Foreign Market Servicing Strategies In The NAFTA Area[*]

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This paper examines the link between globalisation and the growth of trade blocs using the experience of the North American Free Trade Agreement (NAFTA). Globalisation is interpreted as the differential pace of integration of national markets of different types. In comparison with other forms of international business (for example, trade in intermediate and finished products, technology licensing, etc.) foreign direct investment (FDI) is seen as the agent of 'deep integration' (UNCTAD 1993).

Therefore the key link between globalisation and trade blocs is FDI. Not only does FDI raise the issue of 'who is us' (Reich 1990), with the consequent implications of this for policy, it also represents a major strategic weapon for multinational enterprises (MNEs) in their struggle for the world's appropriable surplus (Buckley 1996). This is an important reality of the regionalised world economy, where firms based outside trade blocs face high levels of discrimination.

The second section focuses on the globalisation of markets and the localisation of attempts to build competitiveness (Enright 1998). The third section deals in greater detail with the projected impact of NAFTA on multinational firms' foreign market servicing strategies. The fourth section addresses the implications for the organisational structure of multinational firms.

Globalisation and Regionalisation of the World Economy

The success of the European Union (EU) in achieving greater European integration, the deepening and extension of NAFTA and the rise of free trade areas such as Mercorsur, point towards an accelerating trend in world trade -- the growth of trade blocs. These trade blocs are also investment and technology blocs, encouraging closer ties between member economies.

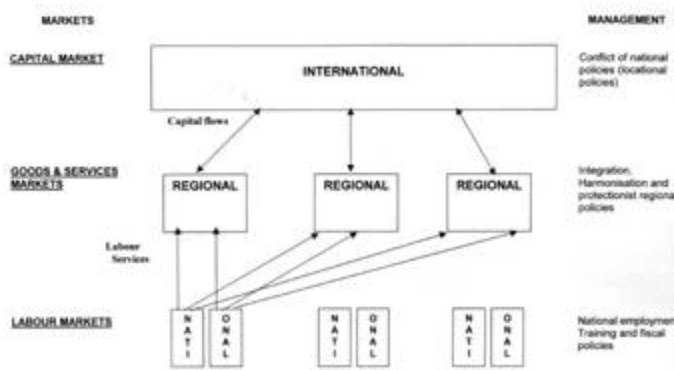
The concept of globalisation has become devalued by the ascendancy of use over meaning. However, if we consider three levels of markets -- financial markets, markets in goods and services and labour markets -- we can envisage each of these moving at a differential speed towards global integration. Financial markets are already very closely integrated internationally, so much so that no individual 'national market' can have independent existence. Goods and services markets are integrated at the regional level. This coordination is largely policy-driven through institutions such as the EU, NAFTA, and ASEAN. Labour markets however are functionally separate at the national level and here integration is largely resisted by national governments (for example, the UK's opt out of the EU Social Chapter to 1997).

Figure 1 shows a highly simplified picture of the world economy. It attempts to show different degrees of integration across various types of market. The suggestion is that financial markets are substantially integrated so that the world financial market can, for many purposes, be regarded as a single market. The market for goods and services is differentiated on a regional

basis with 'single markets' either existing or emerging (especially in the cases of the EU and NAFTA). Such markets are increasingly uniform in regulation, standards, codes of practice (for example, anti-trust) and in business behaviour. They offer the possibility of economies of scale across the market, but are substantially differentiated by these aforementioned factors (and possibly by a common external tariff) from other regional markets. Labour markets, however, remain primarily national. Governments wish to regulate their own labour markets and to differentiate them (to protect them) from neighbouring labour markets. Many of the current difficulties in governmental regulatory policy arise from the difficulty of attempting to pursue independent labour market policies in the presence of regional goods and services markets and an international market for capital.

In contrast, multinational enterprises are perfectly placed to exploit these differences in the international integration of markets (Buckley 1997a). The presence of an international capital market enables capital costs to be driven to a minimum. The existence of regional goods and services markets enables firms to exploit economies of scale across several national economies. Differential labour markets enable costs to be reduced by locating the labour-intensive stages of production in cheap labour economies. A strategy of serving the regional goods and services markets of the world through horizontally-integrated FDI is complimented by vertically-integrated FDI in quality-differentiated labour markets. Vertical integration also reflects the spatial distribution of supplies of key inputs and raw materials. The multinational enterprise achieves advantages through both vertical and horizontal integration. Vertical co-ordination along the value chain is achieved by a variety of methods from contract purchasing through alliances and joint ventures to ownership. The advantages of horizontal integration are achieved by concentrating activities at a single location to achieve maximum economies of scale. Strategic trade and foreign direct investment can be seen to take place within this overall framework (Buckley et al 1998).

