Journal of International Management 21 (2015) 267–276

Contents lists available at ScienceDirect

Journal of International Management

Fox School of Business
TEMPLE UNIVERSITY

Cross-national Distance and FDI: The Moderating Role of Host Country Local Demand

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ARTICLE INFO

Article history:
Received 19 November 2013
Received in revised form 9 October 2014
Accepted 18 November 2014
Available online 9 December 2015

Keywords:
Cross-national distance
Host country demand
FDI

ABSTRACT

In this paper, we draw on the demand-side perspective to suggest that host country local demand influences the relationship between cross-national distance and foreign direct investment (FDI). Using FDI outflows from the United States to a cross-sectional sample of 110 host countries over the period of 2006–2011, we find that distance negatively influences FDI, largely confirming previous research. However, our results also suggest that a host country's local demand mitigates the negative relationship between geographic, cultural and administrative distance and FDI outflows, while it aggravates the negative effect of political distance on FDI.

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1. Introduction

International business (IB) has long been interested in examining the effect of cross-national distance on foreign direct investment (FDI) (Kogut and Singh, 1988; Xu and Shenkar, 2002). The most prominent research stream on this subject is based on the Uppsala internationalization model (Johanson and Vahlne, 1977), which suggests that because certain potential host countries are perceived as more psychically distant from a foreign investor's home country, internationalization through FDI in these host countries is likely to be preceded by market entry modes with less commitment such as exporting or sales subsidiaries. Where FDI does occur, it is more likely to take place in host countries with higher cultural proximity to the home country. Supporting this premise, scholars have generally found that the greater the distance (cultural, administrative, geographic, etc.) between home and host countries, the more difficult it is for home country multinational enterprises (MNEs) to operate, and hence the lower the likelihood of FDI (e.g., Dow and Ferencikova, 2010; Flores and Aguilera, 2007; Kogut and Singh, 1988).

The Uppsala model has been invaluable in its contribution to our understanding of how cross-national differences weigh on the minds on MNE executives, but it also posits a lasting challenge for MNEs in how to overcome the negative effects of distance. To address this question, prior research tends to rely on traditional firm-specific advantages or institutional theory explanations, suggesting that MNEs can either transfer these organizational or managerial capabilities to local units (Buckley and Casson, 1976; Dunning, 1979, 1980; Hennart, 1982), or mimic the organizational practices of the best performing local firms (DiMaggio and Powell, 1983; Zaheer, 1995). These studies shed unique light on the resources and institutional mechanisms necessary to mitigate the distance effect, but largely neglect the demand side factors that may also help further our understanding. It is this lack of attention to demand-side factors that provides the motivation for our paper. Currently, we know very little about whether demand factors moderate the basic premise of the Uppsala model, and if so, to what extent a host country's local demand can help to mitigate or aggravate the negative cross-national distance effect on FDI. Thus, in this paper we seek to overcome these shortcomings by examining 1) the direct effect of

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http://dx.doi.org/10.1016/j.intman.2014.11.002
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demand-side factors on FDI and 2) the moderating influence of host country demand on the negative relationship between cross-national distance and FDI.

The demand-side perspective suggests that market demand is critical to firm value creation, and firms should pay close attention to consumer demand in strategic decision-making (e.g., Priem et al., 2012). Extending this demand-side perspective to the FDI context, we argue that FDI flows will be driven in part by a host country's local demand, which we define as the market value of all goods and services purchased in a host country. Indeed, the idea of local demand as a driver of FDI has made very little traction in the IB field. What has been done to date focuses on supply-side market-seeking motivations (Dunning, 1998; Dunning and Lundan, 2008). Thus, we also contribute to the IB literature by examining the role demand-side pull factors play in motivations for FDI as a complement to the established supply-side arguments.

In this paper, we intend to build upon the recent development of the demand-side perspective to propose that a host country's demand conditions can influence FDI flows by mitigating some of the negative effects of distance on FDI. By including demand-side considerations, we help deepen and extend our current understanding of how MNEs leverage host country local demand to deal with the negative effects of distance in overseas investment. In addition, by investigating FDI outflows from the United States (US), we provide new empirical evidence on the demand-side perspective. As there has been little empirical work that examines the impact of host country local demand on FDI, or the role of demand in how firms view distant markets, this paper is among the first to examine demand-side predictions in the FDI context.

