



RESEARCH NOTE

Host-country headquarters and an MNE's subsequent within-country diversifications

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Abstract

We propose that the establishment of a host-country headquarters (HCHQ) in a large emerging market can be viewed as part of a multinational enterprise's (MNE) political strategy to facilitate its within-country diversifications by reducing institutional intervention of the host government. Using a sample of MNEs in China in the period 1979–2005, we find that MNEs with an HCHQ had a greater number of subsequent diversifications in China, as compared with those MNEs without an HCHQ. This effect was more prominent when the diversifications were in domains with a higher level of institutional intervention. *Journal of International Business Studies* (2010) 41, 517–525.

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INTRODUCTION

Diversification research around the world (Wan & Hoskisson, 2003) and especially in Asia (Chang, 2006) has started to link a firm's institutional environment explicitly with its diversification strategies. This view of diversification research has made a significant contribution to the field of international business (Peng, Wang, & Jiang, 2008), but it is limited in two important ways. First, prior diversification research has not considered an MNE's diversification strategy *within* a specific host country (Delios, Xu, & Beamish, 2008), which we term within-country diversification.

Second, prior studies have focused on diversified domestic business groups in the setting of the institutional environment of emerging markets, but this line of research has yet to examine the within-country diversification strategy of foreign MNEs in such markets. Particularly, given that the institutional environment of an emerging market can constrain an MNE's efforts to conduct its within-country diversifications, little is known about whether there is a politically oriented strategic response to contend with such institutional intervention-related challenges. Indeed, evidence is beginning to emerge that a host-country headquarters (HCHQ) can be an important organizational solution to competing in emerging markets (Luo, 2007; Peng, 1997; Quelch & Bloom, 1996).

These two elements of an MNE's operations in the institutional context of a large emerging market – its within-country diversifications and the use of an HCHQ – are connected to one another.

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Accordingly, in this study we address the question “What is the relationship between the establishment of an HCHQ and an MNE’s subsequent within-country diversifications?” Hence the purpose of this study is to examine an MNE’s subsequent within-country product and geographic diversification strategies (Peng & Delios, 2006), in a large emerging market, with a focus on the strategic role played by its HCHQ. Moreover, we further explore the contingent value of establishing an HCHQ (Lu & Ma, 2008), by considering how an HCHQ influences an MNE’s subsequent within-country diversifications across areas with different levels of institutional intervention.

HYPOTHESIS DEVELOPMENT

The Establishment of HCHQ as a Political Strategy

Recent research suggests that variation in institutional environments enables and constrains the efficacy of strategic choices such as product and geographic diversifications (Peng et al., 2008; Wan & Hoskisson, 2003). In the setting of a large emerging market, MNEs can have strong growth-related motivations to conduct within-country diversifications, but a host-country government’s institutional intervention can potentially impede their subsequent entries into various industries and locations, which makes it essential for MNEs to develop a corporate-level political strategy for their host-country operations (Luo, 2006).

Political strategy research makes the point that because government policies and behaviors influence the effectiveness of firm strategies, firms can engage in political strategies, or proactive actions, to affect the implementation and development of government policy in ways favorable to the firm (Hillman & Hitt, 1999). An MNE’s political behavior refers to the acquisition, development, securing, and use of the capacity to contend with the institutional intervention of host governments (Boddeyn & Brewer, 1994). MNE–host-government interactions are therefore at the center of an MNE’s political strategy, and MNE–host-government relations are fundamental functions under the purview of an MNE’s HCHQ in an emerging market (Luo, 2007).

In large emerging markets such as China and India the practice of establishing an HCHQ has become increasingly prominent (Birkinshaw, 2001). An MNE’s HCHQ is an umbrella holding company that has three strategic roles (Chandler, 1991). Specifically, it is the MNE’s *local administrator*,

which manages the MNE’s local subsidiaries (Luo, 2007); it is the MNE’s *corporate ambassador* to handle host-government relations (Quelch & Bloom, 1996); and it acts as a *foreign investor* (Peng, 1997). The three strategic roles differentiate an HCHQ from other foreign subsidiaries or representative offices, as only the HCHQ has these three strategic roles.

