investment projects must be cost-effective in the short-term.

In the past seven years, the group has imported foreign capital, advanced technologies and equipment through joint venture arrangements with foreign partners in China. It has also set up many joint ventures with indigenous partners. By 1991 these foreign investors contributed a total of US\$42.76 million while inland Chinese partners RMB 63.3 million (equivalent to US\$13.41 million), plus Municipal Light's own capital of RMB 39.85 million (US\$8.443) and US\$11.93 million. The group had imported 55 advanced production lines, consisting of 2100 sets and pieces of technologically advanced equipment, which fundamentally changed the group's competitiveness in international markets. Among Municipal Light's 78 member companies (as of 1990) in China, 7 were ranked as technologically advanced by national authorities. The product range increased from four in 1984 to more than 50 by 1991. It exported 32 products to more than 20 countries including the USA, the UK, France, Germany, Japan, Australia and Hong Kong.

Bicycles have been the most important business for Municipal Light and account for a large part of the group's total exports (see Table 10.2). China Bicycles (Holdings) Co. Ltd was set up in 1983 by one of the group's founding firms with an investment of RMB 29 million as a subcontractor for bicycles manufacturing for a Hong Kong distributor -- Hong Kong Link Bicycles Ltd. Later on, Municipal Light and its Hong Kong partner, changed their cooperation from subcontracting into a contractual joint venture. In 1987, Schwinn Bicycles Co. Ltd of the USA took an interest in the joint venture and became a third partner. With advanced technology and equipment imported from the USA, Japan and the Netherlands, and using Schwinn's brand name and international marketing channels, China Bicycles' production and sales increased significantly. Bicycle production increased from 43,000 in 1985 to 1.07 million in 1990 while export grew from 24,000 in 1985 to 1.044 million in 1990. By 1990, China Bicycles had become China's largest bicycle exporter, accounting for one third of China's total exports of bicycles. It was the second largest bicycle manufacturer and exporter in the world. Target for 1992 is output of 2 million bicycles and export of 1.85 million bicycles to earn US\$322 million (Beijing Review 1992).

**Table 10.2 Municipal Light's Export Performance  
(1983--91, US\$ million)**

Year	Total Exports (US\$.m)	Bicycle Exports	
		Value (US\$ m)	As % of total exports
1984	0.46	0	0
1985	3.26	1.34	41.1
1986	22.01	3.23	14.7
1987	39.49	20.05	50.8
1988	75.19	33.00	43.9
1989	92.97	61.32	66.0
1990	149.58	100.00	66.9
1991	208.05	n.a.	n.a.
1992*	400.00	322.00	80.0

NB: \* Figures for 1992 are projections.

Sources: Notes of Interview with Mrs Shang Shuhua, Senior Economist Shenzhen Municipal Light; Beijing Review (1992)

Following such huge success, the three parties to the joint venture decided to reinvest its three years' profits into the expansion of bicycle production capability. A second bicycle factory, China Bicycles (Longhua) Co. Ltd, is now under construction and scheduled to open by the end of 1992. The factory aims to produce 2.5 million bicycles and export 2.3 million of them by 1993. When this second factory becomes operational, then Municipal Light will become the largest bicycle manufacturer and exporter in the world. At present China Bicycles (Holdings) Co. Ltd is the flagship operation for the whole Municipal Light group.

### **10.3 The Sources of Technological Advantage**

#### **10.3.1 Municipal Light's Generic Strategy**

Municipal Light's main export markets are Hong Kong, West Europe, North America, and Southeast Asia. Mr Yang Fenbo, the Director for Business Development within Municipal Light, suggests that in these markets Municipal Light's market positional advantage is very significant because while quality is not a problem, cost advantage for Municipal Light is very strong over multinationals or local firms. The main thrust lies in Municipal Light's competitive advantage in technology that improves its product quality and range while increasing its production efficiency (productivity) so as to reduce unit costs.

#### **10.3.2 Imported Technology & Equipment**

Mr Yang Fenbo (director for business development) confesses that as group of companies with such diverse products, Municipal Light does not necessarily have cutting edge advantage in each of its businesses, but for its core products (eg. bicycles, enamelware), he is fully confident of the group's technological advantage, which results from its continuous importation and improvement of foreign advanced technologies and equipment through joint venture arrangements with domestic and foreign firms. As the example of China Bicycles Co. Ltd shows, joint ventures, especially those with foreign firms, do not only bring advanced equipment and technologies to Municipal Light but also vital international marketing channels.

Another example of joint venture arrangements is enamelware processing. Though enamelware has been a traditional Chinese export product, it is mainly exported to Third World countries at very low prices because of its low quality due to backward equipment and outdated processing technologies. On the other hand, as enamelware processing is labour-intensive and developed countries are losing their competitiveness in enamelware because of high labour costs, a market niche has emerged in developed country markets.

Municipal Light's enamelware processing technologies were significantly upgraded by its joint venture with Hong Kong Lucky Enamelware Co. Ltd and a Chinese partner, Xi'an Renmin Enamelware Factory. Shenzhen Enamelware Enterprise Co. Ltd, one of Municipal Light's many joint ventures, has the most advanced light-diesel radiation furnace imported from Ferro Co. Ltd of the USA and has adopted low-temperature slow-baking and decal decoration technology. The venture is able to produce over 1,000 kinds and specifications of enamel products. Its enamelware products are confirmed by the Hong Kong Testing Centre to have reached German and US quality standards and the venture is the only firm in China to receive such quality certificates. As a result of the quality recognition, more than 80% of the venture's output is exported to Europe and the USA as well as Southeast Asia. In 1991 this venture exported US\$1.2 million worth enamelware products. The venture has thus become the only Chinese exporter of high-quality enamelware and has been awarded a quality prize by the Light Industry Ministry of China.

In many other product sectors, Municipal Light also imported technologies and equipment from developed countries so that its technological advantage has been significantly improved. Table 10.3 lists some of the member companies of Municipal Light that use imported technologies and equipment.

### 10.3.3 Quality Improvements and Product Range Widening

Mr Yang, director for business development, further suggests that through importing and absorbing, even further improving foreign advanced technologies and equipment, Municipal Light is able to upgrade its products in terms of quality and competitiveness and enlarge its product range. As Municipal Light's production and exports of bicycles demonstrate, with improved technological advantage and cost/price competitiveness, plus access to foreign partners' international marketing channels, Municipal Light has become able to export an increasingly number of products to many countries. It now has 14 joint ventures that each exports more than US\$1 million a year (Yang, 1991). By 1991, Municipal Light was able to produce more than 50 products (with 500 specifications), and 72% of its output was exported to overseas countries.

**Table 10.3 Municipal Light's Member Companies Using  
Imported Technologies and Equipment**

Name of Company	Product(s)	Sources of Tech. & Equip.
China Bicycles (Holding) Co. Ltd	Bicycles	USA, Japan, Netherlands
Shenzhen Everbright Timber Industrial Co. Ltd	Plywood	USA, Germany
Shenzhen Brewery Co. Ltd	Beer	Germany
Shenzhen Agar-Agar Industrial Co. Ltd	Food & drink	USA, Japan
Shenzhen Goldstar Printing Co. Ltd	Food packaging	Germany
Shenzhen Goodyear Printing & Packaging Co. Ltd	Printing & packaging	Japan, Germany
Shenzhen DIC Co. Ltd	Paper	Japan, Switzerland
Shenzhen Paper Co. Ltd	Paper	USA
Shenzhen Guanghua Insulating Glass Co. Ltd	Insulating glass	Austria
Shenzhen Silverpearl Plastic Products Co. Ltd	Plastic & bamboo products	Japan
Shenzhen Enamelware Enterprise Co. Ltd	Enamelware	USA
Shenzhen Goldenbell Battery Co. Ltd	Home appliance	USA
Shenzhen Posewell Computer Weaving Co.	Label weaving	Germany
Shenzhen Anmiz Watch & Clock	watch, clock	Japan

Source: Extracted from Municipal Light Introduction (1991)

### **10.3.4 Product Design and New Product Development**

Although light industry is not R & D intensive, Municipal Light emphasises the importance of product design, style and new product development according to the changes in market demands. Municipal Light's flexible production technologies make it possible for the company to meet small-volume orders from customers.

Ms Shang Suhua, the senior economist of the group, compares bicycle production in Municipal Light and elsewhere in China. Whereas other well-established Chinese bicycle manufacturers (eg, Shanghai Bicycles Group and Tianjin Bicycles Factory) can only produce bicycles at large volumes in one colour and style, China Bicycles can manufacture them at a volume as small as customers demand without much trouble. She suggests that China Bicycles' flexibility is the result of not only its advanced technologies and equipment imported from USA, Japan, but more importantly of its market orientation. Joint ventures with foreign firms' participation, she suggests, are far more market oriented than most of the Chinese SOEs. Municipal Light's quality improvement and responsiveness to market demands has paid dividends. For example, while other Chinese producers can only export their bicycles at some US\$50-60 at most, China Bicycles' products can command a price of US\$150-180.

## **10.4 The Evolution of Municipal Light's Corporate Strategy**

### **10.4.1 SWOT Analysis**

The exports-oriented corporate development strategy pursued by Municipal Light has been no doubt a great success. However, further internationalisation through basically exports faces increasing barriers, which calls for a change of corporate strategy in Municipal Light.

The further opening up of China has brought more opportunities to Municipal Light. Because of its past success, Municipal Light has become recognised by many overseas companies, especially those in Hong Kong, as a favourable partner in various forms of cooperation, including joint venture arrangements in China. And low costs and availability of land and labour in China are attractive to foreign firms in light industry,

which is basically labour-intensive. Furthermore, the proximity of Shenzhen SEZ to Hong Kong makes exports-oriented operations much easier than before as infrastructure in Shenzhen SEZ has been improved. Thus more opportunities emerge for Municipal Light to seek foreign partners to set up operations (via joint venture arrangements) in Shenzhen, the location of its headquarters.

In the international markets where most of Municipal Light's products are sold, although the group has not yet established its own brand, its products have nonetheless penetrated into many developed country markets. Indeed, Municipal Light's products are usually targeted at middle to upper middle grade (quality) market segments of industrial countries. With its cost advantages and thus price competitiveness, as well as its foreign partners' distribution channels, Municipal Light has positioned very well in the international markets.

However, as protectionism is on the rise in many developed countries, such as the USA and EEC, it is widely recognised as very important for China to diversify its exports from these developed countries as much and quick as possible. My Yang Fenbo, the director for business development, has been especially concerned about the protectionism in these countries, because the bulk of Municipal Light's export products is currently destined to North America and the EEC. In the USA, China's MFN status rhetoric and anti-dumping charges will have adverse effect on the competitiveness of China's products (including those re-exported via Hong Kong) in the market; and the EEC commission has expressed several times its intention to impose anti-dumping duties on some products (eg, bicycles) imported from China. (In the summer of 1993, the EEC finally announced the imposition of a 30.6 per cent of anti-dumping duties on bicycles imported from China) (Financial Times 1993, September, 9).

Thanks to the location of Municipal Light in Shenzhen SEZ where state-owned firms enjoy much greater management autonomy than their counterparts in inland China, Municipal Light has created its own competitive advantages in economies of scope and scale (eg, in bicycles), access to international marketing networks controlled by its foreign partners, technological advantages and quality reputation. Moreover, the government has been very supportive of its externally oriented corporate development strategy.

On the other hand, Municipal Light has suffered from lack of strong design capabilities, its own international distribution channels and brand recognition in the international markets.

A SWOT analysis is summarised in Table 10.4.

Table 10.4. A SWOT Analysis for Municipal Light

<b>STRENGTHS</b>	<b>WEAKNESSES</b>
<ol style="list-style-type: none"> <li>1. Management autonomy;</li> <li>2. Easy access to international capital and technology;</li> <li>3. Economies of scope, and scale (in bicycles);</li> <li>4. Advanced technology and equipment imported from overseas;</li> <li>5. Quality reputation.</li> </ol>	<ol style="list-style-type: none"> <li>1. Lack of strong design capability;</li> <li>2. Reliance on foreign partners and distributors in international marketing;</li> <li>3. Lack of internationally experienced managerial personnel;</li> <li>4. Lack of brand recognition.</li> </ol>
<b>OPPORTUNITIES</b>	<b>THREATS</b>
<ol style="list-style-type: none"> <li>1. Market niches (middle to upper grade, low price) in many light product markets;</li> <li>2. Increasing interest of foreign firms to invest in China</li> </ol>	<ol style="list-style-type: none"> <li>1. Protectionism in some countries;</li> <li>2. Increasing competition in international markets</li> </ol>

Source: Compiled from interviews

#### 10.4.2 Municipal Light's New Corporate Strategy

Municipal Light felt compelled to take proactive strategy to achieve its internationalisation ambition. In the late 1990 and early 1991, the management at Municipal Light formulated a new corporate strategy, aiming at becoming a fully



stretched MNE instead of an exporter of light products from China (see Table 10.5).

Table 10.5 Municipal Light's New Corporate Strategy

Aim	Becoming a fully spread MNE
Measure	Internationalisation through exports and foreign production
Action (domestic)	To upgrade technological capabilities and products of existing firms in China, - so as to increase their competitiveness in the international markets.
Action (overseas)	FDI in manufacturing and marketing facilities overseas so as to become a competitive MNE
Implementation (domestic)	Establishment of a production base of bicycle components and parts, to increase the indigenisation of bicycle components and parts production.
Implementation (overseas)	FDI in Canada, the USA, and Southeast Asia, etc.

Source: Yang (1992), interview data.

## 10.5 Municipal Light's Internationalisation

### 10.5.1 Initial Export-oriented Strategy and Exporting

The international orientation of Municipal Light originated from its initial export-oriented strategy at the onset. In other words, Municipal Light was international market oriented at the outset. Relying on the locational advantage of Shenzhen SEZ where the open-door policy was pioneered and being near Hong Kong, Municipal Light was able to attract a large number of foreign and inland Chinese firms to set up dozens of joint ventures in the SEZ. While foreign firms brought hard currencies and advanced technologies, equipment and international marketing channels, inland Chinese firms provide a large production base for Municipal Light's export oriented strategy. The essence of Municipal Light's success in internationalising its activities is its ability to draw upon the strengths of its domestic and international partners to form its own ownership-specific advantages in technology and cost, which make Municipal

Light a fast and successful entrant into international markets. As a result, it is able to export an increasing number of products, becoming one of the largest exporters in China.

#### 10.5.2 From Exporting to Foreign Direct Investments

Municipal Light's exports consist of three parts: export from its joint ventures with foreign investors in China, its wholly-owned subsidiaries in China and its joint ventures with inland Chinese firms. Mr Lin Zhaowei, Deputy Director of Business Management Department, affirms that while Municipal Light's foreign partners to their joint ventures in China have played an important (albeit decreasing) role in the exports of products from their joint ventures, it has to rely on its own efforts to export the products of its own subsidiaries and its joint ventures with indigenous companies. It is the export of products of the latter two types of member companies that pushed Municipal Light to establish its own international marketing networks, because it has become too costly to rely on foreign distributors. Mr Lin suggests that commissions paid to foreign distributors have become very significant in terms of total amount and also Municipal light might lose millions of US dollars worth of export business because market information is controlled by outside distributors who might place orders to competitors.

