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## *Document Version*

Final published version

## *Publication date:*

2009

## *License*

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## *Citation for published version (APA):*

Hoenen, A. K., & Hansen, M. W. (2009). *Oligopolistic Competition and Foreign Direct Investment: (Re) Integrating the Strategic Management Perspective in the Theory of Multinational Corporations*. Department of Intercultural Communication and Management, Copenhagen Business School. CBDS Working Paper Vol. 2009 No. 10

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## **Oligopolistic competition and foreign direct investment**

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in the theory of multinational corporations

*Anne Kristin Hoenen and Michael W. Hansen*

CBDS Working Paper Series  
Working Paper Nr. 10, 2009

# **Oligopolistic competition and foreign direct investment**

(Re-) Integrating the strategic management perspective in the theory of multinational corporations

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## **Abstract:**

*The contemporary literature on foreign direct investment (FDI) has to some extent 'forgotten' a key insight of the early FDI literature, namely that FDI to a large extent is driven by strategic interaction of firms in oligopolistic industries. Instead the FDI literature has focused, at first on FDI as a way of generating efficiency in cross border transactions, and later on FDI as a way to effectively leverage and build capabilities across borders. These efficiency and capabilities perspectives on FDI may have been adequate in a situation where global competition still was in its infancy. However, in recent years, we have seen the emergence of truly global oligopolies, e.g. in electronics, aerospace, aviation, software, steel, automotive, construction, brewing, etc. These oligopolistic industries have been consolidated through massive waves of cross border M&As in the second half of the 90s and from 2003-2007. We argue that in such industries it is not adequate to analyze FDI only in terms of efficiency or resource leverage; FDI must also be understood in terms of its contribution to the global strategic positioning of the investing firm. The paper seeks to re-discover' the oligopolistic competition perspective, drawing on the early insights of the Hymer-Kindleberger-Caves tradition as well as on the recent Strategic Management literature, but bringing these into the context of globalization. It is argued that global strategic interaction in oligopolistic industries is manifest in well known FDI phenomena such as follow-the-leader, client follower, and first-mover. While the paper attempts no formal testing, evidence indicative of oligopolistic competition motivated FDI is presented, e.g. from the recent cross border M&A waves and from the recent surge of FDI in emerging markets.*

**Keywords:** *Oligopolistic Competition; Foreign Direct Investment; Strategic Management*

CBDS Working Paper Series  
Working Paper Nr. 10, 2009 ©  
November 2009

ISBN 978-87-92111-10-4

Editor: Henrik Schaumburg-Müller

## I. Introduction

Clearly, globalisation and such developments as the liberalisation of national market regulations, the removal of trade barriers, and the flourishing of private sector environments worldwide has changed the nature of competition. Competition has become a regional and global rather than a national game. The globalisation of competition is to a large extent an outcome of rapid regional and global consolidation characterising many of today's industries. Major corporations are entrenched in fierce and cut-throat global positioning games, where the end goal appears to be to divide the world between the surviving players. For instance, in the airline industry, increasing privatisation, deregulation and market liberalisation has thrown previously strong national carriers in the midst of a wave of cross border consolidation. In 2008, Air France-KLM (a 2004 merger of Air France and Dutch KLM) planned to buy a 25% stake in Alitalia, while Lufthansa, which swallowed the Swiss national carrier in 2005, acquired stakes in US Jet Blue, in British Midland and considered acquisitions in Brussels Airlines and Austrian Airlines. All these developments were closely watched by big US rivals, themselves heavily consolidating within the US, e.g. America West Airlines and US Airways or Delta merging with Northwest to form the world's largest airline.

To position one-self vis-à-vis rivals on an international scale, foreign direct investment (FDI) is increasingly used as a strategic tool. Multinational corporations (MNCs) acquire assets in foreign countries to expand their market shares at the expense of their main rivals and to access critical resources before their competitors. Moreover, by acquiring foreign assets, MNCs hope to improve their bargaining positions in future consolidation games. FDI in natural resource extraction activities are classical examples of internationalisation of oligopolistic industries, FDI in innovation driven industries such as windpower and pharmaceuticals are more recent examples.

While global oligopolistic competition undoubtedly is an important factor behind FDI, this fact is only weakly reflected in the extant literature on FDI. The FDI literature has generally been mostly interested in, how MNCs obtain greater efficiency by deploying their assets internationally, how they access foreign markets and resources, or how they generate rents by leveraging and building resources internationally. Consequently, the literature has devoted only scarce attention to FDI as a function of strategic interaction between dominant firms<sup>1</sup>. This apparent gap in the FDI literature is surprising given the fact that it since the late 1950s has been recognised that MNCs disproportionately operate in oligopolistic markets (Marcusen, 1995; Graham, 1998), and given the fact that the early FDI literature took its starting point exactly in the observation that FDI is common in industries where competition is inefficient. Thus, early theorists like Hymer (1960/1976), Knickerbocker (1973), Graham (1974; 1978) and Flowers (1976) explained FDI in terms of dynamics in oligopolistic industries. However, this understanding has seemingly been lost as other perspectives on MNCs' global activities, such as transaction-cost economics and the resource-based view, have won prominence. The apparent lacuna in the FDI literature has spurred an interest to explore the extent to

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<sup>1</sup> As stated by Tallman, "the traditional definitions of the MNC have been based on comparative usage of exports, licensing, and foreign direct investment as governance structures for operations in foreign markets. These definitions have decreasing relevance in a globalizing marketplace in which firms are defined more by their terms of competition, or strategy, than by their mode of operation, or structure" (Tallman, 1992; 455).

which it is relevant for the FDI literature to rediscover and expand the notion of strategic interaction among rivals in oligopolistic industries. Thus, this paper aims at reformulating and updating the oligopolistic competition perspective, drawing on the early insights of the Hymer-Kindleberger-Caves tradition as well as on insights of the recent strategic management literature and to illustrate this perspective by providing some real life examples of strategic interaction in FDI.

## **II. The FDI literature and strategic interaction**

In neoclassical trade models it was traditionally assumed that there was no capital mobility and hence no FDI. In the late 1950s, Mundel (1957) tried to integrate capital flows into neoclassical trade economics by relaxing the immobility of capital assumption. According to Mundel, FDI would take place to complement international trade and would thus essentially be a substitute for trade in cases where there were large trade barriers. Later Kojima (1978) argued that FDI took place to complement trade, e.g. in cases where imperfections in trade in factors impair the exploitation of comparative advantages. Another line of theorising focused on FDI as a result of capital arbitrage. According to this view, capital would move whenever the marginal product of the factor in one country exceeded the marginal product in another by more than the costs and risks of movement (Iversen, 1936). FDI was thus motivated with differentials in the interest earned on capital in different locations.

### **The dawn of FDI theory – the Hymer-Kindleberger-Caves tradition**

#### ***Hymer's seminal thesis***

In both trade theory and capital arbitrage theory, perfectly competitive markets were implied<sup>2</sup>. This view was fundamentally challenged with Hymer's seminal PhD thesis from 1960 (1976), in which he proposed a theory of FDI as an international extension of the industrial organisation (IO) SCP paradigm<sup>3</sup>. Thereby, Hymer moved beyond prevailing explanations of international capital flows based on neoclassical financial and trade theory from the standpoint of perfectly competitive markets. In Hymer's view, firms extended a dominant market position in home markets with a dominant position in international markets. In perfectly competitive markets, there would be little FDI, and cross border exchange would mainly take place through licensing and exports. But in cases with deviations from competitive markets, FDI would be common. FDI would take place provided two conditions were met: 1) the MNC would have a countervailing advantage over local firms to make international operation viable (e.g. scale economies or ownership specific advantages such as technology, brands, capital, contacts, etc.), and 2) the market for this advantage would be imperfect (Calvet, 1981; Dunning & Rugman, 1985). Horizontal FDI would take place to extent dominance into new market

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<sup>2</sup> Essentially, we can with Miller and Roth (1994) distinguish between three dominant types of market structures, namely 'competitive (implying many firms, with no dominant firms); 'oligopolistic' (implying few, dominant firms); and 'monopolistic' (implying a single dominant firm).

