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## Motives of large multinationals investing in small transition countries: A literature review

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# Kiel Working Papers

Kiel Working Paper No. 668

**MOTIVES OF LARGE MULTINATIONALS INVESTING  
IN SMALL TRANSITION COUNTRIES:  
A LITERATURE REVIEW**

by  
Klaus-Dieter Schmidt

January 1995



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## **Abstract**

Economic theory suggests that multinationals have clear objectives when investing abroad. It lists a considerable number of factors which may influence the decision but it falls short of explaining them.

The paper investigates how the most popular hypotheses presented in the literature perform in the light of recent experiences. It reviews a series of case studies on western multinationals which entered into a joint venture with eastern companies. It comes to the conclusion that investment decisions are governed by a bundle of overlapping motives. The benefits of geographically dispersed but well co-ordinated activities are seen in certain types of spill-overs that can only be generated in networks. These benefits can be best described as economies of scope.

## **I Introduction: Background and Objectives<sup>1</sup>**

The breeze that has begun swelling the sails of multinational enterprises (MNE) undertaking foreign direct investment (FDI) in transition countries is still trifling compared with the hurricanes that are raging through developed market economies. In certain branches of certain countries it is freshening up notably, though. Obviously, western MNEs are blowing up their cheeks before they put to sea.

Economic theory suggests that MNEs have clear objectives when investing abroad. It lists a considerable number of factors which may influence the decision, but it actually explains only one or a few of them. It falls short in encompassing all these factors. The so-called eclectic theory (Dunning, 1980), so far the most widely accepted and most comprehensive approach which combines several factors, only identifies the conditions which are sufficient or fail to be sufficient for FDI to be profitable, as well as the conditions under which FDI is superior to other modes of servicing foreign markets. It does not directly refer to the motives for investing abroad.

MNEs are global players operating affiliates all over the world. They can be considered as a spider surrounded by a web. The literature suggests that the value of a this web may be affected positively by the number of geographically dispersed locations that can be used and served. The rationale of hypothesizing such a positive relation is derived from the fact that global players can benefit from lower variable costs due to economies of scale and economies of scope realized in networks. Against this background we can assume that FDI of MNEs is motivated by a bundle of factors which are closely connected. Thus, we should stress the complementarity of these factors, rather than their substitutive character.

The paper investigates how the most popular hypotheses presented in the literature perform in the light of recent experiences. These hypotheses are mainly derived from experiences gained in western-style market economies which can hardly be general-

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<sup>1</sup> This paper was presented at the workshop "Joint Ventures in Transformation Countries in the Context of Overall Investment Strategies of their Partners" held in Prague from 20th to 23rd January 1995.

ized. The paper reviews a series of case studies undertaken by several authors.<sup>2</sup> These studies refer to western MNEs which entered into joint ventures (JV) with eastern companies. They do not include so-called greenfield investment without foreign capital participation. The conclusions drawn from these case studies may be helpful to enterprises in transition countries which are contemplating the choice of a foreign JV partner.

## II Preconditions and Motives for Joint Ventures

Eastern enterprises in search of a JV partner should have in mind that western enterprises are not in a hurry to invest in transition countries. In general, they face a lot of alternative investment opportunities all around the world. The market for capital is a competitive one - and competition there is particularly keen. Therefore, they should not have too high expectations. They should take into account the possible motivations of their potential partners - in order to avoid disappointing experiences.

A major reason for the major tensions arising over JVs is the fact that the decisions by the foreign investors are taken under certain criteria which inadequately reflect the decision-criteria of the partners. In general, the decisions by the foreign investors might be very complex. By definition, large MNEs are global players

- with affiliates in several countries,
- with interests in several branches, and
- with equity engagements in several enterprises.

The decisions of MNEs, therefore, involve questions of location of activity around the world, the types of products which should be produced, the technology which should be innovated or transferred, the organizational structure of the foreign affiliates and their position within the parent company's hierarchy, the financial flows between companies, marketing activities, personal relations, and the final decision as to expand, move or shrink other activities. (The decisions of affiliates are less complex since they do not have to take into account other segments of the international activities as much

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<sup>2</sup> A lot of pioneering work has been done by an international research group conducted by Jana Sereghyová, Institute of Economics, Czech National Bank, Prague (1993, 1994). Some studies have also been undertaken recently by the OECD in preparing the "Third East-West Conference of Ministers of Economy, Industry and Trade of G7 and Reforming Countries" held in Warsaw, 5-6 May, 1994 (Sadowska-Cieslak, 1994). A survey of case studies is given by Meyer (1994).

as the parents do.) MNEs have to consider each new JV as a tessera which must fit into the mosaic.

