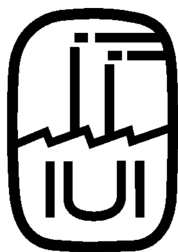

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On the Treatment of Finance-Specific Factors Within the OLI Paradigm

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Abstract

On the Treatment of Finance-Specific Factors Within the OLI Paradigm

This article argues that the body of foreign direct investment (FDI) literature in general and the ownership, location, and internalization (OLI) paradigm in particular would be enriched if finance-specific factors are explicitly incorporated as drivers of FDI. We suggest that financial strategies involving factors such as debt/equity swaps or equity-listings in foreign equity markets affect the firm's relative cost and availability of capital, and motivate a firm's engagement in FDI. Large, research-intensive firms, predominantly resident in the US, UK, Japan or other liquid markets, have in the literature been identified as typical prototypes of MNEs undertaking FDI. These firms are assumed to have no restrictions as regards their ability to achieve a competitive cost and availability of capital, a focus that has made financial capabilities and resources less of an issue in FDI research. Our article mitigates this by emphasizing the relevance of finance-specific proactive strategies for FDI to occur. We generate eight testable hypotheses based on the recognition of finance-specific factors as active drivers of value creating FDI.

On the Treatment of Finance-Specific Factors Within the OLI Paradigm

1. INTRODUCTION

The major proposition of this article is that a firm´s financial strength affects its ability to engage in foreign direct investment (FDI). Proactive financial strategies aimed at enhancing a firm's financial strength are leading indicators of FDI. Such strategies range from pursuing globally recognized accounting and disclosure, listing and selling the firm's equity on prestigious foreign equity exchanges, to the implementation of cross border debt/equity swaps. We argue that by having a superior proactive financial strategy a firm is able to minimize its cost of capital and maximize its availability of capital relative to its competitors, both domestic and worldwide. By lowering the discount factor for any investment (both domestic and global) the firm's likelihood of engaging in FDI would be enhanced. We suggest that finance-specific factors are not merely a by-product of a firm's competitive strength or weakness, but constitute a distinct set that deserves attention when investment patterns are to be interpreted.

Finance-specific strategies are important to all firms but are particularly important to MNEs resident in small, illiquid industrial or emerging capital markets. In the existing literature, these firms are treated in the same manner as MNEs resident in the most financially developed markets such as the United States, the United Kingdom, and Japan. However, MNEs from the illiquid capital markets must first pursue a proactive financial strategy to gain a competitive cost and availability of capital. This is needed to provide a level playing field on

which to compete with MNE's that already enjoy a competitive cost and availability of capital because of their residence in the most developed and liquid capital markets.

Our objective is to provide a theoretical bridge between the FDI research found in international business (e.g. Wells, 1998; Dunning, 2000) on the one hand, and international cost of capital research on the other hand (e.g. Stulz, 1996; Rajan and Zingales, 1998). From the rich body of international business literature we have chosen an eclectic approach; the ownership, location and internalization (OLI) paradigm (Dunning, 1977, 1988, 1995, 1998, 2000). International business research has predominantly focused on how FDI relates to the asset-side of a non-financial firm's balance sheet. One exception is Dunning's (1993:150) discussion of a "financial asset advantage" that concerns "firms superior knowledge of, and access to, foreign sources of capital". He points out how this financial asset advantage usually is a byproduct of the size, efficiency, and knowledge of multinational firms. Dunning provides a point of departure. However, he does not identify specific proactive strategies that firms can undertake in order to create such an advantage, apart from becoming more multinational. In a recent overview article of international business research, and the evolution of the eclectic paradigm in particular, Dunning (2000) does not provide the specifics that need to go into the "financial asset advantage".

Firm size has been assumed to be a good proxy for financial strength in earlier FDI research (e.g. Hennart, 1986). In this paper financial strength is a matter of financial creativity rather than size. Financial strategies as an expression for such creativity are then seen as paving the way for successful FDI. Financial strategies involve finance-specific factors.

In order to illustrate the linkage between finance-specific factors and FDI within an OLI framework let us assume that a firm introduces a financial "blueprint" of how to lower its cost of capital. We also assume that it takes time for the competitors to imitate the chosen

strategy. When the firm is a bank then the case fits well into the traditional OLI framework (Gray and Gray, 1981). This has also shown to be the case for other financial institutions or portfolio investors (Dunning and Dilyard, 1999). If it is a non-financial firm, however, then the case deserves special recognition. How and to what extent can the financial "blueprint" be seen as an ownership advantage for non-financial firms? To qualify as such an advantage it should still be unique to the firm and not easily copied. But what should be put in these requirements? As in the case of a patent in the goods market, where the period during which the firm enjoys a shelter is fixed by the legislators, the answer is discretional. Hence, as long as the financial "blueprint" remains unique to the firm and not copied by others – be it one year or 17 years - it provides an ownership advantage that accrues to the firm in terms of a cost of capital lower than that of its domestic and foreign competitors.

