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FDI entry mode choice of Chinese firms: A strategic behavior perspective

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ABSTRACT

This study investigates the determinants of foreign direct investment (FDI) entry mode choice between a wholly owned subsidiary and a joint venture by Chinese firms that invest overseas. We argue that the FDI entry mode choice of a Chinese firm is primarily influenced by the variables related to the firm's strategic fit in host industry and its strategic intent of conducting FDI. Using survey data of a sample of 138 Chinese firms, the results suggest that a Chinese firm prefers wholly owned subsidiary entry mode when it adopts a global strategy, faces severe host industry competition, and emphasizes assets seeking purposes in its FDI. A joint venture is preferred when the firm is investing in a high growth host market.

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1. Introduction

The popularity of inward foreign direct investment (FDI) to China over the past two decades has been mirrored in recent years by outward FDI from China. China's FDI outflow volume recorded an average annual growth of 60% from 2002 to 2006 (MOFCOM, 2007). As a result, China was the eighteenth largest FDI suppler in the world in 2006 (UNCTAD, 2007). The trend of this rapid growth appears steady. A United Nations' survey to national investment promotion agencies from 154 countries predicted that China would become one of the top four source countries of FDI over the period from 2005 to 2008 (UNCTAD, 2005).

The phenomenal growth of China's outward FDI has drawn attention from researchers to investigate the trend and driving forces of its growth (e.g., Morck, Yeung, & Zhao, 2008; Liu, Buck, & Shu, 2005), and to study the determinants and motivations of the outward FDI by Chinese firms (e.g., Child & Rodrigues, 2005; Liu & Li, 2002; Rui & Yip, 2008). One of the key issues being discussed in these studies is the applicability of extant FDI theories and frameworks in the China context. As Child and Rodrigues (2005) point out, contrary to the mainstream FDI theory (Caves, 1971; Dunning, 2001), Chinese firms invest overseas not to exploit existing competitive advantages, but to redress competitive disadvantages. This is because the ownership advantages enjoyed by Chinese firms are mainly network based (Buckley et al., 2007; Morck et al., 2008) or home country based (Rugman & Li, 2007; Rui & Yip, 2008). In the short term, this strategy supports their overseas expansion intra-regionally, but not globally (Rugman & Li, 2007). Beyond regional expansion, Chinese firms are not driven by their ownership advantage but by their need to build sustainable global competitiveness (Child & Rodrigues, 2005; Deng, 2004), especially by acquiring strategic assets overseas (Rui & Yip, 2008). While challenging the mainstream FDI theory, these arguments are in line with studies on the internationalization of emerging economy firms (e.g., Hoskisson, Eden, Lau, & Wright, 2000; Luo & Tung, 2007; Rajan & Pangarkar, 2000; Wright, Filatotchev, Hoskisson, & Peng, 2005). Chinese firms' FDI activities echo the two strategic options of internationalization for firms in emerging economies, i.e. competitive advantage exploitation in other emerging economies and competitive advantage exploration in developed economies (Wright et al., 2005).

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While much attention has been devoted to the motivation and determinants of Chinese firms' FDI, little is known about how these firms choose their FDI entry mode, especially the strategic choice between joint venture (JV) and wholly owned subsidiary (WOS). The FDI entry mode choice between WOS and JV is one of the most important and challenging decisions for any firm seeking to enter foreign markets (Gomes-Casseres, 1989; Madhok, 1998; Root, 1994). To address this issue, we investigated Chinese firms' FDI entry mode choice from a strategic behavior perspective by introducing a framework that incorporates both the strategic fit and strategic intent aspects of the FDI by Chinese firms. This framework escapes from the asset tacitness and partner opportunism premises of the transaction cost framework in prior FDI entry mode studies (e.g., Gatignon & Andersen, 1988; Gomes-Casseres, 1989). These studies are of little relevance in the China context, as Chinese firms are mostly knowledge seekers, rather than knowledge takers, when they go abroad (Rugman & Li, 2007). Our empirical test results support the strategic behavior framework and reveal the similarities and differences between the decisions of Chinese firms and developed country firms in their choice of FDI entry mode.