### *1 Eclectic Theory Reconsidered*

A notable characteristic of MNEs is that they are able to use their internal production, distribution and information networks on a global scale which allows them to reduce information costs. According to the transaction cost approach MNEs act in a way which replaces (external) market transactions by (internal) intra-firm actions whenever the costs of internal actions are lower than the costs of external transactions (Williamson, 1975, 1981). From this perspective MNEs owe their origin to the existence of market imperfections - namely when (external) markets are difficult to organize, monitor, and control or when they do not exist at all (McManus, 1972; Buckley, Casson, 1976). In imperfect markets transactions cause high costs. The rationale for the MNEs is that they can reduce transaction costs by buying up complementary assets located in different nations and putting their operations under the control of a single unit (Casson, 1979).

The transaction cost argument has been integrated by Dunning (1985) and others into a broader approach which identifies the following three conditions as necessary for FDI to take place (Sander, Schmidt, 1993): a firm must

- believe to have some specific, i.e. ownership advantages when operating in foreign markets that allow it to compete in those markets with other and in particular with indigenous firms;
- perceive some locational attraction of a foreign location as compared to its domestic production base in manufacturing all or parts of its products;
- be convinced that these advantages can be best exploited internally rather than on external markets by means of non-equity arrangements, e.g., licensing agreements or management contracts.

Traditional literature claims that only the combined existence of each ownership, locational and internalization advantages would provide the condition for FDI to occur (OLJ-paradigm). More recently it has been demonstrated that FDI may also be undertaken even if the potential host country's locational advantages are large enough to (over)compensate for only small or even lacking firm-specific advantages (Stehn, 1992). This argument has important implications for transition countries which can bring inter alia extremely low labour costs to bear.



However, the eclectic theory does not refer to the motives of a firm investing abroad. It postulates only the preconditions to be fulfilled (Agarwal, 1985). These aspects should not be confused. A firm may want to penetrate a foreign market - this is the motive for FDI. But it faces a choice. It can serve this market either from its domestic production base or from a foreign base closely located to the market which it wants to penetrate. The eclectic theory only allows to conclude which strategy is the most effective once the motivation is given.

## 2 *Major Hypotheses under Scrutiny*

It is generally agreed that the motives for MNEs undertaking FDI are rather similar to the conventional economic reasons for bringing certain activities as production or marketing control under common ownership. It may be a fruitful start to take a glance at the literature. The literature on MNEs suggests that FDI occurs in response to or in an attempt to internalize the benefits arising from certain "monopolistic" advantages such as advanced technology, sophisticated products, skills, access to capital and information and so on. Lall (1978) has selected a number of hypotheses which seem to be relevant to FDI:

- Marketing requirements: the need of getting market access; the need of controlling distribution facilities; the need of a great deal of specialized after-sales services, of maintaining and updating; the need of transferring information to and from consumers; and the need of keeping direct representation to governments in order to influence politics or to win large orders.
- Exploiting cheap labour: the need of relocating parts of the production to low-wage countries in order to cut costs.
- Specificity of the product: the need of safeguarding uniqueness, high quality standards and suitability to demanded requirements.
- Risk and uncertainty: the need of avoiding disruptions in production, quality changes and other events which may influence sources of supply as prices change.
- Unexploited capacity and scale economies: the need of exhausting their own facilities by supplying related affiliates rather than going to open markets.
- Transfer pricing: the desire to evade high tax rates or to remit profits.
- Government policy in home and in host countries: the need of overcoming trade barriers as tariffs, quotas or local content regulations.

The list of motives is presumably not complete and their significance may be different. However, to understand MNEs' strategies it is useful to subject them to a further examination.

a) Size and Prospects of Markets

The motives mostly emphasized are market access and market exploitation. The reason is simple: firms want to grow. Given the constraints of a saturated and only slowly growing domestic market they are driven to sell their products abroad. Research on FDI therefore has stressed the size and growth of foreign markets as the most important variables for explaining the geographical pattern of FDI (Kravis, Lipsey, 1982; Culem, 1988; Wheeler, Mody, 1992). Although for the time being most markets in transition countries are small in terms of size, they open wide perspectives for the future as they are not so well supplied as western markets. A firm which enters a market quickly can get a pioneer bonus.