FIGURE 1 Internationalisation of Firms -- Conflict of Markets



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However, globalisation has accompanied increased volatility in the world economy. This volatility has created a new agenda for MNEs, which has the search for flexibility as its priority. Flexibility may be defined as the ability to reallocate resources quickly and smoothly in response to change. So far as the MNE is concerned, the impact of change is captured by the volatility

induced in its profit stream. The volatility of profit that would occur if the firm made no response to change summarises the impact on the firm of volatility in its en-vironment (Buckley and Casson 1998). These developments raise profound ques-tions about the responses of MNEs to regionalisation. The central question in this paper concerns the implications for location strategies within the NAFTA area.

It is somewhat ironic that issues of economic geography have not been to the fore in international business theorising. Perhaps this is because of the difficulty of modelling in this area (Krugman 1995) or an unfortunate by-product of the academic division of labour. However, spatial issues should not be under-rated in constructing more satisfactory and comprehensive approaches to international business theory. The key to progress is to elide from geography to the spatial division of labour. Geographical barriers (mountains, deserts, large land masses with no sea coast) represent difficulties of transportation. These vary with historical time because of technological innovations in transportation. Such spatial barriers inhibit trade and therefore the emergence of specialisation and cooperation in effecting a spatial division of labour. The political division of economic space into nations results in countries having an internal division of labour which differs from that prevailing externally. Primarily, this difference is mediated through trade and so the existence of an entrepôt becomes a crucial factor in stimulating exchange and development (Buckley and Casson 1991).

In the modern world economy, this entrepôt function is provided by the MNE. In this sense the MNE compresses space by its organisation -- the mountain comes to Mahomet. The internal and external divisions of labour meet at the boundary of the multinational firm. The spatial boundaries of the state are crucial in international trade, but in a world economy dominated by MNEs, this boundary becomes much less important. The borderless world (Ohmae 1990) results from exchange across the different divisions of labour, and becomes spatially internal to every national market of the global economy. Mediation of different divisions of labour is no longer trade through an entrepôt, but through the mediation of the different price signals generated by the managers of multinational firms. This gives rise to issues such as the 'Who is us?' issue posed by Reich (1990). Is 'us' British firms wherever they are located or all firms in Britain whoever the ultimate owners are? On this issue hangs much of modern economic policy.

Perhaps the permeable boundaries of multinational firms have relegated the importance of geography, as have technological developments in telecommunications that make the management of spatially diverse entities, such as the multinational firm, so much more efficient. If so, this puts much more emphasis on the coordination problem. The importance of the multinational firm arises from the fact that it is a system for integrating and coordinating intermediate product flows arising from activities concentrated at different locations. It is in this sense that the multinational firm represents a real challenge to the nation state. The nation state for its part attempts to coordinate activities within a given spatial area defined by politically and historically-determined national boundaries -- but these are now completely permeable to intermediate product flows of information by telegraphic communications.

Several major trends in the world economy such as the rise of East Asia, the lack of development in the poorest economies, and privatisation and trade blocs, have induced specific market changes. These changes include: new competitors in mass production and high technology

sectors from countries such as Korea and Malaysia; the failure of import substituting investments, for example, in Africa; new competitors and competitive structures in newly privatised industries; and, combined with the driving down of transport costs (through containerisation, etc.), the result is the possibility of new competitive strategies such as international just-in-time production.

These specific market changes require new competences from companies facing these challenges. In general, the competences required are of a more general entrepreneurial type than the previous generation of technological skills required for efficient mass market production. In final product markets, more competition is experienced. In intermediate product markets, the transport cost revolution makes dispersed activities more feasible, and in labour markets, the adoption of policies of deregulation means that more aggressive management policies can introduce increasing flexibility to labour management. In capital markets, the rising number and greater capitalisation of stock markets creates an increasing threat of hostile acquisition, which in turn puts more pressure on company managements to perform above the norm.

This issue brings us back to the idea of the 'centrality' of foreign direct investment (Buckley 1997b). FDI has a crucial role in cementing international economic relations. It is more than just a strategic weapon in a multinational firm's armoury, or a choice among several possible foreign market-servicing strategies (Buckley and Casson 1976; Buckley and Prescott 1989; Buckley and Smith 1994). FDI is a manifestation of a serious competitive commitment in the increasingly interdependent international economy. In many markets, it is not possible to gain a sizeable market share without an investment presence. Increasingly, arm's-length exports to major markets are futile. Selling through agents or distributors does not allow control of the operation or effective flow-back of information to the principal (Buckley et al 1990).