Given the triad of the strategic roles simultaneously played by the HCHQ (i.e., local administrator, corporate ambassador, and foreign investor), we propose that the establishment of an HCHQ is part of the political strategy used to reshape unfavorable institutional conditions, leading to an increase in an MNE’s bargaining power (Boddeyn & Brewer, 1994; Poynter, 1985) and an improvement in MNE–host-government cooperative relationships (Luo, 2001, 2006). In other words, the HCHQ can be viewed as the infrastructure from which the MNE can expand geographically and product-wise within that host country.

Bargaining power increases come first from the host government’s recognition that the HCHQ is the MNE’s *de facto* foreign investor in the host country. The host government highly values the resources contributed by the HCHQ’s future investments, which increases the HCHQ’s bargaining power (Poynter, 1985). Further, as it is the administrator and investor of the portfolio of the MNE’s FDI, the HCHQ can manage subsequent diversifications in a coordinated way by aligning each new project’s goal with the development objectives of the host government, which may also enhance its bargaining power (Boddeyn & Brewer, 1994). The increased bargaining power of the HCHQ will in turn reduce the level of constraints imposed by a host government’s institutional intervention on an MNE’s subsequent diversifications.

The establishment of an HCHQ also fosters its cooperative relationships with host governments. First, the launching of the HCHQ clearly signals the MNE’s confidence in the host country and its commitment to renew, upgrade, and expand its investments (Peng, 1997). This can lead to a greater level of political accommodation, as the HCHQ is perceived as a “public favor” by the host government. Moreover, an HCHQ can contribute complementary resources to the host government for its agenda of economic and social development, through future investments in R&D, manufacturing, trading, and logistics. Further, the establishment of the HCHQ can help build a high degree of organizational credibility by working as an

administrator and investor of the MNE's FDIs (Luo, 2007). Finally, the use of the HCHQ can also heighten the country manager's social status, because the HCHQ is the MNE's corporate ambassador, appointed to handle top-level host-government relations (Quelch & Bloom, 1996). Accordingly, an improved cooperative MNE–host-government relationship could be achieved, which will create a congenial social and political climate, develop organizational legitimacy and sustainability, and confer valuable resources and external legitimacy (Luo, 2001, 2006).

In sum, the establishment of the HCHQ is part of an MNE's political strategy. The HCHQ can increase the MNE's bargaining power, and foster the growth of better MNE–host-government cooperative relationships. These improvements will reduce the host government's level of institutional intervention, thereby facilitating the MNE's process of within-country diversification in this emerging market.

Hypothesis 1a: Compared with MNEs that have not established an HCHQ, MNEs that have established an HCHQ will have a greater number of subsequent within-country product diversifications.

Hypothesis 1b: Compared with MNEs that have not established an HCHQ, MNEs that have established an HCHQ will have a greater number of subsequent within-country geographic diversifications.

The Contingent Value of HCHQ

Although the establishment of HCHQ can facilitate an MNE's subsequent within-country diversifications, the net contribution of this political strategy depends on the level of institutional intervention in domains where the diversification is being made (Lu & Ma, 2008). In a large emerging market, the level of government interference differs across locations and industries (Luo, 2002).

In particular, the level of institutional intervention of a specific location is often related to the level of host government's policy openness toward FDI (Luo, 2001). For instance, certain regions might be designated as open areas, and FDIs in these areas are allowed to operate under a favorable institutional framework (Zhou, Delios, & Yang, 2002), but in less open areas authorities attempt to maintain their control over local markets, and exercise their powers in distributing resources (Park, Li, & Tse, 2006). Consequently, there is a potential for a

higher level of institutional intervention by the host government in less open areas.

Similarly, the level of institutional intervention of a specific industry category is often related to the level of a host government's policy openness toward FDI in that industry (Luo, 2001). For example, the level of institutional intervention is low in encouraged technology-intensive industries; it is modest in low-technology industries, and high in restricted industries (Luo, 2002). Host government officials enjoy substantial discretion and power in industries less open to FDI, because these industries, by definition, are regulated in a non-market way (Luo, 2002). Hence MNEs entering less open industries are more vulnerable to institutional intervention.

Given that the potential for government interference varies across different locations and industries, we expect that the establishment of the HCHQ will be more valuable for an MNE's future diversifications in domains with a higher level of institutional intervention.