A better understanding of the role demand factors play in FDI outflows has important implications for both IB scholars and MNE strategic decision-making. For the IB community, the theoretical suggestion that host country demand mitigates the negative effects of distance suggests that there may be more to overcoming psychic distance that what is currently understood. And for MNE managers, our study shows the importance of recognizing distant markets as an opportunity to provide value to potential customers in those markets, as opposed to focusing only on efforts to avoid them due to perceived differences in the home and host countries.

The remainder of the paper is structured as follows. First, we review the relevant background literature and identify research gaps to develop theory and hypotheses. We then test the hypotheses using US FDI outflows to 110 host countries over the period of 2006–2011. Lastly, we conclude the paper with a discussion of our results, the implications of our findings, the limitations of this study, and avenues for future research.

2. Background literature and hypotheses

2.1. Cross-national distance and FDI

Explaining FDI flows is a common theme in IB research. According to the Organisation for Economic Co-operation and Development (OECD), FDI is defined as a "cross-border investment by a resident entity in one economy with the objective of obtaining a lasting interest in an enterprise resident in another economy. The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the direct investor on the management of the enterprise" (OECD, 2013). In his heavily cited thesis, Stephen Hymer (1976) is among the first to suggest that FDI is a preferred method of market entry because it enables firms to transfer knowledge and other assets without relinquishing ownership or control.

However, Hymer (1976) also notes that a foreign MNEs physical presence in a host country can create problems and conflicts that increase with the distance between home and host countries, now commonly referred to as the *liability of foreignness* (Berry, 2010; Johanson and Vahlne, 2009). Differences between MNEs and host countries create liabilities and increase distance because local workers of MNEs foreign subsidiaries are often unfamiliar with or even openly opposed to the established management practices imposed by MNE headquarters (Slangen et al, 2011). These and other differences such as communication styles (Adler, 1986) are likely to negatively influence performance and impact foreign entry decisions (Flores and Aguilera, 2007; Hennart et al., 2002).

Researchers at the University of Uppsala were among the first to develop the liability of foreignness concept into a distinct construct they referred to as *psychic distance*, defined as the factors that make foreign markets difficult to understand (Johanson and Vahlne, 1977). The basic premise is that as distance increases, MNEs will find it more challenging to gain knowledge of the domestic market, which places them at a competitive disadvantage over local firms (Hymer, 1976; Zaheer, 1995). Similarly, when cultural and geographic differences are high, foreign MNEs often have far greater difficulties in establishing and maintaining local business relationships (Caves, 1996; Slangen et al, 2011). They may also find that large national differences increase the costs of adapting their goods and services to local tastes and preferences (Miller and Eden, 2006), and the difficulty in overcoming discrimination and lawsuits (Hennart et al., 2002; Mezias, 2002). By analyzing FDI patterns, Uppsala scholars conclude that foreign investment tends to start in host markets that are psychically similar to the home market, and then gradually enters other more psychically distant markets (Johanson and Vahlne, 2009; Kogut and Singh, 1988).

Following the Uppsala perspective, we examine four general types of distance that are well accepted in prior cross-national distance and FDI studies: cultural, administrative, political and geographic distances. We provide a brief review of each of these distances in the context of FDI research to derive our *baseline* hypothesis that cross-national distance and FDI are negatively related.

First, culture is one of the most oft-cited and empirically validated factors contributing to psychic distance. Although it has been used in many fields to answer a multitude of research questions, its greatest impact is on the FDI literature (Shenkar, 2001). The most popular approach to cultural distance is based on the work of Geert Hofstede, who proposes several key aspects that distinguish national cultures (Berry et al., 2010). Kogut and Singh (1988) quantify Hofstede's cultural dimensions and provide empirical evidence that MNEs are less likely to invest in more culturally distant host countries from their home country. Likewise, other studies find a

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