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Exchange rate challenges, flexible intra-firm adjustments, and subsidiary longevity

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ABSTRACT

We examine how multinational corporations' (MNCs) foreign subsidiaries enhance their performance through flexible intra-firm adjustments and reduce their exit ratio under exchange rate changes in their host countries. We analyze Korean MNCs where foreign subsidiaries engage in intra-firm sales or purchases of product with counterpart affiliates with opposite price competitiveness. Results show that such subsidiaries can enhance their performance and thereby reduce their exit rates within their host countries. We also find that high host market uncertainty or large subsidiary investment size positively moderates the impact of a subsidiary's performance—enhanced through flexible adjustments through intra-firm trade—on its exit.

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1. Introduction

A multinational corporation's (MNC) foreign subsidiaries are exposed to diverse macro-economic uncertainties (Chung & Beamish, 2006; Cuypers & Martin, 2010). Those external uncertainties require MNCs to structure and manage their international investment portfolios in more flexible and timely manners (Benito, 1997; Belderbos & Zou, 2009; Chung, Lee, Beamish, & Isobe, 2010). The failure to make quick and timely adjustments in response to uncontrollable changes in macro-economic conditions can increase foreign subsidiaries' cost burdens and threaten their performance or longevity (Belderbos & Zou, 2009; Chung & Beamish, 2006; Chung et al., 2010).

Most of existing studies on foreign divestiture argue that a parent MNC is more motivated to abandon subsidiaries facing external uncertainties and thus low performance (Benito, 2005; Hennart, Kim, & Zeng, 1998; Mata & Portugal, 2000). However, the real options lens to multinational flexibility argue that MNC subsidiaries operationally linked to peer subsidiaries in other countries can respond to external uncertainties in more flexibly ways (Chung et al., 2010; Fisch & Zschoche, 2011; Huchzermeier & Cohen, 1996; Lee & Song, 2012). Such flexible intra-firm adjustments enable them to enhance their performance and reduce their exit rates. Specifically, the multinational operational flexibility perspective suggests that firms use their international portfolio of subsidiaries and take advantage of differing changes in macro-economic factors in their host countries by adjusting their value chain activities including productions and sales and/or transfer their resources (Chung et al., 2010; Huchzermeier & Cohen, 1996; Kogut & Kulatilaka, 1994; Lee & Makhija, 2009a, 2009b; Pantzalis, Simkins, & Laux, 2001). Firms with more switching options including available subsidiaries for cross-country flexible adjustments adjusting can enhance their performance and prevent their foreign subsidiaries from exiting even under uncertain macro-economic conditions (Belderbos & Zou, 2009; Chung et al., 2010).

We find that previous studies treat "performance" as either an independent variable for firm exits (Benito, 2005; Delios & Beamish, 2001; Serapio & Cascio, 1996) or as a separate dependent variable from exits (Delios & Beamish, 2001). However, the decision to exit is extremely drastic. Therefore, foreign subsidiaries may attempt to make flexible adjustments in order to enhance their performance before the parent firm makes the decision of exiting. No study so far has considered the impact of a subsidiary's performance enhanced owing to flexible adjustments on its exit. Not all subsidiaries or host countries may be able to make such flexible adjustments. Hence, the frameworks used in the literature have failed to determine the conditions under which subsidiaries can profitably realize multinational operational flexibility.

In response, we address two questions: (1) How can MNCs' foreign subsidiaries facing uncontrollable exchange rate changes in their host countries enhance their performance though flexible adjustments and reduce their exit rates? (2) Under which conditions do these subsidiaries make flexible adjustments? To

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this end, we consider the directionalities of both macro-economic conditions and intra-firm trade. We begin our analysis by considering the currency appreciation or depreciation as two directionalities of exchange rate changes. Additionally, we consider two directionalities in foreign subsidiaries' intra-firm trade, i.e. sales or purchases of products through the internal product market. We predict that under currency appreciation subsidiaries can have better performance by increasing intra-firm purchases of product from their peer subsidiaries exposed to currency depreciation. By contrast, subsidiaries under currency depreciation can enhance performance by increasing intra-firm sales of product from their peer subsidiaries exposed to currency appreciation. We recognize that the existing literature on foreign divestiture including those taking multinational operational flexibility is lack of consideration of these contrasting directionalities.

We also consider two contingent factors to examine the conditions under which these flexible adjustments through intra-firm trade are facilitated more. First, we test the impact of host market uncertainty which is traditionally considered a primary factor for firm value or behavior from the real options perspective (Belderbos & Zou, 2009; Chung et al., 2010; Cuypers & Martin, 2010). Second, we test the impact of the impact of strategic importance embedded in large subsidiary investment amount.

We tested our hypotheses with a dataset of Korean foreign direct investments and find that foreign subsidiaries are engaged in intra-firm sales under host currency depreciation or purchases of product under host currency appreciation with their peer subsidiaries exposed to opposite currency situations. Such subsidiaries having shifts of product with their counterpart companies have better performance and less probability of exit from their locations. We find that adjustments through intra-firm trade yield greater benefits for subsidiaries under high host market uncertainty or in large size. We believe that our arguments are supported by theories related to international trade under inter-country currency value differences, and reduction of transaction costs by the use of internal product markets.

