FOREIGN DIRECT INVESTMENT IN THE EUROPEAN PERIPHERY

THE COMPETITIVENESS OF PORTUGAL

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Submitted in accordance with the requirements for the degree of PhD

The University of Leeds
LEEDS UNIVERSITY BUSINESS SCHOOL

July 2000

To Isabel and Tiago

ACKNOWLEDGEMENTS

Only the support of many people and institutions made possible the completion of this thesis. Above all, however, I must thank my wife, Isabel, for her encouragement to start this project and for her overwhelming support during the course of the PhD, and my son, Tiago, whose appearance during this journey gave a new sense to my life and was a constant source of joy and discovery (yes, I have already forgiven you all those sleepless nights...). My parents, sisters and in-laws, who have always been there for me, also deserve a special mention. The importance of their support is impossible to acknowledge properly.

I would like to express my sincere gratitude to my supervisor, Prof. Peter Buckley, for his permanent encouragement and guidance, essential to the completion of this work. His professional skills will remain a major source of inspiration in my academic career. I extend my appreciation to all members of staff at CIBUL and to those working in Leeds University Business School. A special thanks goes to Dr. Jeremy Clegg who was always available for an academic (and not so academic) chat, and to Ms. Sheila Fordham for her assistance even when going beyond her official duties.

My thanks also go to the many friends, both in Leeds and in Portugal, who made these last years most rewarding in many ways. Knowing that it will be unfair to many, I would still like to name Flávio Hegenberg, Alex Roy, Hanif Akhtar, Chris Forde, Rafa Aguilar, and Robert Wright. Robert and Alex had the additional ordeal of proof-reading this work. To Ana Teresa Tavares and Leonor Sopas I have to thank not only their friendship but also

the academic discussions and suggestions made at many points of this research. This is extended to Fernando Úbeda whose advice with the factor analysis was most important, and to Paulo Sousa who deducted the analytical expression used in section 4.6. Ana Teresa and Leonor also made important suggestions in the elaboration of the questionnaire, as did Vitor Corado Simões of ISEG, Universidade Técnica de Lisboa, Vasco Rodrigues of Universidade Católica do Porto, and Júlio Martins of Faculdade de Economia do Porto. From Madalena Araújo of Universidade Católica do Porto I obtained the formats used in the questionnaire. I also want to express my appreciation to all the managers that generously accepted to take part in this research. Without their disinterested participation neither the interviews nor the questionnaire survey were possible. I would also like to acknowledge the assistance of Ms. Rita Araújo, of ICEP, and several members of the staff at Banco de Portugal in making available relevant non published data.

I am grateful to the editors and referees of *Transnational Corporations*, where an earlier version of section 4.6 was published under the title 'The Investment Development Path: The case of Portugal' (vol. 7, no. 1, April 1998: pp. 1-15.). Their comments and suggestions were most valued. My gratitude goes also to the organisers, referees and participants of several conferences where I had the chance to present some of the earlier results: *25th Annual Conference of the Academy of International Business* (Vienna, Austria, October 1998, 'A Time-Series Analysis of the Locational Determinants of FDI in Portugal'); *4º Encontro de Novos Investigadores de Análise Económica* (Santiago de Compostela, Spain, July 1998, 'The Locational determinants of FDI in the European Periphery'); the same article was also presented at the *24th Annual Conference of the European International Business Academy* (Jerusalem, Israel, December 1998); *25th Annual Conference of the European International Business Academy* (Manchester, UK, December 1999, 'Outward FDI in Manufacturing from Portugal: Internationalisation strategies from a new foreign investor'; *27th Annual Conference of the UK Chapter of the Academy of International Business* (University of Strathclyde, Glasgow, April 2000, 'A Survey Based Investigation of Inward FDI in Portugal').

Finally, this work was not possible without the financial support of Faculdade de Economia do Porto and Fundação para a Ciência e Tecnologia. At Faculdade de Economia do Porto, Prof. Freire de Sousa was especially supportive at the earlier stages of this project and continued being so despite his new duties. Special thanks go as well to Prof. Ana Paula Africano who accompanied my progress with constant encouragement.

ABSTRACT

This thesis analyses the evolution and characteristics of Portugal's inward and outward foreign direct investment (FDI) in recent years and how they reflect changes in the country's competitiveness. Inward FDI was investigated using regression analysis and a postal questionnaire. For outward FDI, semi-structured interviews were conducted at locally owned firms with productive capacity abroad. The investment development path (IDP) was the framework used to integrate the results obtained with the analysis of national competitiveness. The thesis also suggests a novel functional relationship for the IDP in order to reconcile the empirical tests with the underlying theory.

Inward FDI flows into Portugal have declined sharply in recent years, which was shown to be incommensurate with Portugal's size and level of development. The questionnaire survey suggested that efficiency seeking investment was especially affected. This points to the geopolitical changes that have occurred in Europe as a major reason for Portugal's lower attractiveness as a location for FDI. Bureaucracy and a shortage of skilled workers were other important obstacles to foreign investment. Both correspond to institutional failures: the failure to promote an efficient legal environment, and the failure to create advanced assets that compensate for rising production costs as locational determinants of FDI.

Outward FDI was found to be more in line with Portugal's level of development. It is growing fast but requires consolidation. Investment is concentrated in few locations, and cultural proximity (particularly language) plays a major role. However, more than exploiting existing ownership advantages, the firms surveyed were internationalising in order to build new ownership advantages. To reach an efficient size, which is not possible at home when the market is small, or to consolidate the relationship with important clients in oligopsonistic industries were the dominant motivations for internationalisation amongst the firms surveyed.

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ABBREVIATIONS

ACP	Africa, Caribbean and Pacific
CAE	Code of Economic Activity
EEC	European Economic Community
EFTA	European Free Trade Association
EU	European Union
FDI	Foreign Direct Investment
FIEP	Fund for the Internationalisation of Portuguese Companies
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GDPpc	Gross Domestic Product per capita
GFCF	Gross Fixed Capital Formation
IAPMEI	Institute for the Promotion of Small and Medium Size Companies
ICEP	Institute for International Trade and Investment
IDP	Investment Development Path
INE	National Institute of Statistics
MNC	Multinational Corporation
MNE	Multinational Enterprise
NOI	Net Outward Investment
NOIpc	Net Outward Investment per capita
OLI	Ownership. Localisation, Internalisation
PALOP	Portuguese Speaking African Countries
SME	Small and Medium sized Enterprises
US	United States of America
UK	United Kingdom of Britain and Northern Ireland

CHAPTER 1.
INTRODUCTION

1.1. FOREIGN DIRECT INVESTMENT AND THE PORTUGUESE ECONOMY

A small open economy of recent industrialisation, Portugal has the lowest GDP per capita amongst the European Union member states. The roots of Portugal's economic underdevelopment seem to rest very deep, with Portugal's inability to participate in the industrial revolution that spread through continental Europe at the beginning of the nineteenth century. Industrialisation attempts seem to have been blocked by several deficiencies in the local economy, including the absence of an entrepreneurial class, inadequate infrastructure, low skills of the working force, political and institutional instability and, eventually, a very liberal trade agreement with the United Kingdom that led to an overspecialisation of the economy in primary products.

Despite the low levels of development, foreign direct investment has always been part of the Portuguese economy. Port wine, for example, which was Portugal's main export since the seventeenth century until very recently, has always been largely controlled by foreigners (mostly British). Similarly, all the industrialisation attempts in the late 1700s and 1800s benefited from a strong presence of foreign investors. Various reports throughout that period and into the 1920s suggest that a substantial part of the Portuguese economy was controlled by foreign owned firms.

This picture changed substantially in the late 1920s. Following decades of political turmoil and economic mismanagement, a military coup in 1926 created the conditions for the establishment of an autocratic regime. The "New State" set as its primary aim the stabilisation of the country's economic situation, even if at the expense of economic development and growth. Officially, FDI was still welcomed, but the autarchic nature of the regime was soon reflected in restrictive legislation. Only in the late 1950s was this attitude towards FDI reversed again.

The creation of EFTA in 1960 was to radically change Portugal's economic policy. Being strongly dependent on the UK for its international trade, Portugal was one of the founding members of the free trade agreement. This was an unlikely outcome on the face of the country's political regimen. Actually, Portugal was not admitted until very late in the negotiation process. It managed, nevertheless, to join EFTA with very favourable conditions. The other members agreed to take into account the country's low level of development, certainly having in mind the tiny impact Portugal's rather small economy would have in the new free trade area.

Engaged from then on in the process of economic integration in Europe (Portugal became an associate member country of the EEC in 1972), the policy of industrialisation through import substitution put into practice in the previous decade was abandoned in favour of a new strategy of export promotion. Foreign direct investment was an important player in this transformation, even if several sectors remained closed to international trade and investment (mostly in agriculture, services and 'strategic' heavy industries). Economic growth in the following years was impressive, but the result may have been an overspecialisation of the Portuguese economy. The markets opened to other EFTA countries were essentially those for which there was not local production at the time. Adding to this the effect of comparative advantage (Portugal was clearly the lowest labour cost location in EFTA), the subsequent specialisation in low value added labour intensive industries was probably inevitable.

The 1970s were marked by major social, political and economic transformations in Portugal. The first years of the decade registered very strong growth, record inflows of FDI, and a nascent stream of outward investment, all in the unlikely scenario of guerrilla wars being fought in three of Portugal's five African colonies. However, a number of international and domestic factors completely changed this picture. The 1973 oil crisis sent

the world economy into the biggest recession since the 1930s, with a great impact on Portugal's balance of payments due to lower exports and a sharp increase in energy costs. At home the dictatorship was toppled in a coup in April 1974, and the revolutionary process that followed was associated with strong political instability and economic disorder. In 1975, much of the economy was nationalised, the big economic groups that controlled most of the economy before the revolution were dismantled, and international trade relations truncated by the independence of the colonies (which cut almost all economic ties with the former colonial power). The country still had to deal with the return from the colonies of about a quarter million people (some 8 per cent of the Portuguese population), unwelcome in the newly independent countries.

On the face of this it can be no surprise that the economy developed several imbalances. In both 1978 and 1983, Portugal had to seek the support of the IMF, which resulted in restrictive stabilisation plans. Inward FDI, largely untouched by the revolution, was substantially reduced in this period though the flows remained positive. As for outward FDI, the investments of the early 1970s were largely concentrated in the colonies and did not resist the political transformations. Most subsidiaries were nationalised or simply abandoned.

The country's fortunes changed again in the 1980s. With the success of the stabilisation programs and the pacification of the political climate, the conditions were established for Portugal to become a full member of the European Union. Inflows of FDI, which had already been reaching record levels since the beginning of the decade, rocketed from 0.8% of GDP in 1986 to 4.1% in 1990. The political and economic guarantees that EU membership represented, relatively low labour costs and strong economic growth are some of the reasons that may explain this performance.

After 1990, however, FDI inflows registered a sharp decline at least as sudden as the increase in the second half of the 1980s. Despite strong economic growth, inward FDI in 1999 reached its lowest level since the 1950s if measured as a percentage of GDP. Another important transformation of the 1990s concerned outward FDI. Negligible since the revolution, it made an appearance in the Portuguese economy in the late 1980s. But the pace of the transformation was such that in 1997 outward FDI flows were higher than

inward flows for the first time in the country's history[1]. And the gap has been widening ever since.

Several elements may be associated with the recent decline of inward FDI. It is imaginable that after Portugal joined the European Union MNEs adjusted their positions in the country's productive structures and markets. But after five years of EU membership new investment opportunities will necessarily be less frequent. Second, the fall of the Berlin Wall radically changed geopolitical organisation in Europe. The historical ties between the new democracies in Central and Eastern Europe with some of the bigger EU members are probably stronger than with Portugal. Moreover, labour costs were in general lower than in Portugal, and some of the domestic markets potentially more attractive. Another possible explanation is the economic recession in Europe at the beginning of the 1990s. However, this cannot explain the steady reduction of Portugal's share of the EU12 inward FDI flows between 1991 and 1995. In other words, the decline of Portugal's inward FDI may well be associated with a loss of location advantages.

Existing research on the determinants of FDI in Portugal provide only superficial views of the subject. There is apparently a dichotomy in the motivations of foreign investors, which seem to invest in Portugal partly to access the local market and partly to benefit from relatively low labour costs (Matos, 1973; Taveira, 1984; Simões, 1985; Santos, 1997). But overall the local market seemed to have a stronger impact than labour costs (Taveira, 1984). Access to the EU market (Carrière and Reix, 1989) and to natural resources (Carrière and Reix, 1989; Fontoura, 1995) have been less frequently suggested.