Another reason for an establishment in overseas countries is protectionism that prevails in some export-destination countries. Mr Yang Fenbo, director for business development, gives an example of the EEC anti-dumping charges against bicycle imports from China. To overcome protectionist discrimination by host countries, Municipal Light feels it more necessary to set up local manufacturing establishment in the host countries and thus FDI in some host countries has become imperative.

Municipal Light makes it very clear that its FDI is undertaken to further strengthen its competitive advantage and develop its international marketing capability so that the group will emerge as a larger and stronger multinational enterprise. The group states explicitly that its overseas investments in both marketing and manufacturing should make full use of the group's competitive advantage and the locational advantage of the host countries.

Mr Yang Fenbo, the Director for Business Development summarises the motives for

Municipal Light's FDI as to: avoiding "middlemen's exploitation", getting rid of their control of product marketing to end customers and market information, shortening delivery time and increasing export profitability as well as avoiding some protectionist measures used by host countries against importing.

#### 10.4.3 FDI Projects

Since late 1988, the group has sent many delegates to undertake investment feasibility studies to West Europe, North America, Australia, Southeast Asia, Brazil and the former Soviet Union. Since then the company had set up 14 overseas subsidiaries and joint ventures in several countries by 1991.

a). In Canada, Municipal Light has two subsidiaries. Canwah Enterprise Corp. (Canada) was set up in 1990 to process further semi-finished enamelware from the parent company for North American market. This venture has enabled the group to take the advantage of the free trade agreement reached between Canada and the USA (and now Mexico too). However, Mr Yang admits that so far the venture exports a marginal proportion of output to the USA. Another subsidiary, K. S. D. Engineering (Canada) Co. Ltd, was set up by Municipal Light to manufacture PE plastic boats, buoy & pipe and plastic synthetic products for local market. As the venture uses state-of-the-art technologies, its PE plastic boats and other products made not only are cheaper but have the same or even higher quality than glass fibre reinforced plastic products.

b). In the USA, Municipal Light has two subsidiaries. Xinghua Food Ind. Co. Ltd was set up in 1989 in New York to manufacture fruit jelly. The firm uses the equipment and technologies originally imported from Japan but improved by Municipal Light. Furthermore, Municipal Light has signed two contracts to license its improved fruit jelly processing technologies and sell equipment to Russian and Australian firms. Municipal Light in 1990 acquired for US\$15 million W.S.I. Co. Ltd, the largest importer and distributor of bicycles in the West Coast of the USA. The company also has certain product design and development capability. This acquisition provides Municipal Light with a stable distribution channel in the USA for Municipal Light's bicycles manufactured in China.

c). In France, Shenfa (Europe) S.A. was set up in 1991 to manufacture commercial freezing equipment. Assisted by the Shenzhen Municipal government, Municipal Light concluded an investment contract after more than one year's negotiations with several French firms and feasibility studies. The investment not only manufactures commercial refrigerators for the EEC market but also serves as a trading arm of Municipal Light within the European Single Market where goods, labour, capital are freely mobile among member countries of the EC. The establishment of joint venture enables Municipal Light to take non-tariff advantage of the EC and improve Municipal Light's competitive advantage in the market.

d). In Southeast Asia, Municipal Light has one joint venture in Thailand with a local Chinese firm to develop real estate and contract civil engineering projects as well as engage in trading. It has similar arrangement in the Philippines and Australia.

e). In Hong Kong, it has three joint ventures. Shenzhen China Bicycles Co Ltd is an exporting arm of Municipal Light's bicycles. Similarly, Shen Yip Ind. & Trading (Hong Kong) Co. Ltd mainly deals with Municipal Light's import and export business except bicycles. Posewell Computer Label Weaving (Hong Kong) is a joint venture that manufactures trademarks and labels for Municipal Light and other companies.

e). The most recent overseas direct investment by Municipal Light is a joint venture in Lancashire, UK, with Virnas International Co. Ltd to manufacture and market fruit jelly in the UK.

Municipal Light's existing overseas direct investment projects are summarised in Table 10.6.

Table 10.6. Municipal Light's Overseas Investments  
(as of May 1992)

Host country	FDI Project	Project Value	Equity Share	Date of Establishment	Nature of business
Hong Kong	Shenzhen China Bicycles (HK) Co. Ltd	HK\$14 mn	40%	1986	Exporting bicycles from Municipal Light
	Posewell Computer Weaving (HK) Co. Ltd	HK20 mn	75%	1989	Producing various kinds of trademark labels
	Shen Yip Industrial & Trading (HK) Co. Ltd	HK10	100%	1986	Importing & exporting for Municipal Light

Canada	K. S. & D. Engineering (Canada) Co. Ltd	US\$5.2 mn	60%	1989	Manufacturing & marketing PE plastic boats, buoy & pipe, plastic synthetic products
	Canwah International Enterprise Corp (Canada) Ltd.	US\$2.7 mn	100%	1991	Processing & marketing of enamelware, im/exporting trade
USA	Xinhua Food Industrial Co. Ltd	US\$1.8 mn	100%	1990	Processing & marketing SAA fruit jelly for USA market
	W. S. I. Co. Ltd	US\$15 mn	100%	1991	100% acquired distributor of bicycles R & D and product design (bicycles)
Thailand	C. C. A. Engineering Technology (Thailand) Co. Ltd	HK\$8.5 mn	50%	1989	Real estate development contracting of civil engineering projects; im/export trade
France	Shenfa (Europe) S.A.	US\$1.4 mn	70%	1992	Manufacturing & marketing of commercial refrigerating equipment. im/export trade
Philippines	China Jianda Development (Philippines) Co. Ltd	HK\$2.5	75%	1991	Real estate development trading in light industrial products
Australia	Shenzhen Enterprise (Australia) Co. Ltd	US\$1.8 mn	50%	1991	Real estate development im/export trading
UK	Vimas-Shenzhen Enterprise Co. Ltd	US\$2.2	55%	1992	Processing & marketing fruit jelly

Source: Author

## 10.6 Proposition Verification

The foregoing sections have detailed the formation and development of Municipal Light and its creation of competitive advantage as well as its experience of internationalisation. This section will expose the ten propositions to the experience of Municipal Light.

**Proposition 1.** The Chinese national diamond will influence the creation and nature of the competitive advantages of the Chinese MNEs.

Although the inception and development of Shenzhen Municipal Light is remarkably different from that of the previous three case companies (ie, Shougang, Baiyunshan and Northeast Pharmaceutical), the creation and nature of Shenzhen Municipal Light's competitive advantages still bear much the impact of the Chinese national diamond and its evolution. While much of the company's competitive advantages are due to its joint ventures with overseas partners, who have contributed to the creation of its technological advantage and providing it marketing channels in the international markets, the cost advantages of China have been perhaps the single most important incentives for foreign firms to invest there in the first instance. The treatment of management autonomy as competitive advantage by the company further demonstrates the characteristics of the Chinese economic system -- namely the inequality among the SOEs as regards their independence and freedom in managing and operating. Similarly, that the company views its location in Shenzhen SEZ as an important competitive advantage further suggests that unequal treatment of firms located in different regions by the Chinese government.

Municipal Light's cost advantage in the international markets is also mainly due to China's cost advantages in labour, land, etc. Moreover, the large number of importing foreign technologies and equipment by Municipal Light (see Table 10.3.) in creating its own technological advantage has reflected the lack of supplies of advanced machinery and equipment made by indigenous firms, a common feature amongst developing nations that have invested overseas (Lall, 1980, 1982; Wells, 1979, 1980, 1983, 1983).

**Proposition 2.** Chinese MNEs are likely to have technological advantage prior to their outward FDI.

In light of Municipal Light's existing manufacturing FDI, this proposition is only partially confirmed. Out of Municipal light's six manufacturing subsidiaries overseas, only three of them (S.K. & D. Engineering in Canada, Xinhua Fruit Food Industrial Co. in the USA and Vernas-Shenzhen Enterprise Ltd in the UK) can claim to have technological advantage over the local competitors. While the first one (S. K. & D. Engineering) uses state-of-the-art technology in the manufacture of plastic boats and

other products, the latter two ventures use processing technologies originally imported from Japan but improved by Municipal Light. Municipal Light's other three overseas manufacturing establishments (ie, Shenfa (Europe) in France, Posewell in Hong Kong and Canwah International in Canada) also use advanced technologies and equipment made by firms from Japan, the USA and Germany respectively.

**R & D intensity:** As the previous sections reveal, Municipal Light hardly undertakes R & D because the light industry in which the group is engaged is not as technologically intensive as many other industries such as electronics, machinery, etc. Municipal Light has no formal R & D budget, nor has it a research and development unit (at group level). As Mr Yang, the Director for Business Development explains, the most important R & D work for the group is product design and improvements, which are undertaken by the individual subsidiary or joint venture concerned. With such a diverse range of products, he believes that a centralised research and development unit for the group is not necessary. As a result, the group has not collected data on total expenditure on R & D by its member firms. Additionally, because the group has many overseas and domestic partners to its joint ventures, these partners might have contributed their knowledge (arising from their research and development) to the group in the form of product design, quality improvements, etc, but it is difficult to assess the scale of such contribution.

**Advertising intensity:** Although many of Municipal Light's products are consumer products (eg, fruity jelly, enamelware, clocks), the group does not have a big advertising expenditure.

**The Proportion of nonoperative workers:** Light industry is labour intensive rather than technology intensive. But the group has probably the highest proportion of non-operative workers in its major product lines -- bicycles (medium to high grade), quality printing ink, insulating glass, quartz clocks, etc. The 52 advanced production lines, and 2100 sets and pieces of state-of-art equipment (imported from developed countries, by 1991) should have reduced the group's operative workers to minimum amongst firms in the light industry in China. However, no specific comparable data are available for such assessment.

**Economies of scale:** it is impossible to ascertain the economies of scale for Municipal Light because of the diverse products it produces. However, for its major products,

assessment is possible. For instance, it has the third largest bicycle capacity (and the largest capacity of medium and high grade bicycle manufacture) in China. When its China Bicycles (Longhua Branch) plant opens (scheduled to be operative by 1992), it will become the largest bicycle producer in the world. It is also one of the five major manufacturers of enamelware in China.

**Proposition 3.** Chinese MNEs are likely to have experienced an incremental process of internationalisation, namely from indirect exporting to direct exporting, to the establishment of overseas sales offices and eventually manufacturing facilities.

Similar to SEG, Municipal Light's internationalisation does not result from the company's sequential evolution from a domestic producer to exporter to the overseas markets. Thus Municipal Light's experience rejects this proposition. As the previous sections have revealed, the group has been exporting from the outset, omitting both the non-exporting and indirect exporting stages.

Contrary to the incremental internationalisation experiences of the other three established manufacturing firms (Shougang, Baiyunshan and Northeast), Municipal Light had import and export autonomy when it was set up in 1984, making it institutionally unnecessary for the group to export (and import) through other state-owned import and export companies. Thus it is not surprising that Municipal Light exported in 1987 over 60 per cent of its products within three years of its establishment. Moreover, it set up a sales office in Hong Kong in 1984, the same when the group was set up. Moreover, it also leapfrogged to set up a manufacturing subsidiary in Canada four years after the inception of the group.

**Proposition 4.** Chinese MNEs have not initial strategic plan for internationalisation. But as their international involvement deepens, they are likely to formulate an international strategy.

This proposition is denied by Municipal Light's experience as it had an export-oriented corporate strategy from the onset, and subsequent development only reflects its strategic evolution from export-based international strategy to multi-domestic international strategy focusing on both exports and outward FDI.

From a corporate strategy perspective, Municipal Light (and SEG, the next case



company) is in sharp contrast to the previously three case companies (Shougang, Baiyunshan and Northeast Pharmaceutical). The previous three case companies, as all other SOEs established before 1980s, could not have an international orientation in their initial corporate strategies because they had neither sufficient management autonomy to decide their strategies and strategic orientation nor direct access to the international markets due to the compulsory use of the 12 FTCs as their intermediaries in their dealings with the international markets, similar to the situation in the former socialist countries in Eastern Europe (Fantara & Collins, 1990, Huang et al, 1990; also see Chapter 4). The export-oriented firms like Municipal Light only came into being during the era of economic reforms and open-door policy. An isolated and rigidly centrally planned economy would not have allowed this kind of SOEs to emerge at all.

Proposition 5. International strategy will not only speed up the internationalisation process of the Chinese MNEs but also influence the objectives and choice of methods and modes of their foreign entry.

As Municipal Light had an international strategy from the onset, this paragraph will discuss the impact of the evolution of Municipal Light's international strategy from exports-based to multi-domestic operations upon its subsequent inter-nationalisation process. In terms of exports, Municipal Light did enjoy a sharp increase of proportion of exports in total sales from 64 per cent in 1989 to 72 per cent in 1990, the first year when it started implementing the new international strategy. Under its initial exports-based international strategy, the company manufactured and exported products from China, with the support of two overseas marketing facilities in Hong Kong. It set up only one manufacturing subsidiary (Posewell Computer Weaving Co. Ltd in Hong Kong), which produces various kinds of trademark labels for the member companies of the Group. Since late 1989 and early 1990, Municipal Light formulated a multi-domestic international strategy, focusing both on exports from China and investment in overseas manufacturing facilities. Since then, it had set up six overseas manufacturing establishments in Canada, the USA, France and the UK by 1991. At the same time, it had established one joint venture each in Australia, Thailand and the Philippines to develop properties there. Thus the new international strategy does have speeded up Municipal Light's subsequent internationalisation and emphasised on both exports and outward FDI instead of exports only.

**Proposition 6.** In terms of generic strategies, the Chinese MNEs are likely to compete mainly based on cost and thus price competitiveness instead of product differentiation in the international markets.

Although it seems true that Municipal Light generally relies on cost/price advantage to compete in the international markets, the improved product quality and enlarged product range are perhaps more important for its increasing competitiveness in these markets.

In addition, access to international marketing channels of Municipal Light's foreign partners has also contributed to the increase of exports in its total sales.

**Proposition 7.** Chinese firms have modified and improved technology and equipment imported from developed countries in order to create their own technological advantage.

This proposition is particularly relevant to and firmly confirmed by the experience of Municipal Light. From the background section, it has been revealed that Municipal Light had inherited the eight firms which did not have any technological strength. Table 10.3. has listed Municipal Light's subsidiaries and joint ventures in China that use imported equipment and technologies from other countries. Without those improved technologies and equipment imported from overseas, Municipal Light would not have emerged as such as aggressive exporter.

What is interesting is that joint ventures are so extensively used by Municipal Light to transfer and digest imported technologies and equipment from advanced countries. Municipal Light's technological advantage, although no manifested in the measurements such as high proportion of non-operative workers, large R & D expenditure, high advertising intensity, has resulted in a widening range of products, an increasing number of quality prizes, an impressive improvements of product quality. And the effect this technology advantage is that the group has become the largest exporter of light industry products in China and been continuing exporting impressively. It has penetrated a growing number of overseas markets.

