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The role of reference groups in international investment decisions by firms from emerging economies

Jiatao Li [a,*], Fiona Kun Yao [b,1]

[a] Hong Kong University of Science and Technology, Department of Management of Organizations, School of Business and Management, Clear Water Bay, Hong Kong
[b] Haas School of Business, University of California, Berkeley, 2220 Piedmont Avenue, Berkeley, CA 94702, United States

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ABSTRACT

Investments in China by firms from emerging economies were studied to determine how various reference groups affect their foreign market entry behavior. Imitation was shown to be an important factor, but the mechanism seems to vary depending on the institutional environments in the host and the home market. Firms from emerging economies seem to rely on copying the entry decisions of peers from their home country, especially in locations where the risk of government meddling is greatest. The example of firms from developed economies was found to be less influential.

1. Introduction

The factors triggering firms' foreign expansion have received extensive attention in international management literature. Research in this field has embraced the economic perspective viewing cost minimization as a driving force (see Caves, 1996, for a review), the capability-based perspective emphasizing capability building as an inducement (Chang, 1995; Song, 2002), and, more recently, macro-organizational perspectives on international market entry such as institutional theory and organizational ecology (Guillén, 2002). These studies contribute substantially to our understanding of the reasons why multinational corporations (MNCs) expand into foreign arenas. However, they fall short in explaining the pattern of international diversification of firms from emerging economies, and the institutional contexts upon which this pattern is contingent (see Peng, et al., 2008).

Research drawing on the institutional perspective has flourished since the 1970s (DiMaggio and Powell, 1983; Meyer and Rowan, 1977). Although the isomorphic pressure faced by organizations has long been a central focus for researchers in this field, those researchers may have overlooked the potentially momentous role of wide-ranging institutional transitions in shaping organizational behavior (Oliver, 1991; Peng et al., 2008). Because a common feature of emerging economies is institutional change—"fundamental and comprehensive changes introduced to the formal and informal rules of the game that affect organizations as players" (Peng, 2003: 275)—research on emerging economies may contribute to a deeper understanding of the dynamic interactions among institutions and organizations in large-scale institutional transitions (Hoskisson et al., 2000; Peng et al., 2008; Wright et al., 2005).

Studies focusing predominantly on multinationals from developed economies, mainly Europe, Japan, and the United States, have not attributed adequate importance to emerging economies (Hoskisson et al., 2000). Even in the limited number of studies addressing emerging economies, the focus so far has been on a few countries such as China, Korea, and East European economies. Given the notable variations in economic and institutional development among the 64 countries that have been identified as emerging economies (Hoskisson et al., 2000), more research is necessary to broaden our understanding of the pattern of international expansion of multinationals from dissimilar emerging economies.

* Corresponding author. Tel.: +852 2358 7757; fax: +852 2335 5325.
E-mail addresses: mnjtli@ust.hk (J. Li), fionayao@haas.berkeley.edu (F.K. Yao).
[1] Tel.: +1 510 643 1401; fax: +1 510 642 4700.

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Furthermore, past studies have not systematically explored how differences in the institutional environment shape foreign expansions, e.g., how isomorphic pressures shape mimetic strategies. Prior research has documented the crucial role played by institutional frameworks in the host market in shaping foreign direct investment (FDI)location decisions and entry mode choices (Delios and Henisz, 2000, 2003; Henisz and Delios, 2001), yet with insufficient attention to the heterogeneities among MNCs' home countries. Recent work by Wan and Hoskisson (2003) has suggested that home country institutional environments with different levels of munificence have significant implications for success in internationalization. By considering both the home and the host institutional contexts, this study was designed to provide a better understanding of how contextual differences shape the pattern of international expansion from an institutional perspective.