As for outward FDI, the number of existing studies is even smaller. A notable exception is the work of Simões (1996, 1997, 1998), who provides a very good picture of the internationalisation of Portuguese firms. It seems that the expansion of outward FDI in Portugal is associated with growing ownership advantages by local firms. However, an alternative explanation has been suggested (it is, for example, implicit in the arguments of Bessa, 2000); the international expansion of local firms could be fomented by the same factors that originated the reduction of inward FDI, that is, an eventual decline in the competitiveness of Portugal as an investment location.

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[1] Previously available data (e.g. Banco de Portugal, 1997b) put this change in 1995, but the official figures were recently corrected (cf. Banco de Portugal, 2000a), following the adoption of a new methodology that complies with international standards.

1.2. THE RESEARCH PROJECT

The main concern of this research project is the characterisation of inward and outward FDI in Portugal and to analyse how the evolution registered in recent years reflects changes in the country's competitiveness. It starts with a review of the relevant literature concerning foreign direct investment and the growth of multinational corporations (chapter 2). The different schools of economic thought are introduced and confronted when relevant. It is suggested that the investment development path (Dunning, 1981a, 1981b, 1996a) provides the most appropriate framework to analyse the competitiveness of Portugal from the perspective of the changing country's position in the international production network.

Chapter 3 surveys existing evidence on the determinants of foreign direct investment. It provides an empirical foundation for the study of the Portuguese case, which is introduced in chapter 4. This starts with a description of the evolution of the Portuguese economy and a discussion of the roots of the country's relative underdevelopment. It is followed by an analysis of the evolution of FDI in Portugal and a short survey of existing studies. In order to confront the empirical evidence for Portugal (dominated by regression analysis) with the most recent data available, two econometric studies are presented in chapter 4: a longitudinal investigation of the location determinants of FDI in Portugal, and a cross section analysis to include several 'peripheral' European locations, of which Portugal is one. Chapter 4 is concluded with the search for the Portuguese investment development path. The aim is to confront the Portuguese case with the IDP theory, and to introduce the issue of national competitiveness. A novel functional relationship is proposed for the IDP, in order to reconcile empirical testing with the underlying theory

The main empirical investigation is reported in the next two chapters. Chapter 5 corresponds to a postal questionnaire survey of inward FDI. The research concentrates on manufacturing firms and provides a characterisation of foreign firms in Portugal, as well as providing a detailed investigation of the determinants of FDI. Industry, country of origin, size and the year of investment are the main units of analysis. The survey also investigates alternative locations, the role of public incentives, the main problems faced by foreign investors in Portugal, and, in the case of manufacturing firms, the characteristics of the production processes.

Outward FDI is the concern of chapter 6. Investigation is concentrated on firms with productive capacity abroad, or with clear projects to do so in the future. As in the previous chapter, services firms are not considered. Given the small size of the population (27 firms), short case studies based on semi-structured interviews and secondary data (company reports and assorted business news) was the methodology adopted. Chapter 6 describes the development of these fairly recent MNEs, bearing in mind that the aim is to understand the expansion of outward FDI in Portugal rather than individual internationalisation processes.

Finally, chapter 7 provides the overall conclusions. The summary of the previous two chapters is the basis for a discussion of the competitiveness of Portugal. As mentioned above, the perspective is to what extent the recent trends in inward and outward FDI correspond to a change in the country's competitiveness and/or are agents of that change. The chapter is completed with some suggestions for future research.

CHAPTER 2.
FOREIGN DIRECT INVESTMENT AND THE MULTINATIONAL CORPORATION

2.1. INTRODUCTION

International business activity is by no means a recent phenomenon. The lives of Phoenicians and Carthaginians, in the ancient world, were deeply dependent on international business. This economic activity included foreign direct investment (FDI), joint ventures and strategic alliances, among other forms of internationalisation (Moore and Lewis, 1999). Several multinational corporations (MNEs) can also be identified in Europe in the middle ages and in the beginning of the modern era (Dunning, 1993a; Jones, 1996).

The origins of modern international business activity however, are associated with the industrial revolution. Modern MNEs, in particular, have their roots in the massive international movement of factors that took place in the nineteenth century (Dunning, 1993a: p.99). Resource-seeking was the most common motivation of FDI in this period, even if by 1850 many firms had already crossed the Atlantic, in both directions, in what can be defined as market-seeking investment (Dunning, 1993a: p.100; Jones, 1996: p.5).

Despite the presence of FDI, most foreign investment in the nineteenth century - and indeed until the late 1940s – was portfolio capital. As a result, international business activity was largely ignored in economic theory until the late 1950s. On the one hand, the phenomenon did not have a major perceived economic impact. It was widely assumed that MNEs were a passing post-war phenomenon originating in the United States (Jones, 1996: p.3). On the other hand (and probably more importantly), the neo-classical theory, based upon perfect markets and the international immobility of factors, did not easily incorporate multinational activity.

The growth of FDI (and of the MNEs themselves) that followed World War II emphasised the inadequacy of the neo-classical theory to explain the phenomenon and the need for a whole new approach. The volume of FDI not only grew substantially, it started to reduce its concentration in primary goods, and to be increasingly directed towards the production of knowledge-based products in other developed countries (Buckley and Casson, 1976: p.36). Furthermore, important changes in the organisation of international business were taking place, in particular, the development of horizontal MNEs and the new Japanese vertical foreign investments (Dunning, 1979: pp.270-2; 1993a, pp.126-7)[1].

Despite its late arrival, international business literature (and in particular that on FDI) proliferated with increasing speed. The publication of the product cycle theory by Raymond Vernon (1966) was followed by extensive research on the determinants of foreign production, in particular by scholars at the Harvard Business School led by Vernon himself. In the mean time, John Dunning brought a copy of Stephen Hymer's 1960 PhD thesis to the University of Reading where, together with the work of Charles Kindleberger, it had a major impact. The two approaches of the 'Reading School' - the "internalisation theory" (Buckley, Casson, Rugman, Hennart) and the "eclectic paradigm" (Dunning) - provided a consistent explanation of the reasons why firms choose to own production and trading facilities abroad. Furthermore, scholars at the University of Uppsala (Johanson, Wiedersheim-Paul, Vahlne) started investigating the internationalisation process of individual firms, widening the scope of the new discipline.

[1] Until World War II Japanese outward FDI was dominated by trading and financial companies (Dunning, 1993a: p.124).

2.2. The Determinants of Foreign Direct Investment

Over a quarter of a century ago, Dunning (1973: p.289) observed that "|t|here are few branches of economic analysis which are not directly relevant to an understanding of the origin and growth of multinational enterprises". The result was a wide range of approaches to international business, often dependent on the researchers' backgrounds.

2.2.1. Capital theory

Until the 1950s, international direct investment was entirely explained within the traditional theory of international capital movements. Like other forms of international investment, FDI was seen as a response to differences in the rates of return on capital between countries. This suggestion was reinforced by the empirical observation that American firms (the major source of FDI in the 50s) obtained a higher rate of return from their European investments than at home (Mundell, 1960). However, the differential rate of return hypothesis did not resist the inversion in that relationship registered in the 1960s, which was still accompanied by increases in US investment in Europe (Hufbauer, 1975). Neither did it receive much empirical support[2].

Hymer (1960) was the first to expose the deficiencies of this approach. He claimed that the differential rate of return hypothesis was not consistent with several observed characteristics of international investment. First, the United States combined net outflows of FDI with net inflows of portfolio capital. Second, flows of FDI in both directions between two countries were not rare. Third, many subsidiaries complemented the inflow of direct investment with capital borrowed in local markets. And, finally, manufacturing companies were at the time far more important in international direct investment than financial firms. Furthermore, an international difference in expected returns is not sufficient to induce FDI (Caves, 1982: p.25). Under perfect markets, an increase in the short run profits of firms in one country would not induce international investment. Instead, it would attract new entrants that would eliminate any excess profits. Perfect markets and MNEs are not compatible (Hymer, 1960; Kindleberger, 1969; Hufbauer, 1975).

[2] For a survey of empirical tests see, for example, Agarwal (1980: pp.741-2). See also Caves (1996: p.26).

Somewhat more refined than the differential rate of return hypothesis is the portfolio approach, developed in the 1960s using a Tobin/Markowitz stock adjustment model[3]. The portfolio approach assumes that part of the excess profits that should be earned in foreign markets are simply rents for higher risk associated with this alternative use of capital. As recently as 1992, Brainard and Tobin[4] proposed a model in which FDI is simply one of the alternatives to portfolio investment. The rates of return of the different alternative investments are matched with an element of risk in the choice between (imperfectly) substitutable assets to build an efficient portfolio. However, the introduction of a risk correction element, more than being insufficient to eliminate the theoretical drawbacks of the underlying theory, highlights its deficiencies. In fact, Hymer's criticisms of the differential rate of return hypothesis (see above) fully apply to the portfolio theory as well. Furthermore, MNEs can provide a cheap international diversification of a portfolio, but only at a cost: the difference between the (rigid) international mix provided and each investor's optimal mix. And this is very likely to off-set the initial cost-advantage. Finally, the portfolio hypothesis cannot explain the differences between industries' propensities to invest abroad (Agarwal, 1980; Taveira, 1984).

According to Dunning (1973: p.299), the reason why portfolio theory can only partially explain direct foreign investment is that it ignores that "direct investment does not involve changes in ownership. It does, however, involve the transmission of factor inputs other than money capital, viz. entrepreneurship, technology, and management expertise, and is likely to be affected by the relative profitability of the use of these resources in different countries as that of money capital". Furthermore, MNEs are not necessarily profits maximisers. Even if they are, there is no reason why they should forcibly seek higher profits on FDI than on domestic investment (Agarwal, 1980: p. 743).

Also in the capital theory tradition is the risk diversification hypothesis (Rugman, 1975, 1979; Lessard, 1976). The argument is that the international diversification of portfolios is a way of reducing the firm's risk. This makes the MNE a vehicle for geographical diversification of investments. Caves (1996) explains, however, that although the empirical evidence shows that investors recognise the value of international diversification (p.160), the diversification of MNEs is more likely to result from investments that were propelled by other motives (p.21). Indeed, the geographical distribution of the portfolios of existing

[3] Tobin (1958), Markowitz (1959). See Dunning (1973: pp. 300) and Agarwal (1980: p.745) for references to the application of portfolio theory to FDI.

MNEs, very much concentrated in highly correlated countries, is very different from what is suggested by the portfolio diversification hypothesis (Buckley, 1988: p.83).

2.2.2. The International Trade Tradition

It is certainly no surprise that International Trade economists were among the first to study the FDI phenomenon. Foreign production can be a substitute for exports, as it can influence the terms of trade and thus change the whole pattern of specialisation. However, in the neo-classical world of the Heckscher-Ohlin tradition there is no space for foreign direct investment. Any disequilibrium in the prices of goods or factors across countries brought about by different factor endowments would be immediately corrected by international movements of goods (the Samuelson theorem).

2.2.2.1. Mundell and the Heckscher-Ohlin model

Mundell (1957) used an extension of the basic model to show that trade and capital movements can be substitutes, namely, that the introduction of tariffs would induce a flow of FDI towards the country where tariffs are imposed[5]. That is, the same way that restrictions to international movements of factors can be substituted by trade (the original H-O model), restrictions to trade can be replaced by international movements of factors, in particular capital given the intrinsic imperfect mobility of labour.

In a way, these hypotheses based on the Heckscher-Ohlin model are not very different from those based on capital movements. As Taveira (1984: p.10) points out, in both cases "FDI was analysed as a re-equilibrium device within a generally perfectly competitive economy", a major limitation of the explanatory potential of both approaches.

2.2.2.2. Kojima's 'Macroeconomic Approach'

Also in the neo-classical factor endowments tradition is Kojima's 'macroeconomic approach' (Kojima, 1973, 1978, 1982). Kojima tried to explain the distinctive character of trade-oriented Japanese FDI, obeying the principle of comparative advantages, vis-à-vis US investment conducted in an oligopolistic market structure, anti-trade oriented and damaging to both home and host countries in the long run (Dunning, 1993a: p.90).

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[4] Cited in Jong and Vos (1994a: p.9)

[5] Corden (1974) showed that tariffs are not the only impediment to trade that originates FDI from a situation of different factor endowments.

The basic theorem is that "Direct Foreign Investment should originate in the investing country's comparatively disadvantaged industry (or activity), which is potentially a comparatively advantaged industry in the host country" (Kojima, 1982: p.2). If this is the case, Kojima argues, (pro-trade oriented, or Japanese) FDI and international trade are complementary and lead to a dynamic reorganisation in the international division of trade and the associated gains for all countries involved.