We emphasize the distinction between the creation of an ownership advantage and the elimination of an ownership disadvantage. For instance, an Eastern-European firm making its way out of a thin and regulated market by an innovative financial strategy may have eliminated a disadvantage versus its peers in developed countries. But, more importantly in this context, it may also have created an ownership advantage versus its peers in Eastern-Europe to be exploited by FDI during a period, however, limited.

We use existing literature and case-based evidence to identify finance-specific strategies that influence the FDI decision.[1] These financial strategies are grouped into two categories: (1) proactive strategies under the multinational enterprise's (MNE) control; (2) reactive strategies in response to financial market imperfections. Financial reactive strategies that respond to financial market imperfections have already been partly incorporated into the existing FDI and OLI literature. Our contribution is to show that proactive financial strategies can create

O, L, and I advantages. When these strategies are incorporated into the OLI framework, new insights are created from which we generate hypotheses for further testing.

The article is organized as follows. Section 2 summarizes the OLI paradigm with special emphasis on its finance-specific content. Section 3 shows how recognition of proactive and reactive financial strategies adds to the relevance of the OLI framework. In this section we generate eight testable hypotheses related to the influence of proactive financial strategies on the FDI decision. Section 4 presents a summary and conclusions.

2. FDI AND THE OLI PARADIGM

Early research on FDI identified the role played by research and development. Large, research-intensive firms, typically resident in the most developed capital markets, were observed to dominate FDI (Vernon, 1966; Gruber, Mehta and Vernon, 1967; and Hirsch, 1967). The decision to undertake FDI was a stage in their growth strategy (Buckley and Casson, 1976). These firms were able to create differentiated products that could be competitive abroad (Vernon, 1966; Caves, 1971; and Hymer, 1976). The ability for a firm to utilize its competitive advantage through FDI was said to depend on discovering product, locational or financial market imperfections that encourage FDI. Dunning (1958), Vernon (1966), Caves (1971), Hymer, (1976), Buckley and Casson (1976), Dunning (1977 and 1988), Rugman (1980) and Hennart (1989) pioneered the research to find a comprehensive framework for explaining FDI. This became known as the OLI paradigm and has been intensively utilized to the present time.

The OLI paradigm attempts to answer three questions about FDI: (1) Based on present and potential *ownership* advantages should a particular firm be involved in foreign

markets?; (2) Based on *location* advantages, where should the firm invest abroad?; and (3) How should the firm serve foreign markets, should it be through *internalization* (FDI or sales subsidiaries) or through arms length arrangements (such as licensing or export through intermediates)? The OLI paradigm offers a framework for answering these questions. Dunning (2000:163) points out that ".. foreign production undertaken by MNEs is determined by the interaction of three sets of interdependent variables – which, themselves, comprise the components of three sub-paradigms". Hence, when we mention the importance of finance-specific factors in the rest of the paper we assume that they appear as one leg, maybe two, to be supported by the other variables of the triad.

Ownership-specific advantages and finance-specific factors

The "O" in the OLI paradigm relates to ownership-specific (firm-specific) advantages. In deciding whether to undertake FDI a firm must have developed firm-specific characteristics that enable it to be competitive in the home market. These characteristics must be transferable abroad and strong enough to compensate for the extra costs and barriers that confront those who try to do business abroad. Firm-specific characteristics typically possessed by successful MNEs are the proprietary knowledge or know-how incorporated in: (1) economies of scale and scope; (2) managerial and marketing expertise; (3) advanced technology stemming from a heavy emphasis on research; and (4) differentiated products.

The generic term "financial strength" may be included under the heading of "economies of scale and scope" with the implicit assumption that large, research-intensive MNEs are located in liquid, unsegmented markets and have unlimited access to capital, as suggested by Dunning (1993). This is of course not true for MNEs resident elsewhere or for those MNEs that

do not have financial capabilities such as access to foreign equity markets, well developed international banking relationships, globally recognized accounting and disclosure, etc.

Location-specific advantages and finance-specific factors

The "L" in the OLI paradigm stands for location-specific advantages that skew FDI to a particular market. The theory of internationalization and its corollary, network theory, attempt to answer the question of *where* to invest. Aharoni (1966) initiated the behavioral explanation of FDI, especially the initial decision of where to locate FDI. The behavioral approach has been extended and improved by a formalized theory of the process of internationalization that explains not only the initial FDI decision but also the following reinvestment decisions. Network theory explains how the MNE and its subsidiaries interact and compete for power (Johanson and Wiedersheim-Paul 1975; Johanson and Vahlne, 1977; Forsgren, 1989; Kogut and Zander, 1993; Chen and Chen, 1998; and Pedersen and Petersen, 1998).