2. Strategic behavior approach

A strategic behavior approach posits that a firm's FDI entry mode choice serves its strategic behaviors. These include either to maximize profitability (Kogut, 1988), to retain flexibility (Harrigan, 1988), to achieve a superior market position (Aulakh & Kotabe, 1997), or to pursue global synergy effects and other global strategic motivations (GSM) (Kim & Hwang, 1992). This approach is of particular relevance to firms in an emerging economy like China, as these firms go abroad in pursuit of various strategic purposes (Luo & Tung, 2007; Rui & Yip, 2008) that cannot be adequately explained by transaction cost economics. Studies on the strategies of emerging economy firms have revealed two broad strategic options related to their international expansion. Firms can exploit their competitive advantage in other emerging economies as one option, or they can enter developed economies to explore competitive advantages.

The first option is viable because firms from emerging economies have developed competitive advantages in low-cost production. They can use this core competency to successfully compete against foreign firms (Wright et al., 2005). The use of these advantages can extend beyond national borders. As Hoskisson et al. (2000) point out, for emerging economy firms, competing in a global market may be possible in a commodity area where natural resources or labor provide a low-cost advantage. With a good understanding of the relationship between a firm's assets and the characteristics of the industrial environment, a firm can become an aggressive contender globally by using its resources as a source of competitive advantage. Accordingly, the critical issue in this type of FDI is how to align firm resources with the environment (Zajac, Kraatz, & Bresser, 2000). An appropriate FDI entry mode can help a foreign investing firm to achieve strategic fit in a host industry environment. This is because the FDI entry mode choice (between WOS and JV) is essentially a selection of foreign venture ownership structure. It is evident from the literature on organization theory that particular structures are more appropriate for a given environment (Anand & Daft, 2007). For example, when the host industry has the feature of high level of competition intensity, a WOS entry mode is more appropriate for the investing firm to concentrate on its specific advantage and to strengthen its competitive position in the harsh environment (Bell, 1996). A JV entry mode is more appropriate when the host industry faces a favorable demand condition with great growth potential. This mode is more time-efficient for the investing firm to seize the growth opportunity prior to competitors (Kogut & Singh, 1988). These two host industry factors (namely competition intensity and demand condition) represent both threats and opportunities, which are the two critical aspects of the concept of environment-strategy co-alignment (Tan & Tan, 2005; Zajac et al., 2000). Therefore, for a foreign investing firm to achieve strategic fit in a host industry environment, it needs to choose a FDI entry mode in accordance with the host industry competition (HIC) intensity level and demand condition.

While the first option concentrates on the strategic fit between the firm's competitive advantage and host country industry factors, the second option emphasizes the strategic intent of emerging economy firms which drives them to explore the competitive advantages that they currently do not possess (Wright et al., 2005). The outward FDI from emerging economy firms is motivated by their intent to seek strategic assets. International expansion may serve as a 'springboard' for acquiring these desired assets (Luo & Tung, 2007). Furthermore, emerging economy firms that have a global strategic ambition intend to pursue their internationalization with a global, rather than a multidomestic strategic orientation (Rajan & Pangarkar, 2000). Both the asset seeking and the global strategic intent are evident in Chinese firms' FDI. Chinese firms expand overseas to redress competitive disadvantages by acquiring foreign assets and capabilities (Rui & Yip, 2008). They also pursue specific strategic motivations with a global orientation, such as preparing for further global expansion (Morck et al., 2008) and improving global competitive position of existing transnational businesses (Rui & Yip, 2008). Strategic intent can have an impact on the decisions firms make on the choice of a FDI entry mode between WOS and JV. Both WOS and JV modes can be adopted by a firm in order to acquire desired strategic assets overseas (Deng, 2007). However, the more aggressive mode (i.e. WOS) is practically preferred by emerging economy firms (Luo & Tung, 2007) and JV operation is considered less effective as an entry mode for the purpose of acquiring strategic assets (Rui & Yip, 2008). Furthermore, a WOS entry mode is also superior to the JV entry mode when the investing firm pursues global strategic motivations in its FDI, as a high level of control is generally required to ensure a high level of coordination between headquarters and foreign subsidiaries, or among the entire global business network of the firm (Kim & Hwang, 1992). Therefore, from a strategic intent perspective, a firm's

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