<sup>3</sup> The SCP paradigm (the so called Bain-Mason-Scherer structure conduct performance paradigm) holds that oligopolistic market structure determines firm strategy which determines performance. This paradigm has had enormous influence on business economics; for instance it forms the basis for Porter's industry framework, which holds that firm strategy is about identifying favourable positions in a given industry structure. In the SCP paradigm, profits are related less to efficiency in transactions and more to ability to build and defend market positions.

segments and vertical investments would take place to obtain advantages in oligopolistic home markets (Caves, 1971; Li et al, 2005).

### ***The main tenets of the strategic interaction view***

Hymer's explanation of MNCs is based on the prevalence of structural market imperfections providing opportunities for a firm to close markets and increase its market power<sup>4</sup> by exploiting its advantages across borders (e.g. scale economies). Here, structural market imperfections refer to deviations from purely market-determined prices resulting from the existence of monopolistic or oligopolistic market characteristics (Calvet, 1981)<sup>5</sup>. The oligopolistic features of an industry implies that decisions of one firm is directly influenced by and influencing that of other firms in the industry and that firms therefore in their strategies explicitly or implicitly takes into account the strategies of other firms in the industry<sup>6</sup>. Firms' strategic interaction can take many forms from competitive (non-cooperative) to collaborative (cooperative) strategies (Brandenburger & Nalebuff, 1995). The common characteristic is that firms' actions under oligopolistic industry structure are determined by actual or expected behaviour of rivals given the mutual interdependence of players in the industry. *"Thus, oligopoly differs from competition and monopoly in that a firm must consider rival firms' behaviour to determine its own best policy"* (Carlton & Perloff, 2005:153). Taking this view into FDI, FDI is seen as a result of mutual interdependence between the major players in an industry and becomes manifest when *"a firm's decision to engage in FDI hinges on the behaviour or expected behaviour of its rivals"* (Hennart & Park, 1994: 423).

A number of contributions in the wake of Hymer link FDI to market power in oligopolistic industries. One such contribution is Vernon's (1966) "international product life cycle". According to this theory, FDI is an outgrowth of the organisation of the industry, where the fear of imitators explains the FDI sequence of MNCs. Variations of Vernon's IO-based approach include the "follow-the-leader" concept (Knickerbocker, 1973; Flowers, 1976), and Graham's (1974) "exchange-of-threats" hypothesis. The former, provides a strategic behaviour explanation that links FDI to concentration ratios

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<sup>4</sup> Market power means ability to influence market structure and prices. According to Graham (1999), there are two aspects of market power, price setting power and attribute-selection power (Graham, 1999; 14). The first relates to the ability of firms to price their products at will, the second to their ability to select any mix of production varieties. All firms have some price setting and attribute selection power, the extreme version being monopoly, where the absence of substitutes gives the provider full discretion at setting prices and determining attributes. An oligopoly is defined as a situation where there is a small number of firms and small likelihood of substitutes (Graham, 1999; 16). From a welfare perspective, the existence of an oligopoly may lead to prices being too high, the supply of goods and services too narrow, or the production of product and services too ineffective (x-inefficiency).

<sup>5</sup> According to Calvet (1981), structural market imperfections derive from two characteristics of oligopolistic industries: first, strategies and decisions of the involved firms are interdependent. When constructing strategy, firms must take into account the reaction of other identifiable firms. Second, there are barriers to entry, meaning that competitive markets are hard to achieve. The entry barriers may exist due to formal protection of products and technologies through copyrights, trade marks and patents (Calvet, 1981) or through informal protection such as technical standards and collusive practices..

<sup>6</sup> As argued by Friedman, *"for a firm to react to its rivals, it must be affected by their actions and be aware of it. That is, strategic interaction will be prevalent in oligopolistic industries, where a firm's position is affected by the actions of identifiable rivals."* (Friedman, 1983:423)

and market power in oligopolistic industries in terms of oligopolistic reaction<sup>7</sup>. Risk-averse firms replicate a rival's initial FDI to minimise the threat of foreign cost advantages, which might distort the balance of competition or "oligopolistic equilibrium" (Knickerbocker, 1973). On a similar basis, Graham (1974) argues that firms in oligopolistic industries retaliate by establishing subsidiaries in each others' markets on an "exchange-of-threat" basis (Graham 1974; 1978).

In general, IO based explanations placed "*heavy emphasis upon leveraging market power and oligopoly as the explanation for the global expansion of firms*" (Teece, 2006; 127). In other words, FDI was an extension of oligopolistic rivalry into foreign locations and the research emphasised many of the concepts prevalent in IO such as 'pre-emptive investments', 'entry barriers', or 'competitive signalling' (Kogut, 1989; 384) and in general, game theoretical reasoning (Nielsen, 2005).

### **The transaction cost turn**

By the mid 1970s, the IO perception of FDI became subject to growing empirical and theoretical critique. According to these economics driven understandings of FDI, the source of FDI was not to be found 'structural' market imperfections in product markets, but in 'natural' market-failures in markets for intermediate goods. Buckley and Casson (1976) argued that IO explanations ignored costs by focusing on initial advantages of the MNCs, and Teece (1986) argued that an IO model might be valid but had only limited empirical applicability (see also e.g. Lall and Siddharthan, 1982). This critique of the market power based explanation of FDI was part of a more general transaction cost economics counter-movement against the IO perspective. The transaction cost perspective was explicitly motivated with a dissatisfaction with the equation of big firms and welfare reducing oligopolies. It was argued that large firms, rather than being oligopolies that needed to be curbed and/or busted, might contribute to efficiency by organizing internally costly market transactions (Williamson, 1975). In the context of international business, the new economics driven international business theory switched "*attention from the act of foreign investment (...) to the institution making the investment*" (Dunning, 1979: 274). The milestone contributions of Buckley and Casson (1976) and Hennart (1982) introduced a new theoretical perspective on MNCs with the focus of attention on the very *raison d'être* of the MNC. These accounts of FDI are today referred to as the 'internalisation theory'. The internalisation theory explains the existence of MNCs with transactional market failures. A firm internalises cross border coordination and deployment of resources and capabilities when intermediate good transactions are inefficient or more costly than the governance costs of internal markets (Buckley and Casson, 1976; Hennart, 1982). The costs associated with market transactions are partly related to obtaining precise and trustworthy information (information costs), partly to drawing up contracts with market agents (bargaining costs), and partly to control and enforcement of contracts (enforcement costs). The size of transaction costs are determined by the nature of the transaction (e.g. the level of uncertainty, frequency and asset specificity) and by behavioural characteristics of

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<sup>7</sup> The following excerpt encapsulates the main thrust of this theory: "[F]irms A and B...export competing products to foreign country X. Now, suppose A established a manufacturing subsidiary in X. B, uncertain of production economies, if any, that A might gain by manufacturing locally, faces the possibility that it could be underpriced by A in the market place. By establishing its own manufacturing subsidiary, B can match the production costs of A and thereby preserve its market share should A resort to price competition." (Knickerbocker, 1973:26).

market agents (e.g. the degree of opportunism and the presence of bounded rationality) (Hennart, 1991).

From the transaction cost perspectives, the opportunities of MNCs to generate monopolistic rents from international production are limited, partly due to the high costs of running cross border hierarchies, partly due to the fact that global firms also face global rivals and thus competition (Rugman and Verbeke, 2002).