Early on, Aliber (1970) suggested that some FDI is motivated by imperfections in the foreign exchange markets. The OLI framework recognizes such financial market imperfections. For instance**,** Dunning (1993) states explicitly that the propensity of firms to own foreign income generating assets may be influenced by financial and exchange rate variables. Our interpretation is that this influence is a reactive strategy aimed at benefiting from these market imperfections (misalignments). However, the FDI decision can also be influenced by a forward-looking offspring of this strategy, namely, active management of foreign exchange and other financial risks (operating exposure management). In this case, the FDI provides an option in terms of production flexibility in handling exchange rate fluctuations (Kogut and Kulatilaka,

1994). Here we have a borderline case related to the proactive financial strategies that we argue should be explicitly recognized in the OLI framework.

In addition to studies of the role of market imperfections, many studies have been published on the relationship between FDI and individual financial variables related to a specific location. Among the most prominent of these factors are the ones related to exchange rate and political risks. However, such factors are mostly used either as control variables or as part of "risk diversification" as an explanation for outward FDI. Although they are relevant to the cost of capital they are generally not treated as part of the overall concept of financial strength as a key factor for FDI.

Internalization advantages and finance-specific factors

The current theory of "internalization" holds that it is critical for a firm to constantly upgrade proprietary information and control the human capital that discovers it (Buckley and Casson, 1976, 1998; Dunning, 1977, 1981, 1988, 1993, 1995, 1997, 1998; Rugman, 1980, 1981; Krugman and Venables, 1994; Caves, 1996; and Gray, 1996). The "I" (internalization) factor in the OLI paradigm explains why a firm would choose to serve a foreign market through FDI rather than pursue alternative modes without ownership control of foreign activity. This is done through extensive research to develop expertise in technology, coordinated with expertise in management and marketing. Finance-specific information is ignored, as is the relevance of finance-specific expertise.

Without total ownership of its foreign subsidiaries the MNE would face higher transactional monitoring costs (or transaction cost) of its relationships with its subsidiaries. Ownership control through FDI is thus a response to market imperfections in the market for

intermediates, such as knowledge, management, and corporate control. One option for the MNE is to sell its expertise to foreign firms. However, the intermediate markets for such transfers are imperfect and would undervalue the potential value of the transfer. Therefore, an MNE would find it more profitable to exploit its ownership-specific advantages through FDI. In this manner a larger value-added potential from the output of the firm's research could be retained in the MNE. The OLI paradigm does not explicitly address how finance-specific agency costs might affect FDI.

3. FINANCE-SPECIFIC STRATEGIES THAT CREATE FDI ADVANTAGES

In this section we will identify the finance-specific factors that deserve an explicit consideration within the OLI framework because they create advantages relevant for the FDI decision. We believe the importance of finance-specific advantages is much greater now then 20 years ago. The wave of restructuring that is currently sweeping over global business is to a large extent built upon cross-border mergers and acquisitions (M&A). Increased regionalization in Europe, Asia and on the North and South American continents in terms of the EU, ASEAN, NAFTA and MERCOSUR has increased competition leading to anticipation of squeezed profit margins from commercial activities. This has triggered a restructuring involving massive flows of FDI (UNCTAD, 2000). We foresee that the stiffer competition on the commercial side should spill over to the financial side in terms of an increased relative importance of financial factors for the overall competitiveness of the firm. The result will further enforce the current emphasis on managing the cost of capital as a key to value creation. Performance measures such as EVA

(Economic Value Added), MVA (Market Value Added) and SVA (Shareholder Value Added) focus the attention of managers on value creation for both MNEs and domestic firms. Consequently, the spotlight in creating value for the shareholders of the firm is on the combination of FDI and finance-specific factors.

What is then to be seen as an example of a financial ownership advantage? For instance, assume a U.S. firm engages in a proactive financial strategy with the aim of lowering its cost of capital. It considers entering Venezuela by a direct investment. Its financial strategy is to prepare and implement a debt/equity swap. In this way it can create a shelter to a low cost of capital for a longer or shorter period. The shelter is achieved by the firm being the first to execute the debt/equity swap (as was possible in the late 1980s and beginning of the 1990s), or by being the only one among its competitors that is allowed to proceed (sometimes as a result of successful lobbying) and win by handing in the lowest bid. The implementation of the financial strategy starts out with the firm buying a claim on the secondary market for claims on indebted countries. It pays, in our example, a market price of 40% of the claim's face value in U.S. dollars. Next it presents its investment plan to the host country government and awaits an approval to proceed to a swap-auction. As a winner of that auction (with the lowest bid) it receives, in our example, the counter-value of 65% of the U.S. dollar face value in local currency. The cost of a U.S. dollar 65 million FDI has by financial creativity been reduced to U.S. dollar 40 million. The result does not violate an assumption of market efficiency. Moreover, the gap should not be seen as reflecting a market imperfection and as such a basis for a location advantage. Whereas the competitors may have found the higher cost prohibitive, our firm finds out that the favorable cost resulting from its financial creativity more than compensates for all other costs related to an FDI-entry the Venezuelan market.