The role of FDI can thus be seen as to exploit the home country's comparative advantages in intermediate inputs that are embodied in products whose final stages of production give a comparative advantage to the host country (Dunning, 1993a). This is a most significant suggestion: some factor endowments generate comparative advantages that are better exploited abroad. That is, firms can build their competitive advantages upon the home country's specific location-advantages, but best exploit these advantages, partially or totally, abroad, an idea also developed by Dunning (1981a) and to be discussed later.

The macroeconomic approach was the target of many criticisms. Its neo-classical perfect market assumptions are clearly a major limitation, for they ignore economies of scale, product differentiation and other forms of market failure (Dunning, 1993a; Jong and Vos, 1994b). It is not that Kojima is not aware of them. But being unable to distinguish firm level economies of scale from plant level economies (Buckley, 1983b: p.97), he fails to understand that in the presence of market failure hierarchies can improve the international allocation of resources (Dunning, 1993a: p.90).

Another limitation of the macroeconomic approach is its excessive concern with the distinction between the positive impact of Japanese "pro-trade oriented" FDI and the US "anti-trade oriented" FDI. Kojima's belief is that US FDI in technologically advanced industries was premature and doubly damaging. On the one hand, it did not fit the host-country's factor endowments and associated comparative advantages. On the other hand, it prematurely eroded the United States' technology-based competitive advantages. Cantwell (1991), however, argues that export-oriented FDI is not necessarily better than import-substituting foreign investment. The latter can have highly positive spill-over effects. Its total long-term impact on trade can be positive. Furthermore, if of an enclave kind, export-oriented FDI will have little impact on the host-country's technology and entrepreneurial levels.

Buckley (1983b, 1985, 1991) and Clegg (1987) further suggest that, because of its narrow assumptions, Kojima's theory is not applicable even to most Japanese direct investment. "Japanese-type" investment is not more frequent in Japan than in other developed countries (Buckley, 1983b: p.346). As Japanese MNEs matured, the distinction between Japanese- and American- type FDI eroded. And Japanese import-substituting investments in Europe and in the US are certainly not less important than Japanese export-oriented FDI in (mostly) Asian countries (Clegg, 1987; Cantwell, 1991). Buckley (1985) goes as far as to claim that even the analysis by Kojima and Ozawa (1984) of the Sogo-Shosha, Japan's traditional general trading companies, implicitly rejects the macroeconomic model.

2.2.2.3. The Product Cycle Model

Another stream of work that partially builds upon the factor-endowments tradition is the one that takes into account the role of innovation and the diffusion of knowledge. Posner (1961), Hufbauer (1966), Vernon (1966), Hirsch (1967) and Wells (1972) are probably the most important references, with the product cycle theory, normally associated with Vernon, being the model that better describes the role attributed to MNEs in the interaction between technology, international production and trade.

The argument is that technological development generates changes in the products' factors intensity, thus changing the comparative advantages of countries. The role of demand, first discussed by Linder (1961), is also taken into account. Domestic demand can be an incentive to innovate, while international demand similarity facilitates exports. In a world with important technological and market barriers to trade (Hufbauer, 1966. Vernon, 1966), MNEs are the most likely institutions to organise the production and distribution of goods with an international demand for which the most efficient production location is changing over time.

The Product Cycle described that American endowments of highly skilled labour and R&D resources, matched with a highly sophisticated demand, prompted constant innovation among US firms. The consequent technological leadership was the basis for US exports and permitted the development of US multinationals which engaged in import-substituting FDI in other developed countries. As products and technology matured, these advantages were progressively eroded, and US companies were forced to move to new products and technologies. These are then replaced by imitation-driven producers based, first, in other developed countries and, later, in developing countries. What was not clear in

the first versions of the product cycle (usually designated as Mark I) was whether the maturation process would drive out the production of US firms or simply production in the US.

Clegg (1987: p.24) claims that "[the product cycle] is not, in itself, a complete theory of DFI as it does not explain the ownership of production". Not least because the competitive advantage of firms is frequently associated with country-specific advantages (Dunning, 1993a). Clegg (1987: p.26) adds that "the product cycle is primarily a theory of new FDI, and it has little to say on the extensions of existing investments by a mature foreign-investing nation". Nevertheless, Dunning (1973: p.307) defends that "[trade based] models are of special interest in that they emphasise the role of innovations in forging new trade patterns within an imperfectly competitive environment, conditions which are the seed-bed of growth of the modern ME". The trade approach has the merit of highlighting the fact that FDI is but one alternative to service foreign markets. Furthermore, it postulates "the distinctive character of the ME as an owner of resources in different countries compared with national firms".

The Mark I Product Cycle received much empirical support from studies covering the 1950s and 1960s. But Vernon (1971: p.108) himself acknowledged that "by 1970, the product cycle model was beginning in some respects to be inadequate as a way of looking at the US-controlled multinational enterprises". The successive revisions of the model - Product Cycle Mark II (Vernon, 1974, 1979) - drove it very close to the Hymer-Kindleberger approach (Buckley, 1981) - see section 2.3.2.

2.3. Market Imperfections and Industrial Organisation

The bases for a whole new approach of international production based on market imperfections were laid by Hymer (1960). However, his work was largely ignored until Kindleberger (1969) published his own research[6]. Hymer's work is clearly in the industrial organisation tradition - his major concern is with the organisation of production rather than trade flows - and largely inspired by Bain's (1956) theory of barriers to entry in domestic industries[7].

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[6] Hymer's 1960 Doctoral dissertation was not to be published until 1976.

[7] Cantwell (1991: p.22), however, observes that "in Hymer's original version it was a theory of the firm and of the behaviour of the firm rather than a theory of industrial organization in the modern sense".

2.3.1. The Hymer-Kindleberger hypothesis

The Hymer-Kindleberger hypothesis suggests that, because foreign firms have necessarily some disadvantages vis-à-vis domestic firms (e.g., knowledge of the market, communication), they must possess some firm-specific advantages if they are to engage in foreign production (Hymer, 1960; 1968). Furthermore, foreign direct investment is not about the transfer of capital - this could be supplied to local firms using other forms of international financing. It is about the international transfer of proprietary and intangible assets - technology, business techniques, and skilled personnel (Hymer, 1960: p.69). Hymer (1960, 1968) claimed that the existence of FDI is exclusively due to the imperfection of the international markets for these assets. The firm "internalises or supersedes" these market failures through direct investment (Hymer, 1960: p.48).

The problem facing prospective international firms was summarised by Dunning (1973: p.313): "there are two primary determinants of the amount of international production. The first is the extent of the market in each country and the second is the competitiveness of foreign affiliates vis-à-vis indigenous and non-resident firms". That is, the aim of any analysis should be "to identify both the *location* and *ownership* of firms"[8].

A second key element in the Hymer-Kindleberger approach is why firms should choose to exploit their ownership advantages through direct investment rather than exporting, licensing, or other forms of international markets servicing. Buckley and Casson (1976: p.68) and Rugman (1980: p.370), among others, claim this was never clearly explained by Hymer. This was, nevertheless, implicit in Hymer's (1960) original work, and extensively discussed in a later paper[9]. Hymer (1968: pp. 966-970) seems to believe that FDI is the most efficient internationalisation strategy, in particular when compared with licensing; if the advantage is based on technology or on some intangible asset, FDI was considered the most likely solution to maximise profits. Three reasons were presented: (i) the firm's advantage may be very difficult to price; (ii) FDI eliminates the costs of defining and managing a licensing agreement; (iii) it is simply not possible to sell oligopolistic power.

Hymer (1960, 1968) viewed FDI very much as a way of defending and reinforcing market power in oligopolistic industries. In this, it is fully supported by Caves's (1971) analysis of vertically integrated firms. Caves's (1971: p.10) explanation of vertical FDI is an implicit

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[8] Italics in the original.

[9] Hymer (1968). Apparently, the very existence this paper, published in French, was widely ignored until the middle 1980s.

assertion that multinationals can not only exploit perceived market imperfections, but they can use their ownership advantages to create market imperfections themselves. This is, nevertheless, an element only fully understood and integrated in the theory of international investment by Buckley and Casson (1976). However, Caves (1971: p.9) seemed to believe that imperfect markets for knowledge associated with product differentiation were the key for horizontal FDI (p.6). Despite being part of the truth, this is a restrictive view of the reasons behind horizontal foreign direct investment.

Before moving on to the next section, it is interesting to make a brief note on the surprising consistency between Hymer's market power view of FDI and the mainstream Marxist approach to foreign investment, or *neo-imperialism*[10]. The marxist argument is that the level of concentration ("monopolisation") of the industries in capitalist countries generates very high profits. However, since oligopolistic collusion imposes restrictions on the re-investment of those profits at home, they must be invested abroad. Despite the difference in emphasis, this does not differ much from Hymer's explanation of the role of oligopolies in the existence of FDI. Nevertheless, the Marxists tend to ignore the competitiveness of oligopolies that was central in Hymer's approach. Instead, they emphasise the collusive anti-competition aspect of market power. As a result, the two approaches reach rather different conclusions: the neo-imperialists conclude that the expansion of MNEs (mostly from developed countries) into new (usually less developed) locations is nothing else but one more vector of the expansion of imperialism and yet another vehicle for the underdevelopment of the "Third World".

2.3.2. The internalisation approach

Despite the invaluable contribution of Hymer, Kindleberger and Caves, the credit for transforming internalisation into a full paradigm of international production is usually attributed to Buckley and Casson (1976). These scholars did not simply complement previous work; they re-centred the analysis by building upon the theory of the firm (Coase, 1937). Looking at the firm as an alternative institution to markets, their theory "views the MNE as a special case of the multiplant firm" (Buckley and Casson, 1976: p.36).

Buckley and Casson's (1976) assertion that MNEs are typically both vertically and horizontally integrated led them to a model centred on the relationship between knowledge, market imperfections and the internalisation of markets for intermediate

goods. This comprehensive treatment of vertical and horizontal FDI is possible in so much as "the vertically integrated firm internalises a market for an intermediate product, just as the horizontal MNE internalises markets for proprietary assets" (Caves, 1996: p.13).

Additionally, internalisation will happen - and MNEs will grow - only as far as the benefits, including those associated with the barriers to new entrants, are not outweighed by the costs of communication, co-ordination and control, and the 'foreignness' inevitably associated with vertical and horizontal integrated firms. Rugman (1980, 1985) goes as far as to claim that this made internalisation a (the?) general theory of FDI, which will be discussed later.

The internalisation theory evolves from the concept of market failure. Some transactions are more efficiently performed inside the firm than in the market. Buckley and Casson (1976: pp.37-38) specified five types of market imperfections that call for internalisation:

- when the co-ordination of resources over a long period is needed;
- when the efficient exploitation of market power requires discriminatory pricing;
- when bilateral monopoly produces unstable bargaining situations;
- when the buyer cannot price correctly the (usually intangible) goods on sale, or when public goods are involved;
- when government interventions in international markets create incentives for transfer-pricing.

Buckley and Casson (1976: p.39) listed several markets where internalisation is very likely to happen: perishable agricultural products, intermediate products in capital-intensive manufacturing processes, and raw-materials geographically concentrated[11]. However, these were secondary in the analysis. As with Hymer, at the centre of the analysis were the imperfections in the markets for knowledge[12]. These were ideal to illustrate why internalisation is the most efficient vehicle to exploit a proprietary advantage without putting at risk the monopoly it represents to the firm.

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10 See Jenkins (1987: p.27) for references.

11 Casson (1982: p.20) put it in different words: "MNEs will predominate in R&D-intensive industries, in resource-based industries, and when the international division of labour is inhibited by fiscal intervention which can be avoided by transfer-pricing".

12 The emphasis was, nevertheless, different, since Hymer overlooked the concept of transaction costs and emphasised market failure (Dunning and Rugman, 1985: p.229; Casson, 1987: p.6).

Also relevant in the internalisation theory is the perception that the firm is able to internalise externalities even when no market existed before: "the actions of firms can replace the market or alternatively can augment it" (Buckley, 1981: p.9). That is, internalisation includes a theory of how new knowledge is created, a major departure from the Hymer-Kindleberger approach (Clegg, 1987: p.20).

The dichotomy replace/augment emanates from different connotations of 'internalisation' and has important welfare implications: "*Internalization of a market* refers to the replacement of an arm's length contractual relationship by managerial co-ordination within the firm. *Internalization of an externality*, however, refers to an improvement in social efficiency achieved by removing a defect or distortion in the price system" (Casson, 1987: p.36).