**Proposition 8.** The main objectives for the Chinese firms to invest overseas are to gain access to host country markets or third country markets or seek advanced

technologies of the host country. Escaping home country government intervention is also an important likely reason behind their overseas investment.

As Municipal Light has been pursuing international strategies from its onset, it is of course critical for the group to have access to the overseas markets. As far as exports from China are concerned, Municipal Light has no particular worry about access to overseas markets because not only its joint venture partners usually provide their marketing channels in the international markets, but also the group had already established two sales offices in Hong Kong to facilitate its exports to other countries. Its first manufacturing investment in Posewell Computer Weaving Co. in Hong Kong is not market seeking. Instead, its products are sold to the member companies of the group located in China.

Municipal Light's subsequent investments in overseas manufacturing and real estate development are market seeking. Shenfa (Europe) Industrial in France is a particular case of Municipal Light's market seeking FDI as the group had original intention of using the venture to penetrate the EEC single market. Another case of market seeking investment by Municipal Light is its acquisition of W. S. I. Co. of the USA, a distributor of bicycles. This is clear sign of Municipal Light's attempt to further penetrate the US bicycles market.

There is no evidence to suggest the Municipal Light's outward FDI is undertaken to escape home government intervention. This may be due to the loose control of the Chinese government over the activities of SOEs located in the Shenzhen SEZ and because that most of Municipal Light's member firms are joint ventures in China with foreign partners, where the Chinese government barely intervenes.

Proposition 9. Joint ventures are likely to be the main mode of foreign direct investment by the Chinese MNEs.

overall this proposition holds for Municipal Light, because among its 14 overseas investment projects in marketing, manufacturing and real estate development, 10 of them are joint ventures. Moreover, two of its four manufacturing establishments are joint venture arrangements, while all the three real estate development investments are joint ventures with local Chinese.

**Proposition 10.** The Chinese MNEs are likely to have network advantages arising from their ethnical and cultural ties with overseas Chinese communities and from their existing business relationships with overseas clients in their internationalisation.

This proposition is confirmed by Municipal Light's experience. Municipal Light's exports have been largely relying upon the marketing networks of its foreign partners to the joint ventures in China manufacturing bicycles and other products. As regards outward FDI, overseas Chinese are particularly important in the three Hong Kong investments, three real estate development investments (each one in Australia, the Philippines and Thailand), while local business partners have played an important role in the establishment of K. S. & D. Engineering in Canada and Virnas-Shenzhen Enterprise in the UK. Thus network advantage has been one of the most important factors behind the success of Municipal Light's international strategies.

## **10.7 Conclusions**

From the foregoing sections the following, Municipal Light's experience can be summarised as follows:

### **a). Sources of Competitive Advantage**

Municipal Light's pursuit of internationalisation strategy underlines its confidence in its own competitive advantage primarily in technologies. Although its technological advantage is mainly derived from technologies and equipment imported from developed countries through joint venture arrangements with foreign partners, it has not only mastered but also improved them successfully. As a result, it has improved its product quality and increased its product range and variety while reducing unit costs.

Although the light industry is not a technology-intensive sector, Municipal Light has enhanced its product design capability so as to create additional advantage against domestic and international competitors. With these technological edges plus cost/price advantage of being based in China, Municipal Light enjoys considerable positional advantage in many product markets in a number of countries. The experiences of SEG and Municipal Light confirm that Chinese firms can become very

competitive in international markets if they are able to combine their cost advantage with foreign firms' technological advantage and international marketing networks. And obviously joint ventures are quite a convenient arrangement. Perhaps the main problems are the degree to which that foreign firms are willing to allow the Chinese firms to use their international marketing channels and their technologies and extent to which that Chinese firms are able to absorb and further improve the technologies imported from developed countries.

#### b). The Evolution of Corporate Strategy

It has been shown that the evolution of Municipal Light's corporate strategy is in response to development of its own competitive advantages created in the 1980s and the external environmental changes, notably the protectionism in some of its most important export markets. In 1993, the EEC community has decided to impose anti-dumping duties upon all the bicycles imported from China. Despite China Bicycles' attempt to persuade the EEC commission to exempt it from such duties because it has never benefited from the Chinese government's subsidies, the EEC commission has refused its request. As a result, China Bicycles has to cut its annual production of bicycles by a quarter in 1993 (Sing Tao Daily 1993, 20 September. p.5).

While the original strategy emphasised upon the attraction of foreign (and inland) capital and technology to Shenzhen SEZ and exports from there, the new corporate strategy aims to transform Municipal Light from a basically exporter to an MNE, with manufacturing and marketing facilities spread in a number of countries. The new internationalisation strategy has not only influenced the entry methods into foreign markets but also motives of specific FDI projects (eg, to reduce its reliance upon foreign partners in international marketing), and entry modes.

#### c). From Exports to FDI.

Municipal Light exported an increasing number and volume of products to overseas countries, mainly developed ones because of the improvement of its product quality and enlarging product range and also its responsiveness to market demands. Apart from its market orientation, Municipal Light's technological advantage plus its cost advantage have played a decisive role in its increasing exports.

The substantial increase of exports nurtured a desire within the group to replace its foreign distributors with its own international marketing networks in order to serve better its customers. Foreign direct investment in manufacturing brought Municipal Light closer to its customers in the host and nearby countries. Host country's protectionist threats (eg, anti-dumping measurement), also led the group to locate its production there, making it able to take the advantage of regional trading block(s).

Similar to SEG, Municipal Light's overseas investments are all located in developed countries except Thailand and Hong Kong where labour and other production costs are higher than China. The location of Municipal Light's FDI reflects the distribution of its exports. The bulk of Municipal Light's exports are destined for Hong Kong (mainly for re-exports), North America and West Europe and Japan.

## CHAPTER 11 CASE STUDY -- SHENZHEN ELECTRONICS GROUP

### 11.1 Company Background

Prior to the establishment of the Shenzhen Special Economic Zone (SEZ), Shenzhen had only one electronics company (a radio manufacturing firm) employing 108 people. After Shenzhen SEZ was set up, many electronics firms from inland China came to Shenzhen to set up subsidiaries because of the preferential policies and incentives available there.

Between 1979 and 1985, the electronics industry's development in Shenzhen was phenomenal (Table 11.1.). By 1985 Shenzhen had 167 electronics firms employing 17,000 people. In 1985 the output of these firms reached RMB 1,375 million, accounting for 51.4% of total industrial output in Shenzhen SEZ. Together they produced 2.1 million radios, 3.24 million tape recorders, 0.48 million TV sets, 1.23 million telephone sets and 2 million calculators (SEG, 1990. p.6). However, despite its rapid development, Shenzhen electronics industry had the following major problems (SEG, 1990. p.14):

Table 11.1. Shenzhen SEZ's Electronics Industry (1979--85)

Year	Value of Output (Rmb mn)	Increase (%)
1979	1.21	
1980	4	230.0
1981	122	2195.0
1982	128	4.9
1983	326	154.7
1984	1,040	219.0
1985	1,375	32.2

Source: SEG (1990) p.6

- a). Many firms imported parts and components and assembled them for domestic sales rather than exporting, resulting in foreign exchange drainage;
- b). Both manufacturing capability and technological capability were very weak; the product structure, product quality, technological level were unable to meet the standards in international markets;
- c). Shenzhen electronics industry lacked long term planning. Investments were made repeatedly on similar projects that could lead to a short term return at the expense of long term development and prospect. For instance, among the 167 firms in Shenzhen's electronics industry, more than 50 were assembling tape recorders in 1985;
- d). Shenzhen electronics industry lacked competent managerial and technological personnel. Management competence was rather low, which had a negative impact on exporting electronic products.

In order to address these weaknesses, Mr Ma Fuyuan was invited by Shenzhen Municipal Government to restructure the entire electronics industry in Shenzhen. He had considerable experience from senior managerial positions in different functional areas with different electronics firms, and resigned his position as the director of the Computers Administration Bureau (CAB) at the Ministry of Machinery and Electronics Industry in order to take up the challenges posed by Shenzhen's ailing electronics industry.

Shenzhen Electronics Group (hereafter referred to as SEG) was established in 1985 jointly by the Ministry of Machinery & Electronics Industry and the Shenzhen Municipal Government. The aim was to organise Shenzhen-based electronics firms, all of which were small, into an export-oriented group. The group attracted 117 member firms and started operation in January 1986. By the end of the year, it had total sales of Renminbi 1.3 billion (US\$350 million), with exports of US\$70 million, making it one of China's leading exporters that year.

In recent years, the group's overall expansion and international development have continued steadily (see Table 11.2). By 1990, SEG's turnover had reached RMB 3.2 billion (US\$505 million) and exports stood at US\$300 million, accounting for 60% of



its turnover. By 1991, it had established 16 subsidiaries, joint ventures and trading offices in USA, Canada, Kenya, Hong Kong, Macau, Japan, Germany, Australia and Thailand, and had plans to invest in Singapore, Italy, the UK and other European countries (see Table 11. 3.).

Table 11.2 SEG Performance (1986-90)

Year	Turnover (RMB m)(US\$ m)	Profit before Tax (RMB m)	Exports (US\$ m)	Exports as % of Turnover
1986	1,300 (350)	80	70	20.0
1987	1,700 (457)	169	157	34.5
1988	2,100 (467)	210	210	45.0
1989	2,780 (617)	160	250	40.5
1990	3,200 (505)	225	300	60.0

Sources: Based on Tao (1990), SEG Introduction (1991), SEG (1992)

Among the 16 current overseas ventures, 11 are sales subsidiaries and joint ventures, while the other five are manufacturing operations: SEG (Kenya) manufactures and markets colour TV sets, tape recorders, Yi Gao Computers Co. Ltd in Hong Kong develops, manufactures and markets computers, Zhuguang Industrial Co. Ltd in Macau manufactures and exports electronics products, SEG (Thailand) also manufactures tape recorders and radios. In early 1992 it announced plan to set up a large industrial plant in Hong Kong, with an investment of US\$312 million. This plant will manufacture integrated circuits, opening in early 1994. This is a joint venture between SEG, Thompson (USA) and the Hong Kong government, with each contributing one third equity capital. SEG will manage the venture while Thompson provides technology and the Hong Kong government contributes land. The production of the venture will be integrated with SEG's operation in Shenzhen. In addition, three design centres (ie. in Shenzhen, Hong Kong and Silicon Valley in the USA) will support the production and operation of the venture. SEG can be safely described as one of China's leading MNEs.

Table 11. 3. SEG's Overseas Investments (as of July 1992)

Project	Country	Owner-ship Stance	Activities			Product Range	Market Range
			R & D	MFTG	Trading		
Yi Gao Computers Co. Ltd	Hong Kong	65%	yes	yes	yes	computers	Hong Kong and other countries
Shum Yip SEG Co Ltd	Hong Kong	100%	No	No	No	General Headquarters for Overseas Business	
STM-SEG Institute (HK) Co. Ltd	Hong Kong	50%	Yes	no	yes	computers	Hong Kong & Southeast Asia
SEG Thompson (HK) Ltd	Hong Kong	33.3%	no	yes	no	integrated circuits	China, Hong Kong; S.E. Asia
Jiehui Industrial Co. Ltd	Hong Kong	50%	yes	no	yes	CTV sets	Hong Kong, S.E. Asia
Shenguang Industrial Co. Ltd	Hong Kong	60%	yes	no	yes	VCRs, tape recorders	Hong Kong, S.E. Asia, Australasia
Macau Zhu Guang- SEG Co. Ltd	Macau	60%	yes	yes	yes	electronics products	
Kenya-SEG Co. Ltd	Kenya	49%	no	yes	yes	CTVs, VCRs	Africa, Middle East
BWG Chain Stores	USA	100%	no	no	yes	Electronics	North America
SEG Pacific Trading Co. Ltd	USA	40%	no	no	yes	Electronics	USA, Latin America
SEG (New York) Ltd	USA	100%	no	no	yes	Electronics	USA
SEG (Thailand)	Thailand	45%	no	yes	yes	CTVs, VCRs	S.E. Asia
SEG (Frankfurt)	Germany	100%	no	no	yes	electronics	EEC
STM-SEG (Canada) Ltd	Canada	50%	yes	yes	yes	CTVs, BWTVs	North America
SEG (Australia)	Australia	100%	no	yes	yes	CTVs, BWTVs	Australasia, EEC
Keppel SEG	Singapore	50%	yes	no	yes	magnetic drums	S.E. Asia; North America
SEG (Hungary)	Hungary	100%	no	no	yes	electronics	Eastern Europe

Source: Author based on interview data

## **11.2 SEG's Competitive Advantages**

### **11.2.1 The Sources of SEG's Technological Advantage**

SEG's management regards its competitive advantages as different in its domestic and international markets. According to Mr Li Ping, the senior economist and director for strategic development of SEG, in the domestic market SEG is seen as an innovative competitor, while in international markets it has relied on price competitiveness to penetrate markets and gain market share in some market niches, especially in Southeast Asia.

Before SEG could develop an international market for its products, it needed to upgrade its technological capability for international markets. In SEG's process of creating competitive advantage in technology and international marketing channels, Shenzhen SEZ seemed to have provided the right environment. According to an analysis that led to the formation of SEG's export-oriented strategy, SEG could take advantage of being located in Shenzhen SEZ (Tao, 1990). These include:

- a). A larger proportion of profits can be retained by SEG because of lower corporate tax for firms located in SEZs, therefore the group could have funds available for expansion and development;
- b). It would be easier for SEG than its domestic rivals to attract foreign investment and technology because foreign firms have shown their preference for SEZs rather than other parts of China;
- c). It would be easier for SEG than its domestic rivals to export because of Shenzhen's proximity to Hong Kong and also more liberal policies available for firms located in SEZs than elsewhere in China (eg, SEG has been granted import and export autonomy at the outset).
- d). Shenzhen had been at the forefront of China's economic reform and as the window of China's open-door policy, where firms enjoy far more management autonomy than its rivals elsewhere.