The predominance of these two motives has been expressed in various empirical studies, also in case studies. An example is the engagement of Henkel Bautechnik, a German producer of chemicals, in Poland. Henkel Bautechnik has established a JV with a Polish partner, Starporków, for producing building materials. Initially, Henkel was only interested in a bridgehead for organizing sales: "The company thought about securing the market for its products to be able to utilize production capacity existing in Germany. The idea of licencing production in Poland was not convincing for Henkel" (Stankiewicz, 1994, p. 6). The approach of Henkel was that market penetration by exports should come first; establishing a production base should, if at all, come later. This fits the usual pattern of sequencing and timing of FDI.

Even if a JV starts immediately in the field of production, trading activities on the partners home market are often the main objective of the foreign investor. To serve a foreign market from a foreign production base has been the motive for the French Sanofi Sante Nutrion Animale, one of the biggest producers of human and animal pharmaceuticals in the world. Sanofi has established a JV with the Hungarian Phylaxia-Sanofi Veterinary Biological Company Ltd. Hungary's sole vaccine producer and enjoys a very strong market position. The strategy of Sanofi was aimed at developing Phylaxia into a base company. That objective ... was in perfect harmony with the concern's philosophy, which is the acquisition of the highest possible market share in the fields belonging to its special line, by purchasing the local production capacity and the capacities suitable for development. ... Sanofi seems to succeed in meeting one of its most important strategic objectives, i.e. increasing its share on the Hungarian market

... Currently the company owns 23 % of the Hungarian veterinary pharmaceutical market, a share that makes it a market leader" (Lakatos, Papanek, 1994, pp. 22-24).

Another striking example for a trade-motivated acquisition is the engagement of the Colgate-Palmolive Group in Romania. The aim of the internationally operating group has been to establish a bridgehead for production and sales activities in eastern Europe: "Following its strategy of global expansion, Colgate-Palmolive did not hesitate to recognize the collapse of communism in Central and Eastern Europe as the opportunity to enter new, unsaturated markets. Unlike some of its competitors, it moved swiftly to examine the best ways of establishing the local operations. Given the size of its population (23 million, the largest after Russia, Ukraine and Poland) Romania was evaluated as a high potential country despite the disastrous state of its economy and relatively high level of political instability" (Filipovic, Beleanu, 1994, p. 4). In search of potential candidates for acquisition the choice rested on Norvea and Stela, two companies with strong local brands and a leading position in the Romanian market: Norvea was almost a monopolist in the market of toothpaste, and Stela was a leader in the market of soaps. By its early start, Palmolive-Colgate hoped to gain a decisive lead over its main competitors: "Becoming a clear market leader it raised the barriers for entry, so that even the global competitors like Procter & Gamble or Henkel would face up-hill battle in challenging their position" (p. 11).

Obviously, establishing a production base in a transformation country is often just the first step to further engagements in other eastern markets - to carry out experiments. A strategic objective of Henkel's JV in Poland, e.g., has been the expansion of its activities to Baltic countries, Ukraine, Belorussia, and Russia: "Poland is a convenient place to test and check how well an article is sold (and produced) in conditions of post-communist economy ... It is closer, safer and cheaper to get to the former USSR from Poland. This is what certainly guided Henkel and which we recommend for reconsideration of all foreign investors thinking about establishing a business in Poland" (Stankiewicz, 1994, p. 15).

However, as FDI theory suggests, the strategy of MNEs in a host market can be influenced by various factors - such as transport costs, economies of scale, market structure or barriers of entry. These factors may influence the decision for a JV in a different manner. If, e.g., economies of scale and transport costs occur in production, then a trade-off exists between producing at home (and serving foreign markets by exports) and producing abroad. In the case of Henkel the calculation was simple: the export of finished products from Germany to Poland is unprofitable because of high transportation costs. On the other hand, there may be diseconomies of scale when the production

is decentralized. As Rowthorn (1992) has shown, the host country's market size is a critical variable. The replacement of domestic by foreign production is more profitable in a large market than in a small one.<sup>3</sup>

#### b) Labour Costs

From theoretical considerations and empirical observations it can be deduced that FDI is always motivated by searching for the least expensive production, too. Even for a market-oriented JV the cost-related variables are significant. Consequently, much of the literature stresses labour cost differentials between the source country and the host country as an important determinant of FDI (Riedel, 1975; Agarwal, 1978; Cushman, 1987/1988; Wheeler, Mody, 1992; Jeon, 1992). It is a well-known fact that over time MNEs in western countries have been losing comparative advantages in producing labour-intensive products since wages have been rapidly rising. A case study on the JV between Schiesser AG, a Swiss-based producer of high-quality underwear, and Czech Pleas, a company producing the same type of textiles, hits the nail on the head: "The differential between wage costs Schiesser AG and its west European subsidiaries have to carry ... is apparently one of the main reasons why this firm decided to found a joint venture with Pleas" (Sereghyová, 1993, p. 208).