Several other authors made important contributions to the development of the internalisation theory. Horst (1971) presented the first microeconomic model of the choice between investing abroad and exporting from the home base. His model of the horizontally-integrated MNE demonstrated Hymer's suggestion that FDI can be a strategy to enforce collusion. Horst (1972) also distinguished for the first time between ownership and location advantages, to be introduced in the next section (Clegg, 1987: p.32; Caves, 1996: p.54).

Aliber (1970, 1971) proposed a variant of the Hymer-Kindleberger model based on the existence of different currency areas. He argues that firms from countries with strong currencies can borrow at lower cost, which enables them to engage in risky investments in weak-currency areas. Aliber did not try to create a general theory of FDI. His model can be seen as the suggestion that firms internalise imperfections in the capital and exchange rate markets, as they do with any other market failure.

Johnson (1968, 1970) was the first to suggest that knowledge is a public good with near-zero social cost but non-zero private cost. This is the reason why the firm better exploits its knowledge-based advantages through internal markets, as fully addressed in Buckley and Casson (1976). Magee (1977a, 1977b) extended Johnson's work to build the notion of "industry technology cycle", largely inspired by the product cycle theory. He argued that the incentive for firms to internalise the market for technology varies over time. New technologies are more likely to be internalised (Magee used the expression 'appropriability'), but as the technology matures licensing becomes increasingly attractive. The licensing of a mature technology is easier to price and cheaper to monitor, thus

reducing the risks and costs associated with the non-internalisation of the firm's ownership advantage (Rugman, 1981).

Knickerbocker (1973) found that because of oligopolistic behaviour foreign subsidiaries tend to be clustered. Firms tend to follow competitors in their internationalisation decisions, a behaviour also found in the case of domestic diversification (Lamfalussy, 1961). This showed "that it was not just locational variables that determined the spatial distribution of the economic activity of firms but their strategic response to these variables and to the anticipated behaviour of their competitors" (Dunning, 1993a: p.72).

This notion of oligopolistic behaviour is at the centre of the revision of the product cycle, known as 'mark II'. The emphasis of the "new" product cycle theory has moved away from technological development and international allocation of industries to strategic behaviour and how erected barriers to entry support international oligopolistic structures (Vernon, 1974). In this new version, import-substituting FDI was expected as the product matured (as well as the technology, as Magee would put it). This strategic move intends to prevent damaging price wars. Because it is compelled by security rather than efficiency, the welfare outcome is not necessarily a world first-best.

The similarity with the internalisation theory discussed above is evident. However, and despite all the common ground, it must be stressed that a significant difference in approach still exists between product cycle mark II and internalisation. While the latter is a theory of the (international) firm, the former places itself at an industry level of analysis. It is a theory of international location based on oligopolistic behaviour, not a theory of the nature of the international firm.

Cantwell (1991: p.30) suggested an important distinction between the product cycle "competitive international industry approach" and the "market power school" of the Hymer-Kindleberger tradition. "While the market power school suppose that, in general, internationalization lowers the extent of competition and increases collusion amongst firms, competitive international industry approaches share the view that in general the growth of international production tends to be associated with rivalry and to sustain the process of technological competition amongst MNEs". The observation seems to overlook, nevertheless, that in both cases FDI is both the response to and a vehicle of market change.

A rather different approach is Aharoni's (1966) use of the behavioural theory of the firm to introduce the role of management and decision-making process in the explanations of the internationalisation of the firm. Recently, this approach has been substantially developed by Buckley (1993a, 1996a) who has been integrating the new developments in international business theory with those in the theory of strategic management.

2.3.3. The eclectic paradigm

According to Dunning (1979: p.274), the eclectic paradigm resulted from his dissatisfaction with existing theory of international production: the Hymer-Kindleberger approach, the product-cycle theory, and the internalisation theory. The three were considered to be partial explanations of international production. Henceforth, he proposed an alternative line of development which tried to integrate the existing theories in a general and 'eclectic' model in which "the subject to be explained is the extent and pattern of international production" (Dunning, 1991: p.124).

Dunning (1979: p.275) suggests that a firm engages in FDI if three conditions are satisfied:

(i) It possesses net *ownership* (O-) advantages vis-à-vis firms from other countries;

(ii) It is beneficial to *internalise* (I-advantages) those advantages rather than to use the market to pass them to foreign firms;

(iii) There are some *location* (L-) advantages in using the firm's ownership advantage in a foreign location rather than at home.

The concept of ownership advantage is especially important to the eclectic paradigm, not least because it is probably what draws the line with the internalisation theory (Rugman, 1980, 1985; Casson, 1987). Dunning (1979: p.276) distinguished two sets of ownership advantages: those that result from an exclusive access to inputs, intangible assets or markets; and those directly associated with multinationality. Later (1983b), however, he put this distinction in slightly different, eventually more clear, terms. He distinguished between those ownership advantages that arise from the proprietary ownership of specific assets of the firm - *asset* (Oa) ownership advantages - which the firm can choose to internalise or not; and the ownership advantages that can only be exploited if internalised, since they result from the superiority of hierarchies vis-à-vis external markets in the common

governance of a network of assets located in different countries - *transaction* (Ot) ownership advantages[13].

Dunning (1981a: pp.34-35) also considered necessary a systematic distinction between country (home and host), industry and firm determinants of the OLI characteristics: "the propensity of enterprises of a particular nationality to engage in foreign production will vary according to the economic *at al.* characteristics of their home countries and the country(ies) in which they propose to invest, the range and type of products they intend to produce, and their underlying management and organisational strategies".

More recently, Dunning (1993a: p.79) added a fourth, firm-specific, condition to the basic three proposed in 1979:

(iv) Given the configuration of the OLI advantages facing a particular firm, the extent to which the firm believes that foreign production is consistent with its long-term *management strategy.*

One of the main criticisms of the eclectic paradigm is that it includes so many variables that it loses any operationality. Dunning (1991: p.125) partially accepts it, although he sees it as an inevitable consequence of trying to integrate the rather different motivations behind FDI in one general theory. He also accepts that the first versions of the OLI paradigm did not give full account of the dynamic interaction between the variables. The answer to this criticism was the *Investment Development Cycle*, or *Path*, which Dunning first introduced in 1981[14], and which will be discussed later.

2.3.4. OLI versus internalisation

Dunning (1993a: p.85) argues that "the [eclectic] paradigm is less an alternative theory of international production than one which pinpoints the essential and common characteristics of each of the mainstream explanations". That is the reason why he re-named it 'paradigm' instead of the original 'theory'. However, the claim that the eclectic paradigm has uniquely the global explanation of international production is not universally accepted. Rugman (1980), in particular, claims that internalisation is in itself a general

[13] The actual expressions used in Dunning (1983b) were 'asset-power' and 'transaction-power' (p.334). The terms asset (Oa) and transaction (Ot) ownership advantages only appear in subsequent works.

[14] Dunning (1991: p.134, footnote 13; 1981a: p.30, footnote) refers that the notion of an Investment Development Cycle was first proposed by him and Peter Buckley in 1975 at a conference of the UK Chapter of the Academy of International Business, and again in 1978 with Peter Buckley and Robert Pearce in a similar conference.

theory of foreign direct investment[15]. He extensively analysed previous contributions to the theory of FDI to demonstrate that internalisation is the key element in all existing explanations. Hennart (1986) and Casson (1987) seem to agree.

Supporters of internalisation consider that the concept of ownership advantage is irrelevant in explaining multinational activity. Buckley (1983a) saw it as the consequence of applying static concepts to a dynamic issue - the growth of the firm. Casson (1987: p.135) went further, to argue that "Dunning's eclectic theory implicitly denies the original powerful insight of Coase, which is that internalization is the *raison d'etre* of the firm". Dunning's distinction between asset and transaction ownership advantages may be seen as a concession to this criticism (Corley, 1992: p.11). But Casson (1987) admitted that the empirical work recognises the importance of ownership advantages.

Dunning's interpretation is that the difference is one of semantics: "I accept that some ownership-specific advantages are the direct result of firms internalizing the market for their intermediate products across national borders. However, (...) I think it appropriate to refer to the benefit as an ownership-specific advantage and internalization as the modality by which this advantage is realized" (Dunning, 1991: p.132). Ownership advantages may be dynamic and volatile, but they are the factors that, by being internalised, allow firms to cross borders and become MNEs.

Dunning (1991) accepts that the internalisation theory has the leading explanation of why a firm should choose to engage in foreign investment. But he dismisses its capacity to explain the level, structure and location of all international production. Dunning's claim is that for the internalisation theory to achieve that status all kinds of market imperfections would have to be considered in the approach, "in which case the theory loses much of its incisiveness" (p.120). Dunning sees the internalisation theory not as an alternative but as a very important contribution to his own approach. One, he admits, that considerably influenced the evolution of his own view of foreign direct investment (1991: pp.122-123).

The most important distinction between the two versions of the Reading School is probably the explicit reference to the role of macroeconomic variables in shaping international production. Since the very beginning, and despite the many subsequent developments, the internalisation approach is a theory of the firm that chose to cross national borders - a theory of the MNE. By contrast, the eclectic paradigm is a theory of

[15] Although he seems to associate Dunning with the internalisation school (see Fina and Rugman, 1996: p.200)

FDI. It wraps the theory of the firm with the macroeconomic and socio-political environment in which the decisions are made: "The main difference between the determinants of intra-national and international production lies in the unique economic, political and cultural characteristics of separate sovereign states" (Dunning, 1993a: p.86).

2.3.5. Motives for foreign production

The motives for firms to engage in foreign production can be classified in four groups: natural resources seeking, market seeking, efficiency seeking and strategic asset seeking[16]. Natural resources seeking FDI is justified by the fact that these resources – e.g. minerals, raw materials and agricultural products - tend to be location specific. The need to guarantee a cheap and safe supply of natural resources justified much of the FDI flows in the 1800s and early 1900s, largely from the most industrialised nations (i.e. Europe, USA and Japan) to the less developed areas of the globe (Dunning, 1993a: pp.110,124). Market seeking corresponds to FDI that aims at supplying the local market or markets in adjacent territories. It may represent a deeper involvement of the firm, following the success of exports, or the expansion of the firm to a wholly new market. Transportation costs and government regulations are the main reasons behind market seeking FDI. However, Dunning (1993a: pp.58-59) suggested that strategic reasons may also be associated with this type of FDI. Some examples are to follow the firm's clients in their foreign expansion, the need to adapt products to local conditions and tastes, or the reduction of transaction costs.

Efficiency seeking FDI has two main forms. First, and probably the most frequent type, firms often seek to increase their cost efficiency by transferring production, totally or in part, to low labour costs locations. This is especially likely to happen in industries where unskilled or semi-skilled labour represents an important part of the production costs. Common examples are US investment in Mexico's *maquiladoras*, and investment in Portugal and Spain by north and central European countries (cf. chapter 5). The second type of efficiency seeking FDI corresponds to investment aimed at rationalising the operations of existing MNEs. The target may be the exploitation of comparative advantages in adjacent territories (e.g. following a process of economic integration, such as the creation of the Single European Market, in 1992), or to exploit economies of scale and scope across

borders. However, prior market seeking FDI or costs reducing FDI is a pre-condition for this variation of efficiency seeking foreign investment.

Finally, strategic asset seeking FDI is probably the fastest growing of the four motives for overseas investment (Dunning, 1994). Firms increasingly use FDI to obtain strategic assets (whether tangible or intangible) that may be critical to their long-term strategy but are not available at home (see also section 2.3.3). In contrast to the other motives for FDI, strategic assets seeking investment does not imply the exploitation of an existing ownership advantage of the firm. Instead, FDI may be a vehicle for the firm to build the ownership advantages that will support its long-term expansion at home and abroad, as argued, for example, in the network literature (see section 2.4.1). Alternatively, strategic asset seeking investment may not involve strengthening the firm's position, but rather to weaken the competitive position of its competitors (Dunning, 1993a: p.60).

2.4. A Dynamic Approach to Foreign Production

All the explanations of foreign production discussed so far are static approaches. Yet the choice of international production and management is essentially a dynamic issue. According to Dunning and Rugman (1985: p.231), this intrinsic dynamism was already present in Hymer's original work, in his treatment of ownership advantages. Hymer (1960) presented internationalisation as a way of enforcing market power, which implies an evolving world where there is no space for the notion of equilibrium. In a later work, Hymer (1968) made even more explicit this dynamic bi-directional interaction between the internalisation of markets and market structure (Buckley, 1990).