Based upon this analysis, SEG had thus formed an export-oriented strategy at the

outset, which attached great importance to creating technology advantage that would enable the group to export. In order to create a competitive advantage that would enable the group to be competitive in international markets, it has been exploring different routes to increase its own technological capability. These include importing technologies from abroad, establishing its own research and development academy, and technological collaboration with academic institutions and other electronics firms. Each of these is discussed below: -----

a). Importing technologies: SEG's joint ventures in China with foreign firms provided advanced equipment or technological know-how and equipment. Its early partners in joint ventures were mainly small and medium-sized firms from Hong Kong. They provided very valuable market information and international marketing channels. And compared with the backward technologies and equipment used by the electronics firms in Shenzhen before 1986, the equipment and technologies brought by the Hong Kong partners were far more competitive in manufacturing international quality products.

b). R & D Academy: As design capability is very important in the electronics industry, SEG has always put great emphasis on developing its own R & D capacity. The group has attracted a large number of young as well as experienced research and design personnel. With an initial investment of Renminbi 4 million (US\$1.08 million), the group established an R & D academy in 1989, the first of its kind amongst Chinese enterprises, to concentrate on core electronics technologies. There are four central units within the academy: a speciality integrated circuit design centre; a mechanic structure mould design and manufacturing centre; an open laboratory for product development; and a trial production factory for technological commercialisation. Other specific technologies are being developed by SEG's member companies. SEG had started implementing matrix management in technological development, involving its R & D academy, divisions and technological departments of its member companies. SEG's five business divisions -- computers, components, telecommunication equipment, home appliance and non-electronics diversified business -- are all required to maintain their own technological departments with responsibilities to develop specific technologies for their own divisions.

c). Technological collaboration: SEG has established a large number of collaborative research programmes with 28 indigenous companies, and 15 universities and 28 research institutes. Internationally, SEG has set up technological co-operation programmes with DEC, IBM, NEC, Philips, Siemens and Toshiba. (Asian Business 1989, April. p.14).

These three major streams of technological inputs have enabled SEG to introduce a large number of new products to the market at home and abroad. Within three years of the formation of SEG, the number of new products developed by SEG each year increased significantly as Table 11.4 attests.

Table 11.4 New Products Developed by SEG  
(1985 -- 1991)

Year	Number of new products developed and launched	Sales created by new products (Rmb m)
1985	28	100
1986	78	250
1987	215	430
1988	200	450
1989	na	na
1990	225	300

Source: SEG Introduction (1991), SEG (1990). p.168

### 11.2.2 SEG's Generic Strategy in the International Markets

In international markets, SEG competes fiercely with electronics firms from other countries (including Hong Kong, South Korea and Taiwan) basically on price. SEG has a significant competitive edge over its international competitors because of SEG's cheap managerial and technical staff. Its main production base in China also helped maintain its cost advantage over international competitors. SEG's main export markets are in Southeast Asia where it competes fiercely in some market niches with local and third country rivals on low to medium grade products like radio-cassettes, TV sets and tape recorders.

As SEG gradually created its own technological advantage, its product structure has been changing. Originally, radios and radio-cassettes were the bulk of its exports. Now products with relatively high technological content such as large-screen colour TV sets, integrated circuits and semi-conductor chips account for major exports. As Mr Li Ping (senior economist at SEG) explains: "Our products have reasonable quality, and we are mainly competing in price on those items (referring to above mentioned products) in market niches. .... We have unbeatable cost advantage here in China while we are able to get advanced technologies and market information through Hong Kong, but more increasingly from our own overseas subsidiaries and joint ventures".

Of course, successful penetration in international markets is only possible when a firm has an international marketing capability. SEG first relied on Hong Kong intermediaries to export its products. Later on it replaced these intermediaries with its own overseas international marketing channels, though in some cases foreign intermediaries remain important in SEG's exports. Shenzhen SEZ's proximity to Hong Kong and policy advantages granted to SEZs have helped SEG make good use of these Hong Kong agents and eventually establish its own international marketing channels.

### 11.2.3 SEG's Managerial Advantage

In addition to technological advantage, SEG is seen to have managerial advantage, especially over domestic rivals. As Shenzhen has been the forefront of China's open door policy and economic reform, firms located there, whether state-owned or Sino-foreign joint venture and foreign subsidiaries, are given much greater management autonomy than anywhere else in China. Thus, with this management autonomy, firms there have been able to practice "capitalist styles of management" as far as they effective and efficient. That is, in Deng Xiaoping's words, "it does not matter whether it is a white or black cat so long as it catches mice", and SEG is been quite proud of its managerial competence and innovations.

SEG is one of the first large enterprise groups to introduce a series of managerial and organisational changes in response to internal and external developments. It was the

first manufacturing firm in China to implement matrix technology management, regional management of overseas subsidiaries and joint ventures, divisionalised management, etc.

SEG was also the first large Chinese electronics group of firms to implement leverage operations, (ie. its financial resources are mainly borrowed from banks and through bonds and equity issuance. Its major competitors all rely on state allocation of funds). Interestingly, because of pressures associated with leverage operations, SEG is more sensitive than most other SOEs to financial performance, risks and competition.

To survive and maintain competitive advantage in the fast changing electronics markets, SEG has long realised the value of expertise from external sources. It has appointed Bank of China as its management consultants, Kyushu Development Bank (of Japan) and Hong Kong International (Asia) Co. Ltd as its international finance advisers and established business relations with many international banks. It was the first Chinese manufacturing group to set up and maintain close links with so many overseas financial organisations.

In short, SEG's management is characterised as flexible and adaptable to the opportunities and threats offered by the external environment.

SEG's total quality control (TQC) has also been very successful. When Ma Fuyuan, founder and now chairman of SEG, came to Shenzhen in the early 1980s, there were numerous complaints from domestic and overseas customers about the low quality of electronics products made by Shenzhen firms. Ma once held the post of Chief of Total Quality Control Office of the Ministry of Electronics Industry and had considerable experience in TQC. As he declared to a press conference when SEG was set up: "(Product) quality is the life of an enterprise. Our products must be in accordance with international requirements to ensure our group's reputation. .... The first thing I will do is quality improvements".

As a result of its effective quality control and improvements, SEG began to create its own brand name ("SEG", or Saige in Mandarin) and some of the SEG products are becoming highly regarded by the domestic market. Financial performance increased significantly as well. By 1988, SEG reversed its foreign exchange deficit as the value of exports exceeded that of imports. Exports accounted for 45.3% of total sales as compared with 16% in 1985. SEG had become the largest electronics group in China

in terms of total sales, sales of consumer electronics products, output of tape recorders and CTV sets. Profit per employee rose to top among all Chinese electronics firms (Tao, 1990. p.167).

### 11.3 SEG's Strategic Evolution

#### 11.3.1 Initial Export-oriented Corporate Strategy

When SEG was formed, 117 electronics firms (see Table 11.4) became its members on a voluntary basis. The first major challenge for SEG's top management was to transform these member firms into a cohesive group, in light of their main technological and managerial weaknesses as well as their inability to penetrate international markets.

Table 11.4 The Origin of SEG (1986)

Total Capital	US\$6.37 m; HK\$11.5 m; RMB311.62 m	Number of firms
Type of Ownership	100% owned subsidiaries	34
	Joint venture with foreign firms in China	32
	Joint venture with other Chinese firms	51
	Total	117
Product Categories	Computers & periphery equipment	16
	Telecommunication equipment	13
	Domestic appliance	18
	Meters & instruments	16
	Components & devices	25
	Services	14
	Others	15
Total	117	

Source: Tao (1990)



Section 11. 2 shows that SEG has created its own technological advantage through joint venture arrangements with the domestic and foreign partners, its own R & D effort, and collaboration with academic institutions. Apart from using its foreign partners' international marketing networks and overseas distributors, the group also set up trading offices in Hong Kong and the USA to solicit orders for its member firms. As a result, an increasing number and quantity of its products have penetrated international markets.

Initial export-oriented strategy led SEG becoming an increasingly aggressive exporter. By 1990, SEG exported more than US\$300 million, accounting for 60 per cent of its turnover. However, three major factors had compelled SEG to review its original corporate strategy and to formulate a new one.

### 11.3.2 A SWOT Analysis for SEG

First of all, SEG's exports had largely relied on overseas, especially Hong Kong, distributors and intermediaries, which controlled SEG's export marketing and took a large proportion of profit margins. Such reliance had constrained SEG's further development in international markets. To actively penetrate and expand in international markets, it became necessary for SEG to set up its own international marketing network, changing indirect exporting to direct exporting.

Secondly, the austerity programme in the late 1989 led to a relative economic recession in the domestic market. SEG's sales in the domestic market fell sharply and a large number of products were stockpiled. This further increased SEG's determination to upgrade products, adapt to changes in the domestic market and focus upon international markets in order to reduce market risk.

Thirdly, Shenzhen electronics industry originally consisted of subcontractors and assembling factories for consumer electronics products. Since 1985 when SEG was formed, it had become very evident that the industry lacked technological potential and relied on foreign firms for components, parts and raw materials. In sum, SEG needed to rationalise its electronics product structure, by increasing the proportion of

basic products (components, parts and raw materials) and reducing that of consumer products.

Therefore, in order to improve its international competitiveness, SEG needed to focus its investment upon basic products and capital goods while upgrading technologies and products of its existing member firms. To do so, SEG had to attract large foreign electronics companies to set up joint ventures with it so that they could provide the advanced technologies SEG needed. On the other hand, SEG needed to transfer its own technologies to relatively less developed countries in order to make full use of its own technological advantage.

In addition, SEG felt it more convenient and even imperative to absorb high technologies by its overseas subsidiaries and joint ventures. Certain countries (eg, the USA) have banned exports of certain high-technologies to China. For instance, integrated circuits technology is vital in the electronics industry, but new and high technologies in integrated circuits are controlled by developed country electronics MNEs. SEG felt it necessary to set up joint ventures in Hong Kong and developed countries in order to get access to such technologies. Thus "it's not only the market pressures but also political nuance that we (SEG) are facing in our further development", says vice-president Li Junqiu. Moreover, as domestic demands are quite unsophisticated, it is vital for SEG to be close to its demanding customers (especially those in developed country markets) to keep pace with new developments in their demands. "This is a strategic necessity and challenge for us to be alert in these developments if we want to upgrade our technological competence and marketing capabilities, and if we want to a truly competitive hi-tech firm in the global electronics market", asserts Li Junqiu.

A SWOT analysis for SEG is summarised in Table 11. 5. It is against this background that SEG formulated a new internationalisation strategy in 1990.

### 11.3.3 SEG's Internationalisation Strategy

As Mr Li Junqiu, vice president for international operations, explains, "We have experienced a strategic development process in the past six years. .... The goal of our strategy has changed from export-oriented development to multinational expansion

via both overseas investment and exporting".

Table 11.5 A SWOT Analysis for SEG

<p style="text-align: center;"><b>STRENGTHS</b></p> <ol style="list-style-type: none"> <li>1. Management competence;</li> <li>2. Technological strengths among Chinese electronics firms;</li> <li>3. Economies of scope;</li> <li>4. Proximity to Hong Kong and thus international markets;</li> <li>5. Ability to collaborate with research institutions and major electronics MNEs</li> </ol>	<p style="text-align: center;"><b>WEAKNESSES</b></p> <ol style="list-style-type: none"> <li>1. Lack of international brand recognition;</li> <li>2. Lack of control in international marketing channels;</li> <li>3. Lack of internationally experienced managers;</li> <li>4. Reliance upon foreign intermediaries.</li> </ol>
<p style="text-align: center;"><b>OPPORTUNITIES</b></p> <ol style="list-style-type: none"> <li>1. Growing demand for electronics (esp. consumer) products in domestic and international markets;</li> <li>2. Some unserved market niches</li> </ol>	<p style="text-align: center;"><b>THREATS</b></p> <ol style="list-style-type: none"> <li>1. The increasing number of Chinese and foreign competitors in domestic market;</li> <li>2. Strong competition in the international markets</li> <li>3. Unsophisticated domestic demands.</li> </ol>

Source: Compiled from interviews, and SEG's internal reports

According to SEG's internal documents, its strategic goal is to become a leading electronics MNE through "conglomeration, industrialisation, normalisation and internationalisation" and "striving for excellence and being oriented to world", with corporate policies of "driven by market, promoted by technologies and based on manufacturing" and of being "relied on mainland China, based in Shenzhen and developed in overseas markets".

Specifically, SEG's internationalisation strategy means that it needs to "adopt various

methods to establish a global marketing network; focus on overseas direct investment; and establish a global operations and product development system in order to compete with large electronics multinationals in the world", asserts Mr Li Junqiu. According to its strategic plan, by 1995, SEG's total sales will reach RMB 4.5 billion (US\$800 million), exports US\$400 million and pre-tax profits Renminbi 250 million. Product structure will be improved, consumer, investment and basic products will be at the proportion of 29.7 per, 22 per cent and 48.3 per cent respectively by 1995. International marketing network will be established, and overseas manufacturing subsidiaries and joint ventures will account for a reasonable part of total production. Most exports will be through SEG's own marketing channels.

#### 11.4 SEG's Internationalisation

It has been shown that SEG has always been international market oriented, with exports accounting for an increasing proportion of its turnover (ie up from 20 per cent in 1986 to 60 per cent in 1990). In terms of FDI, SEG had already set up seventeen foreign subsidiaries and joint ventures in 11 countries by May, 1992. SEG's management likened international markets to a vast and volatile ocean, and in its internationalisation process the group has experienced an evolution from "borrowing boats" (ie, reliance on foreign partners and distributors), to "building boats" (ie. greenfield FDI), and to "buying boats" (ie. foreign acquisitions). It is now implementing a regional management policy on overseas establishments through five regional headquarters: Hong Kong for Pacific Asia, New York for North America, Manbase for Africa and Middle East, Frankfurt for West Europe, Harbin<sup>1</sup> for CIS and Eastern Europe (see Figure 11.1).

##### 11.4.1 Reliance on Foreign Distributors and Partners

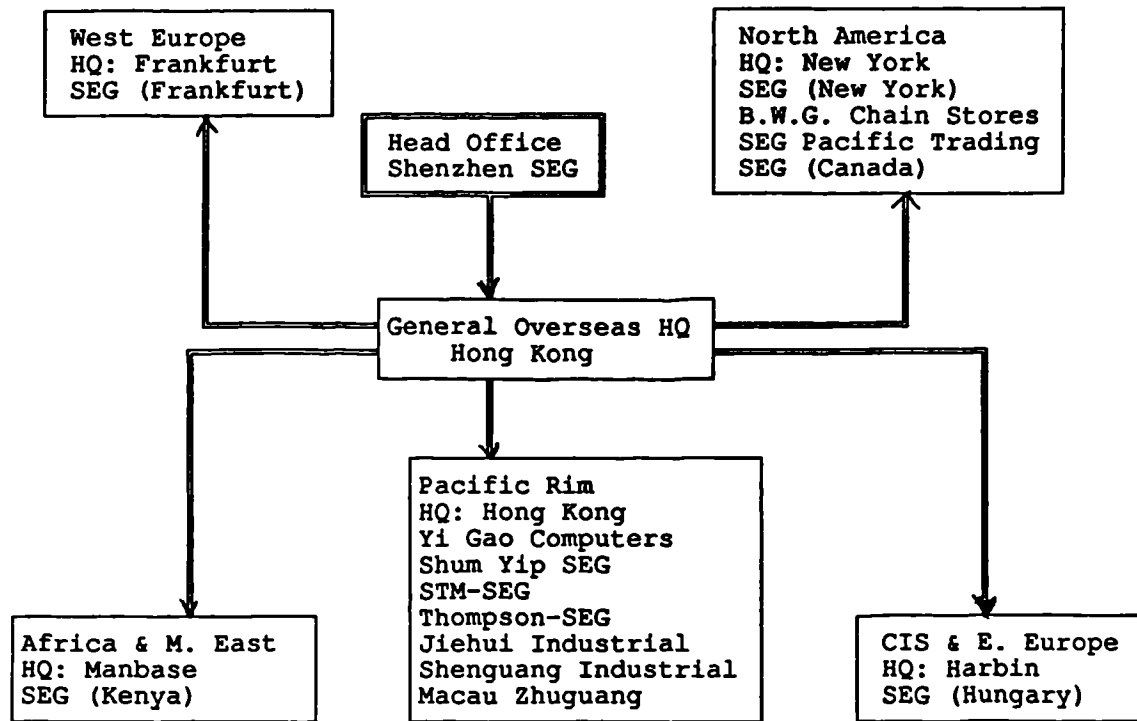
When Ma Fuyuan, President of SEG, was visiting Hong Kong in early 1986, he and

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<sup>1</sup> The headquarters for CIS and Eastern Europe was located in Moscow. The recent events and disturbances forced SEG to retreat from Moscow and Harbin, a Chinese city near Russia replaced the role of Moscow as SEG's temporary regional HQ for CIS and Eastern Europe.

other decision-makers of SEG decided the first course of action for penetrating international market -- "Borrow boats to sail at the sea", ie, to use foreign firms' marketing channels or technological forces to export SEG's products.