No doubt, a significant share of FDI is mainly motivated by labour cost differentials. According to recent polls a growing number of western firms is taking measures for moving production lines to eastern countries or is ready to do so for sweat-shop labour. However, the argument of low wage costs in transition countries should not be overrated. A recent study about the Czech engineering firm CKD Dukla concluded that "the calculatory effects of the extremely low wage costs are partly "swallowed up" by the consequences of the relatively low labour productivity still persisting in most plants of CKD Dukla - at present it reaches probably one half of that achieved in the plants of western partners - partly they got lost because of the relatively low prices (in comparison with prices for which similar goods of western provenance are sold) which CKD was achieving up to now on western markets" (Sereghyová, 1993, p. 222). In terms of unit labour costs the advantage is often much smaller and it may even be offset by transport and other transaction costs.

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<sup>3</sup> Market size is not necessarily defined by political boundaries. Markets can be enlarged by economic integration. Therefore, openness towards world markets is a way of improving conditions for FDI.

In a recent study on the influence of labour costs in Pacific-rim developing countries Agarwal (1989) took the view that possibly the importance of low wages as a locational advantage has decreased considerably. In another study Agarwal, Gubitz, and Nunnenkamp (1991) suspected that the increasing robotization of production processes might have altered the conditions for cost-oriented FDI there.

Sadowska-Cieslak (1994) came to the conclusion that there is a different pattern in the behaviour of small, medium and large multinational companies: "While for the small and medium investors 'traditional advantages' offered by the CEECs, such as low labour costs, cheap resources and investment incentives, are important, for the multinationals they do not appear as prime motivation, though they are considered in the investment process and are perceived by them instead as potential short-term benefits, which will disappear when the countries move to the world prices after finishing their transformation process ... All interviewed businessmen focused on market size in CEECs, opportunity and long-term growth potential when developing their investment strategy" (p. 8).

It should be noted that "sweatshop labour" does not require any equity arrangement. The rationale of an equity arrangement is to internalize market activities. Firms often prefer licensing or offshore processing as an adequate and less risky involvement. Naujoks and Schmidt (1994) observed in labour-intensive branches a trend towards contractual production agreements: "In the typical offshore plant no sophisticated know-how should be required ... normally an offshore plant can be expected to go on its own. There are no specific internalization advantages which could be realized" (p. 3). However, a contractual arrangement does not exclude equity arrangements forever. Rather it can serve as a pre-stage for future FDI activities.

### c) Outsourcing

As market-driven and cost-driven FDI are interlinked, serving the domestic market from a foreign production base appears to be another strong motive for investing abroad. Considerations of optimal timing suggest that MNEs usually start with export for supplying a foreign market, but when reaching a critical market size there they shift to foreign production. Later they even turn to importing the goods and services produced in their plants abroad (Agarwal, Gubitz, Nunnenkamp, 1991). Many products marketed under the brandname of MNEs in developed countries are produced in developing countries.

Roughly one third of the world trade consists of intra-firm trade among affiliates of MNEs (Bonturi, Fukasaka, 1993; Naujoks, Schmidt, 1994). The overwhelming importance of intra-firm trade is due to MNEs' outsourcing efforts. In terms of industrial organization outsourcing is a special attribute of lean production - a concept of vertical disintegration - as companies come to rely on external suppliers instead of internal production. Intra-firm trade can be used as an instrument for "cross-subsidization" of high-cost production by imported low-cost products. Frequently, it takes place if exports and imports are linked: a company in a high-cost country delivers semi-processed goods to a partner in a low-wage country for refining, finishing or assembling and then these goods are reimported to be incorporated into domestically produced final goods. Important product groups for outsourcing are textiles, clothing, and footwear on the one hand, components, parts of electrical and mechanical machinery and electrical engineering on the other hand. Interestingly enough, outsourcing is not exclusive to typical labour-intensive industries. Rather an important and steadily growing share takes place in so-called screwdriver industries which mainly do assembly works and therefore are very suited for relocating these plants.