The forces outlined in Figure 1 can be expected to have a major impact on the current and future institutional arrangements in the international economy. This section suggests that international business theory leads to several predictions of changes in the global economy. These will include: a greater share of inter-national business activity being focused on mergers and acquisitions; increasing volatility of foreign direct investment based on cheap labour-seeking strategies; differential success between firms and between of given nationality; creating value from a reputation for managing assets; leveraging of generalised skills to create powerful globally-integrated groups; and competition of national territories to create non-transferable asset bases (Buckley and Casson 1998).

FIGURE 2 Interaction Between Country of Location and the Ownership of Assets by Firm

		Asset Ownership by Firms	
		Conventional Assets	Appropriable Skills
Country of Location's Competitive Base	Labour Costs	1. Vertical Disintegration Volatile Home Economy	2. Mixed Outward DFI and Inward Labour Cost Seeking DFI
	Public Assets	3. Inward Investment - Home Firms as Takeover Targets	4. International Vertically Integrated Structure with Powerful Home Base

FIGURE 2 Interaction Between Country of Location and the Ownership of Assets by Firm

FIGURE 3 Examples of Interaction Between Country of Location and the Ownership of Assets

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FIGURE 3 Examples of Interaction Between Country of Location and the Ownership of Assets

This will lead to the configuration of the world economy as pictured in Figure 2. Quadrant 1 represents the situation where the country of location is competing on labour costs (or labour flexibility in the external market sense), interacting with firms which have asset skills (physical assets, patents, brands). This leads to a vertically-disintegrated structure with a volatile 'home' economy where the firms' transferable skills can combine with cheap labour at home or elsewhere. Quadrant 2, similarly, shows a country of location competing on low-cost labour, but this time interacting with firms which have appropriable generalised management skills. This leads to a mix of outward FDI seeking locationally-fixed public assets together with a fluctuating flow of cost-reducing inward investment. Quadrant 3, which combines locationally-fixed public goods with firms with asset skills, will represent prime targets for inward takeovers of indigenous firms. Quadrant 4 represents the powerful home base of a vertically integrated structure, both forward and backward. Figure 3 gives examples of interaction between country of location and the ownership of assets by firms.

Figure 4 examines the implications of the changes identified by plotting their effect on the change of contractual arrangements made by multinational firms. East Asian and other 'new multinationals favour non-contractual means of acquiring assets and knowledge and also have a

penchant for joint ventures with foreign-owned multinationals. In their outward involvements, they favour greenfield ventures, often on a wholly-owned basis, but also using joint ventures. They are insufficiently integrated, so far, into the world capital market and are culturally unfamiliar with takeovers, so that the acquisition mode favoured by Western multinationals does not appeal to them. The newly privatised companies have had recourse to inward licensing and joint ventures in order to acquire skills and technology previously unavailable to them (or of which they previously had little need, such as generalised marketing skills). They have also come under the acquisition spotlight, as foreign predators see them as ripe targets on account of their undervalued assets and unreleased potential. In their outward activities, they have favoured licensing and joint ventures, to access capabilities which they do not possess, while some of them have sought to complement this strategy by acquiring packages of assets. Finally, the development of trade blocs has facilitated and been facilitated by joint ventures and acquisitions between multinational firms.

FIGURE 4 The Changing Configuration of Modes of International Business Activity

	Rise of New Economies		Privatisation		Trade Blocs
	Inward	Outward	Inward	Outward	
Non-Contractual Modes					
Imitation	✓				
Educational Transfers	✓				
Piracy/Counterfeiting	✓				
Contractual Modes					
'Licensing'			✓	✓	
Control Modes - FDI					
Joint Ventures	✓	✓	✓	✓	✓
Greenfield Ventures		✓			
Acquisition			✓	✓	✓

FIGURE 4 The Changing Configuration of Modes of International Business Activity

Thus, we can observe a different emerging configuration of modes of doing international business from the position of the early 1980s (Buckley 1981). Non-contractual modes are increasing in importance as (covert) means of technology transfer but in areas where higher levels of competitiveness and market development exist, joint ventures and acquisitions are in the ascendant because these are key means of acquiring capabilities. These foreign market servicing strategies are examined in greater details in the next section. Since NAFTA has gone very far in the direction of discrimination, especially in sensitive sectors such as textiles and apparel and automobiles (Fontagné 1995), FDI can be seen as a necessary strategy to gain access to the NAFTA market, so the entrant firms can behave as insiders. We then examine what NAFTA means for the use of the various strategic weapons that multinational firms can use to serve the North American market(s).