The finance-specific factors are here recognized within a framework of proactive and reactive strategies. Exhibit 1 relates these strategies to the OLI paradigm. As mentioned earlier, the reactive strategies are partly covered by the current OLI framework. What is new here is the role of four proactive financial strategies as drivers of FDI. Below we will discuss these strategies one by one and generate hypotheses about how they motivate FDI within an OLI framework.

Insert Exhibit 1 here

Gaining and maintaining a global cost and availability of capital

With reference to Exhibit 1, one category of proactive financial strategies by MNEs is designed to enhance financial capabilities in order to gain and maintain a competitive cost and availability of capital. For example, a company in a former Soviet republic lowers its cost of capital by breaking out from its segmented, illiquid home capital market by listing on a less prestigious Western European equity market. By this strategy it does not achieve a global cost of capital but the strategy helps the firm to be ahead of its major peers and to be the first to enter a foreign market by FDI. For a Western European based company competitive can mean the achievement of a global cost of capital by some means that are unique among its peers. This may also motivate them to enter a foreign market by FDI. Moreover, for a U.S. firm already enjoying a global cost of capital there is still room for an advantage achieved by the use of some financial innovation or blueprint. This was exemplified in terms of an innovative use of debt/equity swaps earlier in this paper. We list in Exhibit 1 a number of important interrelated sub-elements of this strategy. All of them should be seen as instrumental to the creation of an ownership advantage.

Competitive sourcing of capital globally

The ability for a firm to minimize its cost of capital and maximize its availability should be seen as an ownership advantage. A firm that has chosen a proactive financial strategy to achieve this objective has a competitive advantage in future bidding to acquire international assets. This also provides the firm with a partial protection from being acquired by another firm that also has a competitive cost and availability of capital.

Research-intensive firms, such as those in pharmaceutical, biotechnical, tele-communications and information technology industries, have a particular problem in raising adequate debt financing. They lack sufficient collateral because of holding a high proportion of intangible assets (patents and discoveries) that have potential future value but little present liquidation value. If such firms are resident in small, illiquid industrial or emerging markets, their ability to achieve competitive financial strength is dependent on following a proactive strategy to gain and maintain access to global equity markets. For example, during the 1980s a number of Nordic MNEs in research-intensive industries utilized proactive strategies to gain a global cost and availability of capital, usually as a prelude to acquisitions or greenfield investments abroad (Oxelheim, Stonehill, Randøy, Vikkula, Dullum and Modén, 1998). These MNEs included such global leaders as Ericsson (telecommunications, Sweden), Hafslund Nycomed (pharmaceutical, Norway), Nokia (telecommunications, Finland), and Novo Industri (pharmaceutical and biotechnology, Denmark).

Hafslund Nycomed, a pharmaceutical firm from Norway, provides an illustrative case example. Now the firm named Nycomed Amersham has evolved into an Anglo Norwegian company headquartered in Buckinghamshire. As part of an earlier internationalization effort the

firm cross-listed its shares on the New York Stock Exchange (NYSE) in 1992. This was done to prepare the way for a US$ 74.7 million U.S equity issue. In 1994, Hafslund Nycomed was able to acquire Sterling Winthrops, its former U.S. distributor and a significant research company in its field. The U.S. acquisition was financed by a targeted U.S. bond issue. The financing for the acquisition would have been unattainable without the prior U.S. equity offer and NYSE listing. At a first glance the development could be interpreted as if a finance-specific *ownership disadvantage* had been eliminated. However, it should rather be seen that a supportive financial ownership advantage had been created in relation to its major competitors from Germany and Italy. Without this proactive financial strategy Hafslund Nycomed would not have been able to undertake its foreign expansion.

Access to competitive sourcing of capital globally provides MNEs with resources beyond mere financial strength. An international equity issue can help growing firms to overcome their lack of global commercial visibility when located in a small or underdeveloped home market. A typical equity issue abroad helps the firm not only to become more visible but also more knowledgeable about particular foreign markets (Saudagaran, 1988; and Modén and Oxelheim, 1997). Hence, firms that have recently made an international competitively priced equity issue have invested in an ownership advantage that is signaling future FDI.