2. Theory and hypotheses

2.1. Coping with environmental challenges through flexible intra-firm trade adjustments

Real options theory sheds light on why and how a firm retains flexibility under uncertainty (Bowman & Hurry, 1993; Dixit, 1989; Dixit & Pindyck, 1994; Kogut, 1991; McDonald & Siegel, 1986). When firms cannot anticipate what is going to occur with their investments, firms need to prepare for an uncertain future by structuring their investments in a manner that more future decision rights are embedded. The future decision rights allow firms to monitor their markets and respond to unexpected changes at relatively low costs (Chi, 2000; Chi & McGuire, 1996; Chung et al., 2010; Fisch, 2009; Folta & Miller 2002; Kogut, 1991; Kumar, 2005; Reuer & Leiblein, 2000).

The real options explanation of benefits of multinationality is that an MNC is able to exploit external environmental uncertainties structuring and utilizing its international portfolio of subsidiaries (Fisch & Zschoche, 2011; Lee & Makhija, 2009b, Lee & Song, 2012; Tong & Reuer, 2007; Tong, Reuer, & Peng, 2008). Specifically, this perspective holds that MNCs can deal with uncontrollable changes in macro-economic conditions and exploit cross-country cost differentials in a better manner by relocating their value chain activities or transferring the resources held in their foreign subsidiary portfolios across multiple countries (Allen & Pantzalis, 1996; Huchzermeier & Cohen, 1996; Pantzalis et al., 2001; Tang & Tikoo, 1999). In that sense, MNCs' flexible responses to divergent macro-economic changes across countries depend largely on the operational links among their subsidiaries. Specifically, MNCs can adjust their production and sales by shifting products from unfavorable locations to favorable locations through their internal product markets.

From a foreign subsidiary's standpoint, its exploitation of such flexibility embedded in its parent MNC's multinationality and its capacity to change its current strategy without incurring significant costs rely on its interactions with other peer subsidiaries within the MNC's network (Kiyota, Matsuura, & Urata, 2008; Lee & Makhija, 2009a; Little, 1986; Rangan, 1998). One important index for a subsidiary's operational link to its peer subsidiaries in other countries is its intra-firm trade activities within the same MNC network. Here intra-firm trade means purchases or sales of products among peer companies across countries (Feinberg & Gupta, 2009; Lee & Makhija, 2009a; Little, 1986; Rangan, 1998).

Intra-firm trade among peer companies reflects operational linkages and global integration (Feinberg & Gupta, 2009), and provides benefits to foreign subsidiaries. It creates internal product market and thus enables member firms to transact their inputs and outputs at relatively low costs and thus reduce transaction costs relative to arm-length transactions including outsourcing (Feinberg & Gupta, 2009; Kiyota et al., 2008). Additionally, a subsidiary's operational connection to its peer subsidiaries in other countries allows the subsidiary to retain more flexibility by adjusting its production and sales volume according to differing directional changes in the same macro-economic factor (Belderbos & Zou, 2009; Fisch & Zschoche, 2011; Rangan, 1998). Therefore, the negative impact of environmental change might be less for MNCs with greater intra-firm trade (Rangan, 1998). Meanwhile, when a foreign subsidiary is not operationally linked to other subsidiaries through intra-firm trade, it cannot take advantage of multinational flexibility (Chung et al., 2010; Monteiro, Arvidson, & Birkinshaw, 2008).

2.2. Host currency changes, intra-firm trade adjustments, and subsidiary performance

MNCs require new strategies when faced with uncontrollable changes in their production costs and in the price competitiveness of products (Buckley & Casson, 1998; Chung et al., 2010; Huchzermeier & Cohen, 1996), which place huge cost burdens on subsidiaries (Kogut & Kulatilaka, 1994). Specifically, when a foreign subsidiary faces unfavorable changes in its host country's macro-economic environment, it may experience greater difficulty in operating successfully. The literature shows that change in currency value is one of the greatest macro-economic sources of risk for MNCs' foreign subsidiaries (Belderbos & Zou, 2009; Chung et al., 2010; Lee & Song, 2012; Tang & Tikoo, 1999). Because previous studies have focused on MNCs' subsidiary networks as a whole, they haven't been able to link a firm's activities in a country with the country's exchange rate. Thus, it would be ideal to consider a focal host country and the changes in its exchange rates while looking at the inflows or outflows of that country to understand the direction of exchange rates.

Changes in currency value can be either favorable or unfavorable for subsidiaries operating in foreign locations. While depreciation of the local currency is a favorable change that enhances foreign subsidiaries' price competitiveness, appreciation of the local currency is an unfavorable change that causes the foreign subsidiaries to lose price competitiveness. The price of goods rises as the local currency appreciates, making it more profitable for a subsidiary to import products from subsidiaries operating in other countries with better price competitiveness. When a subsidiary is exposed to appreciation in the local currency of its host country and increases intra-firm trade with its affiliates in other countries facing currency depreciation, it can make up for

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