Figure 11.1 SEG's Regional Management Network



Source: Author (based upon interview information)

Hong Kong electronics industry has been always export oriented. It has already established an international marketing network. To use effectively Hong Kong's export marketing network, SEG needed to set an office in Hong Kong to facilitate communications between SEG and Hong Kong firms. In March 1986, SEG decided to set up Shum Yip-SEG Ltd in Hong Kong. In early 1987, Shum Yip SEG began its operations. A lot of orders came from Hong Kong firms to Shum Yip SEG. Later on, another trading office was set up in Tokyo to solicit orders. SEG's jointly produced mini-computers have been exported via Semi-Tech's marketing channels, earning SEG at least US\$20 million a year. SEG sent a sales representative to Semi-Tech. In addition, SEG encouraged its member companies to set up direct export relationships with their overseas customers and encouraged them to select good distributors in host countries.

Another method used by SEG to export was through joint ventures in China with foreign firms. In a typical joint venture, foreign partner was required to market all or a large proportion of products made by the venture. In other cases, SEG's firms after receiving orders from foreign firms, manufactured products under the foreign firms' brand names and the products were exported to them.

#### 11.4.2 Greenfield FDI

The strategy of "Borrowing boats to sail at Sea" made it possible for SEG to export a large amount of products to Western Europe, Southeast Asia and North America without its own international marketing channels. Meanwhile, SEG's decision-makers were thinking of the second strategy --"Building Boats to Sail at Sea", ie, setting up overseas subsidiaries and joint ventures. This strategy became necessary if SEG wanted to get rid of reliance on foreign and partners and distributors in international marketing.

Under this strategy, SEG had invested in major regions where it had strategic interest.

- a). Hong Kong and Macau: To further strengthen Shum Yip SEG's position as the general headquarters of SEG's overseas subsidiaries. Its main task is to

develop overseas business and train expatriate managers and technicians. In addition, three joint ventures were set up in Hong Kong and Macau. They are: Shenguang Industrial Co. Ltd to develop tape recorder products and export electronics products, Jiehui Industrial Co. Ltd to develop and export colour TV sets, and Zhuguang SEG Ltd to develop, manufacture and export electronics products. Later on, Semi-Tech SEG Technology (HK) Ltd was established as a centre of new product development and design, technology transfer and procurement of components from overseas. It is a joint venture between SEG and Semi-Tech (Global). While recent investment of US\$312 million in Hong Kong by SEG, Thompson of USA and Hong Kong government, this venture will manufacture integrated chips and is the largest single manufacturing investment in the colony in the past five years.

- b). **North America Region:** This is the largest electronics market in the world with a hierarchy of market demands in electronics products. Import control barriers are few and import tariff is low. This is region as strategic importance in SEG's international marketing. SEG's establishments in North America include: SEG Pacific International Trading Co, a joint venture between SEG and the USA's PIC, exports SEG's products to USA, Mexico, Venezuela and Brazil through PIC's COMB; a trading representative in New York to develop SEG's sales in the USA; and STM SEG in Canada, a joint venture with Canadian STM, to develop, manufacture and market SEG's electronics products in the country.
- c). **Europe:** As the second largest electronics market, SEG attaches priority to this region. A trading office had been opened in Frankfurt to co-ordinate SEG's activities in Europe. It has also decided to establish joint ventures in Milan of Italy and Lancashire of the UK to assembly CTV sets, using SEG's CKD components, for the EEC markets. SEG has plans to open two more trade offices in Belgium and Holland.
- d). **Australasia:** SEG has already set up an electronics joint venture in north Australia to manufacture electronics products, 30% of which is sold locally while the rest is exported to other countries.
- e). **Asia Pacific Region (outside Hong Kong & Macau):** SEG's direct investments

in this region include a trading office in Tokyo, a joint venture in Singapore with Keppel Group (to develop and manufacture hard discs and use Keppel's marketing channels to supply local and overseas markets), a joint venture in Thailand to manufacture colour TV sets.

- f). Africa: This region is very different from other regions. The market is not very developed and per capita consumption is very low. But given the large population in Africa, it still has quite a large market potential. As SEG's export products are in the low to middle grade ends, with price being the basic competitive weapon, they are particularly competitive in developing countries. So in 1987 SEG set up a joint venture with HEIMNS of Kenya to assemble tape recorders and TV sets for Kenyan and other African countries. In this joint venture, SEG exported equipment, technologies and components and converted them into equity stake of 49%. SEG is responsible for product development, product quality and supply of raw materials and components for the venture, while HEIMNS for labour and product marketing.

Through "building boats" (ie, greenfield FDI and joint ventures), SEG has set up an international marketing network. Compared with relying on foreign distributors and Hong Kong intermediaries, SEG's overseas subsidiaries and joint ventures give it more flexibility, control and stability in international marketing. SEG has also become less vulnerable to protectionism in the host countries. Noteworthy is that SEG's internationalisation has led to such a framework in which the focus of product development and marketing is in Hong Kong and North America while manufacturing is mainly based in China and Hong Kong.

#### 11.4.3 Overseas Acquisitions

Although greenfield FDI made it possible for SEG to reduce its reliance on foreign distributors to certain extent, the group was not content with the speed of "building boats" in establishing an international marketing network. It thus decided to take a bolder strategy -- "buying boats", ie, to acquire and take over overseas enterprises and sales networks.

In 1988, SEG acquired a 38 per cent stake of BWG, a group of 95 chain stores in the East Coast of the USA. The chain stores are a leading distributor and retailer in



consumer electronics in North America. This acquisition provides a long term exporting channel to the USA for SEG and other Chinese firms in electronics and related industries. The chain stores can also provide USA market information for SEG to organise export product manufacture.

At the same time, SEG led two other Chinese firms and a Hong Kong firm to take over Hong Kong Yi Gao Computers Co. Ltd. This is a high-tech firm manufacturing micro-computers and peripheral equipment. The company has state-of-art equipment and processing technologies. Although its production facilities are located in Guangdong, marketing is co-ordinated and R & D is undertaken in Hong Kong. After four years' hard work, Yi Gao Computers had set up nearly 20 sales outlets in Europe and most of its products were exported to West Europe. Thus the acquisition of Yi Gao provided SEG with a ready marketing channel to Europe.

In addition, SEG has plans to take over take equity stake in several companies in Hong Kong to meet its increasing export needs.

### **11.5 Proposition Verification**

The foregoing sections have outlined the formation and development of SEG, its creation of competitive advantages, the evolution of its corporate strategy and its experience in internationalisation. SEG's approach to internationalisation, as seen from above elaboration, is quite unconventional. Its location in Shenzhen SEZ helped it to implement an export-oriented strategy, in which process SEG created its own competitive advantages in technologies and management.

The competitive advantage in technologies and management help SEG internationalise its operations, in terms of exporting and foreign direct investment. Foreign investment in return further strengthens SEG's international marketing advantage and its capability to get access and absorb foreign technologies. To be more specific, the five propositions derived from literature review are now subject to verification by SEG's experience.

Proposition 1. The competitive advantages of the Chinese MNEs are likely to be influenced by the characteristics of the Chinese national diamond and its evolution.

Similar to the case of Shenzhen Municipal Light, SEG has created its competitive advantages mainly due to its location in the Shenzhen SEZ, which is the result of the economic reforms and Open-Door Policy. Specifically, the liberal policy in Shenzhen SEZ had made it possible for SEG to emerge and become a competitive electronics group of companies, which were neither competitive or export-oriented prior to the formation of SEG. With greater management autonomy (particularly the autonomy to engage directly in import and export) than its counterparts in inland China, SEG has been able to forge directly international involvement from the onset, which has been critical in its initial export-oriented international strategy as well the later internationalisation strategy.

Without the cost advantage of China, it would be difficult for SEG to attract so many foreign firms to establish joint ventures in China. Consequently, its reliance on cost advantage and thus price competitiveness in the international markets also reflects the common feature of the Third World MNEs (Lall, 1980, 1982; Wells, 1979, 1980, 1983, 1984).

Proposition 2. The Chinese MNEs are likely to technological advantage in technology prior to their internationalisation.

Like the previous four case companies, SEG can only provide data in comparison with its domestic rivals instead of international competitors. SEG's proportion of university and college graduates in its total employees (as a proxy for the proportion of its non-operative workers) had increased to 40 per cent in 1989, a ratio far higher than any large electronics firms or conglomerates in China (Li, 1991). The nearest ratio (27.7 per cent) was for Panda Electronics Group, which was comparable to SEG in size in late 1980s (Intertrade 1988, September, p.43). And the industry average was 18 per cent (Li, 1991).

It should be pointed out that Shenzhen SEZ has becoming increasingly attractive location for university and college graduates in China since its inception in 1980. In fact, since 1985 Shenzhen SEZ has been the most preferred location for them. This is perhaps the single most important reason why SEG could recruit such a larger number of graduates than its domestic rivals.

The R & D expenditure data were not available from the headquarters of SEG, because its R & D Academy only carries out the research and development on core technologies. Its six divisions and member firms have their own decisions on R & D investment on specific research projects related to their own products and operations, which make it difficult for SEG to consolidate groupwide R & D expenditure. What's more, SEG's extensive technological collaboration with academic institutions in China and abroad would make the figure of its groupwide R & D expenditure (even if available) a less effective indicator of its R & D capability.

Advertising, has not been used much at SEG, and there has been not formal budget for advertising, like Shougang, Northeast, Municipal Light.

As for economies of scale, again no comparable data are available simply because SEG has too many member firms in different major product categories. Thus it can be assumed that economies of scale are not an important determinant of SEG's multinationality or degree of internationalisation.

Perhaps the number of new products successfully launched is a better indicator of technological advantage. As Table 5 showed, SEG had successfully launched a larger number of new products than its domestic rivals during the period 1986-90 for which data were available. For example, in 1988, SEG had 200 new products, while its arch rival, Panda Electronics Group, had only 30 (Intertrade 1988, September).

Proposition 3. Chinese MNEs are likely to have experienced an incremental internationalisation process, starting from no export to indirect export, to direct export, to the establishment of overseas sales offices and eventually manufacturing facilities abroad.

From the previous sections it has been revealed that prior to the formation of SEG, some of its founding member firms had already been exporting. SEG continued to export when it was formed with an export-oriented strategy in 1985/86. In this context this proposition is irrelevant to SEG's experience.

Unlike Shougang, Baiyunshan and Northeast Pharmaceutical, but like Municipal Light, SEG has not experienced the indirect exporting through other state-owned import and export companies experienced. This was the preferential policy available in

SEZs where firms are exempt from the regulation of import and export procedure and encouraged to export (and import in order to assist attracting foreign technology and capital).

Secondly the irrelevance of this proposition should become clearer when one considers SEG's leapfrog from exporting, partially relying upon Hong Kong intermediaries, to the establishment of one manufacturing and marketing subsidiary (Shum Yi) in Hong Kong in 1986 when it started operation at home. And the acquisition of a firm of 95 chain stores in the USA in 1988 (ie, two years after its formation) could also shed doubt on the relevance of this proposition of stage-by-stage incremental internationalisation.

Proposition 4. Chinese firms may have no initial strategic plan for internationalisation. But as their international involvement deepens, they are likely to have formulated and been pursuing an international strategy.

From the previous sections on the formation and strategy development of SEG, it should quite clear that SEG was formed with an export-oriented development strategy at the outset. And this strategy contained exporting as the essential part. Thus SEG did have strategic plan for internationalisation from the start, although this initial strategy rested mainly upon exports.

The overall development of SEG, can be best interpreted using the model of business development strategies by Young et al (1989, p.7). Both domestic and overseas markets are served by SEG although it focuses its efforts on international markets. Integration (backwards and forwards) and diversification in terms of geographic markets, technology and products ( both related but also unrelated to some degree) are also present. Along the dimension of internationalisation, importing, joint ventures in China with foreign firms, exporting, overseas joint ventures, overseas sales subsidiaries and overseas manufacturing establishments all appears in SEG's experience.

Noteworthy is that in the case of SEG, importing, exporting and joint ventures with foreign firms in China have all been explored and utilised from the outset since the formation of SEG. In this respect, SEG is similar to Municipal Light but different from Shougang, Baiyunshan and Northeast where international outlook was absent

originally and emerged only in the late 1970s and 1980s. And SEG's internationalisation represents a strong international awareness and orientation among top management, which confirms the suggestion by Young et al (1989) that international orientation of managerial personnel is one of determinants of a firm's internationalisation, so is the firm's confidence in its competitive advantage in technologies, product quality, etc.

**Proposition 5.** International strategy will not only speed up Chinese firms' internationalisation process, but also influence their motives and choice of methods and modes of foreign entry.

Since SEG had been formed with an initial exports-based international strategy, the ratio of exports to total turnover had increased from 20 per cent in 1986 (the year of SEG's establishment) to 60 per cent in 1990. With the evolution of SEG's international strategy (ie, from exports-based to multinational expansion), foreign entry motives also changed from increasing and facilitating exports from China to both exports and local manufacturing for the local and adjacent markets. For instance, SEG (Kenya) manufactures TV sets for the African and Middle East markets. In addition, gaining access to foreign technological expertise is becoming important motive for some of SEG's foreign investment projects such as SEG-Thompson in Hong Kong, STM-SEG in Canada and Keppel-SEG in Singapore. As for foreign entry methods, in addition to greenfield investment and SEG had begun to use acquisition in its overseas investment. However, SEG has not yet started to license its technologies, perhaps due to its lack of state-of-the-art technologies in the industry.

**Proposition 6.** In terms of generic strategies, the Chinese MNEs are likely to compete mainly on cost advantage and thus price competitiveness instead of product differentiation in the international markets.

