

Chapter 9

Overcoming Liability of Foreignness: An Analysis of Early Foreign Investment in China

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ABSTRACT

This study examines the liability of foreignness (LOF) faced by multinational enterprises (MNEs), and the effects of strategies employed to overcome the liability. Based on a sample of 3,085 Sino-foreign joint ventures formed in manufacturing sectors in China, the authors find that Hong Kong investors, who are often perceived to have lower LOF than investors from other countries, are more actively engaged in strategies to overcome the LOF. Specifically, Hong Kong investors actively adopt strategies to seek local markets, maintain investment flexibility, utilize their competitive advantages in labor-intensive industries, and leverage cooperative synergism to improve their performance. Investors from other countries adopt market seeking and cooperative synergy approach to improve performance.

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1. INTRODUCTION

Multinational enterprises (MNEs) investing abroad face a significant liability of foreignness (LOF) (Kindleberger, 1969; Hymer, 1960, published 1976; Caves, 1982; Dunning, 1993; Zaheer, 1995; Zaheer & Mosakowski, 1997; Miller & Parkhe, 2002; Mezias, 2002). The LOF from increased expenses due to large spatial distance between parents and subsidiaries. More importantly, operating in an unfamiliar political/legal, social/cultural, and economic/technological environment and dealing with new competitors, customers, suppliers, creditors, government agencies, and others would inevitably increase costs for the foreign investors. Overcoming the LOF has been a fundamental issue for both executives and researchers of MNEs (Dunning, 2000).

This study examines the LOF and how foreign investors respond to the liability in a transitional, developing economy, China. China is selected as the host country because it is one of the largest foreign direct investment (FDI) recipients in the world. Furthermore, foreign investors face significant LOF as the country moves from a closed, central-planned economy to a more open, market-oriented economy. This is especially true during the early years from 1979 through early 1990s. The significant inflows of FDI and unique foreignness experienced by MNEs provide a unique opportunity to study how foreign investors overcome the liability in order to succeed in this new market.

This study is different from previous research in the following aspects. First, it attempts to fill a void in the literature by examining LOF faced by investors in a large developing country. Second, this study examines different levels of LOF faced by MNEs from various home countries/regions. Third, we examine the MNEs' responses to the LOF and the outcomes of these strategic responses.

Using a sample of 3,085 Sino-foreign joint ventures formed from 1979 through 1992, we find that Hong Kong investors actively adopt strate-

gies to seek local markets, maintain investment flexibility, utilize their competitive advantages in labor intensive industries, and leverage cooperative synergism to improve their performance. Investors from other countries largely adopted market seeking strategy, and cooperative synergy approach to improve performance.

2. LIABILITY OF FOREIGNNESS

New entrants to a foreign market face LOF. Hymer (1960/1976) laid out his argument for the LOF forty years ago. Local firms enjoy better information about their country, economy, language, laws, politics, etc. than the foreign firms. Without the information, foreign investors incur additional operating costs. A similar argument has been made by Buckley and Casson (1976), Dunning (1977), Caves (1982), and Hennart (1982). Kindleberger (1969) focused on the spatial distance between the parents and their subsidiaries. Buckley and Casson (1976) related LOF with unfamiliar political, legal, social, cultural, economic/competitive and governmental environment. In sum, operation in a foreign country will entail higher costs than operating in the home country (Hennart, 1982, p. 2).

Zaheer (1995) classified sources of the LOF into the following categories: (1) spatial distance between home and host countries, (2) unfamiliarity or lack of roots in a local environment, (3) host country environment, and (4) home country environment. Matsuo (2000) listed three sources: (1) difficulty in establishing a new organization while facing cultural and language barriers in the host country, (2) unfamiliarity with economic and political regulations or the host country and (3) difficulty in communicating with the parent company because of spatial distance.

Large spatial distance between parents and subsidiaries creates disadvantages for investors, while geographic proximity translates to the location advantage. Doing business abroad inevitably involves the nuisance of travel and long distance

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