Hypothesis 2a: The positive effect of the establishment of an HCHQ on the number of subsequent within-country product diversifications will be greater when the product diversifications are made in locations with a higher level of institutional intervention.

Hypothesis 2b: The positive effect of the establishment of an HCHQ on the number of subsequent within-country geographic diversifications will be greater when the geographic diversifications are made in industries with a higher level of institutional intervention.

METHODS

Sample

China is a good setting for this study, because its size provides substantial locational and industrial variance in levels of institutional intervention, while its economic growth has been accompanied by high levels of FDI since the mid-1980s (Luo, 2006). We used a sample of Fortune Global 500 corporations that had operated in China in the period 1979–2005.

We draw information from MOFCOM, whose researchers collected annual data on Fortune Global 500 firms' FDIs in China. The FDI profiles had information on the name of each foreign subsidiary, foundation year, business scope, location, and

industry. Our dataset is a longitudinal record of the operations of 428 MNEs, of which 137 had set up an HCHQ in China by the end of 2005.

Variables

We have two dependent variables. The first is *number of subsequent within-country product diversifications*, which was the count of entries into new industries (as coded into four-digit SICs) of MNE i in China in a given year t in a given type of location category. The second is *number of subsequent within-country geographic diversifications*. We identified and counted all the new cities in China in which MNE i entered in a given year t in a given type of industry category.

The independent variable is *HCHQ*, an indicator variable, which took a value of 1 if MNE i had an HCHQ in China in a given year t . We identified whether an MNE had set up an HCHQ in China by referring to the description of the business scope of each subsidiary, as provided by MOFCOM database. For example, MOFCOM database showed that Panasonic had launched 59 foreign subsidiaries in mainland China by 2005. Notably, it had a unique subsidiary called “Panasonic Corporation of China”, which was an investment company established in 1994, with the business scope described as “to provide support for and be in charge of the overall direct investments in China”. This information indicates that this subsidiary is Panasonic’s HCHQ in China.

Table 1 summarizes MOFCOM’s reports on several MNEs’ China HCHQs, as supplemented by our interview with Mr. Peter Yam, the former president of Emerson China’s HCHQ. As shown in Table 1, the common roles played by these HCHQs are to manage the MNE’s existing China-based subsidiaries, conduct further FDIs in China, and negotiate with the Chinese government on behalf of the global headquarters. These roles were similar whether these firms were Japanese, American or European MNEs.

We created an ordinal variable – *institutional intervention in a location* – to capture the level of institutional intervention across subnational locations in China. We coded locations following research on the evolution of China’s open-door policy in different regions (Zhou et al., 2002). We defined the level of institutional intervention in a location as 1 if the subsequent product diversification is conducted in a special economic zone, 2 if in an opening coastal city, 3 if in a coastal open economic zone or open coastal belt, 4 if in a

provincial capital city or a major city along the Yangtze River, and 5 if in any other area in China.

Using various editions of the *Industry Catalogue for Foreign Investment* we created another ordinal variable – *institutional intervention in an industry* – to measure the level of institutional intervention across industries in China. We defined the level of institutional intervention as 5 if a subsequent geographic diversification was conducted in an industry in the Restricted category B, 4 if in Restricted category A, 3 if in the Allowed category, 2 if in the Encouraged Non-Technological category, and 1 if in the Encouraged Technological category (Luo, 2002).

Our corporate-level time-varying control variables included *firm size* (log of a firm’s total revenue), *firm performance* (return on sales), *firm diversification*, and *local experience* (log of years of operation in China).

We also included *cultural distance* (Kogut & Singh, 1988), *annual government expenditure as percent of GDP*, *annual GDP growth*, the *annual inflation rate*, and the *US dollar–Chinese yuan exchange rate*. We had fixed effects of transition periods in China (1979, 1992, and 2001), industry, and category.

Analytic Techniques

We used Lee’s (1983) generalization of the Heckman selection model to correct for potential selection bias. In the first step we predict the hazard of establishing an HCHQ by analyzing our data using a piecewise exponential event history model with robust clustering on each MNE (Box-Steffensmeier & Jones, 2004). We included in the specification an MNE’s firm size, firm performance, firm diversification, cultural distance, China’s GDP growth, industry dummies and the number of MNEs that had an HCHQ. We included a composite measure of local operational complexity using a principal components analysis of an MNE’s number of FDIs in China, its number of within-China product diversifications, and its number of within-China geographic diversifications.