H1: A firm is more likely to engage in FDI when it has access to competitively priced equity.

Strategic preparatory cross-listing

The proactive strategy of raising capital can be pursued in many ways. If the ultimate goal is to raise equity on a prestigious equity market, such as in London or New York, an MNE can

follow a cautious track as a learning process. This involves cross-listing and raising equity in less prestigious markets. The alternative is to implement the strategy in one step.

The literature shows a positive effect on the market value of foreign firms listing on U.S. stock exchanges (Sundaram and Logue, 1996; and Foerster and Karolyi, 1999). However, several studies have shown an even more favorable effect on market value for firms following a dual strategy of simultaneously cross-listing and raising new equity on a foreign stock market (Modén and Oxelheim, 1997; and Miller, 1999)[2].

Daimler Benz (now DaimlerChrysler) provides case evidence. In 1993 Daimler Benz became the first German company to list on the NYSE. On the day of the listing announcement its stock price increased by as much as 30%. The Daimler Benz cross-listing was done to prepare the way for a multibillion dollar Euro-equity issue to help finance FDI, namely their new automobile manufacturing plant in Alabama, USA. The NYSE cross-listing and U.S. equity issue also paved the way for the subsequent merger with Chrysler in 1998. The Daimler Benz case clearly suggests that a proactive financial strategy was instrumental in making it economically advantageous to make a FDI in the U.S.

The high frequency of Israeli companies listed on NASDAQ (number three in this respect) as a prelude to strategic acquisitions is another case evidence of the connection between an international listing and FDI. Many of these firms, predominantly high-tech companies, have actually set a trend by making their initial public offering international.

Whether or not the strategy of cross-listing has as its ultimate aim to float new equity abroad, it should be seen as an investment in a financial ownership advantage. The advantage materializes once the company has managed to attract the attention and support of international portfolio investors. Since the cross-listing contributes to a better global recognition of the

company the advantage will eventually accrue to the firm in the present value calculations of a potential foreign target company or greenfield investment. Hence, it will provide the company an opportunity to offer, in a sustainable way, a higher price than competitors when bidding for acquisitions. However, cross-listing is often limited by a firm's small size and the heavy cost and listing requirements of the most liquid stock exchanges, particularly the New York Stock Exchange. Since cross-listing is a prelude to an equity issue as a means for financing FDI, we suggest that:

H2: A firm is more likely to engage in FDI when it is cross-listed in a prestigious capital market.

Gaining access to capital at a competitive rate is very much a matter of global recognition. Interrelated to the two previously mentioned sub-elements of a proactive strategy to raise such capital, are three sub-elements clearly aimed at bridging cross-border information gaps. These sub-elements are: (1) providing information to investors using globally-recognized accounting and disclosure standards; (2) maintaining strong bank relationships at home and abroad; and (3) maintaining a strong credit rating.

Providing accounting and disclosure transparency

A firm attempting to gain a global cost and availability of capital needs to attract international investors to purchase and hold its securities. One of the keys to this strategy is to provide transparent accounting and disclosure of information. This implies that a firm's financial statements must meet international accounting standards, either U.S. Generally Accepted Accounting Practices (U.S. GAAP) or International Accounting Standards (IAS). The firm must

also commit to an ongoing investor relations program to keep investors informed about the firm and allow investors personal access to the firm's key executives (Useem, 1998). These activities can be expensive in terms of time and money but are an investment in an ownership advantage.

Evidence of the necessity to invest in transparency is provided by a recent comprehensive survey of German accountancy (Glaum, 2000). It finds that more than 80% of German firms (end of 1997, early 1998) expect to prepare financial statements in accordance with international accounting standards (either US-GAAP or IAS) within year 2003. One of the major concerns of German managers is the ability to attract international investors. A case in point was the restating of Daimler Benz's financial statement in connection with its 1993 cross-listing on the NYSE. Its restated earnings for the first half of 1993 dropped from a profit to a $592 million loss. Nevertheless, investors responded favorably (30% increase in its stock price). Increasingly, German companies have recognized that the ability to provide transparent, timely, and reliable accounting information is necessary in order to achieve a global cost and availability of capital for the eventual undertaking of FDI.

H3: A firm is more likely to engage in FDI when it is following globally recognized accounting and disclosure standards.

Maintaining strong commercial and investment banking relationships

Gaining recognition by international investors is not accomplished in a vacuum. The key for a firm to attract international investors is to maintain a close relationship with the most important international banks and investment firms (Useem, 1998). These global players under-write and syndicate almost all debt and equity issues that are sold abroad. They also control and

advise the leading trust funds, pension funds, mutual funds, and other institutional sources of funds. The successful sales of a firm's securities both abroad and domestically depends on the marketing efforts and perceived quality of its financial sponsors.