It is indeed quite difficult to assess SEG's positional advantage for each of its products in each of its major markets in terms of cost/price and quality, which calls for more focused research. However, as Section 11.2. has revealed, SEG's main advantage over its domestic rivals is its innovative capability, resulting in a large number of new products developed and launched every year. Its main source of competitive advantage lies in its capability to commercialise technologies developed by inland Chinese companies (as its joint venture partners or technological collaborators),

research institutes and universities. And SEG's organisational structure and corporate policies seem to be conducive to successive innovations in terms of product design and new product development.

However, SEG's innovative advantage may not appear very strong against international competitors. Instead, SEG's cost advantage does give it a competitive edge against them. In one word, SEG can turn technologies into competitive advantage more effectively than domestic competitors and more cheaply than international competitors. SEG has been competing mainly on price competitiveness in the international markets despite its attempts to establish a brand awareness. In fact, the thrust of SEG's initial exports-based strategy was the cost advantages available in China, which made it possible for SEG to attract foreign firms notably those in Hong Kong, to invest in Shenzhen and produce products for exports.

Despite the fact that operating SEG's overseas subsidiaries and joint ventures is much more expensive than in Shenzhen, SEG still manages to enjoy cost advantage over its local and international competitors due to the low costs of its expatriate managerial and technical staff.

However given the competitive and technology-intensive nature of the electronics industry, cost advantage alone is not sufficient to warrant the survival of the firm in the international markets. The rapid increase of exports in SEG's turnover owes much to its technological improvements through contribution of foreign partners to the joint ventures in China, its own R & D efforts and its collaborations with research institutions in China as well as with foreign leading MNEs. Moreover, its stringent total quality management programme has also contributed to its technological improvements as well as quality improvements.

Proposition 7. Imported and adapted technology is likely to be one of the main sources of technological advantage of the Chinese MNEs.

It is true that the imported technologies and equipment had played an important part in the creation of SEG's own technological advantage. Noteworthy is that SEG has used joint ventures with foreign partners as the main method of transferring foreign technologies. By September 1991, the group had set up 45 joint ventures with foreign firms in China (Ma, 1991).

SEG's domestic partners to their joint ventures, as well as SEG's technological collaborators (academic institution) and its own R & D Academy have also made significant contribution to the creation of SEG's technological advantage. While foreign processing technologies are imported from overseas, inland Chinese partners are far important than foreign firms in helping SEG create its design and new product development capabilities.

The creation of competitive advantage by SEG combines the elements of location advantages offered by the government to Shenzhen SEZ and associated with its proximity to Hong Kong, and the technological capabilities of inland Chinese firms and academic institutes as well as foreign firms. Above all, it's SEG's capability to combine these elements with its R & D facilities that gives rise to SEG's own technological advantage. This capability may be best interpreted as the core competence in the view of Prahalad and Hamel (1990) and Grant (1991). However, it should be emphasised that while SEG's competitive advantage in technology and management lay down the foundation for its internationalisation, the latter re-enforces its competitive advantage in international marketing.

Therefore, SEG's experience confirms that contention that Third World MNEs derive their technological advantage through importing technologies from developed countries (Wells, 1983, 1984; Lall, 1986: ). However, it should be noted that Hong Kong is far more important than traditional developed countries like US, Japan and European nations in providing advanced technologies to SEG. SEG's joint ventures with foreign firms are important channel for it to get advanced technologies, and most of SEG's joint ventures are made with Hong Kong firms, though only in the last couple of years SEG started to launch joint ventures and technological collaborations with firms such as NEC, DEC, Toshiba and Philips from the very developed countries.

Proposition 8. The main motives for the Chinese firms to invest overseas are to again access to the host country markets or third markets, or seek advanced technology of the host country. Escaping home government intervention is also likely to be an important reason behind their outward FDI.

It is true that SEG's overall motive for FDI has been market seeking. However, there

are cases where foreign investment aims to seek advanced technologies (eg, STM-SEG in Canada, Thompson-SEG in Hong Kong). Moreover, while SEG's early FDI projects, particularly those in Hong Kong, aim to facilitate exports from China in an attempt to reduce its reliance upon foreign partners' international marketing channels, some later FDI projects (eg, SEG in Kenya) aim to penetrate local and adjacent market through local manufacturing. The most notable exception to market-seeking FDI is Thompson-SEG in Hong Kong, which will supply integrated circuit chips to the parent company in China, although the venture will also export its surplus output to the Southeast Asian market.

Escaping home country intervention is not important in SEG's FDI. Some of SEG's subsidiaries and joint ventures in Hong Kong that undertake trading activities may look like "escape" investment, but in fact the Chinese government does really intervenes the operating and management of SOEs located in Shenzhen and other SEZs. Instead, it is the convenience of communication in Hong Kong that has motivated SEG to conduct trading activities through Hong Kong instead of in Shenzhen, just over the border of Hong Kong.

Among the 17 outward FDI projects, seven (ie, Yi Gao Computers, STM-SEG, Jiehui Industrial, Shengguang Industrial in Hong Kong and Zhuhuang Industrial in Macau, STM-SEG in Canada, Keppel-SEG in Singapore) undertake R & D activities. In addition to gaining access to advanced technologies from these countries, these ventures also serve as the platform for SEG to train its technological staff and let them gain international experience. For example, Keppel-SEG in Singapore will enable the Chinese parent to gain expertise in the manufacture of magnetic drums. Similarly, STM-SEG in Canada manufactures colour and black and white TV sets but its R & D department will give SEG access to its Canadian partner's technological expertise in computer hardware.

Proposition 9. Joint ventures are likely to be the main investment mode of the Chinese MNEs in their outward FDI.

This proposition has been confirmed by SEG's experience because only 11 of its 17 overseas FDI projects are joint ventures (see Table 11.3.). Despite SEG's high proportion of exports in turnover and 17 overseas subsidiaries and joint ventures, SEG still lacks confidence in its own international marketing capability and views



## 11.6 Conclusions

This case study chapter has detailed the formation and strategic development of SEG, its experience of creating competitive advantage, the evolution of its corporate strategy and its experience in internationalisation. The ten propositions are discussed in terms of their relevance to SEG's experience. The first proposition about the impact of characteristics and evolution of home country diamond upon the creation and nature of competitive advantage of the Chinese MNEs is confirmed. The second proposition about Chinese MNE's technology advantage seems to hold for SEG, although two measurements (a higher proportion of university and college graduates in its all employees, and a far larger number of new products developed each year, than its domestic rivals) have to be used to substitute for conventional measurements used by previous empirical research.

The third proposition about incremental nature of Chinese firms' internationalisation process is unconfirmed because the group had an exports-based international strategy from the outset and set up a manufacturing and marketing subsidiary in the same year as the parent started operation at home. Indeed, the export-oriented development strategy, and subsequently internationalisation strategy, seem to have contributed more than any single determinant to SEG's rapid internationalisation, as the case of Municipal Light.

Related to the denial of third proposition, SEG's experience also denies the fourth proposition that the Chinese firms initially have no strategic plan for internationalisation as the group was set up with an exports-based international strategy.

As regards the fifth proposition that an international strategy will speed up the Chinese firms' internationalisation process and impact their motives, methods and modes of foreign entry, this case study shows that the evolution of SEG's strategy from exports-based development to multinational expansion has not only increased the proportion of exports in its turnover but also broadened the motives, methods and modes of its foreign entry.

The sixth proposition about Chinese firms' technological advantage derived from

technologies and equipment imported from developed countries is also confirmed, although it should be noted that SEG had used numerous joint ventures with foreign partners as the main method to import foreign technologies. In addition, SEG's own R & D Academy, its domestic technological collaborators (including joint venture partners, academic institutions) have also made significant contribution to its technological advantage.

The seventh proposition about the Chinese MNEs' reliance upon cost advantage and price competitiveness in the international markets has been confirmed by this case study, although it should be noted that its main competitive advantage over domestic rivals lies in its capability to innovate and commercialise, resulting in larger number of new products developed and launched each year than them. In international markets, SEG has focused on a number of niches (eg, in Southeast Asia) where its cost advantage and technological advantage can be combined and explored.

As regards the motives for FDI, the SEG case generally confirmed that the most of its outward FDI projects are market seeking and/or technology seeking. However, SEG does not seem to have invested overseas in order to escape the home government intervention as Shougang does. This is no doubt related to the fortunate location of SEG in Shenzhen SEZ where the government has minimal intervention into the activities of firms, even the SOEs. Moreover, SEG's original export-oriented strategy from the outset had also reduced SEG's exposure to these domestic problems.

As majority of SEG's overseas investment projects are joint venture arrangements, this case study supports the proposition that joint ventures are likely to be main investment mode by the Chinese MNEs. In relation to the importance of SEG's joint ventures both in China and overseas, the network advantage SEG has enjoyed in creating its own technological advantage, in access to its partners' international marketing channels and in overseas direct investment has confirmed the last proposition that the Chinese MNEs are likely to have enjoyed network advantage arising from their cultural ties with overseas Chinese communities and from their business relationships with their foreign partners in their internationalisation.

## **PART IV.**

### **CONCLUSIONS & IMPLICATIONS**

## CHAPTER 12

### SUMMARY OF THE CASE STUDIES, IMPLICATIONS, LIMITATIONS AND FURTHER RESEARCH

#### 12.1 Introduction

While much has been written about the internationalisation of firms from the Third World, often based upon flawed aggregate statistical data and quantitative surveys, few detailed case studies have been undertaken to examine the actual interactions between the evolution of home and host country conditions, the creation and developments of firm-specific competitive advantages, the evolution of corporate strategies and the internationalisation of the firms. This study by employing detailed case studies of five Chinese manufacturing MNEs has attempted to explain these complex interactions.

This chapter attempts to summarise the findings of the case studies of the five Chinese manufacturing MNEs. The contribution of this research to the theoretical and empirical literature is also discussed. The implications of the findings of this research for both the Chinese SOEs and the Chinese government are explored, and limitations of this research considered. This chapter also points to further research directions.

#### 12.2 Summary of the Case Studies

This section summarises the experiences of the five case companies as a group in light of the ten propositions.

*Proposition 1.* The competitive advantage of Chinese MNEs are likely to be influenced by the characteristics of the home country diamond.

The five case studies confirmed that the home country diamond and its evolution impacted upon the creation and nature of competitive advantage of the five case

companies. In the case of Shougang, it is the Contract Responsibility System that enabled it to retain sufficient funds to undertake technological improvements and innovations as well as diversification into other industries. In this process, Shougang has been transformed from a technologically backward iron and steel producer to one of the largest conglomerates in China, with substantial technological advantages even by international standards. This has encouraged Shougang's ambition to become one of the world's 500 largest MNEs by 1995, which underlines its current corporate strategy. The liberalisation in both state-owned enterprise management and foreign trade has also led to the diversification of the two pharmaceutical case companies, although the long-standing relationship between the SPA and Northeast seems to have stabilised the role of the firm as an exporter. The impact of home country diamond evolution upon corporate strategy and behaviour is most evident in the cases of SEG and Municipal Light, because the two export-oriented manufacturing company groups would have been impossible had the economic reforms and Open-Door Policy not been started.

The home country diamond has also influenced the nature of competitive advantages and generic strategies of these five case companies. Lack of competitive pressure at home, plentiful supply of cheap labour, technical and managerial staff, and lack of demanding customers at home, all contributed to their focus upon cost competitiveness instead of product differentiation in international markets. However, during the past 15 years of economic reforms and Open-Door Policy, they have all made efforts to upgrade their technological competence through importing and adopting foreign technologies, research collaborations with other parties and in-house R & D facilities. These technological improvements have contributed to the improvements of their product quality, yet they all fail to differentiate their products successfully in the international markets.

What emerges from empirical research of the five case companies is that they have mainly perceived their competitive advantage (eg, technological advantage, product quality) over their domestic rivals instead of international competitors including MNEs from other Third World countries. This highlights the fact that their main

competitive advantage in international markets lies in low costs and price competitiveness instead of product differentiation (see Proposition 6), and that there has been a substantial gap in labour and other operating costs between the Chinese firms and their nearest Third World competitors. Only Shougang has been able to compare itself with the world's leading steelmakers in technological advantage.

*Proposition 2.* Chinese MNEs are likely to have competitive advantage in technology reflected in proportion of non-operative workers, R & D expenditure, advertising intensity and scale of economies.

This proposition generally holds for all the five case companies, in their comparisons with their domestic rivals, although specific measurements differ for each case company. Table 12.1 has outlined the measurements of technological and other advantages of the five case companies.

The proportion of non-operative workers was substituted for by the proportion of university graduates among staff. The reason for this substitution is that most employees having been educated to university level and above are working as either professional or technical staff, and few of them are working on operative posts.

Among the five case companies, only Municipal Light was unable to provide data on this measurement, but the group had a higher proportion than its domestic rivals of up-to-date equipment imported from abroad, which should have led to a lower proportion of non-operative workers.

Data for R & D expenditure for the five case companies was either poor or unavailable. R & D expenditure usually came from four sources: new product development fund (directly allocated to research and development unit(s) within the firm), fund for the trial production of new products, fund from capital investment (in case of technical innovation(s) involved), R & D fund allocated from the state (if a project is classified as national key project).

Table 12.1 The Technological and Other Advantages of the Case Companies

	Shougang	Baiyunshan	Northeast	Municipal Light	SEG
Proportion of Non-operative Workers	The largest number & highest proportion of university graduates in steel industry	The largest number & highest proportion of professional & technical staff in pharmaceutical industry	The second largest number & second highest proportion of technical staff in pharmaceutical industry	Not applicable	The largest number & highest proportion of university graduates among electronics firms
R & D Expenditure	Not the largest in the industry	Largest in the industry	Unknown	Not important	Unknown
Number of Patents	Largest among all Chinese firms	Unknown	Unknown	Unknown	Unknown
Number of Quality Prizes	Yes, larger than domestic rivals	unknown	Yes, largest in the industry	Unknown	Unknown
Number of New Products introduced each year	unknown	Yes, larger than domestic rivals (but diversified businesses)	Best capability to upgrade product quality & standards	Unknown	Largest than domestic rivals
Economies of scale	Yes, for steel production	Yes, for final dosgae forms	Yes, for synthetic drugs	Yes, for bicycles	Unknown
Advertising Intensity	Not important	The largest advertising & PR spender among all Chinese firms	Not important	Not important	Not important
Sectoral Diversification	Yes, most diversified among major steelmakers in China	Yes, far more diversified than any competitor in pharmaceutical industry	Yes, diversified into related industries	Producing a larger number of unrelated products than any other firm within the light industry	Yes, more diversified than major domestic competitors in China

Source: Author

In case of group of firms (eg, SEG and Municipal Light), virtually no data for consolidated R & D expenditure exists at group level because their divisions and firms have all made their own decisions on R & D budgets. Thus this measurement should not be used as an indicator of technological advantage of the firms in China.