Like other forms of "sweat-shop labour" - outsourcing does not necessarily call for an equity involvement. Partly due to externalities and transaction costs, MNEs need to organize their transactions within the firm rather than on the market, though in the case of intermediate goods, e.g., market failures may arise due to problems in transferring product specification and other technical details to unaffiliated partners in foreign countries. An equity arrangement makes it much easier for the parent MNEs to provide strategic guidance. Additionally, in relation to its affiliates an MNE safeguards control over proprietary information - whereas under licensing and other forms of contractual arrangements there is a risk of losing in-house know-how to a third party (Rugman, 1987). It is no surprise that MNEs in negotiation with a potential JV partner try to reach a contract which gives them the responsibility to run the company. In this respect it is less important to have or not to have the majority of shares. The more important issue is to have the situation under control.

Although much has been written to explain cost-driven FDI in general, only little attention has been given to outsourcing as an important motive for it. In most case studies this point has been addressed only implicitly. An exception is the study done by Sander (1994) about the JV between Volkswagen and Skoda. As the author pointed out explicitly it had been the strategy of Volkswagen to fully integrate both Skoda and its Czech suppliers into the firm group: "The new supplier concept for the Volkswagen Group aims above all to integrate suppliers as equal partners in working along the value added chain and promoting them to become efficient suppliers ... Creating an ef-

efficient national supplier industry ... is meant to secure long-term competitive advantages for Skoda and, above this, to gradually develop into low-cost high-quality sources of supply for all members of the Volkswagen Group" (p. 13).

#### d) Transfer Pricing

A further motive for setting up a JV may be the desire to establish a "shunting track" for profits. It is a well-known fact that MNEs can use the instrument of transfer pricing for manipulating their profit-and-loss account. Tax rate differences between source and host country, e.g., may be an incentive to transfer profits from a high tax country to a low tax country by charging and, respectively, paying low internal prices for intra-firm deliveries. An equity investment generally provides better opportunities for transferring profits internationally than portfolio investments do (Lall, 1973, 1979; Rugman, Eden, 1985).

Transfer pricing is legitimate and quite usual in normal businesses. Nevertheless, in a JV between a western and an eastern company "unfair" internal delivery prices may be a sore point. Managers and employees in eastern subsidiaries of western companies are often suspicious that the benefits of low labour costs are "eaten away" by low transfer prices.<sup>4</sup>

The problem with this story is that there is no sufficient answer to it. In a world of perfect capital markets ruled by the "law of one price" this problem would not exist. Insofar, transfer pricing always indicates that markets are imperfect. For instance, low transfer prices paid to subsidiaries' deliveries are often the result of existing restrictions on repatriation of profits from host to source countries. Governments in transition countries are very interested in "internalizing" profits derived from local subsidiaries of foreign companies: they would like these profits to be invested in the subsidiaries themselves. However, without restrictions on profit repatriation this will only happen if governments create a favourable investment climate by, e.g., deregulating national capital markets.

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<sup>4</sup> Sereghyová (1994) has raised this point recently in an update of an earlier case study about the JV between Volkswagen and Skoda. Though she argues very cautiously: "As experiences show, purchases undertaken by foreign investors from their own subsidiaries are often effected at prices, which leave them only a minimal profit margin ... It may be assumed that between a.s. Skoda and the VW-concern will be observed absolutely correct relations, which do not permit such practices. But it cannot be ruled out that with the strengthening of the position of this concern as a majority shareholder of a.s. Skoda, it might increase the pressure it exerts on the price level of deliveries of this joint venture, targeted at other members of the VW group" (p. 20).

e) Tax Arbitrage

Since profit maximization is the ultimate goal of business, tax evasion by means of arbitrage may be a further motive for investing abroad. MNEs can considerably increase their net profit if they move operations to a place where the tax burden is relatively low. In recent years governments in western countries have started a world-wide race in cutting tax rates - in order to make their countries more attractive for international capital. Most governments in transformation countries have promptly responded and set out to offer financial incentives for FDI.

Nevertheless, the issue appears to be ambivalent. Several studies based on interviews with managers of MNEs report that they consider factors such as resource endowments, level of development, future growth performance, market size, infrastructure facilities and political stability to be much more important in their investment decisions than tax rates, tax holidays and subsidies (Sadowska-Cieslak, 1994). Such incentives are regarded as too volatile, transitory or even illusory. Tax holidays, e.g., are usually given only during the early stage of a JV - when it is least likely to show profits. Even if low tax rates and tax holidays are granted extensively, foreign investors' response is usually restraint.<sup>5</sup> Needless to say that they are an extra income and accepted with pleasure.