Novo Industri (now Novo Nordisk) pioneered the efforts by a number of Nordic MNEs to escape dependence on segmented and illiquid home capital markets (Stonehill and Dullum, 1982). Prominent international financial institutions orchestrated the Nordic securities issues. In Novo's case Goldman Sachs (U.S.) and Morgan Grenfell (U.K.) were the lead sponsors. Morgan Stanley (U.S.) was the lead sponsor for a number of other Nordic equity issues abroad (Oxelheim, Stonehill, Randøy, Vikkula, Dullum and Modén, 1998). Having a close international banking relationship creates an ownership advantage in terms of lower agency costs stemming from reduced information asymmetries and access to a broad investor clientele (see e.g. Sharpe, 1990 and Boot and Thankor, 2000).

H4: A firm is more likely to undertake FDI after it has retained as advisors one of the prominent international banking institutions.

Maintaining a competitive credit rating

In order to gain a competitive cost and availability of capital, a firm must gain access not only to foreign equity markets but also to international debt markets. These include the Euro-syndicated loans, Eurobond, Euro-medium term loan and Euro commercial paper markets. Such a strategy creates a viable alternative to total dependence on the firm's commercial bank. Escaping total dependence is especially important for firms resident in bank-dominated economies such as Germany, Japan and many emerging market countries.

Gaining access to international debt markets relies on a firm's credit rating. Most, but not all, firms that hope to tap these markets ask for a credit rating from Moody's, Standard & Poor, Fitch, or other credit rating services. The higher the credit rating, the lower the interest rate. Without an "investment grade" rating (usually A or better) it is in most cases not possible to tap the international debt markets for significant amounts of capital. Proactive strategies aimed at creating an ownership advantage in terms of a strong credit rating also help to establish a firm's credibility in equity markets and with government officials in potential markets for future FDI. Anecdotal evidence in terms of a surging demand for credit rating services points to an increased use of this kind of proactive strategy.

H5: A firm is more likely to engage in FDI when it enjoys a strong investment grade credit rating.

Negotiating financial subsidies and/or reduced taxation to increase free cash flow

In addition to raising equity and debt in global capital markets, the MNE also relies on internally-generated free cash flow. With reference to Exhibit 1 again, our second proactive financial strategy deals with activities aimed at negotiating financial subsidies and/or reduced taxation to increase free cash flow (Oxelheim, 1993). In case of positive outcomes these benefits will accrue in terms of ownership and locational advantages. A positive outcome materializes in a company-designed package of benefits. The low cost of capital following from the subsidy and/or reduced taxation should be seen as an ownership advantage. Being a company-designed benefit makes it disputable to classify the negotiated outcome a locational advantage as well. However, according to our view, the mere propensity by the host government to negotiate signals that the

benefit also may fulfil the criteria for being a locational advantage; being available to everyone on an *ex ante* basis.

Case evidence is provided by the aforementioned Daimler Benz. It was able to negotiate favorable financial and operating concessions as a prerequisite for locating their new automobile manufacturing plant in Alabama. Other anecdotal cases are the firm-specific tax packages negotiated by BMW in South Carolina, Disney in France, and Hyundai in Oregon.

H6: A firm is more likely to engage in FDI when the firm is able to negotiate reduced taxation and/or to attract subsidies for financing it.

Reducing financial agency cost through FDI

Our third proactive financial strategy is based on *financial* agency costs and how they can be transformed into OLI advantages. MNEs can reduce financial agency costs through FDI, while exploiting an ownership advantage. For example, if an MNE enjoys a low global cost and high availability of capital, why should it let other firms with higher cost of capital provide the funding for part of its foreign presence (for example through joint venture partners or other local intermediates)? The imperfect market for financial intermediates encourages the MNE with a globally competitive cost of capital to utilize this advantage within the firm. In other words, a FDI that capitalizes on the financial capabilities and resources of an MNE leads to lower and more dependable financial transaction costs, as well as lower monitoring costs than would be the case with potential licensees, joint venture partners, or independent distributors.

The financial agency costs of undertaking FDI can be further reduced in cases where the host country also provides a supportive investment industry. When the aforementioned

Hafslund Nycomed made an equity issue and cross-listing in the U.S. market in 1992, the company was able to attract favorable attention from the leading pharmaceutical investment industry in New York, more so than would have been the case in other locations. We emphasize the fact that the combination of international equity issues, international listings, and FDI, can create lower monitoring costs for MNEs. Thus, financial agency costs should be added to the list of transaction costs that are featured in the internalization theory of FDI. We hypothesize:

H7: A firm is more likely to engage in FDI when the firm is able to reduce financial monitoring costs through such an investment.