The R & D expenditure should be viewed as an input to rather than an indicator of technological advantage. Anyhow, it is the quality of research and development as well as the magnitude of R & D expenditure that determined the technological advantage of a firm. Therefore, two output variables were used to measure technological advantage, namely, the number of new products developed and launched, and the number of quality prizes won each year (or accumulated over the past five years). In the case of Shougang, the number of patents was also used as an indicator of its technological advantage, for which data was available. However, China only passed Patents Law in 1988, which may have led to many patentable unregistered innovations. Thus this measurement can be only used as supplementary to the other two.

Overall, these three measurements should in fact be a better indication of technological advantage rather than simply R & D expenditure.

Economies of scale are important as an indicator of technological advantage of the five case companies, especially for their core business. However, because all these five case companies have diversified businesses (in terms of industrial sectors), this variable should thus be less important in measuring the case companies' technological advantage.

Advertising intensity reveals nothing about the competitive advantage of Chinese firms. Among the five case companies, only Baiyunshan has a formal budget for advertising and public relations, and it focuses on the domestic market. The rest have not spent much (in terms of formal budget) on advertising (and PR), and any advertising tended to be on ad hoc basis.



Finally, sectoral diversification is apparent for all the five companies. The case companies are the most diversified firms in their respective industries (core business). Northeast is the exception. It has only integrated backward to raw materials production and forward to final dosage forms manufacture as well as into pharmaceutical machinery, related to its core business.

*Proposition 3.* Chinese MNEs are likely to have experienced an incremental stage-by-stage internationalisation process, namely from not exporting, to indirect exporting, to direct exporting, to the establishment of overseas sales offices and eventually manufacturing facilities abroad.

This proposition has gained partial support from three case companies, namely, Shougang, Baiyunshan and Northeast while the experiences of Municipal Light and SEG denied its applicability.

The distinction between the newly established companies (ie, those set up after 1980) (eg, SEG and Municipal Light) and the three others, the established companies (ie, those set up before the 1980s) is important in terms of their initial corporate strategies (Huang et al, 1991).

For Shougang, Baiyunshan and Northeast, the three established manufacturers in China, the proposition coincides with their experiences. They have all experienced a process of change from indirect exporting to direct exporting. However, their initial indirect exporting was institutionally mandated because Chinese manufacturing firms did not have any direct import and export autonomy before 1980. As Chapter 4 has revealed, the 12 state-owned trading companies had monopolised foreign trade activities. In other words, all import and export activities had to be handled by them without exception. Thus they initially relied upon indirect exporting, and later on they become able to export directly when they were granted import and export autonomy in the 1980s. This supports the proposition of incremental internationalisation. However, support remains limited to this point because they then leapfrogged to the establishment of overseas manufacturing, instead of establishing an overseas sales

office first.

The proposition was not applicable to Municipal Light and SEG because they started direct export at the outset, and also leapfrogged from exporting to the establishment of overseas manufacturing facilities, bypassing the stage of overseas sales offices. Table 12.2 outlines the chronological developments of the five case companies' internationalisation processes.

Table 12.2. The Internationalisation of the Case Companies  
-- A Chronology

Company Name	Year of Establishment	First Export (Year)	Import/export autonomy	First Joint Venture in China	First Overseas FDI (Year)	
					Sales	Manufacturing
Baiyunshan	1973	1976	1985	1986	1987	1987
Municipal Light	1984	1984	1984	1984*	1988	1988
Northeast	1946	1968	1987	1988	1990	1991
SEG	1986	1986	1986	1986*	1986	1986
Shougang	1919	1978	1981	1987	1989	1988

\* Some joint ventures set up before the formation of two groups were among the founding members of the respective groups.

Source: Author

*Proposition 4.* The Chinese MNEs may have no initial strategic plan for internationalisation. But as their internationalisation deepens, they are likely to have formulated and been pursuing internationalisation either as part of their corporate strategies or as one of the most important constituents in their corporate strategies.

This proposition only holds for two well-established case companies (ie, Shougang, and Northeast Pharmaceuticals). There has been a strategic change in their market orientation, namely from purely domestic market to both domestic and international markets. Once they had been granted direct import and export autonomy and as they

proceed further to internationalise, they have attached an increasing strategic importance to internationalisation. For Shougang, internationalisation has now become its current corporate strategy while Northeast has been pursuing an export-based international strategy.

Baiyunshan is still pursuing a mainly domestic market oriented conglomerate diversification strategy, although it plans to set up several overseas R&D centres in future.

The two new companies, namely Municipal Light and SEG, had export-oriented strategies from the onset. And both of them are now pursuing multinational development strategies, focusing upon both exports from China and outward FDI. Indeed, their strategic orientation to international markets has contributed more than any other single factor to their high degree of internationalisation and multinationality.

*Proposition 5.* International strategies will not only speed up Chinese firms' subsequent internationalisation process but also influence their motives and choice of foreign market entry methods and modes.

The findings of the five case studies confirmed that corporate strategies played an important role in the internationalisation of the firms. In the case of the three companies (ie, Shougang, Municipal Light and SEG) that are pursuing internationalisation strategies, their corporate strategies have decisive impact upon the speed of internationalisation, as well as the motives, methods and modes of foreign entry.

The contrasting experiences of the two pharmaceutical companies, Baiyunshan and Northeast, illustrates the impact of their corporate strategies upon their internationalisation. While Baiyunshan may seem to possess greater competitive advantages than Northeast in technology, management autonomy and marketing expertise, it has been pursuing a domestic-market oriented, conglomerate

diversification strategy. As a result, its degree of internationalisation has remained insignificant (with exports accounting for less than 10 per cent by 1992). Northeast, in contrast, has been oriented towards international markets since the late 1960s (albeit due to the increasing export quotas imposed by the State Pharmaceutical Administration). The degree of its internationalisation has been on the rise, with exports accounting for more than 60 per cent of its total sales by 1992. Although Northeast's long standing relationships with its foreign pharmaceutical customers contributed to its high proportion of exports, it can be argued that its international market orientation is a major determinant. Baiyunshan and Northeast both have less than five overseas investment projects, which coincide with their lack of strategic orientation in this dimension. Thus the contrasting experiences of Baiyunshan and Northeast Pharmaceuticals also confirm the impact of corporate strategy upon the internationalisation process.

The impact of international strategy upon the speed of internationalisation is most evident in the case of Shougang. Its strategic change from domestic conglomerate diversification to internationalisation had led to a rapid increase in its exports (from US\$9.88 mn in 1987 to US\$210 mn in 1991) and in the ratio of exports to total turnover. Its recent acquisitions of several firms in Hong Kong have clearly indicated its quickened pace of internationalisation under its current corporate strategy.

For the four companies (SEG, Shougang, Shenzhen Municipal Light and Northeast Pharmaceuticals) pursuing international strategies, the impact of such strategies upon the nature of their internationalisation is clearly evident. While Northeast's export-based international strategy has led to its focus upon exports from China with foreign direct investment being supplementary, SEG and Shenzhen Municipal Light's strategic evolution from export-oriented strategies to internationalisation strategies has enabled them to focus upon both foreign direct investment and exports. Indeed, most of their FDI projects were undertaken after they had formulated internationalisation strategies.

*Proposition 6.* In terms of generic strategies, Chinese MNEs are likely to base their

competition primarily upon cost advantage and thus enjoy price competitiveness in the international markets.

To verify this proposition calls for more focused research on each of the products on offer by the companies concerned in each of its major markets. However, from corporate perspectives, these five case companies tend to support the notion that price competitiveness remains the most important competitive edge for Chinese firms in international markets. However, it is necessary to consider too the importance of product quality, and new product development in their becoming internationally competitive.

Cost advantage has been the most obvious positional advantage the Chinese MNEs have in international markets. Price competition seems to be the most popular competitive strategy in international markets though SEG has been attempting to create its own international brand name. The MNEs examined here have not yet concentrated on brand development. They still rely heavily on OEM sales. In this aspect, Chinese multinationals resemble their counterparts from other Third World countries (Wells, 1984; Lall, 1986), even until recently Asia's NIEs (McDermott & Young, 1989; McDermott, 1991). Even Baiyunshan, which operates without much government intervention, has not yet developed an international brand name though in the domestic market its brand has been remarkably successful.

The cost advantage and price competitiveness of the five case companies in international markets basically originated from China's low labour costs and inexpensive expatriate managerial and technical personnel in their overseas establishments. Furthermore, product quality has improved steadily both prior to, and as a consequence of, internationalisation. These quality improvements are closely associated with the firms' absorbing and further enhancing imported technologies and equipment (see Proposition 7), which also helps them increase productivity, gain economies of scale and thus further reduce production costs.

*Proposition 7.* Chinese firms are likely to have modified and improved technologies

and equipment imported from developed countries in order to create their own technological advantage.

Like MNEs from other Third World countries such as India (Busjeet, 1980; Wells, 1984; UNCTC, 1988), Singapore (Ting, 1982; Fong & Komaran, 1985; Hui & Fong, 1986), Hong Kong (Chen, 1983; Wells, 1984; Yeung, 1988), South Korea (McDermott & Young, 1989) and Taiwan (McDermott 1991), the Chinese MNEs obtained their technological advantages mainly through absorbing and improving technologies and equipment imported from developed countries. However, in the case of Shougang, the company did not scale down the imported technologies as experienced by MNEs from other Third World countries (Wells, 1984). On contrary, it scaled up, which may be interpreted as related to the large market potential in China.

It has to be pointed out that technology importing alone does not explain why these Chinese companies were able to become multinationals. Evidence from these five case studies suggests that they are continuously upgrading their internally developed technological skills (in mainly process innovations but also product innovations), resulting in continuous improvements in product structure and quality, greater production efficiency and a reduction of unit costs, all ultimately resulting in better financial performance. This steady investment in technological progress and continuous improvement of technological competence distinguishes these case multinational companies from the domestic ones. In addition, international orientation and outlook seem particularly important in differentiating SEG and Municipal Light as MNEs from the other three case companies (Shougang, Baiyunshan and Northeast) and domestic market oriented companies. These three case companies, as discussed previously, have experienced evolutionary strategic changes in terms of market orientation and overall corporate strategy.

Thus this proposition is confirmed by all the five case companies. For the established companies, they had imported, modified and improved technologies and equipment, for which they paid hard currencies. Later on they used joint ventures (with foreign

partners) as the main mode of transferring foreign technologies.

The two new companies, SEG and Municipal Light, have relied basically on joint ventures as the main method of importing foreign technologies and equipment.

Foreign technologies and equipment has been imported through a variety of channels -- outright buying of patents and technical know-how, joint ventures, technical consultancies from foreign experts, etc (see Section 12.3 for the role of joint ventures in China in the internationalisation process of the case companies) (see Section 12.3 for the role of their joint ventures in China with foreign partners). By the time they started to set up overseas establishments, they had created their own technological advantage.

*Proposition 8.* The main motives for Chinese firms to invest overseas are to gain access to host country markets or third country markets, or seek advanced technology of the host country. Escaping home country government interference is also likely to be an important reason behind their outward FDI.

Previous empirical studies of MNEs from other Third World countries have suggested a number of motives why firms in developing countries should internationalise. These include boosting exports (Vernon, 1979; Busjeet, 1980; Chen 1981; Jo, 1981), avoiding trade restrictions such as import quotas and high tariffs imposed by industrial countries (Chen, 1981; Jo, 1981; Hood & Young, 1987), limited home market (Busjeet, 1980), diversifying risk (Busjeet, 1980), and seeking low cost production locations (Wells, 1977; Vernon, 1979; Chen 1981; Jo, 1981).

Throughout this research, it has been found that several factors have motivated Chinese firms to internationalise. Some of these factors are uniquely related to China's domestic environment, such as their desire to escape government intervention, dissatisfaction with the rigid and fragmented domestic market, incentives for generating foreign exchange earnings, circumvention of export quotas (imposed by the domestic government), and attracting foreign firms to invest in China (so that

the joint ventures in China could enjoy fiscal incentives as well as other preferential treatments available for foreign invested firms) (see Huang & McDermott (1992) for a full discussion of these motives). These factors have encouraged Chinese firms to seek development opportunities overseas (Wang, 1984; Ye, 1992). Strategic intent to become a "modern MNE" has also been an important motivating factor for the internationalisation of Chinese firms (Ye, 1992).

A number of other motivations for FDI by the Third World MNEs can be identified among the case companies. These include their desire: to achieve market diversification (eg, Baiyunshan and Northeast's joint venture in the Mauritius, Shougang in Indonesia and Malaysia); to gain access to advanced technologies in host countries (Shougang in the USA); to promote export of machinery, raw materials and semi-finished products (Baiyunshan and Northeast's joint venture in Mauritius); to access raw materials (Shougang in Peru). The case companies have also been motivated to integrate forward (Northeast in the USA); penetrate third country market (Northeast and Baiyunshan's joint venture in Mauritius) as well as overcome weaknesses in technology (Shougang's acquisition of Mesta Engineering in the USA) and international marketing (sales offices by the case companies in Europe, Hong Kong and North America).

This research has indicated that motives for FDI differed from those for exports, and indeed differ from one FDI project to another. Although many of the motivations for exporting hold true for FDI too, there are also differences in the motives between exporting and FDI. In general, FDI was undertaken where export opportunities were restrained or additional location variables made FDI a more attractive entry mode for the Chinese MNEs. In this sense, exporting and FDI were complementary rather than substituting activities among the Chinese MNEs examined in this research.

The five Chinese manufacturing multinationals studied here do not invest mainly in countries less developed than the home country. Instead, most of their investments are located in either developed countries or more advanced developing nations in terms of per capita income (see Table 10.3. and next section on the regional



distribution of their FDI projects). This pattern can be explained by their desire to penetrate and/or defend their market in these host countries. The bulk of Chinese exports and of these case companies are directed to developed country markets rather than developing countries. This pattern of FDI by the Chinese MNEs is also an indication of their self-confidence in their competitive advantage against developed host country firms and firms from other countries. Some of the investments made by the companies in the study were aimed at getting access to technologies in the host countries.

Table 12.3. Outward FDI Locations of the Case Companies  
(by number of FDI projects, as of July 1992)

Company	Asia				Europe		North America		Others	Total
	HK	Macau	Japan	ASEAN	EC	East	USA	Canada		
SEG	5		1	2					2	17
Municipal Light	3	2		2	1		1	2	1	12
Shougang	2	1		3	2	1	2		3	13
Northeast	1				1		4		1	5
Baiyunshan	1		1		2		1	1	1	4
Total	12	3	2	7	6	1	8	5	7*	50*

\* There is one joint venture by Northeast and Baiyunshan in Mauritius. So the total number of FDI is one less than the sum of all.

Source: Compiled by author

*Proposition 9.* Joint ventures are likely to be the main method of investment by the Chinese MNEs in their outward investment.

This proposition is confirmed by the collective evidence of the five case companies. Among the 50 overseas investment projects undertaken by the five case companies by July 1992, 29 were joint ventures. In particular, joint ventures were the predominant mode of foreign market entry in their outward FDI in manufacturing. However, there were only 4 out of the 16 trading investment projects (see Table

12.4).