f) Trade Restrictions

Numerous studies emphasized the impact of trade restrictions as a motive for FDI (Hymer, 1976; Lall, Siddharthan, 1982; Eu, Min, 1986; Jeon, 1992). By protective measures like tariff rates, quotas, anti-dumping duties or local content regulations, earlier investments into foreign markets can become obsolete or new investments impossible. For fear of a "fortress Europe" many Japanese firms, e.g., established assembling plants in EC countries during the 1980s. But this argument is more applicable to large economies than to small economies as most of the transition countries have only a

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<sup>5</sup> Their incentive effect may be overruled if host countries are considered as politically and economically unstable: "Although the government of the Slovak Republic is willing to grant extensive tax holidays (up to 10 years) to foreign investors who would be investing in regions of high unemployment and even by other considerable tax-reductions might be achieved case-by-case, up to the end of March 1993 only 10-12 mill. USD were newly invested in the country. This might be caused by the fact that foreign investors were still be observing changes in economic policies applied in the Slovak Republic as well as developments in its overall economic and political situation" (Sereghyová, 1994, p. 21).



small market potential. Insofar, small economies cannot hope to be successful in attracting FDI by cutting off its markets (Agarwal, Gubitz, Nunnenkamp, 1991).

However, just because of the relatively small size of markets in most transition countries MNEs expect regulations for protecting their own production in these countries. It was reported by Sander (1994) that Volkswagen was able to accomplish an import duty of 19 percent ad valorem on newly produced foreign cars. The protection is, although degressive, expiring in the year 2001: "Thus, on the domestic market Skoda enjoys a certain, though decreasing degree of trade protection" (p. 8). Granting trade protection may be only a "side-dish" for most MNEs. Sometimes, however, it can be the decisive factor in deciding for a particular country. The rise of the Brazilian automobile industry in the 1960s and 1970s, e.g., was the consequence of granting foreign companies access to the domestic market - and conceding them later a privileged position in form of several incentives including an import substitution policy (Fischer, Nunnenkamp et al., 1988).

#### g) Exchange Rate Risks

A further motive behind FDI decisions is often the desire to minimize the risks of exchange rate fluctuations. MNEs usually invest a lot of money in penetrating foreign markets. A high volatility of exchange rates makes it hard for them to calculate exports to these markets (Zilberfarb, 1989, p. 150). MNEs with geographically widely distributed subsidiaries can cope much better with this problem than firms producing only in one market: they can shift production between national markets at different stages of the "exchange rate cycle". Thereby, MNEs are able to undertake riskier investments with a higher rate of return. In developed market economies this may not be a serious problem: fluctuations in exchange rates are limited and a rich menu of standard techniques allows to safeguard risks at relatively low costs. In most transition countries, however, the risks of exchange rate changes are high, and so are the insurance premiums to be paid (especially as the insurance function of the banking system is still underdeveloped).

#### h) Environmental Regulations

Stringent environmental laws in western countries may make pollution-intensive industries in competitive there. To relocate such industries to countries with milder regulations may be a further motive for FDI (Pearson, 1985; Siddharthan, Kumar, 1990). It

is a well-known fact that the legislative standards in transition countries are much lower than in the western world. Thus they have a significant locational advantage.<sup>6</sup>

In recent years pollution of the environment has become a sensible issue in transition countries, too. There now exists a strong aversion or even resistance against "dirty industries". In this respect foreign investors will not shout their true motive from the rooftops. Insofar, it is not very likely that the environmental motive appears explicitly in any investigation.

### g) Hostile Takeovers

In competitive markets firms usually fight with no holds barred. Hostile takeovers are part of the usual business. The motive for acquiring a foreign firm is then simply to liquidate it in order to extinguish a troublesome competitor.

Although this issue has already been raised in the literature on FDI in transformation countries (Galgóczy, 1993), its empirical evidence still remains unclear. For the time being there are no studies which examine this issue. However, from a theoretical point of view vicious acquisitions should be the exception rather than the rule. In a small open economy a local firm is seldom in a strong position with respect to the national market. This firm cannot block the way for an omnipotent MNE penetrating the market. On the contrary, in most cases it can be easily competed out of the market. This is much cheaper for the MNE in every respect. The liquidation of a firm can cause a lot of trouble. It may destroy the good reputation of the investor - by that he may lose instead of win market shares.