Reducing operating and transaction exposure through FDI

MNEs are subject to operating (foreign exchange, interest rate, and price) exposure, as well as foreign exchange transaction exposure. The proactive strategy to reduce this exposure is a borderline case between the reactive strategies mentioned later and the proactive strategies we urge should be included in the OLI framework as drivers of FDI. As was previously noted, this strategy is an offspring of the general recognition of market imperfections within the OLI framework. A successful risk management program is assumed to create value and lower the cost of capital. It is seen as an ownership advantage and as such creating an incentive for MNEs to undertake FDI.

H8: A firm is more likely to engage in FDI when the firm has implemented a successful program to reduce financial and operating exposure.

Exhibit 1 also lists strategies that react to perceived market imperfections. Most of these reactive strategies have already been researched, although not always within an OLI framework. The following strategies deserve attention.

Foreign exchange rate market imperfections

The OLI framework has been criticized for not giving sufficient attention to exchange rate variables (Itaki, 1991). We believe that misaligned exchange rates affect the *timing* of FDI, rather than being the main motivation for a particular FDI. Overall there have been mixed empirical results on the question of whether there is a universal link between exchange movements and FDI. For example, Swenson (1994) found a positive correlation between dollar depreciation and inward FDI. On the other hand, Stevens (1998) failed to identify such an effect. Part of the reason why the results are inconclusive could be that most research on this issue has been conducted at the macro level of countries, rather than at the firm level of actual FDI decisions. Research on MNEs suggests that exchange rate volatility, rather than exchange rate misalignments, affects FDI decisions (see e.g. Ekström, 1998).

Misaligned stock markets

Case evidence also suggests the possibility of a timing impact on FDI from an undervalued or overvalued national stock market. Some of the largest recent financial "bubbles" have been the overvalued Japanese stock market in the 1980s' (Ito and Iwaisako, 1995), and the undervalued post-crisis emerging markets of Southeast Asia in 1998 (Johnson et. al., 2000). Both scenarios have provided unique investment opportunities for MNEs. During the 1980's the Japanese MNEs increased their FDI, especially acquisitions, in the United States and Europe. In

1998 and 1999 MNEs throughout the world undertook considerable FDI (acquisitions) in depressed asset markets in Asia. This "bottom fishing" strategy has shown how industrial investors have been able to make timely FDIs not easily accessible to portfolio investors. One such example is when Tektronix, Inc. bought its key supplier for $10 million in cash for a 160,000-square-foot facility and some industrial equipment in Penang, Malaysia, from CAM Advanced Technologies. The purchase price was way below the pre-crisis level, and according to Daniel Kunstler of J.P. Morgan Securities in San Francisco: "Let's face it, asset values in Asia have come way down. That can't be all bad." (Oregonian, 1998).

During the last decade FDI through acquisitions in the United States has been motivated partly by a rising U.S. stock market, but also by good growth prospects and a low U.S. rate of inflation. These acquisitions occurred despite a potentially overvalued U.S. dollar, although the strong dollar effect was partly alleviated by a heavy use of new stock issues by foreign MNEs to finance these acquisitions. As an anecdotal evidence of the link between stock market misalignments and FDI we refer to the new pattern of foreign equity issues that has emerged during the later part of the 1990s. Directed and euro-equity cash issues have to a large extent been replaced by directed non-cash issues used as payment for FDI acquisitions. It should be noted, however, that these new stock issues were very dependent on the foreign MNEs' themselves achieving and maintaining a low cost and high availability of capital.

Restrictions on the movements of funds

A finance-specific locational factor that is often neglected in the OLI framework is the need for an MNE to have unrestricted ability to transfer funds internationally. This right is necessary in order to attract international investors to buy and hold the MNEs' securities, which is

the key to enjoying a global cost and availability of capital. If a country was to impose capital controls on the transfer of funds or restrict ownership of its own MNEs, it risks losing the competitiveness of its own economy. MNEs from outside the country can react to the financial result of political risk with a variety of strategies, but MNEs resident in that country have fewer strategic options available. However, before controls are imposed resident MNEs sometimes engage in FDI in "safe" countries, i.e. political risk safety seekers. One example was the transfer of some MNE headquarters from Hong Kong to "safe" countries prior to the Chinese takeover. Hong Kong and Shanghai Banking Corporation (now HSBC) adopted this strategy.

FDI to minimize taxation

In an effort to minimize taxes, an MNE might undertake FDI in a tax haven country, or at least in a country with a relatively low tax rate. Foreign subsidiaries located there create the possibility of earning lower-taxed income or at least deferred tax income. Such income can be enhanced through transfer pricing strategies, although taxation authorities usually carefully scrutinize transfer prices. Minimizing taxation should be considered not only a locational but also an internalization advantage. The ability to earn income in the right locations is much easier to accomplish with foreign subsidiaries that are fully owned than if the MNE must deal with outside partners.