### **The Eclectic framework**

By the late 70s, there were three competing paradigms: On the one hand, we had theories conceiving MNCs as ‘Coasian efficiency seekers’, on the other hand, theories viewing MNCs as ‘oligopolistic rent seekers’ (Moon and Roehl, 2001). Both bodies of theory were revolting against neo-classical trade economics’ and financial theory’s perfect competition view. In an attempt to bridge the seemingly conflicting interpretations of FDI, Dunning (1988) suggested his eclectic OLI framework. This framework asserted that that the existing understandings of FDI essentially were complementary. Thus, FDI is determined by the relationship between ownership-specific factors (firm-level O-advantages), location factors (country-level differences), and internalisation factors (transaction costs). Not only is Dunning’s eclectic paradigm mentioned because of its incontestable value as a unifying framework, but foremost because it induced an important reorientation in the FDI literature: attention was drawn to the fact that not all monopolistic or competitive advantages of firms derive from market structure failures or the internalisation of markets. Furthermore, the framework argued that it is necessary to distinguish between the nature and characteristics of the advantages possessed by firms and the way in which these are deployed. Hence, the eclectic paradigm marks an early theoretical link between the previous neoclassical, market power and transaction cost perspectives.

The OLI has since been subject to numerous critiques but remains a key reference point in the International Business literature. Among the critiques raised are that the framework tries to unite incompatible theoretical traditions and perspectives (Dunning, 2000); that the OLI variables are impossible to separate analytically and that globalization makes them increasingly blurred (Cantwell and Narula, 2001); that it focuses on FDI as motivated with exploiting existing advantages rather than building new advantages (Kogutt and Zander, 1993; Grant et al, 2000; Matthews, 2006); that it is static and ignores dynamics of firm internationalization (Johanson and Vahlne, 1978; Madsen and Servais, 1997); and that it is related to the era of hierarchical capitalism rather than the era of alliance capitalism (Madhok, 1997). Lastly, the OLI has been criticised for not adequately incorporating strategic dimensions and variables<sup>8</sup>. Let us turn to this critique:

### **The strategic management perspective**

Certainly, the internalisation perspective contributed greatly to the understanding of FDI. However, it relied heavily on technological or economic arguments dictating efficient firm structures under static conditions. As argued by Tallman, transaction-based theories “*suffer from a condition that we might call economic determinism*”

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<sup>8</sup> In fairness, Dunning (1993; 2004) introduced a ‘S’ factor (strategic) to the OLI that was argued to modify the influence of OLI factors on a particular firm’s actions in regard to FDI (Li et al, 2005). However, this idea was to our knowledge never developed further by Dunning.



(Tallman, 1992:458) in that FDI is explained as a function of structural efficiency rather than strategy. Similarly, Calvet (1981) argued that transaction cost based models essentially are static, helpful in choosing the optimal structure in a particular set of circumstances, but not capable of responding to changing environments. Hence, it was argued that the internalisation perspective is limited to operational effectiveness and economic efficiency and largely fails to account for the dynamic context and rapidly changing environments. In short, it was argued that there is a need to integrate a strategic management perspective into FDI theory (Tallman, 1991,1992; Li et al, 2005).

### ***A strategic management perspective on FDI***

It is necessary to clearly define what is meant by the buzzword *strategic management* in the given context to illustrate the shift in FDI theorising. Whereas economic reasoning tends to emphasize operational effectiveness in individual activities, strategy is about combining a whole system of activities (Porter, 1996)<sup>9</sup>. Hence, ‘strategic’ implies a more holistic, long-term oriented view, in which uncertainty and ambiguity play a larger role, and which embraces a firm’s external environments (e.g. market turbulences) as well as firm idiosyncrasies and managerial discretion in decision-making (Leibold *et al.*, 2005). Thus, a main idea of the strategic management literature is that uncertainty and idiosyncratic aspects of the firm environment brings to the fore the manager and the way in which he/she interprets these environmental conditions and combines internal competencies.

The strategic management perspective has made its way into scholarly work on FDI. Drawing upon strategic management provides additional insight in situations, in which FDI strategy cannot be explained by straight-on economic reasoning or asset-based arguments, but requires viewing FDI as part of its broader context, e.g. allowing for managerial discretion or a firm’s competitive situation. The strategic management literature questions the view that MNCs react in similar ways on similar constraints and opportunities. The perspective brings to the fore the role of the manager in navigating through complexity to make decisions regarding global allocation of resources. Moreover, the perspective moves from a focus on the firm to a focus on interaction of firms<sup>10</sup>. Finally, strategic management perspective holds that we need a more holistic perspective on individual FDIs, viewing them in terms of their strategic and operational significance for the investing firm. As argued by Kogut (1989), “*the fundamental change in thinking about global competition in the 1980s has been the shift in interest over the decision to invest overseas to the strategic value of operating assets in multiple countries*” (Kogut, 1989; 385).

### ***The resource based perspective on FDI***

The quest to incorporate strategic management thinking in FDI theory has intensified over the past two decades as the merits of this perspective have become ever more

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<sup>9</sup> Porter (1996) defines the essence of strategy as ability to differentiate oneself against competitors, that is “*choosing to perform activities differently or to perform different activities than rivals.*” (Porter, 1996; 64).

<sup>10</sup> In the words of Nielsen, “*during the past 25 years, Western academic research on the theory of global business strategy has focused on the individual firm or multinational enterprise (MNC) as the primary unit of analysis*” (Nielsen, 2005; 398) thereby ignoring the importance of the interaction of these investments with the global strategy of the MNC.

striking in the rapidly globalising marketplace. One avenue for integrating strategic management into FDI is through the resource based perspective. The application of the RBV signifies an important shift in the FDI literature, which had previously been dominated by academics with an economic mind-set and trained within economics, whereas the RBV was first articulated by strategic management scholars (see e.g. Wernerfelt, 1984 or Barney, 1991).

The RBV perceives the growth and competitive advantage of the firm as a function of its ability to mobilise, sustain, and expand internal and external resources and capabilities that are rare, valuable and difficult to imitate or substitute (Barney, 1991). Where the focus of the transaction cost perspective was on gaining competitive advantage by reduction of costs, the focus of the RBV is on the pursuit of Ricardian rents through leverage of resources. And where the focus of IO is on gaining competitive advantage by raising entry barriers for competitors, the focus on the RBV is on hard-to-copy resources and capabilities that may earn the firm rents<sup>11</sup>.

In relation to explaining FDI, the resource based perspective will in particular focus on two aspects of MNCs, namely their ability to generate rents by leveraging existing resources internationally and second, their ability to generate future rents by building capabilities through internationalisation. Leveraging is about exploiting excess managerial, technological or financial capabilities beyond a saturated home market<sup>12</sup>. Building new capabilities through internationalisation is about complementing existing resources with assets acquired abroad or building new advantages by learning from international operations.

A sibling to the RBV is the *knowledge-based theory* (KBT) of the firm (see e.g. Kogut & Zander, 1993; Grant, 2000). This theory draws on the inherent aspects of organisational learning and knowledge transfer across borders to explain the existence of the MNC. Essentially, this perspective argues that knowledge is a generic resource and that the defining characteristic of a MNC is “*its superior efficiency as an organisational vehicle by which to transfer this knowledge across borders*” (Kogut & Zander, 2003: 516). In other words, a MNC is a firm that has especially strong capabilities for internal transfer of knowledge across borders (Li et al, 2005;8).

The resource based and knowledge based perspectives have been exceptionally successful in directing focus to internal resource leverage as the source of competitive advantage and thereby also FDI. The integration of these perspectives into modern FDI theorising appears to be a valuable and logical development, and the past two decades have seen an increasing number of scholarly works moving in this direction (see Tallman, 1991; 1992; Hennart & Park, 1994; Dunning, 1997; 2000; Rugman & Verbeke, 2003). The resource and knowledge based perspectives have steered the FDI literature towards a new trajectory, and helped it address some of the challenges to

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<sup>11</sup> As argued by Peteraf (1993), the understanding of rent is what distinguishes the resource based thinking from the SCP based IO thinking. In the resource (and knowledge based) perspective, the temporary propriety control of resources is the real source of competitive advantage. Thus, it is ability to differentiate in the market that is the source of income or what Barney (1991) labels Ricardian rents. In contrast, the rents emphasized by monopoly models come from entry barriers within industries, and may entail advantages related to size, unique resource access, or being first movers. Where the determinants of strategy are more or less exclusively found at the firm level in the resource based theory the market power theories find the sources of strategy at the industry level (Peteraf, 1993).