The study had two objectives. The first was to identify FDI reference groups which might influence foreign investment decisions. The prior investments by reference firms from the same emerging economy were investigated as one possible influence. FDI reference groups were defined in terms of whether they were from the same home country, from another emerging economy or from a developed economy. Since China was the focus of the study, the groups were further categorized as Asian or non-Asian. In addition, local policy uncertainty in a host location and the institutional differences between the host and home countries were singled out for study as two factors which might moderate imitative entry strategies. Local policy uncertainty was evaluated specifically in terms of political institutions which could induce policy unpredictability in informal and formal institutions in a host location (Henisz and Delios, 2001; Meyer and Nguyen, 2005). The dissimilarity in the institutional profiles of the home and host countries was included as another moderator (Kostova, 1999; Kostova and Zaheer, 1999).

Two research questions were addressed: how FDI reference groups affect the foreign market entry behavior of firms from emerging economies; and whether and how imitation depends on the institutional environments in the host and the home markets. This emphasis on the various impacts from different reference groups parallels recent recognition that the firms constituting a regional network are heterogeneous and create different externalities (Chang and Park, 2005). By incorporating the home and the host institutional environments into the study of international expansion, the study was designed to address the question of how the local policy uncertainty and the institutional differences between the host and home countries moderate strategic mimicry.

Consider first the impact of prior FDIs from different reference groups on FDI by firms from an emerging economy. The effects of host market policy uncertainty and home country institutional distance on international expansion will then be considered. These relationships were tested in this study using data on manufacturing ventures set up by firms from emerging economies in China from 1979 through 1995. China started an economic and institutional transition in late 1978, officially opening its doors to foreign direct investment. This data set thus allowed study of MNC sub-units from the beginning of China's economic transition, and investment dynamics over time.

2. Theoretical background

2.1. FDI reference groups

Several groups can serve as referents for multinationals making FDI decisions. A strategic group is a cluster of firms that are comparable in terms of some aspect relevant to strategy (Caves and Porter, 1977; Hunt, 1972). The notion of strategic groups allows firms to specify rivals and position themselves within industries, which makes more sense of competition (Hatten et al., 1978; Porter, 1980). A strategic group could also act as a reference point for group members making decisions (Fiegenbaum and Thomas, 1995). Inter-firm mimicry and signaling enable strategic group members to tune their strategies toward an appropriate group reference point and formulate strategic moves in concert (Porter, 1980). Additionally, through inter-group comparisons, group members can reposition their strategies using other strategic groups as benchmarks (Kumar et al., 1990). The idea of strategic groups as reference points is further reinforced by institutional and ecological theories, which propose that collections of firm-level strategic recipes can legitimize actions and generate isomorphic pressures (DiMaggio and Powell, 1983; Hannan and Freeman, 1977).

In the context of FDI, MNCs belonging to the same strategic group may imitate each other, thus affecting each other's entry decisions. Reference groups based on a multinational's country of origin have previously been applied to define recognizable populations of organizations (Guillén, 2003; Yiu and Makino, 2002). In this study, beyond grouping multinationals from the same home country, a four-cell typology was used, grouping firms in terms of whether or not their country of origin was from the developing world and whether it was Asian or non-Asian. The focus in this study was on the rate at which MNCs from emerging economies enter a host market, and on whether or not the rate can be related to prior entries from different reference groups.

The reference groups were defined in terms of home country and emerging economies because multinationals from the same home country tend to have similar organizational structures and to possess comparable resources, facilitating collective strategic moves (Wan and Hoskisson, 2003). So multinationals from the same home country were treated as one reference group. Then, given that emerging economies are “low-income, rapid-growth countries using economic liberalization as their primary engine of growth” (Hoskisson et al., 2000: 249), multinationals from emerging economies are normally regarded as coming from less munificent resource environments compared to firms from developed economies. When investing in other emerging economies, MNCs from emerging economies are thus more likely to formulate similar exploitative strategies to those of firms from other emerging economies (Wright et al., 2005). An institutional setting similar to their home market should facilitate the transfer of resources and capabilities to a new host emerging market (Lee and Beamish, 1995; Pananond and Zeithaml, 1998). Investors from other emerging economies could thus be viewed as another reference group. However, foreign firms from more developed economies might present as a very different reference group for investing firms from emerging economies, and a competitive