### 3 *Short and Long-term Strategic Behaviour*

In a highly simplified model of global investment, MNEs decide on the various investment opportunities by computing the rate of return of each alternative project in alternative countries and comparing these rates with the respective capital costs. In this model the time factor is often neglected. Some investment opportunities are bound to promise high profits even in the short run, whereas others seem to incur heavy losses for many years to come. The empirical results from several studies provide some evidence that investments of large MNEs in small economies are governed by long-term

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<sup>6</sup> The hasty takeover of the eastern German cement industry by western firms can be mainly explained by the strong German anti-pollution laws which make it extremely difficult to build new cement plants in the western parts of Germany.

perspectives. Most MNEs want to become a leader in the market which they expect to be steeply growing. This requires building-up brand-awareness through establishing effective distribution and service systems. As the costs of entry are high, profitability can be expected only in the long run.

OTIS-ELEVATOR in St. Petersburg, an American-Russian JV in the elevator industry, is a good example for the long-term behaviour of most large MNEs investing in transition countries. A study described this strategy as follows (Lapin, Kud, Shekshnya, 1994):

- OTIS-ELEVATOR, an unchallenged global market leader with almost 50 operating units all over the world, will play a dominant role also in the Russian market: by 1995 a share of 30 p.c. of the new elevator market should be achieved. The target is to become a "full cycle firm", to be involved in the production, installation, maintenance and modernization of all kinds of elevators.
- At the first stage only products are sold which are mainly manufactured in western European factories. Then as soon as possible imports should be gradually replaced by locally produced elevators: "By implementing this strategy OTIS also hoped to minimize transportation costs and take advantage of the foreign exchange rates and price levels in the Soviet Union, which allowed to expect production costs of internally manufactured elevators to be significantly lower than at OTIS facilities elsewhere" (p. 8).
- In the longer term perspective, factories in Russia should not only supply domestic markets but should also be used as a base for exporting to other central and east European countries.

Such a long-term investment requires a well designed schedule of sequencing and timing according to the specific circumstances of the country under consideration. An investor should not try to run before he can walk.<sup>7</sup> Exploiting local peculiarities of supply and demand in an integrated world economy is much more complicated than in a textbook model. It is no surprise that recent studies emphasize the experience effect of FDI: to operate in a foreign country requires country-specific knowledge which can be primarily gained by making a direct investment in that country (Yu, 1990). From this we can derive that positive experiences in a country are a strong incentive to undertake

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<sup>7</sup> Initially, OTIS had planned to sell locally produced elevators to central and eastern European countries. But due to the traditional low-quality image of Russian-made "high-tech products" it has proved impossible to export them.

further investments there. That is what MNEs usually strive for: a continuous investment program rather than a single project.

#### 4 *Greenfield Investment or Joint Venture?*

MNEs in search of foreign equity arrangements have one of the options: either they can undertake greenfield investments or they can invest in already existing firms. In transition countries the former socialist firms are mostly in a deplorable state suffering from both technological backwardness and overmanning.<sup>8</sup> To engage in their restructuring is expensive and risky. Foreign investors, therefore, should prefer to start from scratch when intending to take up activities there.

Interesting enough, the majority of western MNEs start FDI in form of a JV. The main motives for setting up a JV are the following:

- A JV can reduce the "cost of entry" - provided that the right partner is chosen. Especially firms with lack of insight into local conditions can benefit from their partners' country-specific knowledge.
- A JV can save time. Frequently, existing technical capacities and human skills can be used immediately - although enormous efforts are necessary to start the operations as efficiently as possible.<sup>9</sup> If the partner's local brands are well known, a certain market position can be reached quickly.
- A JV can limit the risks. It does not require a 100 p.c. ownership; also a minority participation of less than 50.1 p.c. may give an investor full control over operations.

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<sup>8</sup> In a case study illustrating the experiences of a German-Polish JV between the Benkiser AG and the Polish Pollena S.A. in Nowy Dwor, the weakness of the Polish partner was described as follows: "There was virtually no marketing ... The firm relied on an old, state-owned collapsing distribution system ... The production of soap and fatty acids was ecologically unsafe and economically nonviable. The technology was very modern but useful for production of detergents that the market did not accept ... The company was overstaffed by 50 % ... Finally, the company lacked vision and strategy" (Obtój, Chrostowski, Zielniecki, 1994, pp. 8-9).

<sup>9</sup> Other analysts have been quoted as saying that setting up a JV is more time consuming and costly than undertaking a greenfield investment. It is argued that by starting from scratch the negotiations are often less complicated and the investment requirements often smaller because of the absence of restructuring, re-education and conversion costs (Sadowska-Cieslak, 1994).