<sup>12</sup> For instance, a key resource for global firms is ability to obtain scale advantages, and a key advantage for multi-domestic firms is to be able to adapt to tastes and conditions in smaller markets (Li et al, 2005).

conventional theorising caused by rapid globalisation and the emergence of knowledge-based economies (Dunning, 2000). They initiated an important shift in literature by moving beyond a narrow market power and efficiency-based economic mind-set dominant in earlier FDI theory towards increasingly integrating insights from strategic management to explain FDI<sup>13</sup>.

### ***Summary: Swings of the pendulum***

As stated in the introduction, there is a strong *empirical* case for the increasing relevance of a strategic interaction perspective on FDI due to changes in the competitive landscape. In many cases, FDI appears to be driven by firms' strategic interdependence and global positioning games rather than economic gains at firm-level or acquisition of assets associated with individual investments. As a consequence, firm action such as investing into new markets needs to be seen also from a strategic interaction perspective if we are to adequately explain the dynamics and nature of MNCs' global activities.

As strategic interaction in FDI has received quite some attention in early IO-based theories, it is surprising that these theories have not been taken up more explicitly in the large and highly dynamic recent FDI literature that purports to adopt a strategic management perspective. Whereas the original FDI theories focused on the issue of strategic interaction and oligopolistic competition, the advent and increasing prominence of transaction cost and resource based theories led to a setback of this perspective and it was implied that oligopolistic theories are at best secondary to the issues which yield insight into MNC activity (Teece, 2006).

The scarce attention to strategic interaction in contemporary FDI literature can in part be attributed to the fact that current studies have mainly focused on firm-level factors. Industry factors, such as competition level, intensity of rivalry or consolidation trends, have received surprisingly little attention as direct determinants of MNCs' investment decisions (Graham, 1998; Grøgaard *et al.*, 2005; Chittoor and Ray, 2007). At best,

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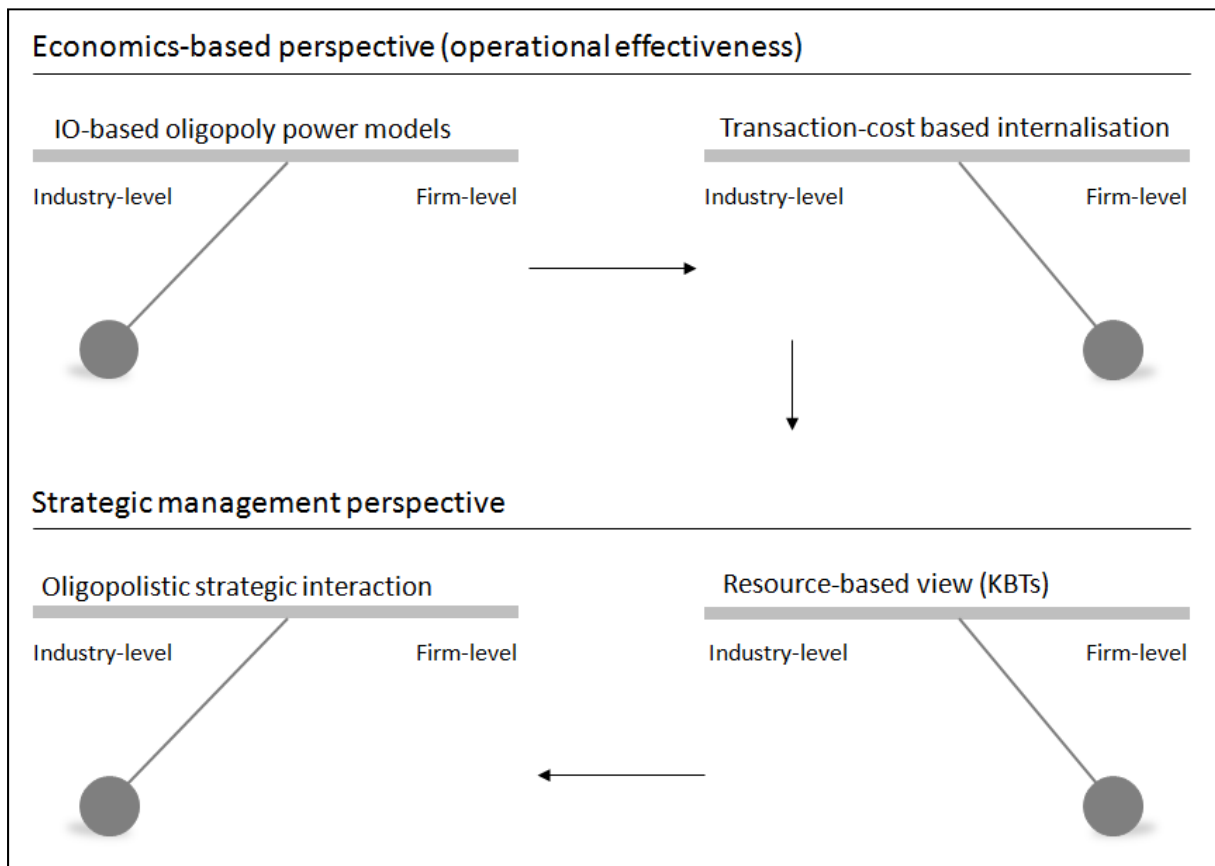
<sup>13</sup> In this connection, we might also add the network view of MNCs, which could be seen as an extension of the resource based view in the sense that ability to use networks to create competitive advantage is becoming an essential resource for MNCs. As mentioned above, a key insight of the strategic management perspective is that individual investments should be seen in conjunction with other investments. This insight derives from the network understanding of the MNC (Hedlund, 1986; Porter, 1986; Kogut and Zander, 1993; Bartlett and Ghoshal, 1989). The idea is that individual investments are strategically interdependent and that the value of each investment should be valued in light of its role in the global strategy of the investor. Hedlund's (1986) notion of heterarchy formulates the idea of a MNC as consisting of multiple centres of activity that compete and collaborate and where impetus to new advantages and strategies can come from many areas of the corporate network. This conception of the MNC is reflected in the subsidiary mandate literature (for a review, see e.g. Birkinshaw, 1998), where the traditional view of subsidiaries as subdued the mandates and charters assigned by headquarter has been challenged and where the leverage potential and discretionary powers of subsidiaries is emphasised. Bartlett and Ghoshal (1989) argued that a key to competitive advantage of MNCs was their ability to manage an integrated network of subsidiaries. This networked or transnational model replaced previous multi-domestic or global models of cross border strategy. The knowledge based view (Kogut and Zander, 1993) emphasised that MNCs essentially are superior organisations for diffusion of knowledge across borders, so called knowledge leverage (Grant *et al.*, 2000). Porter (1986) argued that an optimal configuration of the value chain is key to MNCs' success and that MNCs are moving from 'dispersed' (multi-domestic) to 'concentrated' value chain configurations characterised by a disintegration and subsequent global re-integration of previously nationally organised value chains. The network view of MNC strategy is also inherent in financial theory. According to Real Options theory, which challenges the predominant net-present value (NPV) logic of accounting assets and liabilities, the value of an investment must be assessed not only based on the net present value of current and future income streams but also in terms of the strategic or real options offered by that investment (Kogut, 1989; Forsgren, 2002). Options arise, e.g. because multinationality gives the MNC an opportunity to react to a currency crises, a sudden market collapse, or an need to retaliate against a global competitor. The essential idea of all these accounts is that MNC strategy is about coordinating and managing an increasingly global portfolio of assets in an optimal way and that this management can be more or less centralised.

current scholarly contributions account for a firm’s broader competitive context mostly by including it indirectly as a moderating variable. Accordingly, they remain limited in regard to viewing foreign investment as a deliberate choice based on what kind of assets can be extracted from the investment at firm-level.