In the second step we used the results from the first step to generate a *selection variable* λ :

$$\lambda_{it} = \frac{\phi\{\Phi^{-1}[F_i(t)]\}}{1 - F_i(t)} \quad (1)$$

where $F_i(t)$ is the cumulative hazard function for MNE i at time t , ϕ is the standard normal density function, and Φ^{-1} is the inverse of the standard normal distribution function (Lee, 1983). We included λ in models that tested our hypotheses.

Table 1 Strategic roles of MNEs' HCHQs in China

MNE	Year China HCHQ established	China HCHQ	Strategic roles of China HCHQ
Fujitsu ^a	1995	Fujitsu (China) Co. Ltd (FCC)	It serves as the investment company. It is in charge of Fujitsu's FDIs in China. Its establishment helped develop cooperative relationships with national-level and regional-level governments, which has effectively reduced the negative effect of economic segments on its FDI activities.
Panasonic ^a	1994	Panasonic Corporation of China (PCC)	Panasonic established this China-based investment holding company to manage and serve all its FDI projects and businesses in China. Its establishment marked a new stage for Panasonic's overall FDIs in China, and many of the functions of Panasonic's global HQ have been transferred to PCC.
Toyota Motor ^a	2001	Toyota Motor (China) Investment Co. Ltd (TMCI)	TMCI has actively participated in investment-related issues and provided various services for the subsidiaries. TMCI is Toyota's China "window", as it deals with government relations, media relations, and communications with other social organizations.
General Electric (GE) ^a	1994	GE (China) Co. Ltd	This HCHQ has provided support and services for GE's FDIs. GE China's major functions include representing of GE in administrating, supporting and serving all GE's subsidiaries in China, and acting as the investor to negotiate with the Chinese government on FDI projects.
Pfizer ^a	2004	Pfizer (China) Investment Co. Ltd	This HCHQ is in charge of all of Pfizer's FDIs and its future FDI projects in China. Its establishment signaled Pfizer's strong commitment to China, to the Chinese government, and to the Chinese people: "Deeply rooted in China, Pfizer will achieve long-term development in China."
Bayer ^a	1994	Bayer (China) Co. Ltd	This HCHQ was established to be in charge of all of Bayer's FDIs in China. This establishment marked a milestone for Bayer's expansions in China, and paved the way for its future FDIs there.
Siemens ^a	1994	Siemens (China) Co. Ltd	This HCHQ has three major functions: (1) it is an investment holding company to control and manage Siemens' investments in China; (2) it provides shared services to Siemens' subsidiaries in China – especially in public relations and government relations; and (3) it facilitates Siemens's new FDIs in China.
Emerson ^b	1993	Emerson Electric (China) Holdings Co. Ltd	As the highest level of organization of Emerson in China, this HCHQ is in charge of all of Emerson's FDIs in the various industries and regions in China, which makes Emerson China look like a China-based domestic business group. Local governments in China welcome MNEs that have established their China HQ with the function of investment.

Sources: ^aReports of Transnational Corporations in China 2001–2006, China Economic Press, edited by Chinese Academy of International Trade and Economic Cooperation, a research institute under the Ministry of Commerce).

^bInterview with the former President of Emerson's China HQ (Peter Yam).

For our hypothesis tests we used Liang and Zeger's (1986) method of generalized estimating equations (GEE), which generalizes quasi-likelihood estimation to the panel data context. This method accommodates non-independent observations, and analyzes both within- and between-firm variations.

We assumed that there was a first-order autoregressive disturbance (AR1), in which disturbances from the prior period for a firm are correlated with disturbances in the current period. Further, we estimated robust standard errors using the Huber–White sandwich estimator (White, 1980). As we

had non-negative count-dependent variables, we specified the GEE family as a negative binomial model to address overdispersion in the dependent variable (Greene, 2000).