NAFTA's Impact on Foreign Market Servicing Strategies

Foreign Market Servicing Strategies

There is an extensive literature on the foreign market servicing strategies of companies, which has been reviewed in Buckley and Prescott (1989). Much of the analysis took place at the level

of the firm, using the twin concepts of internalisation and location to differentiate the three primary forms of foreign market servicing (exports, licensing and FDI) from each other. At its most simple, exports (X) can be distinguished from the other two methods by the location effect. With exports, the bulk of value-adding activity takes place in the home country, whilst the other two methods transfer much of value-adding activity to the host country. Similarly, licensing (L) can be differentiated from X and FDI by the externalisation effect. L represents a market sale of intermediate goods or corporate assets by the firm. In licensing the firm sells rights and the use of assets to a licensee. In X and FDI such activities are internalised (Buckley and Casson 1976, 1985; Dunning 1993, 1998). Broadly, then, the internalisation and location effects separate the three generic forms of market servicing.

Exporting can take many forms: direct exporting to final customers; exporting via market-based intermediaries or exporting via a company-owned sales and marketing office. The large geographic distance between Canada and the UK means that the cost of transporting goods across the Atlantic can act as a powerful incentive for investment or contractual arrangements, unless the high value-added nature of a product can withstand the costs of exporting. Direct exporting involves firms operating at a distance, and therefore can mean that companies lack local image, fail to display a commitment to the local market and, possibly, have difficulty in persuading customers of their ability to provide after-sales cover. However, direct interaction with clients allows them to work closely with their customers to develop mutually beneficial solutions to problems. In the early stages of market development FDI serves as a way of testing out market opportunities, establishing a customer base and developing a degree of awareness of potential clients. In the longer term, the growth of the foreign operation will dictate the location of FDI and associated personnel within the target market. To this end, firms may be aware of the long term potential of moving from exporting to some type of foreign investment, although such a move is not considered viable until a critical mass has been achieved, and FDI can be justified. Exporting via a local market-based intermediary requires the firm to rely on an external agent for the successful sale and marketing of its products in the foreign country. Finally, the establishment of a sales office abroad permits the firm a degree of market involvement, particularly for the purpose of gathering information and tracking market developments although, unlike a foreign subsidiary, an office does not constitute a separate firm with the potential to act and plan independently.

Licensing can also take a variety of forms ranging from simple contract manufacturing to the packaging of an array of competitive assets and services for sale to a foreign organisation. Contractual arrangements are usually entered into because the manufacturer lacks the critical resources to enter the market directly (often involving their overcoming barriers to entry) or to service the market effectively. Equally, the host market firm enters into the contract in order to supplement its own resources in some way. In these cases, cooperation is the key transaction characteristic.

Finally, the generic term "foreign direct investment" covers a variety of strategic alternatives: assembly, full manufacturing or sales marketing investment. It also encompasses the choice of entry mode: the establishment of greenfield facilities or the take over of an existing firm. The choice of mode of doing business abroad and its dynamics emerge as very complex, influenced

not only by industry-specific factors and location-specific factors but also by individual firm-specific factors. They are also subject to large degrees of uncertainty.

NAFTA's impact on inward direct investment

Following Buckley et al (1998), Forsans (1995, 1996), Forsans and Waverman (1996), four kinds of strategies related to FDI can be pointed out following the consolidation of trade blocs in general, and NAFTA in particular: defensive import-substituting strategy, reorganisation investment, rationalisation investment, offensive import-substituting investment. We shall examine these strategic choices in greater detail.

Defensive import-substituting investment is a response by firms to the trade-diversion effects that occur from NAFTA.[1] The removal of trade barriers among NAFTA members leads to an increase in the locational advantages of the mem-bers. A switch from an export-based strategy to a FDI one allows the firm to maintain its market share threatened by the trade-diversion effects. This switch is obligatory since it is the only one that both allows an outsider to gain access to the NAFTA market(s) and to behave as an insider.

Trade-creation effects exert pressures to reorganise the production in accordance with members' comparative advantages.[2] This leads to "Reorgani-sation investment". Firms are likely to regroup their production facilities in fewer locations where more favourable production costs can be found.

Scale effects occurring from integration induce a decrease in production costs within the trading bloc making these locations better places for international sourcing. These efficiency gains encourage "Rationalisation-investment", that is, FDI that responds to international differences in production costs.

As a result of NAFTA's dynamic effects, the size of the barrier-free market within which a firm operates expands. These growth-enhancing and market-augmenting effects of NAFTA give rise to "Offensive import-substituting invest-ment", that is, FDI whose motivation is to take advantage of growing demand and the opening up of new markets.