The above leads to the conclusion that industry-level dimensions as potential direct determinants driving foreign investment strategy are not entirely neglected, but have lately – with the exceptions mentioned below - not received the scholarly attention they deserve. Thus, a logic implication of applying the strategic management perspective in contemporary FDI theory is the need to rediscover industry-level determinants of FDI, and build on the findings academic scholars provided back in the 1960s and 1970s to understand real-life phenomena regarding foreign investment strategy in some industries.

Our argument can be illustrated by using the metaphor of a pendulum moving back and forth to illustrate the reviewed developments and shifts in FDI literature (see *Figure 1*). As a natural swing, it seems logical to rediscover the “lost child” of strategic interaction in light of the strategic management perspective. Drawing upon strategic management literature provides additional insights to inform an analysis of competitive strategic interaction in oligopolistic industries as an industry-level determinant of FDI. The strategic interaction perspective embraces firms’ mutual interdependence and strategic competitive behaviour among rivals in oligopolistic industries.

**Figure 1**



### III. Manifestations of strategic interaction in FDI

Our argument in the previous has been that the FDI literature has been so consumed with the efficiency and later RBV explanations that the original IO stream on FDI has become side-tracked. This does not mean that strategic interaction in oligopolistic industries has been entirely ignored. Thus, a number of accounts of MNC global strategy within the strategic management literature focus on industry configuration as a driver of internationalisation strategies. For instance, Hamel and Prahalad (1985) analyse core strategies of firms and argue that firm strategy in global industries is motivated, *inter alia*, by cross subsidisation and retaliation. Yip (1989) finds the sources of strategy in external industry globalisation drivers related to markets, costs, governments and competitive factors. And Porter (1986) argues that FDI can be seen as a way of countering competition in multiple markets. Also within economics, a number of authors have taken up the issue of strategic interaction in the context of FDI: Apart from the aforementioned early contributors to FDI theory of the Hymer-Caves-Kindleberger tradition, the so called new trade economics have directed attention to strategic interaction in FDI. Thus, while clearly being ambiguous toward the role of MNCs in international trade (Dunning, 1997; Gilpin, 2001), Nobel laureate Paul Krugman has in several of his writings emphasized how oligopolistic firms affect trade pattern and the location of economic activity. And Markusen, noting that traditional trade theory have failed to integrate insights of Industrial Organization into modelling, has undertaken significant work aimed at incorporating the MNE into formal general-equilibrium trade models (see e.g. Markusen, 2000; Markusen and Venables, 1998). Thus, it is argued that firms “endogenously” decide where to invest and how much, thus significantly affecting trade profile and locations of economic activity. Moreover, Graham (1998) has examined the implications of strategic interaction in oligopolistic industries for public policy, and Schenk (1999) have assessed that much FDI essentially is an expression of risk minimisation strategies in oligopolistic industries.

We will argue that strategic interaction in FDI essentially is manifest in four generic phenomena: The first is the classical ‘follow the leader’ situation, where FDI takes place because the industry dominant firm has invested in the foreign location. The second is the ‘client follower’ situation, where various supply and related firms follow the dominant lead firms’ internationalisation path in order to maintain their relation to the ‘client’. The third phenomenon is the ‘first mover’ situation, where FDI takes place because moving before competitors into a foreign location provides the investing firms with strategic advantages vis-à-vis their main competitors. The last phenomenon is the ‘Global Chess’ situation, where FDI takes place as part of competitive games in locations unrelated to that of the specific FDI.

#### *Follow the leader*

The classical hypothesis of the IO based FDI theory still stands, that is that FDI essentially is a result of defensive moves in oligopolistic industries. Knickerbocker argued that risk-averse firms follow their main competitors to avoid distorting oligopolistic equilibrium. When one firm within an oligopolistic industry moves, the other players will have to consider their move<sup>14</sup>. Thus, the movement of one firm may

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<sup>14</sup> Based on a study of the entry of the Japanese tier industry into the US, Yo and Ito identifies three forms of such interaction strategies: 1. The creation of ‘duopolies’ where firms essentially are dividing world markets between themselves; 2. ‘Oligopolistic reaction’ where firms duplicate each other’s investments in

“trigger a chain reaction of countermoves at both domestic and international levels by rivals anxious to protect their positions” (Schenk, 1996; 26). Often in oligopolistic industries, firms will imitate each other’s actions, because the alternative to imitation – pursuing a differentiation strategy – may prove costly and dangerous (Lieberman and Asaba, 2006). Reflecting Porter’s (1979: 217) early point that firms imitate each other because “*divergent strategies reduce the ability of the oligopolists to coordinate their actions tacitly ... reducing average industry profitability*”<sup>15</sup>, it has been argued that a benefit of a follow the leader strategy is that it facilitates collusive behaviour (Leahy and Pavelin, 2003).

A related concept is ‘herding’, that is the phenomenon that investors in the same industry tend to converge on a particular country at the same time, but unrelated or only vaguely related to economic fundamentals of that location. Herding is essentially ‘reckless’ behaviour based on safety in numbers; as long as everyone else are behaving recklessly, the likely-hood of serious repercussions for the individual firm is low. Herding should not necessarily be seen as irrational; as argued by Lung (2000; 25) “*it is not that they are blind – this is simply the logical result of competitive processes in an oligopolistic industry*”<sup>16</sup>.

### ***Client followers***

Another type of investment akin to follow the leader investment and motivated with reactive positioning vis-a-vis dominant firms is ‘client follower’ FDI strategies. Client followers are essentially investors that follow their customers into new markets. Where follow the leader dynamics take place between firms in the same industry, client follower dynamics takes place between firms in different industries engaged in a buyer-seller relationship. While the client follower phenomenon is commonly described in the FDI literature, it is rarely related to strategic interaction, but more seen as a way of reducing transaction cost of international production and preserve networks. However, in cases where the buyer has a strong bargaining position vis-à-vis suppliers – typical of oligopolistic industries – suppliers may be pressured to follow the dominant firm into new locations in order to sustain their contract with the dominant firm in any location. As argued by Terpstrain in a study of the advertising industry, internationalising with the major accounts is crucial to survival of supplier service firms, “*otherwise the service firm risks losing the client in the domestic market*”<sup>17</sup>. Client following FDI can also be

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foreign locations; and 3. Competitive industries where there is no strategic interaction between investors (Yu & Ito, 1988).

<sup>15</sup> Quoted from Levintal and Asba 2006

<sup>16</sup> While the identification of follow the leader and herding dynamics could be indicative of strategic interaction between firms, there could also be conventional efficiency reasons behind such behaviour, e.g. that follow the leader strategies help firms make decisions under information uncertainty. Thus, the follower assumes (rightly or wrongly) that the leader has superior information, and therefore follows the leader into new investment destinations. Herding simply occurs “*when it is optimal for an individual, having observed the actions of those ahead of him, to follow the behavior of the preceding individual without regard to his own information*” (Bikhchandani et al., 1992). Similarly, within the institutional organisation theory, imitation of other firms action plays an important role in understanding FDI, however here not as part of collusive activity. Thus imitation is a key form of institutional isomorphism (Lieberman and Asaba, 2006). In the context of FDI, the idea of this perspective is that MNCs largely do whatever other firms in the organisational field are doing in cases where there are high levels of uncertainty (Westney, 2001).

<sup>17</sup> Quoted from Majgård and Sharma, 1998.

seen as the extension of collusive relationships between clients and suppliers into new locations aimed at keeping new comer firms out and/or fixing prices. Thus, exclusivity of client-supplier relationships (prohibiting the suppliers from working with other clients) may be a way of constraining the competitors' choice of suppliers, be they local firms or MNCs. This process is called 'delinking' of competitors from their supply base (Lin and Saggi, 2007).

Our point is that client follower FDI may be unrelated to the profitability and resource gains of the individual investment, but alone a reflection of strategic interaction between clients and suppliers in other locations.