However, the credit for the first consistent attempt to create a dynamic model of international production goes to Raymond Vernon (1966, 1974). The product cycle theory evolves around technological change and how it affects the distribution of production worldwide. The emphasis on dynamic interactions was reinforced in the revision of the model (Mark II) where oligopolistic behaviour, dynamic and in permanent disequilibrium by nature, takes the centre stage. Nevertheless, the classical tradition of general equilibrium that has always dominated economic thinking was not fully eliminated. The stages analysis

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[16] It should be noted that this classification differs from that of Dunning (1993a), which considered a category of 'resource seekers' that included the natural resources seekers, the search for cheap supplies of unskilled or semi-skilled labour, and the acquisition of technological capabilities, management or marketing expertise, and organisational skills (Dunning, 1993a: p.57).

suggests that the dynamic phases are periods of evolution between intermediate points of equilibrium.

Kojima (1982: p.8) expected to explain the dynamic effects of FDI with his macroeconomic approach. In a concession to his earlier critics, however, he admitted that the use of a comparative static method for a real dynamic model of international division of labour is restrictive. Nevertheless, Kojima and Ozawa (1985) insisted on the dynamic nature of their analysis of the impact of the international transfer of factors of production and goods in the welfare of countries. They believed that "a study of the creation and international dissemination of entrepreneurial endowments is the key to developing a theory of dynamic comparative advantage" (Kojima and Ozawa, 1985: p.136). But their method was still 'comparative static'.

In his criticism of Kojima's model, Buckley (1985, 1991) exploited the dynamic elements associated with internalisation. He argued that internalisation provides a greater cooperation between the different units of the firm, which in the long run stimulates R&D and is likely to provide dynamic welfare improvements (Buckley, 1985: p.119). Cantwell (1989, 1991) has a very similar reasoning, only with the emphasis on the role of technology accumulation. Nonetheless, the internalisation theory lacks a truly dynamic approach. Buckley (1990: p.663) seems to agree when he argues that there is a need to integrate approaches that pay attention to "the dynamics and disequilibrium at the levels of the firm, markets and international competitors" both in the strategic trade theory and in the theory of international business.

It must be said that attempts were made to incorporate dynamic elements in the theory of international production. Partially influenced by Aliber (1970), Buckley and Casson (1981) analysed the foreign market servicing decision of firms. In their model, firms switch between modes of foreign market servicing with different fixed and variable costs in response to changing market conditions. However, Buckley (1983a) considered that the assumptions required by the model made it too complex to be operational.

More importantly, Buckley (1983a) demonstrated that the incorporation of dynamic elements in the analysis of international production refuted the proposition, central to Hymer's original work, that local firms have an advantage over foreign entrants. Buckley (1983a) argued that a stepwise analysis of foreign market entry highlights the importance of elements intrinsic to multinationality that "make the established MNE a radically different

competitor than a first-time foreign entrant" (p.48). The determinants of foreign expansion for new foreign investors can differ from those of established MNEs.

The increasing importance of dynamic issues is the central element in Buckley and Casson's (1998) 'state of the discipline' discussion. They consider that uncertainty and market volatility made MNEs' flexibility the leitmotif of the new research agenda. Foreign market entry decisions can no longer be seen as a sequence of one-off events, but as a continuos systemic process (Buckley and Casson, 1998: p.22). New issues must be brought to the fore: international joint ventures; cooperation and business networks; entrepreneurship and corporate culture; organisational change.

2.4.1. The Scandinavian School

With an intrinsic dynamic approach to international business, the Scandinavian school (also called "Uppsala" or "internationalisation" - Johanson and Wiedersheim-Paul, 1975; Johanson and Vahlne, 1977; Johanson and Mattsson, 1988; Vahlne and Nordstrom, 1988) was largely developed in the 1970s from the empirical observation of the internationalisation process of individual (mostly Swedish) firms. From their empirical observations, Johanson and Wiedersheim-Paul (1975) and Johanson and Vahlne (1977) concluded that firms gradually develop their international operations by a process of incremental knowledge and commitment.

As in Hymer (1960), it is believed that, because they have little or no knowledge of the local conditions, foreign firms are at a disadvantage vis-à-vis local competitors. Although 'objective' knowledge about foreign countries can be bought by the company, 'experiential' knowledge can only be obtained through direct experience (Johanson and Vahlne, 1977). Only the effective presence in foreign countries provides this critical element if the firm is to become an efficient player in international markets. Moreover, the process of foreign expansion is influenced by the firm's past experience, the size of potential markets and, most importantly, the firms' psychic distance to each potential host country. The latter is defined by factors such as the differences between home and host countries in terms of language, culture, political systems, level of education, and level of industrial development. Because of the correlation between cultural and geographic distance, psychic distance is also normally strongly associated with geographic distance[17].

[17] Johanson and Vahlne (1977: p.33) defined psychic distance as "the sum of factors preventing the flow of information from and to the market".

Typically, internationalisation starts with exports via independent representatives (agents), followed by the establishment of sales subsidiaries and, eventually, productive subsidiaries. This is clearly a process of increasing resources' commitment, as well as progressive knowledge acquisition. The fact that foreign subsidiaries are frequently established through the acquisition of former agents or by contracting key persons in the agents' structure (Johanson and Vahlne, 1977: p.33) is consistent with the knowledge acquiring view.

At the same time, the knowledge acquired in neighbouring countries (in terms of psychic distance), where internationalisation is likely to start, will permit the progressive expansion to countries increasingly further apart. That is, economies of scope in the learning process allow the firm to expand to new foreign countries, ever more distinct from the home country. These economies of scope also permit the firm to overcome the restrictions imposed by limited managerial capacities, which would not permit the firm to enter several foreign markets simultaneously (Casson, 1994). Furthermore, the impact of the internationalisation process in the firm's organisational capacity, human resources and organisational structure (see Welch and Luostarinen, 1988) will probably enable it to jump stages after certain critical knowledge of international markets is obtained. This is particularly evident when the firm expands its operations to countries psychologically far from the home country, but close to others where it is already established.

On the face of this, internationalisation is no more than "the consequence of a process of incremental adjustments to changing conditions of the firm and its environment" (Johanson and Vahlne, 1977: p.35)[18]. However, a fully dynamic approach to international production was not provided by the Scandinavian researchers until the mid 1980s. The original model only tried to explain early stages of internationalisation, ignoring competitive factors that change over time, in particular international competition. Johanson and Mattsson (1988) and Vahlne and Nordstrom (1988) argued that in order to analyse situations where both the firm and the market are highly internationalised it is necessary to look at industrial markets as networks of relationships between firms[19].

Knowledge and resource commitment remained the cornerstones of the network approach. However, it considers that the internationalisation of the firm depends on its capacity to build long term links with other firms in foreign networks (Johanson and

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[18] Aharoni (1966) is recurrently cited by the authors of the internationalisation school.

[19] Arguably, the original analysis applies essentially to investors from small countries (Johanson and Mattsson, 1988: p.299). Firms from countries with big domestic markets may be large enough to start internationalisation with a big productive FDI project.

Mattsson, 1988: p.296). This network of relationships permits the creation of a capital of trust that reduces transaction costs and increases cooperation in the development of new products and technology. In other words, it represents a specific competitive advantage even when it is an unintended by-product of the firm's short term options (Vahlne and Nordstrom, 1988: p.262). But the network is also in permanent change, and the firm's position in it requires constant investment.

Vahlne and Nordstrom (1988: p.262) argued that a successful entry in an international network depends on the firm possessing some specific (e.g. technological) advantage (an Oa-advantage in Dunning's parlance). But once established in the network, the knowledge of the market and the special relationship with suppliers and customers becomes an advantage in itself, allowing the firm to maintain its international position even if the original advantage erodes[20].

According to this approach, internationalisation depends on the firm's network relationships rather than on firm-specific advantages (Coviello and McAuley, 1999: p.227). Henceforth, firms may not internationalise to exploit existing ownership advantages (cf. section 2.3.3). Instead, internationalisation may be the vehicle to access foreign strategic assets that will permit to offset prior deficiencies in the firm's ownership advantages (cf. section 2.3.5 on strategic asset seeking FDI). The network is, in this sense, a facilitating element. Both Fujita (1995) and Gomes-Casseres (1997) found evidence that smaller firms (less likely to possess strong ownership advantages) rely on network linkages to build up their ownership advantages and to gain economies of scale and scope (Chen and Chen, 1998: p.446).

2.4.2. Modes of foreign market servicing

The internationalisation school presented foreign market entry as an incremental process. However, the choice was limited to that between a subsidiary (FDI) and a contractual arrangement (licensee or agent). The latter was expected to precede the former (Vahlne and Nordstrom, 1988: p.258), as well as purely commercial FDI being expected to precede productive FDI. Furthermore, in a process of incremental involvement, joint ventures represent an intermediary stage between contractual arrangements and wholly owned international projects.

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[20] The convergence with Buckley's (1983a) suggestion that multinationality is an advantage in itself (Dunning's Ot-advantages) is obvious.

Buckley and Casson (1976) used a costs-benefits analysis to suggest a very similar international involvement path. Their claim was that, in normal conditions, the fixed costs associated with licensing are lower than those resulting from FDI. They are, however, higher than exports because of the need to guarantee that the licensing agreements are respected by the licensees. Since the opposite happens with variable costs, market servicing tends to follow the sequence: exporting - licensing - FDI. Buckley and Casson (1981) added that the switch in modes of market servicing is also affected by the life-cycle of the product, the firm's familiarity with the foreign market, and the firm's degree of internationalisation.

Rugman (1981) also examined the choice between exporting, FDI and licensing. He was, however, very much concerned with the appropriability problem (Magee (1977a, 1977b) and believed that licensing is a risky modality. "The very existence of the MNE is threatened by premature or otherwise inappropriate licensing" (Rugman, 1981: p.70). Hence, he concluded that licensing will only take place in highly mature industries, which results in that the sequence between the three foreign market servicing strategies will be exporting–FDI-licensing. This negative view of licensing, in particular in the earlier stages of the product cycle, is shared by Vahlne and Nordstrom (1988: pp.258-259).

In fact, it seems that Rugman provided a very detailed analysis of a special case of Buckley and Casson's (1981) model - when one of the modes (licensing) is inefficient[21]. Alternatively, it may be suggested that Buckley and Casson (1976) underestimated the fixed costs associated with licensing. Nevertheless, Rugman (1981: p.74) concedes that the growth of standardised products and a better government regulation are increasing the use of non-equity forms of international involvement (licensing, joint ventures). In other words, better regulation reduces the costs of licensing, increasing its attractiveness at any stage of maturity.

2.4.3. The Investment Development Path

The Investment Development Cycle, or Path, was introduced as a dynamic approach to the OLI paradigm (Dunning, 1981a: p.34). However, contrarily to the eclectic paradigm where the macroeconomic variables are simply one level of analysis, the investment development path is largely a macroeconomic approach (Cantwell, 1991: p.39).

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[21] This possibility is generically discussed by Buckley and Casson (1981: p.80). They also suggested that the choice between foreign market servicing alternatives is affected by the product cycle (p.85).

The investment development path suggests an association between a country's level of development (proxied by GDP *per capita*) and its international investment position (net outward FDI stock *per capita*). The basic hypothesis is that, as the country develops, the conditions facing domestic and foreign companies change. This will have an impact on the flows of inward and outward FDI. However, inward and outward FDI affect the economic structure as well. In other words, there is a dynamic interaction between the two. The IDP also accepts that governments can influence the country's conditions and, consequently, FDI flows and domestic firms' ownership advantages, a notion new to the mainstream theory of FDI.

According to the IDP, countries evolve through five stages of development (Dunning, 1981a, 1981b, 1986b; Tolentino, 1987; Dunning and Narula, 1996b):

Stage 1

The first stage is associated with pre-industrialisation. Countries in this stage will not attract any foreign investment, except probably for a few companies eventually interested in exploiting existing natural resources, but with little or no integration in the national economy. Very small domestic markets, inadequate infrastructure, a poorly educated labour force and undeveloped commercial and legal frameworks are some of the factors that explain this low attractiveness. On the other hand, domestic companies do not possess any significant ownership advantages, and outward FDI will be nil. Dunning (1981a: p.38) suggests that, if they exist at all, O-advantages are probably best exploited through other forms of international contracting (e.g., minority direct investment, portfolio resource flows or exports).

Governments at this stage usually have two sets of actions. They try to improve basic infrastructure and to upgrade human capital; and they adopt macroeconomic policies that are intended to change the structure of domestic markets and industries - import protection and export promotion are two examples.

Stage 2

The combination of national policies pursued by the government will eventually create some location specific advantages. In consequence, inward FDI starts to rise, probably attracted by an emergent domestic market in consumer goods, but also in transport, communications and construction (including public demand in infrastructure). Frequently, this happens in response to tariffs imposed by the government. As in stage 1, export-

oriented FDI will probably exist in natural resources-based industries. Some vertical integration into labour-intensive activities upstream in the value-chain can also be expected if and when basic infrastructure has been provided. Labour-intensive manufacturing and tourism are other sectors likely to attract foreign investment at this stage.