Table 12.4 The Foreign Entry Methods by Case Companies  
(by July 1992)  
(Wholly-owned Subsidiaries v Joint Ventures)

Company	Investment in overseas trading offices		Manufacturing Investment	
	Number of Subsidiaries	Number of Joint Ventures	Number of Subsidiaries	Number of Joint Ventures
Shougang	4	1	2	6
Baiyunshan	0	1	2	1
Northeast	3	0	0	2
Municipal Light	1	1	3	7
SEG	4	2	2	10
Total	12	4	10	25*

NB: \* There was a joint venture between Baiyunshan and Northeast Pharmaceuticals in Mauritius.

Source: Compiled by Author

*Proposition 10.* Chinese MNEs are likely to have enjoyed network advantage arising from their cultural ties with overseas Chinese communities and from their previous business relationships in their internationalisation process.

Overseas Chinese appeared to be important in the internationalisation process of Chinese manufacturing firms examined in this study. Hong Kong Chinese and to a less extent the Chinese in Southeast Asia have been always important business partners to the Chinese MNEs in those host countries, so long as the local Chinese establishments proved to be reliable and capable business partners. Nonetheless, the five case companies have all expressed wishes to reduce their reliance upon the overseas Chinese and increase their control over marketing and operations in these host countries.

The role of overseas Chinese in the Americas seemed to be mainly limited to the early stages of the firms' direct exports and initial outward FDI. Once the Chinese firms gained experiences in the host markets via direct exports and local operations, they tended to avoid relying upon local Chinese communities.

This may have to be explained by the fact that manufacturing enterprises in China had no direct import and export experiences before the 1980s because international trade was monopolised by the 12 national FTCs. As a result, the Chinese manufacturing firms had no opportunities to participate directly in international business and no international experiences.

### **12.3 A Chinese Approach to Internationalisation ?**

In the literature, the Nordic Model (Johnson & Vahlne, 1977) and the Product Life Cycle Model (Vernon, 1967, 1979) are the two main theories explaining export and FDI in a process context. In view of the characteristics of the Chinese economy and the Chinese MNEs examined, the approach to internationalisation taken by Chinese MNEs tends to be characterised by a). the importance of their changing corporate strategies, b). the role of joint ventures both inside China and overseas, and c). the improvement of technological advantage, which are discussed in detail below.

a). *A change of corporate strategy*: it has been shown that long established SOEs have been transformed from a purely domestic market orientation to a domestic and an international market orientation, and Shougang has gone the furthest to focus primarily on internationalisation. Thus their approach to internationalisation has coincided with the Nordic Model (Johnson & Vahlne, 1977). However, caution must be exercised when accepting the applicability of this model to Chinese MNEs given that they had no autonomy for direct international involvement before the 1980s and that they sometimes leapfrogged from indirect exporting to the establishment of manufacturing facilities overseas.

The Nordic model lacked explanatory power for the newly established manufacturers (ie, those founded after 1980), especially those in the SEZs in China. Newly established manufacturers like SEG and Municipal Light have always been oriented mainly to international markets.

b). *The role of joint ventures:* joint ventures in China with foreign partners have occupied a very important role in the process of Chinese firms' subsequent outward internationalisation. All five case companies studied have set up numerous joint ventures in China with foreign firms. In doing so, they not only obtained advanced technology and access to international marketing channels, but also learnt much on setting up and managing overseas subsidiaries and joint ventures. This was to prove invaluable when they themselves began to establish operations overseas.

c). *Market and technology seeking motives for FDI:* the Product Life Cycle Model has not been expressly tested in this study because the model was developed at a country rather than firm level. However, it is also possible to refute the applicability of the theory to Chinese MNEs because the PLC model is by virtue a cost-minimising model whereas nearly all FDI projects undertaken by the five case companies were located in developed countries (see Table 12.3) which were and are high cost locations relative to China. Furthermore, Chinese firms may have been climbing upwards in the technological ladder, and according to the PLC model there would be no FDI from China.

In summary, corporate strategies have played an extremely important role in the internationalisation process of the Chinese firms. Corporate strategy not only influences the way the Chinese firms generated and improved their competitive advantage in response to the external changes, especially the Chinese domestic diamond, but also determines the speed of their subsequent internationalisation as well as the motives and choice foreign entry methods and modes.

## 12.4 Methodological Contribution

It has been argued that empirical research in China is a very challenging task for any researcher. Mobility is restricted by the inadequate transport system, and telecommunication remains primitive with demand far outweighing the capabilities of the existing network. These difficulties are compounded by the absence of a national telephone directory and fairly up-to-date directories of Chinese business. The problems posed by the low level of economic development pale into insignificance however in comparison to the cultural barriers. (Accessing decision-makers requires an elaborate indirect approach using "guanxi" (personal connections). Gaining access per se is of little benefit unless the interviewee can be persuaded to be open and forthright. Chinese managers are unaccustomed to be questioned by outsiders.)

(This hostile research environment, plus the limited applicability of existing theories of the MNE and the internationalisation of firm to Chinese manufacturers, led to the conclusion that the case study method was the most appropriate.)

The use of the case study method has two major attributes. (Firstly, the researcher had used a contingency approach to gaining access to the case companies. This means that a wide range of personal contacts ("guanxi") were deployed to establish the necessary access to the senior managers of the case companies.) Based upon the rapport established with the senior managers, the researcher also took the opportunity to request further information about the companies, their internationalisation, etc, besides the interview data. These multiple sources of information have enabled the researcher to present the case studies in an historical and environmental context.

Secondly, the case studies have reflected the researcher's belief that the case study approach may often be richer and deeper than a quantitative survey in revealing a wide range and complex issues of the subjects investigated. In each case study there was a common focus reflected in the ten propositions related to the nature of competitive advantage of the case companies, their process of internationalisation, the impact of their corporate strategies upon their inter-nationalisation process. Thus the

purpose of the propositions was to ensure that all case studies had a common focus. Moreover, it was also possible to provide evidence to verify the propositions derived from the literature.

## **12.5 The Implications of This Research**

The findings of this research appear to have some implications for both the Chinese SOEs and the Chinese government. For individual Chinese SOEs that aspire to become MNEs, they have to tackle simultaneously two eminent tasks: the management improvements and reforms within the firm and the internationalisation of business. Without the former, it is impossible for them to create sufficient competitive advantages to ensure the success of the latter. It is clear that preliminary resources and capabilities are needed before they can undertake internationalisation beneficially. These include their managerial and technological competence, particularly their capability to improve the quality of their products to be marketed in both the domestic and international markets.

Internationalisation per se should not be itself an objective of the Chinese SOEs. It is important for them to have a clear understanding of what their corporate objectives and strategies are and why exports and especially outward FDI should be undertaken to achieve these objectives. This requires them to monitor continuously and assess realistically their competitive advantages and identify opportunities and threats in both the domestic and international markets in order to formulate feasible corporate strategies. As the Chinese domestic market has been growing faster than almost any other country, the Chinese firms have to be more thoughtful to justify their internationalisation, especially their outward FDI.

There is no doubt that direct investment in overseas marketing facilities and particularly manufacturing establishments is very risky, because very few Chinese manufacturing SOEs have sufficient international experiences and expertise to ensure

the success of such investment. More efforts should be made to train at least key managerial and technical staff for international operations.

For the Chinese SOEs, one of major benefits from the internationalisation of business is that they can learn and adopt appropriate management practices and techniques in the process because operating and competing in these countries will provide them with the direct lessons. As the Chinese economy is becoming more market oriented and more interdependent with the international markets, this benefit will become more apparent.

However, in their quest to become leading MNEs, the Chinese SOEs should be aware of the potential risks associated with outward FDI, particularly overseas manufacturing facilities, and the enormous difficulties in coordinating and controlling overseas operations and marketing. It is thus useful for them to be aware of different options in the methods and modes of outward FDI.

In their process of internationalisation, it seems useful for the Chinese firms to take advantage of the ethnic ties and cultural links with the vast and geographically dispersed overseas Chinese communities, which could help them overcome their difficulties arising from their lack of international marketing experiences and thus unfamiliarity with the local business environments of the host countries. It is also good for them to make use of existing business relationships with their clients of the host countries when they decide to invest in these countries.

For the Chinese government, a great policy challenge has arisen from the internationalisation of the Chinese SOEs. As the Chinese MNEs are state-owned, and there have been already many difficulties in SOE reforms and making them profit and competitive, the internationalisation of the Chinese SOEs seems to further complicate the issues. As the experiences of the five case companies demonstrate, enterprise reform and their internationalisation seems to be interactive. If the government wants to succeed in reforming the SOEs, it is important to take into account the perspective of the firms as regards their management autonomy, corporate and

business strategies and their motivations for outward investment.

On the one hand, there is a clear sign that SOEs should be allowed greater management autonomy, including their right to engage in outward FDI. On the other, it must be realised that giving SOEs full management autonomy is not the panacea to all the problems they have, because they have to face eventually competition from other domestic firms and international rivals as the Chinese economy is becoming fully market oriented and more interdependent with international markets. The Chinese government should start taking actions to improve SOEs' international competitiveness while reforming them. For example, it can increase the proportion of business studies subjects with an international orientation in the tertiary education, encourage SOEs to organise or participate in training courses and seminars in Business Studies and specially International Business subjects. The industrial policy should also bear in mind the needs to dismantle ministerial and regional protectionism prevailing in the domestic market so as to create an integrated market for firms to reap from economies of scale and encourage inter-firm fair competition.

Moreover, an understanding should be developed to distinguish capital flight (for the personal benefits of a few top managers and government officials) and genuine outward FDI (for the benefits of firms) so as to formulate proper policy to prevent the former while encourage the latter.

Lastly, the government policy of encouraging only the inter-nationalisation of the trading companies needs a reassessment and adjustment, as these five case studies show that there are clearly good reasons why the manufacturing firms should undertake outward FDI and that they are capable of undertaking such investment beneficially.

## **12.6 The Limitations of the Present Research**

The present research has several methodological limitations. From a methodological



perspective, the major limitation associated with the present study is the generalisability of the findings from the five case studies. In addition, the analysis of case data and the presentation of case study may be controversial.

Like any other research using a qualitative research methodology, the question of generalisability of qualitative research (including case study) work can always be challenged. According to quantitative methodology, generalisability of findings from research depends on the representativeness of sample. Thus the findings from these five case studies can not be generalised to all Chinese manufacturing firms that have internationalised their operations.

First of all, it is difficult to ascertain the degree to which the five case companies constitute a representative sample because there is no data available about the population of Chinese manufacturing MNEs. (Even if such data were available from official sources, the accuracy of such data may be omitted, because as this researcher discovered, Chinese manufacturing MNEs do not always report all of their overseas FDI projects.)

However, even those disposed to quantitative research are likely to conclude that even unrepresentative cases may prove valuable if accepted for what they are, namely exploratory research rather than hypotheses testing.

As argued in Chapter 6, (many qualitative researchers suggest that the representativeness of the cases may not even be relevant at all. They believe that the generalisability of quantitative research does not depend on the representativeness of the cases, but on the plausibility of the logic of analysis (Worseley and others, 1970, p.112).) Logic inference is epistemologically quite independent of statistical inference (Mitchell, 1983).

If the cases are not "representative", then the findings from these cases can reveal the limits of a "representative" sample. Still the findings from the case studies may be important in increasing our understanding and knowledge of the subject researched.

This researcher takes the stance that qualitative research is at least as important as quantitative research. Given the present difficulties in obtaining data on Chinese manufacturing MNEs and in getting access to them, the findings from these five case studies can be treated as exploratory.

The exploratory nature of this research should not be taken as to deny the relevance of the existing theories on MNEs and internationalisation of business. Rather, it is the peculiarities of the Chinese economic system and structure which constrain the applicability of theories based upon the experiences of firms from mainly developed market economies. Throughout this research, it has been seen that the creation of competitive advantage and the internationalisation of Chinese manufacturing firms are closely intertwined with the economic reforms and open door policy. This finding alone can hardly be generalised to other countries.

Operationalising quantitative research has been and will remain very difficult. Chinese firms still have much to learn regarding competition, the market mechanism and modern management techniques. (Using quantitative survey assumes respondents have a fairly good understanding of the subject and either possess or can obtain the information required in the survey questionnaire) Such assumptions are unwise, given that firstly most Chinese managers have not been exposed to management training, and secondly identifying (a sufficient number of) individual respondents is almost impossible because of the absence of up-to-date business directories.

In addition, many Chinese managers do not think themselves as managers but as government officials (cadres). The implication is that they tend to treat information as secret, not to be imparted to researchers outside their organisations, especially those from abroad. Respondents to quantitative methods are thus unlikely to provide sufficient and reliable information. Qualitative research, on the other hand, can be more effective and the data obtained through such research, is more reliable. This is because qualitative (eg, case study) researchers can establish personal contacts ("guanxi" in Mandarin) with a small number managers (respondents), which will significantly help the researcher not only to get access to required data but also to )

ensure the reliability of the data provided.

## **12.7 Further Research**

In light of the above mentioned limitations of the present research and the acceleration of pace of Chinese firms investing overseas, a number of research topics have emerged as important for future research on Chinese MNEs.

1). Quantification. Although large scale quantification will remain very difficult , this is important to indicate the magnitude of the emerging MNEs from the People's Republic of China and their economic and managerial impact on the Chinese economy. Such research can also yield valuable insight to a number of issues such as to what degree that the propositions verified by this research can also be substantiated by the population of Chinese MNEs. Taking into account the deficiencies in the official statistical data about the Chinese MNEs and the difficulties in gaining access to them, it is perhaps necessary to use a small but representative sample to test the hypotheses derived from the propositions used in this research.

2). Strategic and organisational issues: Research can be undertaken to reveal how the organisational structure of Chinese manufacturing and services MNEs has changed in response to their strategic changes and degree of internationalisation. For example, how do the Chinese MNEs cope with the managerial challenges (especially human resources) as their internationalisation deepens ?

3). The Role of Joint Ventures: Research into the links between joint ventures by Chinese MNEs and foreign partners in China and the Chinese MNEs' internationalisation should be further extended. Attention can be paid to the contribution of joint ventures in China to the creation of Chinese parents' competitive advantage and the internationalisation process.

4). Service MNEs: Research into Chinese service MNEs seems important as services organisations are very important in Chinese outward FDI. Services organisations have not only invested overseas in service sectors, but some of them have set up manufacturing establishments overseas (eg. Sinochem, Minmetals, Sinotrans). Particular attention should be directed to explain why Chinese service MNEs have neither been enthusiastic nor successful in setting up joint ventures or other collaborative alliances with Chinese manufacturing firms. Does this phenomenon reflect the ministerial (industrial) division within the Chinese government ? Findings from research on Chinese service MNEs can also have interesting comparisons with their manufacturing counterparts in terms of the sources and nature of their respective competitive advantage.

Given the rapid expansion of exports from China and of FDI by Chinese firms, these research areas will be very fruitful in helping us gain a comprehensive understanding of the creation and evolution of competitive advantages of Chinese firms, the changes of their corporate strategies and internationalisation experiences, as well as how their internationalisation impacts upon their corporate performance.

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