FIGURE 5 Effects of NAFTA FDI-Based Strategies of Multinational Firms

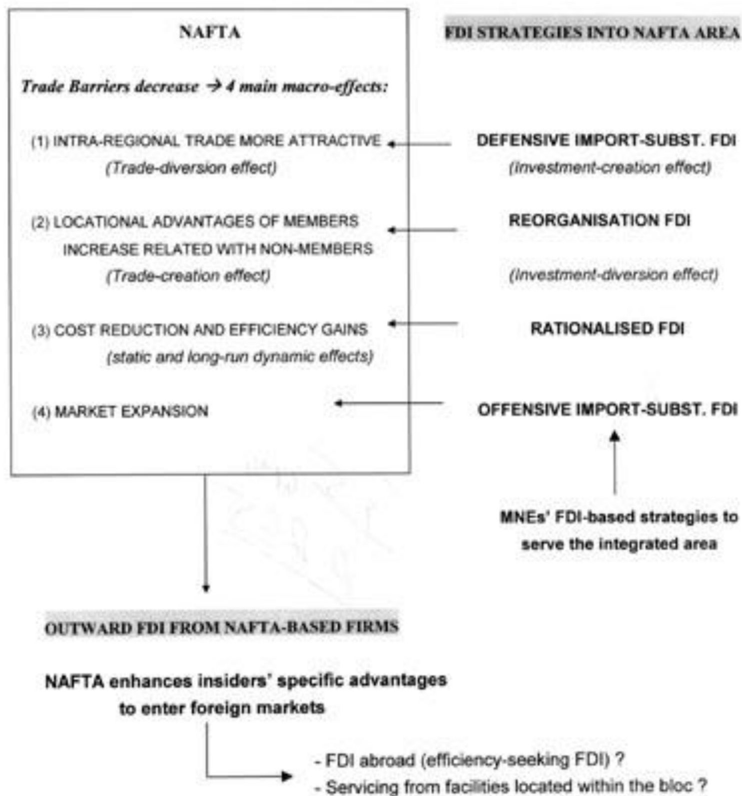

FIGURE 5 Effects of NAFTA FDI-Based Strategies of Multinational Firms

Figure 5 sums up the effects of NAFTA on FDI through its impact on intra- and extra-regional trade. The removal of trade-barriers within the NAFTA area induces direct effects on the location of the production as well as indirect effects through the impact it exerts on income levels, competition, innovation, etc. The relationship between trade and investment is very complex. Defensive import-substituting investment (responding to trade-diversion effects) by its nature replaces trade. Other investment-based strategies can complement a trade-based strategy, especially in the case of rationalisation-investment and reorganisation-investment, which can encourage inter-industry trade (rationalisation-FDI) and intra-industry trade (reorganisation FDI).

These strategic responses also affect FDI levels within the area, as well as their geographical and sectoral distributions. Cost-reduction effects can generate reorganisation or rationalisation investments depending upon whether the MNE served the integrated market with imports from non-member states or from production facilities located within the trading bloc. In the first case rationalisation investments can occur from decreasing production costs within the area, and from increasing opportunities to exploit scale economies. In the second case, reorganisation-investments will take place within more specialised facilities, each with a smaller scope of production activities. X-efficiency gains could attract rationalisation FDI as the costs of intermediate inputs become cheaper within the NAFTA area. Overall, the removal of market fragmentation and the stimulus to growth from the dynamic effects of customs unions open up new opportunities for FDI by firms with strong competitive advantages. Finally, the uncertain

issue of NAFTA's future trade policy can also attract FDI motivated by the fear of future restrictions in market access to the enlarged market. However, this new FDI can lead to surplus capacities within the trading bloc, and do not necessarily correspond to an efficient world-wide distribution of investment resources.

NAFTA's impact on outward direct investment

NAFTA will also affect outward FDI to third countries from MNEs located inside the trading bloc. Indeed, the cost-reduction effects occurring from the static and dynamic effects of free trade areas (with consequences for scale economies, X-efficiency gains, country specialisation, competition and innovation) can improve the competitiveness of regionally-based MNEs and help them to exploit foreign markets better. It is likely that the attraction of servicing foreign markets from production facilities located outside the trading bloc will be reduced relative to servicing markets from locations inside. In this case trade replaces foreign production owned outside the bloc. However, the search for efficiency to cope with increased competition within the bloc can lead firms to conduct rationalisation FDI outside the trading bloc, in order to have access to cheaper inputs.