Outward direct investment at this stage will be low, reflecting the scarce ownership advantages of domestic firms. It is likely that existing O-advantages have been developed in industries connected with natural resources or other primary activities that managed to produce semi-skilled and moderately knowledge-intensive consumer goods. Hence, despite its initial low level outward FDI will start to rise as domestic firms engage in market-seeking FDI in (probably less developed) adjacent territories and, more important to the development of their O-advantages, in strategic asset-seeking investment in developed countries.

The domestic government frequently has an active role in inducing these early internationalisation attempts. Dunning (1993a) argues that the combination of domestic and foreign investment that results from the country's improved L-advantages will generate agglomerative economies and increase labour productivity. This will positively affect both domestic firms O-advantages (and decrease foreign firms') and the country's L-advantages themselves. Hence, it is claimed, "in these initial stages of development, the role of government is especially important" (Dunning, 1993a: p.88)[22].

An important characteristic of this stage is that the combination of fast growing inward FDI with only exploratory outward foreign investment will make the country an increasingly net receiver of FDI. Or, in other words, the country's net stock of foreign investment is increasingly negative.

Stage 3

The development of domestic firms' O-advantages and increasing production costs associated with higher wages will translate, sooner or later, into a reduction in the rate of growth of inward FDI and an increase in the rate of growth of outward direct investment. As a result, net inward investment per capita will start to fall. That is, comparative advantages in labour-intensive industries will deteriorate, creating an incentive to search for new less developed locations for these industries. At the same time, stronger O-advantages of local firms make them more able to cope with an increasingly exigent domestic demand

prompted by the rising incomes, and with foreign competition. Larger markets also mean more opportunities for economies of scale, favouring the development of domestic firms' O-advantages. Market seeking outward FDI to both less and more developed countries is also expected, as it is strategic assets-seeking investment in stage 4 and 5 countries.

Furthermore, the changing O-advantages of domestic firms will be decreasingly associated with the home country's specific characteristics or government policies and more with the possession of intangible assets and knowledge by the firms themselves. In other words, O-advantages, at first largely country-specific, will become progressively firm-specific. FDI induced O-advantages, or the advantages resulting from managing and co-ordinating geographically dispersed assets (Ot-advantages), make their appearance. O-advantages also become an active element in the reshaping of the country's L-advantages, side by side with government policies and economic growth. These L-advantages will now be defined by a large domestic market, a growing stock of human capital, and a stronger technology capacity. In response, import-substituting inward FDI will be progressively replaced by efficiency-seeking production.

Dunning (1981a: p.41) still recognises a significant role for governments at this stage. Governments have the tasks of further reducing market imperfections and of encouraging a deeper integration between domestic and foreign firms. Dunning claims that governments' policies should have two distinct aims. On the one hand, to attract foreign investment to industries where domestic firms are unable of exploiting existing L-advantages. On the other hand, to provide incentives for the internationalisation of domestic firms in those industries where they already possess significant O-advantages and the country's L-advantages are weak or eroding. This may mark the beginning of the country's international investment specialisation. In any case, "structural adjustment will be required if the country is to move to the next stage of development" (Dunning and Narula, 1996b: p.6).

Stage 4

Countries in stage 4 are those that became net outward investors, with outward FDI still growing faster than inward FDI. It means that domestic firms now possess the ownership-advantages to compete in any domestic or foreign market. They grew in size and they diversified both geographically and in terms of industries. At this stage, Ot-advantages,

[22] Dunning (1993a: p.88) cites also Porter (1990) and Ozawa (1989).

those resulting from multinationality, are far more important than Oa-advantages. Production processes are capital and knowledge intensive. The reasons to engage in outward FDI will also diversify. In labour-intensive industries, domestic firms will continue to engage in efficiency-seeking FDI in (less developed) countries with lower wages. Outward investment to overcome trade barriers will be found in countries in any stage of development. Rationalised and strategic asset-seeking investment in other countries in stages 4 and in countries in stage 5 will take place in innovatory industries.

Following a tendency felt since the very first stages of the IDP, the country's L-advantages are now almost entirely based on created assets. Consequently, inward FDI will include market- and asset-seeking direct investment from countries in lower stages of development, but it will mostly be rationalised and strategic asset-seeking investment from other stage 4 countries. Intra-industry production is a consequence of the growing similarity in the O-advantages of firms from countries at this stage, and it generally follows prior growth in intra-industry trade. In part, it translates the increasing propensity by MNEs to internalise trade and production (Dunning and Narula: 1996b: p.7).

At this stage, the role of government has changed. It still concentrates on improving market efficiency and reducing transaction costs. However, and more importantly, governments begin to take a more strategic intervention in supporting infant industries and reducing the economic and social impact of eliminating declining industries.

Stage 5

The existence of a fifth stage of the IDP to include the leading developed countries was first suggested by Dunning only in 1986 (Dunning, 1986b: pp.30-31). It resulted from the difficulty to explain the convergence and balancing of FDI stocks in most developed countries since the middle 1980s. Despite permanent high stocks of both inward and outward FDI, the net outward investment (NOI) position of stage 5 countries will revolve around zero, alternating between positive and negative balances according to the short term evolution of exchange rates and economic cycles.

Dunning (1986b)[23] suggests that this is the combined influence of economic and technological convergence among the leading developed countries with the tendencies already described in stage 4: countries' L-advantages are increasingly associated with created assets, and firms' O-advantages are more transactions-based and less assets-based.

As a result, cross-border trade and investment are essentially conducted inside the MNEs. International investment flows of any country in stage 5 will be more dependent on the strategies of its MNEs and of MNEs from other countries in stages 4 and 5 than on differences between the countries themselves (which are very few anyway). These MNEs will increase their commitment to rationalising their international production networks (which they certainly started in previous stages) with investment in other developed (stages 4 and 5) countries. They will also continue to direct FDI to less developed countries, mostly in natural resources and labour intensive industries. At the same time, stage 5 countries will be the recipients of market-seeking and strategic asset-seeking investment from countries in lower stages of development.

It should be noticed that it is implicit in the description of stage 5 that no single country has an advantage over the other developed economies. MNEs, alone and independently of the domestic or host country's location advantages, are the dominant force in shaping international production and trade. MNEs increasingly behave like "mini-markets" (Dunning and Narula, 1996b: p.8) and to some of them the whole concept of home country is becoming meaningless, as they transform themselves from Multinational Enterprises into Transnational Corporations.

Governments, nevertheless, retain a role in the dynamic economic restructuring. Buckley (1996b: p. 2) suggests that "a fundamental role of government is to seek to appropriate some of the rents earned by transnational firms". As firms assume a greater importance in shaping the world economy, national governments are increasingly assuming the role of strategic oligopolists. They must take into account the behaviour of MNEs, but also that of other governments (Dunning and Narula, 1996b). Inevitably, some governments will be more able to play the dual oligopolistic game than others.

2.5. Conclusion

It is clear from the above review that different approaches to international business resulted in a wide ranging body of literature. The reasons why individual firms engage in international activities are the centre concern. And the key seems to be market imperfections, which prompt companies to internalise cross border activities. In many respects, this is not very different from what firms do inside national borders. As such,

[23] See also Dunning and Narula (1996b: pp.7-9).

internationalisation can be seen as just another dimension of the growth of the firm (Buckley, 1993b). Nonetheless, this is a dimension unlike the others. On the one hand, countries differ in their legal, political and cultural characteristics, which generates a whole set of managerial problems. On the other hand, multinationality changes the very nature of the firm, and can be in itself a source of competitive (*ownership*) advantages[24].

The issue of change, or the intrinsic dynamic nature of the internationalisation process, was of particular appeal to the Scandinavian school. As any disadvantage faced by any firm, those associated with doing business in a foreign country are neither permanent nor universal. Internationalisation is a learning process. It can be managed through a process of progressive commitment of resources, starting in more familiar countries and moving to ever more distant ones. If the internalisation of ownership advantages explains why MNEs exist at all (Dunning, 1991), only this dynamic approach to internationalisation can describe the process of the development of a multinational corporation.

However, in order to understand the way international production is organised worldwide a last critical element is needed. And that is the importance of locational factors. Only the interaction between the internalisation of ownership advantages with location advantages can explain the configuration of MNEs' activity worldwide. This seems to be a description of the eclectic paradigm (Dunning, 1979), except that it cannot be dissociated from the dynamic elements of the investment development path (Dunning, 1981a, 1981b, 1986b).

The aim of this research project is to analyse the competitiveness of Portugal from the perspective of the country's position in the international production network. From what was described above, this will entail the investigation of the locational advantages associated with foreign and domestic firms operating in Portugal, as well as the process of internationalisation of domestic firms. The eclectic theory and in particular the investment development path will constitute an appropriate framework of analysis.

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[24] That the geographic distribution of the firm's activities can be in itself an ownership advantage was recently restated by Dunning (1998a).

CHAPTER 3.
EMPIRICAL EVIDENCE ON THE DETERMINANTS OF FOREIGN DIRECT INVESTMENT

3.1. INTRODUCTION

The task of reviewing the empirical investigation of the determinants of FDI is not an easy one. The existence of competing theories (see previous chapter) and the very broad characteristics of countries and markets originated a wide range of methodologies and levels of analysis that are frequently difficult to compare (Dunning, 1993a). The variety of the researchers' interests also contribute to the diversity of empirical approaches to international business activity.

The 1950s and, in particular, the 1960s marked the first attempts to explain FDI[1]. Due to the limitations faced by researchers, these were essentially surveys or case studies. First, the theoretical body of knowledge, still dominated by the neo-classical school, provided little a priori insight into the determinants of FDI. Second, statistical analysis was at the time restricted by very limited computing capacity. Third, data on FDI was rare or did not exist at all. It is symptomatic that Dunning (1973) engaged in a discussion of measurement issues before embarking on a survey of the existing theory.

[1] See Dunning (1973) for a survey of these early studies.

A much more relevant stream of research was the one led by Raymond Vernon in the late 1960s[2]. Very much concerned with testing the product cycle hypothesis, these investigations expanded existing theory while collecting valuable data on MNEs and on FDI flows and stocks. The work of the 'Multinational Enterprise Project' was continued by many other surveys that since the 1970s have been trying to identify the determinants of FDI and of the growth of MNE activity. The development of new statistical techniques was, naturally, of great support.

Although several limitations to the explanatory power of surveys remained, these studies permitted to identify important issues, many now considered 'evident'. One such idea was that ownership specific advantages are very much culture specific. MNEs that operate in different industries but which are from the same country seem to share many O-advantages (Dunning, 1990). In other words, even if O-advantages should be, by definition, firm specific, they are inevitably influenced by locational factors. Another element identified to be relevant in the shaping of O-advantages is the degree of multinationality. This includes the MNE's age and the number and cultural variety of countries in which it is present (Archer, 1986). Location advantages, on the other hand, were identified as largely industry specific.

The type of FDI was the other main defining element (Dunning, 1993a: p.143). Political stability, an appropriate institutional and legal framework, and good infrastructure seemed to be relevant for every kind of investment. However, determinants like market size and growth were identified to be critical for market seeking investment but largely irrelevant for resources or efficiency seeking FDI. The role of the host government, including tax and other fiscal incentives, on the other hand, was held to be essentially associated with efficiency seeking investment (e.g. McAleese, 1985). Technology and highly sophisticated markets were considered important in explaining efficiency seeking investment in the most developed countries (Dunning, 1993a). However, this is probably better classified as strategic asset seeking investment.

Internalisation elements were less frequently identified. Nevertheless, Archer (1986) and Ozawa (1989)[3] concluded that the need to control strategic inputs was frequently

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[2] Dunning (1993a: p.138) cites a number of articles associated with the 'Multinational Enterprise Project' that Vernon led: Aharoni (1966), Hufbauer (1966), Hirsch (1967), Gruber, Mehta and Vernon (1967), Keesing (1967), contributors to Wells (1972), and Knickerbocker (1973).

[3] Cited in Dunning (1993a: p.145)

associated with FDI. The immediate reason could be to assure a stable supply or to bar the access to competitors. Another determinant was to control the relationship with the final clients (Buckley and Mathew, 1979). Yet another reason was the fear that a licensee would turn into a competitor (Archer, 1986) or that it was not sufficiently efficient (Dunning and Norman, 1987). Economies of common governance associated with FDI were also frequently identified in the literature (Dunning and Norman, 1987; Dunning, 1993b).