RESULTS

Table 2 provides descriptive statistics and correlations for our final sample of 405 MNEs. In our models, we mean-centered independent variables before creating the interaction terms. All models reported in Table 3 were significant as gauged by the model chi-square (χ^2) statistics. Models 1–3 had subsequent product diversifications as the dependent variable; Models 4–6 had subsequent geographic diversifications as the dependent variable. We built the models incrementally, from the baseline (Models 1 and 4) to the addition of the HCHQ variable (to test Hypotheses 1a and 1b in Models 2 and 5), to the addition of the interaction between HCHQ and the relevant level of institutional intervention. The changes in model χ^2 were significant ($p < 0.001$), marking the improvement in overall model fit by the addition of the respective variables in each model.

Models 1 and 4 include the control variables. In Models 2 and 5 we added the HCHQ variable, which took a positive and significant ($p < 0.001$) coefficient estimate, thus supporting Hypotheses 1a (Model 2) and 1b (Model 5). In Models 3 and 6 we added the relevant interaction terms, with the positive and significant coefficients of the respective interaction terms ($p < 0.001$) supporting Hypotheses 2a (Model 3) and 2b (Model 6). Taken together, these results show that an HCHQ is positively related to the number of an MNE's subsequent within-country product/geographic diversifications, but that this positive effect is greater, the higher the level of institutional intervention in a location or industry.

CONCLUSION AND DISCUSSION

We propose that institutional intervention from a host government can constrain an MNE's subsequent diversification strategies in a large emerging market, but the establishment of an HCHQ can be an organizational solution that is part of an MNE's political strategy to contend with institutional intervention. We defined an HCHQ as having three primary roles: administrator, ambassador, and investor. These roles facilitate the pursuit of an HCHQ as part of an MNE's political strategy, which can position the MNE to increase its bargaining power and improve its cooperative relationships in

Table 2 Descriptive statistics and correlations^a

Variable	Mean	s.d.	1	2	3	4	5	6	7	8	9	10	11	12
1. Number of subsequent product diversifications	0.07	0.33												
2. Number of subsequent geographic diversifications	0.07	0.28												
3. Host-country headquarters (HCHQ)	0.23	0.42	0.16	0.08										
4. Firm size (log)	9.76	0.90	0.12	0.05	0.28									
5. Firm performance	0.04	0.10	-0.01	-0.00	0.05	-0.06								
6. Firm diversification	3.60	2.96	0.15	0.06	0.17	0.14	-0.01							
7. Local experience (log)	2.67	1.33	0.02	0.00	0.00	0.05	-0.03	0.06						
8. Cultural distance	2.99	0.58	-0.02	-0.04	0.02	0.05	0.02	-0.10	-0.04					
9. Government expenditure (% of GDP)	15.61	2.86	-0.10	-0.10	0.06	0.05	-0.03	-0.02	-0.03	-0.02				
10. GDP growth	9.57	2.05	0.06	0.06	-0.07	-0.01	-0.03	0.02	0.01	-0.01	-0.13			
11. Inflation rate	7.04	2.10	0.00	-0.00	0.00	0.01	-0.00	0.01	0.01	-0.01	-0.02	0.50		
12. Foreign exchange rate	7.65	1.47	0.03	0.01	0.22	0.18	-0.04	-0.08	0.01	0.03	-0.25	-0.05	-0.00	
13. Institutional intervention (location)	3.00	1.41	-0.04		0.00	0.00	-0.00	0.00	-0.00	-0.00	-0.00	0.00	0.00	-0.00
14. Institutional intervention (industry)	3.00	1.41		-0.02	0.00	0.00	-0.00	0.00	-0.00	-0.00	-0.00	0.00	0.00	-0.00

^aN = 405 firms; 24,055 observations; Pearson correlations $r > |0.027|$, significant at $p < 0.05$.

Table 3 GEE regressions of Fortune Global 500 firms' within-country diversifications in China, 1979–2005^{a,b,c}