It is important here to remember that NAFTA is only one trading bloc in the world economy. Experience gained in the expanded home market (NAFTA) can be transferred both to the European Union (EU) and the more slowly integrating Asian markets. Potential investment in Southeast and East Asia may benefit from these economies of learning. Progress towards 'competitive integration' in Asia have been slow. The formation of the ASEAN free trade area (AFTA) in 1992 represented a beginning but membership enlargement to include other Southeast Asian countries has complicated the market integration process, as has the Asian currency crisis (Yue 1998). The AFTA so far focuses mainly on trade liberalisation, but attempts are being made to extend its provisions to investment and services. AFTA has much to learn from the progress of the EU and NAFTA and the emergence of the Asia Pacific Economic Cooperation (APEC) forum which includes AFTA, NAFTA and the Australia-New Zealand Closer Economic relations (CER) schemes (Parrenas 1998). Providing principles of 'open regionalism' are followed, and the liberalisation process is undertaken on a most-favoured-nation (MFN) basis, there will be considerable scope in the future for extension of these principles to investment and services, which well provide increasing opportunities for outward investment by NAFTA member countries.[3] Similar arguments also apply to MERCOSUR in South America.

Multinational firms' strategies between trading blocs

The emergence and the consolidation of trading blocs such as NAFTA give rise to important implications in terms of how multinational firms are doing business abroad. As we said, the primary purpose of the formation of a trade bloc is to shift locational attractiveness -- to encourage investment diversion (switching from outside the bloc to intra-bloc investment). Trade blocs also attempt to induce a switch in the market servicing strategies of extra-trade bloc firms from exporting to inward investment. In addition to diverting investment into the bloc by non-bloc multinationals, trade blocs will also affect the investment location of both insider and outsider firms (as noted earlier). The creation of a single market from a series of separate markets may make a central production site more attractive. This has potential for firms to create

a 'hub and spoke' system of central facilities (manufacturing) combined with a set of distribution outlets radiating from the central facility. As a location strategy, this can be combined with an ownership strategy, where joint ownership of distribution can be utilised (Buckley and Casson 1998). It could also be argued that the formation of a trade bloc (more accurately a single market) provokes a move from a multidomestic strategy (where firms can treat competition in each country as separate) to a 'global' strategy, where strategy becomes inextricably intertwined across the integrated market (Porter 1986). On a regional scale, it is evident that following regional integration, a UK firm that formerly invested in Canada to service the Canadian domestic market may now consider switching investment to the USA or Mexico. New investors face the same decision. This argument applies in parallel to, say Canadian investors or potential investors, in the UK within the context of the EU and the Single Market programme (SMP) to achieve an integrated internal market.[4]

Consequently, trading blocs are likely to affect competitive advantages, the location of production of both foreign investors and insiders, and indeed their foreign market servicing strategies. Depending on the level of the external tariff and non-tariff barriers, the locational effects are likely to favour the substitution of exports for local production. It is also evident that the removal of intra-regional distortions may represent relative discrimination against foreign firms (Clegg 1996). However, within the integrating area, the locational effects are likely to encourage more plant and process specialisation particularly in sectors where economies of scale are important. These economies, as well as those arising from geographical diversification and economies of scope are, together with the absence of trade barriers, likely to allow firms to further exploit the economies of common governance. The impact on foreign firms very much depends on their existing locational strategies. It is possible that established Canadian investors in the UK, and UK investors in Canada, may benefit (Buckley et al 1994). Clearly, many factors, including industry and firm-specific factors will be influential.

NAFTA's impact on outsiders: the examples of UK firms and NAFTA

An earlier study by Buckley et al (1994) focused on how Canadian and UK firms regarded the development of NAFTA. UK firms, in general, saw NAFTA as a market opportunity. Many firms felt that the long-term attraction was the broader market scope and size, in the form of the greater freedom to offer goods across the whole of North America. There were a number of firms who maintained that, for strategic reasons, a presence in both markets would continue to be important in the future. These firms resisted the cessation of direct operations in either Canada or the USA, although the form of their business activities would be likely to change.

The nature of firms' adjustments in the wake of NAFTA depends on the starting position of the investor. For firms newly entering North America, location in one market may indeed be employed as a platform for expanding into the rest of NAFTA. For established investors, more harmonised legislation on standards is more likely to stimulate the replacement of subsidiaries with representative offices than to generate increased cross-border business. The rationalisation of manufacturing facilities between Canada and the USA may be possible, with the caveat that local representation through sales and marketing will still be necessary. Some firms already operating through intermediaries may seek distributors through which to service the whole of

North America. However, the preferred approach for this group of firms is to secure new intermediaries to develop business potential in other geographical areas.