3.2. US INVESTMENT IN THE EEC

The progressive improvement in the quality and availability of data on FDI since the end of the 1960s permitted the development of an increasing number of econometric studies. Not surprisingly, American investment in the EEC concentrated the researchers' attention for many years (Scaperlanda, 1967; Bandera and White, 1968; Scaperlanda and Mauer, 1969; Goldberg, 1972; Schmitz and Bieri, 1972, Lunn, 1980; Scaperlanda and Balough, 1983). Two main hypotheses dominated these studies: tariff discrimination and market size, actual and potential.

The tariff discrimination hypothesis is of neoclassical origin (Mundell, 1957). It was among the most frequently cited variables in survey studies. However, the evidence from research on US investment in the EEC was not absolutely conclusive. Schmitz and Bieri (1972), Lunn (1980) and Scaperlanda and Balough (1983) found tariff discrimination to be important. Scaperlanda and Mauer (1969) did not find it statistically significant. Goldberg (1972) and Culem (1988) obtained inconclusive results[4].

In a much more recent study of US investment in Europe, Clegg (1996: p.193) suggested that, in the presence of imperfect markets, the impact of protectionism may be more subtle than suggested by the level of external tariffs. The process of creating a customs union is likely to increase discrimination against non-EEC producers, even if external tariffs are not increased (or have been reduced through GATT negotiations, as has been the case). Clegg (1996) concluded that this 'relative discrimination' is better supported by the data than the absolute level of tariffs.

The market size hypothesis also derives from neoclassical theory - Jorgenson's (1963) model of domestic investment. It was introduced in the studies of the determinants of FDI as a location variable associated with economies of scale (Scaperlanda and Mauer,

[4] Culem (1988: p.894) attributed his unexpected results to the presence of multicollinearity.

1969: p.560) and, thus, market imperfections. It assumes two levels: the absolute size of the market, and its growth rate.

Despite the strong theoretical sense of the claim, the empirical support is apparently inconclusive. Studies that used data prior to the first enlargement of the EEC, when new investment was dominant (Bandera and White, 1968; Scaperlanda and Mauer, 1969), found market size significant, but not market growth. The opposite was found by Culem (1988) with more recent data[5]. Nevertheless, the results of Schmitz and Bieri (1972), Lunn (1980) and Scaperlanda and Balough (1983) support both hypotheses.

Clegg (1995) tested both variables with data for a 40 years period (1951-1990). The aggregate data produced very poor results. However, after dividing the period of analysis there was strong support for the market size hypothesis in the period 1951-72, and for the market growth hypothesis in the period 1973-90. In other words, new investment seems to be associated with market size, while expansionary investment is responsive to market growth.

Other variables were occasionally found to be associated with US FDI in the EEC. Exchange rates were supported by Scaperlanda and Balough (1983) and Lunn (1983). Clegg (1995), however, did not find them significant, which was explained with the expected long run impact of exchange rates on international investment. Cultural links (between the US and the UK) and prior exports were found by Culem (1988) to be relevant. Clegg (1995) found relative interest rates significant for US investment in the EEC, although the relationship was stronger in the 1950s and 1960s than in the next two decades. This contradicts Culem's (1988) results, which reported only to the second period of Clegg's research[6]. Clegg also found expected changes in interest rates to be significant in the first of those periods, but not in the second. He believed that floating exchange rates, imposed in 1973, may have reduced the chances to arbitrate between home and host country.

Few of the investigations of the determinants of US FDI in the EEC covered labour costs. Since market seeking was the dominant motivation, labour variables could eventually be expected to be secondary. One exception was Culem (1988), who tested the relevance of

[5] In the same study, Culem (1988) found European investment in the US (mostly first time investment) to be related to the size of the market but not to its growth

[6] Surprisingly, a regression for the full period found the variable not to be significant, which suggests caution in the interpretation of Clegg's result.

absolute and relative labour costs, both corrected for differences in productivity. He found none to be significant for US investment in the EEC, despite being positive for intra-EEC FDI. A different result was obtained by Clegg and Scott-Green (1998). They found labour costs negatively associated with US FDI in the EEC (EC12). However, when they divided their data into three groups of countries according to the respective level of development, labour costs were only significant for the poorer countries (Greece, Portugal, and Spain), and positively signed. Their suggestion was that US FDI was attracted to regions with low wages, but inside these sub-regions locations with higher labour skills (proxied by higher costs) were preferred.

3.3. THE DETERMINANTS OF FOREIGN DIRECT INVESTMENT

The study of US investment in the EEC is simplified by the homogeneity of the phenomenon analysed. The hypothesis tested is that FDI is attracted by a large and growing internal market protected to some extent by trade barriers. Other empirical studies of the determinants of FDI have a far more complex task. Differences across countries of origin and destination, and between industries make the development a consistent model particularly difficult. Still, a substantial amount of research on the determinants of FDI in developed and developing countries alike was produced in the last twenty years. They vary widely in the objectives, countries and period covered, underlying theory (many totally lack one), and level of analysis. As a result, a wide number of hypotheses and potential determinants were tested.

3.3.1. DOMESTIC MARKET

As seen above, the potential impact of the domestic market on FDI derives from neo-classical theory. A big domestic market permits the exploitation of economies of scale, which is likely to increase the attractiveness of FDI vis-à-vis alternative forms of internationalisation. Empirical evidence of the relevance of the host country's market as a determinant of FDI was recurrently found in survey studies and in the investigation of US FDI in the EEC (see above). Naturally, all the subsequent econometric tests of the locational determinants of FDI included the domestic market as an independent variable. Most found it to be significant.

Several proxies for the relevance of the domestic market are available. Market size is normally measured by total GDP, as in most studies of US investment in the EEC. Private

and public consumption can be used as alternatives (Lucas, 1993). GDP per capita is a common proxy when the relative level of sophistication of heterogeneous local markets is at stake. As for market potential, real GDP growth rate or population can be used. The latter is less frequent because of the limitations associated with overlooking the economic data[7].

Interpretation of the results, however, must be undertaken carefully. GDP per capita, for example, is normally correlated with the level of skills of the workforce. This implies that without a properly specified model it may be impossible to know if the variable is measuring the sophistication of the domestic market or the quality of the labour force. Another example results from the correlation between GDP and exports. Access to big export markets can be a location advantage in itself (see next sub-section). But exports and GDP tend to be correlated (not least because exports are one of the components of GDP), which can generate multicollinearity if the two variables are used simultaneously (an empirical limitation frequently ignored). Lucas (1993) avoided multicollinearity with the use of private and public consumption instead of GDP.

Another difficulty is that foreign direct investment is itself a source of growth. If FDI flows have an expansionary effect in the economy, the econometric test may take the cause for the effect. In fact, the likelihood is that there will be a bi-directional effect between FDI and GDP, which can only be appropriately modelled by a system of simultaneous equations (O'Sullivan, 1993).

3.3.2. Export Markets

Most of the empirical evidence of the attractiveness of export markets to FDI is indirect. The importance of export markets is implicit in the observation that FDI grew steadily in Europe after the announcement of the creation of the EEC, in the 1950s, and that of the 1992 Internal Market. The same can be concluded from the findings of Root and Ahmed (1979) that economic integration is a significant variable among developing countries[8].

More direct approaches were used by O'Sullivan (1993) and Lucas (1993). O'Sullivan (1993: p.141) based his model on the fact that in the period studied (1960-80) foreign

[7] Taveira (1984) found it to be a significant determinant of inward FDI in developing countries but not in the developed countries.

[8] In the period covered by Root and Ahmed's study (1966-70), Latin America was the most economically integrated developing region, and also the one attracting more FDI. The results would certainly be very different today.

investors in Ireland exported over 80 per cent of their non-food output. Since the United Kingdom was the destiny of a big percentage of these exports, export markets were proxied by the UK's real GDP. It was found strongly significant. Lucas (1993) used an index of foreign GDP to assess the importance of export markets in attracting FDI to the export oriented countries in East and Southeast Asia. He concluded that FDI was more responsive to foreign markets than to the home market despite being both significant.

Adopting a different level of analysis (the firm rather than the country), Caves *et al* (1980) and Saunders (1982)[9] found a positive relationship between the export propensity of Canadian-based firms and inward FDI. Access to the Commonwealth preference schemes might have been a major motivation for the investing firms, most of which were from the US.

The degree of openness was found by Kravis and Lipsey (1982) to be a significant determinant of the location of export oriented investment by US MNEs. The variable was introduced as a proxy for the price of material inputs - the more open the economy the lower the price. However, a high degree of openness also represents important export markets. Which of the two effects the variable was really measuring is hard to identify.

3.3.3. Government policies and protectionism

The potential of export markets is very much linked with economic policy. Of particular importance is the option between protectionist and outward looking policies. There is abundant empirical support for the claim that export orientation attracts FDI (Riedel, 1975; Kravis and Lipsey, 1982; Hein, 1992; Dollar 1992; Lucas, 1993; Jun and Singh, 1996). MNEs are attracted to export-oriented countries, on the one hand, because of the export potential *per se*, and, on the other hand, because export-oriented countries have better economic records, suggesting a more stable economic an social climate, and eventually more attractive domestic markets.

There is, however, a clear contradiction between these results and the tariff discrimination hypothesis discussed above for the studies of US investment in the EEC. The suggestion was that FDI can be encouraged by barriers to trade (Schmitz and Bieri, 1972; Lunn, 1980; Scaperlanda and Balough, 1983). This was also the conclusion reached by Horst (1972) for US investment in Canada, by Lall and Siddarthan (1982) for inward FDI in the US, by

[9] Cited in Dunning (1993a: p.166)

Wheeler and Mody (1992), for US investment across the world, and by Jeon (1992), who found a dummy variable representing non-trade barriers to be a significant determinant of Korean FDI in developed countries.

A number of factors help to explain the contradicting results associated with protectionism. Market imperfections and 'relative discrimination' (Clegg, 1996) between foreign and domestic firms vary widely across industries and countries, making the results particularly sensitive to sample and methodology. Furthermore, protectionism often coexists with export orientation. Protected economies can attract export-oriented FDI by opening selected industries to FDI or by creating export processing zones.

In any case, barriers to trade tend to be significant only when market seeking is the main motivation of FDI. When that is not the case, protectionism becomes less important. Moore (1993) did not find evidence that German FDI was induced by tariffs in the host countries. Similarly, Kumar (1990) concluded that protection was not a determinant of investment in India. Dunning (1993a: p.165) mentions that Agodo (1978) obtained the same result for US investment in Africa.

3.3.4. Government incentives

The incentives given to foreign investors represent another important element of government policy. This is a determinant of FDI frequently cited in surveys (Robinson, 1961; Forsyth, 1972; Andrews, 1971; all cited in Dunning, 1993a). The relevance of government incentives was equally acknowledged by McAleese (1985). It is a fact that an increasing number of countries are taking part in 'location tournaments' (David, 1994), competing programs of incentives designed to attract multinational firms. This includes developed and developing countries alike, often due to an imitation effect. However, it was the opinion of UNCTAD (1998: p.104) that incentives are not a relevant determinant of inward FDI. They are much more likely to influence the precise choice of location within a country or region once the investment decision has actually been made.

Government incentives are difficult to quantify. There is a huge variety of packages that governments can provide. The incentives they include are frequently confidential, indirect (the building of specific infrastructure, cooperation in training schemes), differed in time (tax reliefs), or simply impossible to measure (preferential access to the domestic market, favourable legislation). Probably as a result of that, regression analysis of the importance of government incentives failed to produce the expected results. Kumar (1994) found

incentives less successful than export processing zones. Lim (1983) and Wheeler and Mody (1992) concluded that they were no substitute for good infrastructure, natural resources, or an expanding domestic market. Tsai (1991) and O'Sullivan (1993) claimed that government support was not a significant determinant of FDI in Taiwan and Ireland, respectively, in spite of massive programs to attract FDI[10].

3.3.5. Natural Resources

Until World War II the exploitation of local resources was the main reason why firms engaged in FDI (Dunning, 1993a). Since then, the characteristics of foreign direct investment changed substantially, but the possession of natural resources can still be an important determinant. Developing countries in particular, often have to rely on their endowed resources to compensate for very low levels of created assets. But natural resources are also very important for the economy of developed countries such as Canada or Australia.

Dunning (1981a: p.44) demonstrated the impact that natural resources have in the expected pattern of FDI. For any level of development, resource-rich countries receive consistently higher levels of foreign direct investment. On the other hand, scarce natural resources can be a push factor to the internationalisation of domestic firms, transforming the country into a net foreign investor at early stages of development.

Given this, it should be expected that most econometric studies of FDI, in particular those concerning developing countries, include some proxy for the possession of natural resources. Surprisingly, this is not the case. The influence of the original studies of US investment in the EEC, which understandably ignored natural resources, can be part of the explanation.