### ***First mover motivated FDI***

Where follow the leader and client follower dynamics focus on the investment motives of the dominant firms' 'tale', the 'first mover' phenomenon is concerned with the investment motives of the dominant firm it self. Essentially, being a first mover is a way to create, consolidate or further develop oligopolistic advantage. First movers are firms that are staking out positions in foreign locations to obtain advantages vis-à-vis their competitors following later<sup>18</sup>. First movers are essentially trying to deter followers or prevent them from growing by capturing and controlling new markets through FDI. If successful, they may gain more or less exclusive control over geographical markets, e.g. by creating brand loyalty among new consumer groups or by getting control over human and natural resources. First mover dynamics are particularly strong in oligopolistic industries, as the "winners-take-all" and in such industries, we may see "*competition for markets*" rather than "*competition in markets*" (Jacobsen, 2008; 62).

Where follow the leader motivated FDI is defensive and reactive, first mover FDI is proactive and pre-emptive. Horizontal FDI may be a typical example of the creation of dominance through pre-emption, but also vertical FDI may restrict the possibilities of entry for newcomers by strangling the local supply chain or by forcing newcomers into prohibitive costly investments in new sales and distribution infrastructures. While first movers may not always get full control over the market they enter first, they may still benefit in a larger competitive game as their first mover investments may force competitors to prematurely undertake investment in the location in question (Miller and Folta, 2002).

### ***Global Chess***

Where the previously discussed manifestations of strategic interaction in FDI are related to the timing of the investment, a final category of strategic interaction focuses on FDI motivated with competitive games taking place in other locations. As argued by Porter (1986), a global industry is characterised by the competitive position of a company in any one market being dependent on its position in other markets. Thus, FDI may be motivated with global positioning of a firm vis-à-vis its competitors, rather than with specific properties of the individual investment. For instance, FDI in a given location could simply be retaliation for a move made by competitors in another location (Graham, 1974). It could also be that a specific FDI is undertaken to confuse

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<sup>18</sup> As reported by Jacobsen (2008), first mover advantages can derive from three factors; technological leadership (e.g. patents and faster learning), buyer switching costs (e.g. costs of learning to use new products; costs in terms of moving from known to new products, or costs associated with contractual and technical constraints), and pre-empting competitors access to scarce resources (e.g. inputs or market segments).

competitors and hide real strategic intentions. Sometimes, MNCs may acquire assets and positions in given locations, not due to the properties of those assets and positions, but because they provide the investor with pawns in future games.

A special case of global competitive games is when dominant firms in oligopolistic industries carve up global markets between them. Thus, it can be predicted that MNCs, rather than moving into markets already inhabited by competitors, will avoid head to head competition and instead strive for a tacit or explicit carving up of the global market. This will increase profits for the incumbent firms in the industry, but of course not social welfare (Ito and Rose, 2002). Another example is the ‘mutual forbearance’ hypothesis (Edwards, 1955), which holds that dominant firms in an industry will hold assets in each others markets thereby maintaining a credible threat against the other players in case their behaviour becomes too aggressive in other locations which would be suboptimal for the oligopolistic equilibrium (Ito and Rose, 2002).

An interesting issue is, whether strategic interaction in oligopolistic industries is in any way culturally determined. What happens for instance, when national oligopolies that have different ‘rules’ of collusion collide (Kogut, 1989). Nielsen (2005) argues that Asian firms play according to rules different from those adopted by western firms, and that this might be part of the reason why western firms have problems addressing the rising Asian challenger firms. Thus, in western management practice and literature, global strategic interaction is often conceived in terms of ‘Chess’ games. However, Nielsen argues that many challenger firms from Asian developing countries may be playing another game, the in Asia popular ‘Go’ game (Nielsen, 2005). Where strategies using the chess logic will focus on the main prize, the king, strategies using the Go logic will focus on everything but the king, the strategy being to in-circle and strangle the opponent (Nielsen, 2005). Thus, the Asian firms build positions that are deemed less attractive by the lead firms – e.g. serving as OEMs to lead firms or catering to sub premium markets, typically local markets in developing countries. These “*underdefended*” markets and positions - what Hamel and Prahalad (1994) call “*uncontested profit sanctuaries*” - are since used as a *launching pads* for the challenger firms (Nielsen, 2005; 405). Thus, “*the new global competitors approach strategy from a perspective that is fundamentally different from that which underpins Western management thought*” (Hamel and Prahalad 1990)<sup>19</sup> and this may explain the problems for western MNCs to effectively halt the expansion of those Asian firms.

#### **IV. Examples of strategic interaction shaping FDI**

In the following we will offer illustrative examples of strategic interaction in FDI. Our aim is to exemplify that it makes sense to complement the traditional understanding of FDI as mainly motivated with resource or efficiency considerations, with the understanding laid out by early FDI theory of FDI as motivated by strategic interaction in oligopolistic industries. The examples we will consider are related to the waves of mergers and acquisitions (M&As) in recent decades and to the surge in FDI in emerging markets since the early 1990s.

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<sup>19</sup> Cited from Nielsen (2005; 399).



## Mergers and acquisitions and FDI

### *The importance of M&As*

Cross border M&As are the acquisition of foreign firms through buy outs or mergers. M&As can be horizontal or vertical; the latter case involves firms at different stages of the production process, the former involves firms at the same stage. M&As accounted for 70-80% of FDI during the M&A booms of 1995-2000 and 2003-2007; in deed, in 2007, the total value of M&As were almost \$1700 billion out of total global FDI of app. 2000 billion (UNCTAD, 2009). The declines in FDI in the early 2000s and after 2007 are both accounted for largely by falls in M&As; in 2008 M&As fell with 30% compared to 2007 and this process can be expected to accelerate in 2009.

### *M&As and oligopolistic competition*

In many cases, M&As are simply resource and efficiency seeking<sup>20</sup> and can thus be understood without reference to strategic interaction. However, the fact that much of the current growth in M&As takes place in industries with limited numbers of large players may indicate that strategic interaction also plays a role in cross border M&As (WIR2000; 155). Thus, it has been suggested that as many cross border acquisitions apparently fail to contribute to efficiency, company growth or shareholder value (that is criteria on which company performance normally are valued), there must be other – e.g. strategic interaction reasons – behind those M&As<sup>21</sup>. For instance, Schenk (1989) argues that “*the existence of strategic interdependence under uncertainty, conditioned by the availability of funds, may compel managements to undertake mergers even if these will not increase economic performance. With multi-market oligopoly omnipresent, and given the increasing weight assigned to stock market performance appraisals, which to a large extent are reputationally determined, the ultimate result will be an economy-wide merger boom.*” In other words, M&As are according undertaken to create “*strategic comfort*” and “*minimise the largest possible regret*”, rather than enhancing shareholder value and/or economic efficiency (Schenk, 1999).

More specifically, strategic interaction can motivate cross border M&As in the following ways: First, rapid growth through acquisitions may be an effective strategy to fend off hostile takeovers (UNCTAD, 2000; 154). As size is a more effective barrier to takeover than e.g. profitability (Schenk, 1999), firms failing to grow rapidly in a consolidating industry are potential targets of takeovers. Second, M&As may give investors first mover advantages vis-à-vis their rivals. In oligopolistic industries, fast and surprising entry into new countries is often paramount to success; obviously, entering through stealth using green field investment is impracticable. Waiting for too long will mean that the pool of suitable acquisitions targets will dry out and give first movers time to introduce anti-competitive practices and barriers to entry (UNCTAD,

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<sup>20</sup> Thus M&As are motivated with efficiency factors such as the quest for scale advantages, avoidance of duplication of fixed costs such as R&D, or reduction of transaction costs. They are also motivated with building new resources; by acquiring assets abroad, the investing firms can increase the efficiency of its existing portfolio (capability leveraging) and build new competencies and advantages.

<sup>21</sup> According to Schenk (1999), studies of performance of M&As have found a shortfall in performance of the acquiring firms in industries as diverse as manufacturing and banking and advertising. Some explanations on the bad performance after M&As focuses on managers and their quest to maximise personal income while not that of share holders, while other explanations focuses on strategic interaction factors.