Variable	Subsequent product diversifications			Subsequent geographic diversifications		
	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
1. Firm size	0.27*** (0.07)	0.18*** (0.07)	0.19** (0.07)	0.09 (0.12)	0.04 (0.11)	0.03 (0.11)
2. Firm performance	-0.33 (0.44)	-0.58 [†] (0.33)	-0.55 [†] (0.33)	-0.45 (0.64)	-0.54 (0.52)	-0.54 (0.50)
3. Firm diversification	0.08*** (0.01)	0.05*** (0.01)	0.05*** (0.01)	0.01 (0.03)	-0.00 (0.03)	0.00 (0.03)
4. Local experience	0.02 (0.04)	0.03 (0.03)	0.03 (0.03)	-0.01 (0.04)	-0.01 (0.04)	-0.00 (0.04)
5. Cultural distance	-0.15 [†] (0.08)	-0.19** (0.07)	-0.19** (0.07)	-0.34** (0.11)	-0.37** (0.11)	-0.36** (0.11)
6. Government expenditure (% of GDP)	-0.20*** (0.03)	-0.24*** (0.03)	-0.24*** (0.04)	-0.23*** (0.04)	-0.25*** (0.04)	-0.25*** (0.04)
7. GDP growth	0.09*** (0.02)	0.15*** (0.02)	0.15*** (0.02)	0.09** (0.03)	0.11*** (0.03)	0.12*** (0.03)
8. Inflation rate	-0.05** (0.02)	-0.07*** (0.02)	-0.07*** (0.02)	-0.07** (0.02)	-0.08*** (0.02)	-0.08** (0.02)
9. Foreign exchange rate	-0.02 (0.05)	-0.11* (0.05)	-0.12* (0.05)	-0.14 [†] (0.08)	-0.18* (0.08)	-0.18* (0.08)
10. Selection variable	-0.97*** (0.17)	-0.71*** (0.13)	-0.70*** (0.14)	-0.76** (0.25)	-0.57* (0.22)	-0.55* (0.22)
11. Institutional intervention (location)	-0.13** (0.05)	-0.14** (0.05)	-0.31*** (0.06)			
12. Institutional intervention (industry)				-0.05 (0.03)	-0.05 (0.03)	-0.20*** (0.05)
13. HCHQ		1.28*** (0.10)	1.37*** (0.10)		0.79*** (0.14)	1.23*** (0.15)
14. 11 × 13			0.31*** (0.06)			
15. 12 × 13						0.37*** (0.07)
Constant	-1.56 (1.30)	-0.44 (1.20)	-0.59 (1.21)	3.43 (2.17)	3.85 [†] (2.01)	3.59 [†] (2.01)
Wald χ^2	1309.64***	1971.09***	1904.84***	329.11***	403.55***	454.21***
Change in χ^2 (1)		166.06***	28.26***		33.38***	24.94***
Change in χ^2 (3)			215.21***			67.09***

^aN=405 firms; 24,055 observations. [†]p < 0.10; *p < 0.05; **p < 0.01; ***p < 0.001.

^bGEE options: Family (negative binomial), link(log), corr(ar1), semi-robust standard errors.

^cModels included transition period, industry, and category fixed effects.

MNE–host-government interactions, and further reduce the deterring effect of institutional intervention to its diversification activities.

In our empirical tests, we found that the establishment of an HCHQ had a positive effect on an MNE's subsequent within-country diversifications in China. More importantly, this effect was greatest when an MNE was entering locations and industries that had the highest levels of institutional intervention.

Our theoretical and empirical analyses advance the existing literature. We move from an examination of diversification strategy at the global level to an analysis of an MNE's diversification strategy in a host country, which helps develop a broad notion of host-country-level strategy for future MNE subsidiary research (Delios et al., 2008). Second, we define the three roles of an HCHQ to identify how an HCHQ can contribute to the development of an MNE's diversification strategies in a host country.

We conceptualize the establishment of an HCHQ as a new type of political strategy for an MNE's operations in host-country settings in which institutional intervention is prominent. Our data provide some insight into the strategic roles of the HCHQ (Table 1), alongside empirical results that are supportive of our contentions that an HCHQ facilitates diversified expansion in institutionally challenging domains. Future research can extend and deepen our analyses by specifically identifying the processes and actions taken by an HCHQ to execute its political strategy and overcome the deterring effects of institutional intervention.

This research is relevant to the recent strategic practices of MNEs operating in large emerging markets in Asia and beyond. The findings provide insights for MNEs operating in these markets by pointing to the benefits of consolidating and

integrating a firm's FDIs under an HCHQ. Setting up an HCHQ is especially critical to MNEs that expect to transform themselves from being a foreign competitor to becoming a strategic insider in the host country (Luo, 2007). In all, our study lays a foundation for future work on the roles and value of an HCHQ to an MNE's political strategy formulation and implementation in the institutional context of large emerging markets.

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