Finally, it is an open secret that governments in transition countries prefer JVs - in order to find strong partners for restructuring the ailing firms and for preserving a certain degree of economic sovereignty over the country's industry. Consequently, they offer attractive incentives to make a JV palatable. Because of this the acquisition of an existing firm can be a good deal for a foreign investor.

### III Conclusions: Towards a Comprehensive Approach

From the case studies examined we can derive that an MNE's investment decision is governed by a bundle of overlapping motives rather than by just one of them as it is suggested in most popular hypotheses on FDI (Annex). Insofar, the literature, although very extensive, is quite unsatisfactory.

Traditional literature has considered the MNE as a firm running a number of independent, locally oriented affiliates distributed all over the world. The benefits of these activities have been mainly associated with economies of scale simply by means of expanding production. In the literature, however, the MNE is increasingly understood as a global network (Bartlett, Goshal, 1989; Cantwell, Sanna-Randaccio, 1993). The benefits of geographically dispersed but well co-ordinated activities are seen in certain types of spill-overs that can only be generated within the networks. These benefits can be best described as economies of scope.

Economies of scope in international networks may stem from

- the locational division of labour: each affiliate is specialized according to local characteristics such as specific natural resources, human skills and market experiences,
- the transfer of knowledge within the internal organizational structures: each affiliate can provide others with firm-specific assets such as technological and marketing know-how or financial and managerial expertise,
- the control over proprietary information: each affiliate is under the guidance of the parent company which minimizes the risk of dissipation.

As in a family the affiliates of an MNE can benefit from combining their specific strengths. But they must also subordinate themselves under the common interest. And they have to share the burden of a difficult fate occurring to anyone of them. This is, by reducing the complex story to a simple formula, the rationale of multinationality - and perhaps the main motive for FDI.

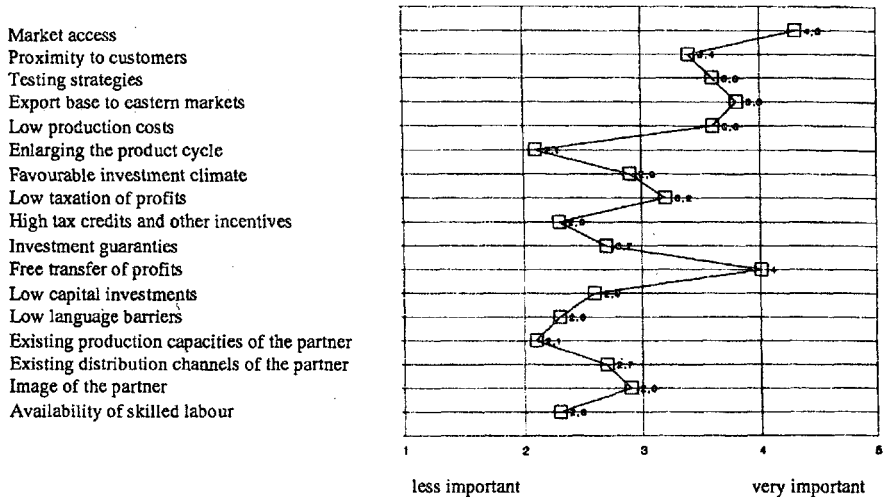
Enterprises in central east European countries in search of a JV partner should be aware that they will become a member of a large family, usually with the dominant presence of a foreign parent company. The consequences may be thoroughly mixed: on the one hand, by entering a JV enterprises in central and east European countries will get the resources they need for successful restructuring. They can expect to be provided with investment capital, with technological, marketing and managerial know-how and with access to international markets. On the other hand, they will probably lose quite a bit of independence; and they will become vulnerable to the troubles other members of the group may face. No doubt, JV partners share a common destiny - in good times and in the rough.

**Annex:**

**Motives of German Enterprises with Capital Participation in Hungary**

A basic problem in evaluating the motives of MNEs investing abroad is the fact that case studies usually provide only qualitative information. But they do not allow to assess the relative importance of certain motives. One of the few investigations which provide scaled information is a study undertaken by Pfohl et al. (1992). The study used structured interviews of 18 German and 40 Hungarian JV partners (Chart 1). Pfohl et al. found market access as primary motive for investing which also includes establishing a base for exporting to eastern countries and testing strategies for penetrating eastern markets. Low production costs are an important, but not a dominating motive. Obviously, it is expected that this advantage will disappear over the next few years. The Hungarian data also suggest that specific investment incentives are of minor importance whereas a good general investment climate, especially free transfer of profits, is of major importance.

Chart 1 - Motives for German Enterprises for Choosing a JV Partner in Hungary  
1990 (Average of Answers)



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