2000; 143). Thus, M&A are effective and necessary means of the aforementioned preemptive investments (Cantwell, 1992).

### ***An example: The brewing industry***

An example of global strategic interaction in M&As can be found in the brewing industry. Currently, the brewing industry is amidst a fierce global consolidation game. Over the last decade, the number of large companies has been cut dramatically so that whereas the top 20 brewing groups controlled roughly half of the world's total beer volume at the end of the 1990s<sup>22</sup>, only four players today account for the same share of global beer sales.<sup>23</sup> The consolidation process is partly driven by scale factors and partly by market power factors; to make money in this industry you must be able to effectively generate global scale advantages in production, sales, marketing, distribution and procurement. Moreover, you must have a dominant position in the market segments you are operating in. The Danish brewery Carlsberg is present in 150 markets worldwide and has in recent years expanded dramatically, from a national brewery with a small global niche market portfolio, to a major player in mass markets for beer<sup>24</sup>. Carlsberg is the smallest of the largest breweries, and was a decade ago destined to become a second rank player, prone to hostile takeovers. However, a number of successful acquisitions brought the company back in the game and is now number four in the industry, well above its closest competitor. Carlsberg has, for example, obtained a dominant position in the lucrative Russian market through its recent acquisition of Scottish Newcastle which together with Carlsberg had a fifty-fifty joint venture in Baltic Beverages Holding (BBH), the dominant brewery in Russia. Also in Western China has Carlsberg been successful in building a dominant market position through rapid and often secretive acquisitions of local breweries. The point of this case in the context of this paper is that many of the acquisitions by Carlsberg are of less relevance in terms of contribution to efficiency or market access, but probably mainly acquired as pawns in the intensifying global consolidation game. The brewery industry also exemplifies that growth prospects (in an industry like brewing mostly through an aggressive acquisition strategy) is effective to fend off hostile takeovers. That Carlsberg is still a major independent player can probably to a large extent be attributed to its aggressive acquisition strategy<sup>25</sup>.

### **FDI in developing countries**

In recent decades, FDI flows into developing countries and transition economies have increased from a level around 20-30% to a level around 30-40% of total FDI. Alone in

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<sup>22</sup> Modern Brewery Age, 10-07-2000, Consolidation in beer industry increasing

<sup>23</sup> Reuters website, 14-07-2008, Factbox – Leading brewers in the world by volume (URL: <http://uk.reuters.com/article/UKNews1/idUKL1447429820080714?pageNumber=2&virtualBrandChannel=0&sp=true>)

<sup>24</sup> Source: [www.carlsberggroup.com](http://www.carlsberggroup.com)

<sup>25</sup> Another example is the recent acquisition by InBev (number one in the industry) of Anheuser-Bush (number three in the industry. Although a heavy target to swallow (and an expensive acquisition to finance), the merger was not a surprise given that A-B, prior to the acquisition, was known to be the only one among the top five breweries in the world, which could not claim to be a truly international player. All others “have a large and growing exposure to emerging markets that balance their strengths in mature markets”. A-B was “almost as large as InBev in terms of profit, yet it remains too concentrated on the mature US market for its core profits as its international strategy has been focused on minority stakes, and is therefore less aggressive than its more acquisitive peers.” ([www.carlsberggroup.com](http://www.carlsberggroup.com)).

2006, inflows in these countries increased by 21% and 68% respectively over those in 2005, the highest levels ever (UNCTAD, 2007). Even if global FDI contracted with 15% in 2008 over 2007, FDI in developing countries increased by 8% (UNCTAD, 2009). The surge in FDI in these countries may partly be a reflection of intensifying competitive games between western MNCs aimed at capturing their relatively unsegmented consumer markets, or get access to increasingly attractive factor markets. Thus, the surge in FDI in developing countries and transition economies might be expressions of strategic interaction in at least four ways:

### ***Building a dominant position in markets with low competition***

Emerging markets may offer some 'easy' competitive gains, as these countries may have either non-consolidated market structures, or alternatively, have protected but inefficient national oligopolies and monopolies. In the first case – the green-field economy – first movers may experience low cost entry, building consumer loyalty at low costs, making windfall profits by meeting a pent-up demand, and obtaining privileged access to authorities at minimal investment (Arnold and Quelch, 1998). In the second case – the brown-field economy - the initial assumption would be that FDI would be deterred as foreign firms may face great entry barriers raised by local oligopolists (on top of the usual disadvantages of foreignness). However, in emerging markets this logic may be reversed; the local oligopolies will often be relatively inefficient and the prospects of quick growth and super-normal profits will be high for newcomers, especially as host governments increasingly opens up for foreign firms to invest in these countries. Thus, western MNCs will be particularly encouraged to do FDI in countries with local oligopolies (Hennart and Park, 1994).

A related argument is that emerging markets give first mover advantages at lower costs and with smaller commitment than do traditional markets, as they will be less congested with competitors. Ghemawat (1986) reports that the US retailer Wal-Mart systematically has targeted small and less attractive markets in order to get first mover advantages in less competitive settings, and Jacobsen (2008) reports that Carlsberg in Eastern Europe has concentrated on the smaller Baltic countries rather than the larger and more consolidated Hungarian and Czech markets, and in China, on the Western China market rather than the rather 'crowded' Eastern China market.

Early FDI in emerging markets may not just be an extension of the powerful players' competition into green-field locations, but may also be smaller players' bedding on high potential returns by being first movers. Risk willing small and medium-sized MNCs may thus be bedding on low current competition and huge future market potentials. In other words, competitive dynamics make those firms least capable of being first movers move first (Narasimham & Zhang, 2000) into developing countries. Whether these first mover will be successful depends the maturity of the industry (Jacobsen 2008; 82), the segmentation of the market, and -obviously - luck. Evidence from the internationalization of Danish industry in deed suggests that the first to move into a recently opened economy are SME entrepreneurial firms (Hansen, 2006).

### ***Pre-empting global competitors***

MNCs may invest in emerging markets to check their main global competitors and make sure they do not get a foothold in these markets. According to classical investment analysis, the investor should wait and assess the robustness of future demand before making an investment (Aussilloux, 2000). However, when firms nevertheless invest in

emerging markets at an early stage of development, it could be because they fear that first moving competitors - so called Stackelberg leaders - will get a foothold in the market which is difficult if not impossible to challenge for late movers. Firms in oligopolistic industries will therefore often reach the conclusion that the risks of allowing competitors to get a - irreversible - foothold in the market exceed the uncertainty of local demand (Aussilloux, 2000). The costs of failing to pre-empt competitors' investments may be immense if these markets prove to - as many argue they will - become the market or the resource bases of the future. The upshot of this argument is that strategic interaction dynamics will tend to be relatively stronger in markets with high demand uncertainty - e.g. emerging markets - than in markets with greater certainty.

Clearly, the race to obtain leading or at least strong positions in the rapidly growing emerging markets is in full motion. There are plenty examples of firms that use FDI in emerging markets as a strategic means in globally integrated competitive wars. A case in point is the global car industry. Here we have seen a strong herding effect in developing countries to an extent that most of these investments can be deemed to be unprofitable; as argued by Lung (2000), FDI in car production capacity in developing countries exceeded even the most optimistic forecasts several times. In 1992-93, producers in Turkey invested in building production capacity of 1 million vehicles for a market of 3-500000. In Brazil, investors build capacity for car production in 1997 that at best would be met by demand in 2003. In Vietnam, car makers were investing massively during the 1990s in spite of an almost non-existent local market. Another example is the apparent herding of global banks in Asia prior to 1997. Here, western banks expanded their exposure in the Asian countries in spite of the economic and financial fundamentals indicating the contrary, a fact which according to some observers contributed to the Asian crises in 1997-1998 (Como, 200?).