The sheer size of the North American market, and the fact that there remain certain barriers that continue to segment Canada and the USA, mean that a single strategic approach to NAFTA is unlikely for many firms. For instance, legislative differences arising out of historical developments persist.[5] These considerations explain why many firms will continue separate organisational developments in both markets.

The research by Buckley, Pass and Prescott arrived at the conclusion that NAFTA has consolidated firms' trade and FDI strategies towards the North American market, rather than led to completely new strategies. The promise of greater freedoms has led to opportunities being seized earlier, although the "real" economic benefits from the establishment of a single market are still some way off. Certainly, the growing power of the region brought about by North American regional integration is an important magnet for investment. The sample of firms studied by Buckley, Pass and Prescott evidenced a deepening concern that to be competitive globally means developing business in all the major markets of the world, in particular, the triad regions of Europe, America and Asia-Pacific. The drive for regional integration should be understood in this context. In developing North American integration, the policy objective is very much to play on firms' investment strategies, and to convince them that North America will offer an enhanced rate of return on investment.

NAFTA's impact on insiders: Canadian firms and NAFTA

Integration must be seen as posing new challenges for business consolidation and rationalisation within "domestic" trading blocs as well as impacting on bilateral relations between trading blocs -- that is, NAFTA and the EU. Canadian firms voiced a great deal of concern over the impact of NAFTA on the Canadian economy and the long-term effects for Canadian competitiveness (Buckley et al 1994). The removal of US branch plants out of Canada, and the potential for Canadian firms to relocate activities in Mexico added to the severe recessionary pressures besetting the economy. Rather than leading Canadian firms to become inward-looking within the North American market, these developments are having the reverse effect. They are encouraging firms to adopt an outward-looking view based on growth opportunities outside Canada and the USA, which are seen as offering sustainable potential.

NAFTA's impact on insiders: US and Mexican firms

There is considerable evidence that US firms see the NAFTA region as a single integrated home market and treat the investment opportunities it offers as a largely monolithic area, differentiated only by cost structures. The exception to this is, of course, varying perceptions of currency risks. Investment into Mexico is impeded by currency worries. This barrier will remain until NAFTA becomes a single currency area, which, as in the case of the Euro, is an issue in which political considerations predominate.

Mexican firms find themselves with opportunities in NAFTA which few of them are, as yet, able to grasp. FDI requires sustainable advantages over local firms and a management structure

capable of exploiting and building on current capabilities. Few Mexican firms currently have these abilities. We can however expect a few pioneering firms to begin to expand their activities outside Mexico into two kinds of markets, those where language confers advantages (Latin America and Spain) and as familiarity increases into NAFTA's "single market".

Theoretical implications

The emerging pattern of foreign market servicing strategies between Canada and the UK is highly complex and dynamic, with changes in the operating environment brought about by economic integration and changes in the international competitive arena reshaping strategic thinking. The simple taxonomy of exporting, licensing and strategic alliances, and foreign direct investment as being an either/or choice is challenged here. A considerable number of firms simultaneously conduct several forms of market servicing in different areas of their business in the same market. There are also many strategies of a non-traditional, or hybrid nature, which incorporate elements of various modes.

This diversity is easier to understand in theoretical terms than might first appear to be the case. Regional integration leads to a greater pressure on firms to diversify by product, by mode, and by geographical area. As previously separate markets become unified through regional integration, and price convergence (and thereby competition on price) proceeds, so the incentive to diversify rises. The firm's portfolio of real assets become over-concentrated in the integrating regional market, and an outward-looking strategy is a logical response, in order to diversify the portfolio. The implications of these developments for the organisational structure of multinational firms are taken up in the following section.

Research confirms that the internationally diversified firm typically exhibits superior performance (or lower risk) linked to the degree of multinationality, and is able to enjoy a lower cost of capital compared with non-diversified firms, on account of its attractiveness to wealth holders (Clegg 1992). A number of classic studies demonstrated that the degree of geographical diversification through FDI reduces the variance in firms' earnings, for example, Rugman (1976, 1979) for US investors, and is positively related to firms' share prices (Agmon and Lessard 1977). These studies confirmed that investors recognise the MNE as an indirect diversification instrument. As returns in the local markets of the USA and Canada become more correlated, so cross-border FDI within NAFTA will become a less effective instrument of diversification. As argued at the beginning of this paper, because firms must raise capital in a global financial market, inferior risk-return performance will be a source of competitive disadvantage. It follows that in the longer term, after the locational adjustments immediately attributable to NAFTA, firms based in the USA and Canada will increasingly seek investment opportunities outside NAFTA that contribute more effectively to reducing the risk of their portfolios. Therefore, in principle, the long-run impact of NAFTA should lead to greater inter-trade bloc FDI, with FDI organised as efficiently as possible within each bloc.