4. SUMMARY AND CONCLUSIONS

The theme of this article is that the OLI paradigm should be enriched by an explicit recognition of the FDI-drivers that emerge from four finance-specific proactive strategies. We argue that firms that successfully follow proactive financial strategies are rewarded with

subsequent finance-specific ownership advantages that can be most effectively exploited by undertaking FDIs. An explicit consideration of the exploitation of such advantages within the OLI framework will add explanatory value to the paradigm.

As proactive financial strategies we mention competitive sourcing of capital globally; cross-listing on foreign exchanges; providing accounting and disclosure transparency; maintaining strong commercial and investment banking relationships; maintaining a strong credit rating; negotiating financial subsidies and/or reduced taxation; reducing financial agency costs through FDI; and reducing operating and transaction exposure. Proactive finance-specific strategies are particularly important to MNEs resident in small, illiquid industrial or emerging capital markets. In addition to these proactive strategies we discuss financial reactive strategies that respond to foreign exchange rate market imperfections; misaligned stock markets; restrictions on the movement of funds; and opportunities to minimize taxation.

All the above financial strategies are presented within an OLI framework in order to explain whether they lead to ownership, location, or internalization advantages. A survey of the existing literature on FDI and OLI suggests that finance-specific factors are recognized mostly as control variables or locational advantages to be dealt with by reactive financial strategies. Based on the OLI framework and case evidence we suggest for further testing eight hypotheses that link finance-specific factors and FDI within a proactive strategic framework.

First, we suggest that a firm is more likely to engage in FDI when it has access to competitively priced equity. Second, we hypothesize that a firm is more likely to engage in FDI when the firm is cross-listed in a prestigious capital market. Third, we suggest that a firm is more likely to engage in FDI when it is following globally recognized accounting and disclosure standards. Fourth, we hypothesize that a firm is more likely to undertake FDI after it has retained

as advisors one of the prominent international banking institutions. Fifth, we suggest that a firm is more likely to engage in FDI when it enjoys a strong investment grade credit rating. Sixth, we hypothesize that a firm is more likely to engage in FDI when the firm is able to negotiate reduced taxation and/or to attract subsidies for financing it. Seventh, we suggest that a firm is more likely to engage in FDI when the firm is able to reduce financial monitoring costs through such an investment. Finally, we hypothesize that a firm is more likely to engage in FDI when this enables the firm to reduce financial and operating exposures. Successful testing of these hypotheses should lead to an enriched OLI paradigm.

Since financial capabilities and resources are important global competitive variables, the article suggests that small industrial and emerging market MNEs must be able to gain and retain their present access to foreign investors. The policy conclusion drawn for governments is not to overreact to economic crises by imposing controls that cut off critical access to global capital markets. Such policies would have serious repercussions for FDI by their own MNEs.

NOTES

[1] It should be noted that this article addresses the finance-specific factors only in relation to the MNE's outward FDI decision. Although domestic investment decisions are affected by the same finance-specific factors that affect outward FDI, the article does not cover investment in a country undertaken by firms resident in that country or as inward FDI. The article does not discuss the open question of whether or not FDI increases the share value of an MNE. However, it does suggest that a higher share value (lower cost of capital) could lead to increased FDI, especially in the case of making acquisitions paid for by shares of the MNE's stock.

[2] Modén and Oxelheim (1997) concluded that a simultaneous cross-listing and new equity issue in the period 1981-1993 created an 11% cumulative abnormal return for Swedish firms during the first five days after the announcement of this dual strategy.

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Exhibit 1: Finance-specific factors and the OLI paradigm

Financial Strategies	Ownership advantages	Location advantages	Internalization advantages
Proactive Strategies			
1. Gaining and maintaining a global cost and availability of capital:			
a. Competitive sourcing of capital globally	X	X	
b. Strategic preparatory cross-listing	X		
c. Providing accounting and disclosure transparency	X		
d. Maintaining competitive commercial and financial banking relationships	X		
e. Maintaining a competitive credit rating	X		
2. Negotiating financial subsidies and/or reduced taxation to increase free cash flow	X	X	
3. Reducing financial agency cost through FDI			X
4. Reducing operating and transaction exposure through FDI	X		
Reactive Strategies			
1. Exploiting undervalued or overvalued exchange rates		X	
2. Exploiting undervalued or overvalued stock prices		X	
3. Reacting to capital control that prevent the free movement of funds		X	
4. Minimizing taxation		X	X

Note: The crosses in the boxes indicate where we argue that there is a connection between FDI and finance-specific strategies.