### ***Pre-empting local competitors***

Emerging markets may be the breeding ground for the industry leaders of the future and MNCs may invest to mitigate the growth of such challengers. Thus, MNC strategy in emerging markets may to a large extent be motivated with monitoring and suppressing local challenger firms. Even if the investors have no returns on their investments in emerging markets, the money may still be well spent as they quell a potential global competitor. This point is clearly emphasized by the marketing literature. Many MNCs in emerging markets make the mistake that they concentrate on the premium/global segment and thus fail to see the local competitors emerging from the local and glocal market segment (Arnold and Quelch, 1998). The local firms operate at lower costs and are perfectly positioned to capture the vast middle class markets as they develop. The local firms' advantage is further consolidated by the scale advantages coming out of catering the mass markets rather than exclusive premium markets (Dawar and Chattopadhyay, 2000)<sup>26</sup>.

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<sup>26</sup> As reported by Dawar and Chattopadhyay (2000), Japanese television producers Sony and Matsushita were in the mid 90s highly successful in capturing the Chinese premium market for television sets, obtaining market shares of 75% and a sale of 1.5 million sets. However local producers such as Changhong, Konka, and Panda catered to the even larger lower prices market and sold over 5 million units. This allowed them to gain scale advantages, which later positioned them to take on the Japanese producers in the premium market.

An illustrative case is the Danish producer of pumps Grundfos. Grundfos has 80 subsidiaries in 45 countries, 66 sales offices (of which 8 have production) and 14 production units, where the largest are in China and Hungary. The company has 12 brands apart from the Grundfos brand. In recent years, the company has been moving toward a globally integrated matrix organisation, with local sales responsibilities pared with global line functions, enabling it to tap into knowledge around the globe, while keeping scale advantages. The company has traditionally produced pumps, but in recent decades the focus has increasingly been on offering 'solutions' in the form of organising flow systems e.g. in OEMs. Grundfos has the strategy that it needs to be number one or two in its markets, otherwise it will not be able to make money. China plays a key role in Grundfos' strategy and the company has made substantial investments in this country. Part of the investment is aimed at creating an export platform, but another part is aimed at servicing the rapidly growing Chinese market. At the present, 20% of the market is controlled by the major players (the 'consolidators'); they are almost equally large and their moves are relatively predictable. The main strategic challenge facing Grundfos in China is the huge 'tale' of small local companies moving into Grundfos' business segment. While the major players generally avoid "*shaking the boat*" too much, the upcoming local firms are "*unpredictable*". As a consequence, while Grundfos traditionally has been operating in premium markets only, it has decided also to target the sub-premium market, otherwise it fears that it will see Chinese competitors take this market and use it as a platform for moving into high end markets<sup>27</sup>.

Also the Danish wind-turbine industry might be a good example of similar dynamics. The world's biggest producer of wind-turbines Vestas - currently controlling more than 20% of the world market for wind turbines - has invested massively in China. Vestas entered into China at an early stage and installed its first mills in the Shandong and Hainan provinces in 1986 and had by 2008 installed more than 1,000 wind turbines in thirteen provinces in China<sup>28</sup>. By 2008, Vestas upgraded the mandate of its Chinese subsidiary significantly and invested large amounts in strengthening its position in the Chinese market. These investments have taken place despite severe capacity constraints in the company's global value chain. Thus, the Chinese investments appear to be made due to strategic market portfolio thinking, i.e. that Vestas expects China to be a market of critical importance in the future. Therefore, Vestas now has established a presence (sales organisation, large-scale wind park projects, etc.) so that global incumbent competitors (e.g. Siemens, GE or Gamesa) and not least local Chinese newcomers do not get ahead of them and capture the market. In other words, it appears that Vestas strategically has allocated its extremely scarce capacity in a (at the current moment) less profitable region (as compared to higher potential sales margins in Western Europe or US) knowing that it needs to establish a presence in the market competing in a global industry in which competitors also target China.

### ***Client followers***

Lastly, we will argue that there is evidence to suggest that much client following FDI in developing countries is motivated, not so much with the potential economic and resource gains of moving with the client into the new location, but rather with the

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<sup>27</sup> Grundfos company presentation, University of Ålborg, 27/10 2008.

<sup>28</sup> Vestas - Press Release 30-12-2008

[http://www.vestas.com/files/Filer/EN/Investor/Company\\_announcements/2008/081229-MFKUK-52.pdf](http://www.vestas.com/files/Filer/EN/Investor/Company_announcements/2008/081229-MFKUK-52.pdf)

potential global strategic repercussions of not doing so. When the largest Danish bank 'Danske Bank' invested in China in the early 2000s, it was mainly to avoid losing its corporate customers in Denmark, who in growing numbers were starting up activities in China. The customers pressured the bank to move or else they would look for other banks that could offer world wide, one stop and integrated financial services (Eriksen, 2006). FDI in China was in other words undertaken to prevent other Danish and foreign banks from acquiring growing market shares in the Danish corporate banking industry. Another example is from the Danish wind-turbine industry; when Danish suppliers to the large windmill producers Vestas and Siemens invest in India – companies such as LM Glasfiber, AVN, Steel Clusters etc. - it is not because they cannot do without the Indian market in their portfolio, but mainly because they fear that they will lose a privileged supplier position globally and because they are afraid of providing local suppliers in India an opportunity to develop competencies in their field (Hansen et al, 2009).

## **V. Conclusion**

Essentially, firms can be successful by increasing efficiency/ reducing costs (the TCE perspective) or by generating rents (supernormal profits), either due to their ability differentiate activities vis-à-vis competitors (the RBV perspective), or by suspending competition through the exercise of market power. One or more of these three generic strategies are inherent to all business activity, including foreign direct investment by MNCs. Our contention in this essay has been that while the efficiency and resource based thinking has taken the front seat in the recent FDI literature, the third leg, the oligopolistic competition perspective, has faded from sight. While transaction cost and resource based reasoning remains key to FDI, we argue that we need to complement the theory with an account of, how oligopolistic competition considerations may affect the MNC investment decision.

Thus we argued that strategic interaction is manifest in a number of FDI phenomena; follow the leader, client followers, first movers, and global positioning games. All these phenomena are about firms undertaking FDI wholly or partly motivated with strategic interaction with other firms in oligopolistic industries. As the purpose of the paper was to position the strategic interaction perspective on FDI within the larger FDI literature, no empirical testing was attempted. However, we offered a number of examples and cases that might be support our contention that strategic interaction actually is an essential part of FDI, e.g. in connection with cross border M&As or in connection with FDI in developing countries.

<b>Contrasting conventional FDI theory and the strategic interaction perspective</b>		
<b>Phenomenon</b>	<b>Explanations offered by conventional FDI theory</b>	<b>Explanations offered by a strategic interaction perspective on FDI</b>
<b>Cross border mergers and acquisitions</b>	<ul style="list-style-type: none"> <li>• MNCs obtain efficiency gains from M&amp;As e.g. scale advantages and reduced transaction costs</li> <li>• M&amp;As undertaken to augment existing assets, e.g. acquisition of brands and technologies</li> </ul>	<ul style="list-style-type: none"> <li>• Fast entry for first movers requires acquisition</li> <li>• Acquisitions are expressions of herding and follow the leader</li> <li>• Growth through acquisition is necessary to remain a player in a given industry and avoid being taken over</li> <li>• M&amp;As are part of global Chess and Go games</li> </ul>
<b>FDI in emerging markets</b>	<ul style="list-style-type: none"> <li>• Access low cost production locations</li> <li>• Access rapidly growing markets</li> <li>• Access advanced assets such as strong skill base and clusters</li> <li>• Reduce costs, including transaction costs, of building new markets</li> </ul>	<ul style="list-style-type: none"> <li>• Entering markets with weak local competition</li> <li>• Obtain first mover advantages in factor and product markets</li> <li>• Prevent challenger firms from evolving out of emerging markets</li> </ul>

In conclusion, while motives behind FDI are manifold and complex, we suggest that strategic interaction dynamics may have significant impact on the scope, geographical profile and sector orientation of FDI and that such dynamics are likely to be more important in the future as markets and thereby competition become increasingly global. As a consequence, the literature on FDI needs to more explicitly integrate strategic integration in its theories.

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