Implications for the Organisational Structure of Multinational Firms

The pressures analysed in this paper will have a profound impact on the organisational structure of multinational firms. They are presented with two key imperatives -- to create appropriable

assets, especially those based on generalised management skills (and, by analogy, to prevent leakage of returns from assets where appropriability is difficult) and to derive rent by internalising locationally specific public goods. These imperatives require radical restructuring and will alter the scope of such firms.

Leakages in appropriability can be stemmed in two ways: by moving into assets which do not leak and by stopping leakages in conventional assets (Buckley 1983). As Figure 4 showed, non-appropiability is a key issue in 'non-contractual transfers'. Largely, because of institutional difficulties, multinationals have hitherto found it difficult to control these transfers -- they are largely occurring under the auspices of governments, universities, other non-commercial entities and through grey and black markets. Our analysis leads us to expect that multinational firms will increasingly seek to control these areas. This will involve political action to internalise some governmental activities (or at least quasi-internalise them by representation in government and in the governing bodies of non-commercial organisations), and to seek to extend patent rights, licensing arrangements, copyright, branding design and technological protection and to clamp down on piracy and counterfeiting.

Our analysis further suggests that acquisition in particular and joint ventures will become more important as FDI modes. Acquisition results from companies capitalising their general entrepreneurial skills -- backing their valuation of what these skills can achieve with post-takeover assets against the market's valuation. This will lead to a new breed of financier, whose key skills will be to value generalised entrepreneurial and management skills residing in a firm's system of control. Company valuation will become even more of an art and even more well rewarded for those at the successful apex of activity. One key part of these skills will be cultural sensitivity, for foreign acquisitions require this quality in abundance in order to release the value promised to the financiers in the post-acquisition integration phase.

The Search for Flexibility

Much of the recent literature on the theory of multinational enterprises has emphasised their search for flexibility (Buckley and Casson 1998). Attempts to build flexibility into the organisation of multinational firms have been a response to the rationalisation and restructuring of international business and to the increasing volatility of the world economy. Flexibility -- the ability to reallocate resources quickly and smoothly in response to change -- has been a major aim of the management strategies of multinational firms, and it suggests that firms seek real options (Trigeorgis 1996) which can be taken up or dropped depending on the out-turn of the project. Joint ventures are an important case of an information-gathering real option, which enables the firm to reassess its future stance (Buckley and Casson 1996, 1998).

Rongan (1998) following inter alia, Kogut (1983, 1985, 1989) and Kogut and Kulatilaka (1994) assesses the degree of flexibility actually utilised by multinationals in response to exchange rate changes. The implementation of flexible strategies will depend upon physical immobilities (fixed assets, plant level economies of scale, etc.), strategic immobilities (weak internal control systems, administrative heritage), past investments in flexibility and technological flexibility.

All this is relevant for multinationals facing new locational requirements where trade blocs form, consolidate and extend (and break up), for a primary purpose of the formation of a trade bloc is to shift locational attractiveness -- to encourage investment diversion (switching from outside the bloc to intra bloc investment). Trade blocs also attempt to induce a switch in the market servicing strategies of extra-trade bloc firms from exporting to inward investment. This strategy proved very successful vis-à-vis Japanese firms in the run up to the formation of the EU's single market in 1992.

Conclusion

The formation and growth of trade blocs is clearly a major factor in the decisions of multinational firms on foreign market servicing strategies. Both market seeking and efficiency seeking foreign direct investment into the expanding trade bloc are likely to be encouraged as market size grows and costs fall where economies of scale can be achieved. There are also likely to be more subtle effects arising from import substituting FDI (tariff wall jumping) for both offensive and defensive reasons. Firms which already have FDIs within the bloc may well choose to rationalise their investments in response to changing production costs and they may reorganise production units in fewer location. The interaction between location factors and ownership factors may result in more "hub and spoke" operations with large-scale production hubs linked to joint ventures distribution outlets to deal with (cultural) differences across market. Sectoral, product and spatial influences will produce widely differentiated strategies among firms, but a common element will be a search for flexibility by firms in a globalising world.

This issue also has important dynamic implications. It has been shown that multinationals need to plan their foreign market servicing strategies in a dynamic, flexible fashion. One of the key advantages of a successful multinational firm is the ability to reallocate resources in a low cost manner. Therefore, it is to be expected that future changes in NAFTA, and in other groupings of economies, will provoke changes in and reactions to, their external environment. This dynamic interaction is accelerating, producing the phenomenon known as globalisation.

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