Among those that included natural resources, the results are mostly supportive of their relevance to inward FDI. Owen (1982) found a dummy variable representing natural resources intensity a significant determinant of FDI in Canada. This is consistent with the results of Buckley and Dunning (1976), who found a similar variable not significant for the UK. Taveira (1984) studied the determinants of US investment in two sets of developed and developing countries and found the percentage of primary commodity exports in total

[10] O'Sullivan (1993) acknowledges that the variable used may not appropriate all the support effectively provided to foreign firms by the Irish government. Lim (1983) was equally critical of the data available to him.

exports to be significant in both cases. Lim (1983) obtained similar results with the share of minerals in total exports in 27 developing countries. Contradicting results were obtained by Root and Ahmed (1979) for the ratio of raw materials exports to GDP, but they excluded extractive FDI from their study, which certainly influenced the findings.

3.3.6. Labour Costs

The importance of labour costs as a determinant of FDI is almost self imposing. Contrarily to capital and technology, labour has very low mobility. Therefore, MNEs can reduce production costs by transferring the more mobile production factors to areas where labour is cheaper. Usually this implies moving operations from developed to developing countries, but can also involve rationalisation investment among developed countries.

The evidence obtained from the literature, however, is not absolutely conclusive. In the case of investment among developed countries labour costs were normally found to be irrelevant. Some examples are Buckley and Dunning (1976), Owen (1982), Gupta (1983), Dunning (1980), Taveira (1984), or Culem (1988). A different conclusion was, nevertheless, reached by Caves *et al* (1980) and by Saunders (1982). Both studies found wages a significant determinant of US investment in Canada.

When developing countries were included in the sample, the relevance of labour costs tended to increase. This was the case with Schneider and Frey (1985), despite wages being less important than the level of development or the balance of payments, Lucas (1993), and Kumar (1994). Jeon (1992) found that increasing domestic wages at home were associated with Korean FDI in developing countries. Riedel (1975) and O'Sullivan (1993) suggested that relative wages were among the most important determinants of FDI in Taiwan and Ireland, respectively. Finally, Flamm (1984) concluded that offshore investments were sensitive to labour costs, despite a moderate response to wage changes.

Two exceptions to this were Kravis and Lipsey (1982) and Wheeler and Mody (1992). Neither of the studies found labour costs to have a significant impact on the location of US subsidiaries in samples that included both developed and developing countries. Kravis and Lipsey (1982) suggested that labour skills, which were not accounted for in the model, could be the reason for the unexpected result. Wheeler and Mody (1992) provided a different interpretation. Their results suggested that, as the national income increases, market size offsets the importance of labour costs as a location factor - the loss of one

location advantage is compensated by improvements in the other, which invalidates the regression analysis.

One problem associated with measuring labour costs is whether they should be corrected for differences in productivity. There are arguments in both directions. On the one hand, differences in labour costs reflect to some extent differences in productivity, which implies that the correction should be made. On the other hand, MNEs can obtain high levels of productivity anywhere in the world with the transfer of managerial and organisational skills alongside capital and technology. Due to differences in culture and labour skills, productivity levels are still likely to differ between similar plants of one MNE. But the differences can be expected to be much smaller than between national averages.

As Dunning (1958: p. 135) demonstrated for US firms in the UK, foreign subsidiaries tend to have higher productivity levels than their domestic counterparts. Productivity differences can be expected to be particularly high in less developed countries, precisely where the wage differences ought to be bigger. This would explain why MNEs tend to pay wages above the national average. According to The Economist (2000b: p.19) wages paid by foreign firms in Turkey, for example, are more than twice the national average. Even in the US foreign firms pay more than domestic ones: 4% in 1989; 6% in 1996 (The Economist, 2000a: p.87), even if in this case productivity differences may not be the main explanation.

Another important factor is that firms probably base their decision in relative rather than absolute labour costs. But to find the appropriate benchmark is not easy. Differences between home and host countries are the most immediate solution. However, the comparison with alternative locations is equally important (Tsai, 1991). Lansbury et al (1996) used two alternative measures to test the determinants of FDI in Central and Eastern Europe. (i) Relative labour costs between the countries studied[11]. (ii) The ratio of each country's labour costs and those in Portugal and Spain (considered the main competitors for FDI). The latter seemed to produce stronger results.

Finally, there is the impact of previous experience to be considered. The presence in a particular labour market represents valuable information in terms of human resources management and the estimation of future costs. Therefore, when considering alternative investment locations, the firm can be expected to favour countries where it already has

[11] The Czech Republic, Hungary, Poland and Slovakia.

operations, unless the wages differentials are very high. Tu and Schive (1995) found that MNEs that first invested in Taiwan in the period of low wages were still investing in Taiwan in the 1990s. However, the size of individual projects had been negatively affected by labour costs, and most labour-intensive investments had been relocated overseas.

3.3.7. Labour Skills

A highly skilled workforce was one of the product cycle explanations for US leadership in innovative products. Labour skills were also associated with other countries' imitation ability, and even in mature industries minimum skills are required to obtain a productivity level that allows economic production. As with other determinants, however, measurement difficulties frequently discourage researchers. Taveira (1984) and Schneider and Frey (1985) used the percentage of population in secondary education, but found no evidence of its significance. This variable is, however, too aggregated and is probably no more than an indicator of the level of development.

In fact, school attendance is unlikely to be the relevant element. March (1988) extracted a sample of 200 British men from the General Household Survey of which 41 per cent had no qualifications and a further 10 per cent had only an apprenticeship. However, only 3.5 per cent were classified as unskilled manual workers. This suggests that even in the presence of low levels of formal education, the existence of an industrial tradition, for example, may lead to reasonable productivity levels with low training costs.

Most support for the relevance of labour skills is, in fact, indirect. Swedenborg (1979) was surprised by a positive relationship between the wages of foreign Swedish subsidiaries and FDI. Her suggestion was that high wages simply reflected the skills of foreign workers (Dunning, 1993a: p.164). Lall (1980)[12] and Kravis and Lipsey (1982) made a very similar interpretation of their results regarding labour costs, while Lansbury *et al* (1996) concluded that MNEs were attracted to Central and Eastern Europe by labour skills as much as by labour costs.

At the firm or industry level, the investigation of the role of labour skills is much simpler. Lall and Siddarthan (1982) tested both total remuneration and the proportion of non-production workers in the labour force as determinants of inward FDI in the US. Neither

[12] "Monopolistic Advantage and Foreign Involvement by US Manufacturing Industry", *Oxford Economic Papers*, vol. 32: pp. 102-122.

was significant, which is consistent with the fact that foreign investment in the US is likely to be predominantly market or strategic asset seeking.

3.3.8. Physical and Cultural Proximity

Physical distance is frequently presented as a proxy for transport costs (e.g. Dunning, 1993a: p.166). Because they increase the costs of exporting from the home country, transport costs may induce horizontal FDI. Nevertheless, they increase the costs of intra-firm co-ordination and input transfers, which restricts vertical FDI. Physical distance is also a good proxy for cultural or psychic distance, which the Scandinavian (or internationalisation) School proved to have a strong impact on FDI (see chapter 1).

The development of the internationalisation theory (Johanson and Wiedersheim-Paul, 1975; Johanson and Vahlne, 1977; Johanson and Mattsson, 1988; Vahlne and Nordstrom, 1988) was essentially inductive. Its development was based on evidence from small samples of Scandinavian firms. But the same conclusions were reached by Davidson (1980), for example, with a much wider sample. Moreover, Taveira (1984) found US investment in both developed and developing countries to be negatively affected by physical distance. Grosse and Trevino (1996) identified an association between physical and cultural distance and investment in the US. Veugelers (1991) concluded that a shared language and neighbourhood increase FDI. The latter was equally supported by Moore (1993). Papanastassiou and Pearce (1990) found dummy variables for EC and Commonwealth countries positively related to UK investment but a negative association with physical distance. Previous levels of bilateral trade were identified by Lansbury *et al* (1996) to be a determinant of FDI in the US.

3.3.9. Political risk

Political instability reduces a country's attractiveness as a location of FDI. Political events can disrupt the economic order, eliminate markets or even put past investment at risk, as in the case of nationalisation of foreign owned assets. Even in less radical situations investment is likely to suffer, because instability makes it difficult to predict cash flows. Not surprisingly, political risk is normally identified in survey studies to be at the top of managers' concerns (Tu and Schive, 1995; Akhtar, 1999).

However, econometric studies frequently fail to establish a relationship between political risk and FDI flows (e.g. Chase et al, 1988; Flamm, 1984). Tu and Schive (1995) combined

survey analysis with econometric testing to conclude that political stability and social order are, in general, preconditions for FDI, but have little influence on the amounts invested. This is consistent with Lucas' (1993) suggestion that events which generate political instability (e.g. Marcos' martial law in the Philippines, Park's assassination in South Korea) do reduce FDI, but have a short run impact[13].

Another difficulty to the political risk hypothesis is that firms' assessment of political risk depends on the country of origin, the managers background, or the timing of investment. Tu and Schive (1995) were surprised by the fact that foreign firms' perception of political instability in Taiwan varied widely with the year of first investment in the country. Furthermore, a country with a record of political struggle and social unrest but ruled by a "friendly" government can be an attractive location. Schneider and Frey (1985) found political aid received from Western countries and the World Bank to have a strong positive effect on FDI in developing countries, while aid received form the Communist block had a negative impact. Political instability had, nevertheless, a significant negative impact.

The composition of their investment portfolios may also influence firms' attitude towards the risk associated with individual countries, since geographically diversified firms can dilute individual risks (Cosset and Suret, 1996; Butler and Joaquin, 1998). Moreover, a portfolio balancing effect may even incentive firms to invest in countries with relatively high political risk. This was, for example, Flamm's (1984) finding for the semiconductors industry. His subjects openly admitted scattering production facilities across a broad range of countries as a protection for potential political disruptions in one location[14].

3.3.10. Exchange Rates and Balance of Payments

The eventual importance of exchange rates to the location of FDI was first suggested by Aliber (1970). His argument was that the existence of different currency areas would generate FDI flows (see chapter 2). He considered that "the greater the fixed capital stake of an investment, the more important it is to take account of possible movements in future exchange rates" (Dunning, 1993a: p.62). A model that explains the impact of exchange rates volatility on location decisions of MNEs was provided by Goldberg and Kolstad

[13] Lucas (1993) also found that "good news", such as the Olympic Games in South Korea or Acquino's succession in the Philippines, have a positive short term impact on FDI.

[14] In the previous chapter it was shown that the risk diversification hypothesis (Rugman, 1975, 1979; Lessard, 1976) does not hold as a general theory of FDI. It seems to be, nevertheless, one of many factors that can influence the investment decision.

(1995). All this helps to understand why exchange rate fluctuations are frequently cited in survey studies.

To measure the risk associated with international capital markets, Schneider and Frey (1985) included the deficit of the Balance of Payments in their 'politico-economic' model. A bigger deficit means a higher risk that restrictions to free capital movements will be imposed. They obtained a very significant negative relationship between the deficit of the Balance of Payments and the level of FDI. Similarly, Lucas (1993) found a positive association between FDI and the level of foreign reserves, which suggests that foreign investors are sensitive to the risk of currency devaluation. O'Sullivan (1993) claimed that exchange rate risk contributed significantly to explain FDI in Ireland. And Grosse and Trevino (1996) suggested that exchange rates were one of the most significant factors in explaining FDI in the US.

Contradicting results, however, were obtained by Moore (1993) who found no evidence that German investors favour countries with fixed exchange rates with the deutsche mark. Moore, however, used membership of the ERM as a proxy dummy variable, which overstates the risk associated with currencies that are not members but follow the movements of the participating currencies.

3.3.11. Industrialisation and Infrastructure

Good infrastructure is generally identified as a determinant of any type of FDI by survey studies. As for industrialisation, its importance results from the more structured economic life that accompanies it, and from the informal skills embodied in the labour force that result from a tradition of industrialisation. More industrialised countries also attract more technology intensive investments and, eventually, strategic asset seeking FDI.

Root and Ahmed (1979) used the ratio of manufacturing output to GDP as a proxy for industrialisation in their study of developing countries, but concluded it was not a significant determinant of FDI. Taveira (1984), on the other hand, found the level of industrial development to be a significant determinant of FDI in developed and developing countries alike, although more so in the latter than in the former. Wheeler and Mody (1992) also found the level of industrialisation strongly significant in both groups of countries. However, in the case of developing countries it was less relevant than the quality of infrastructure.

Infrastructure, on the other hand, seemed to be the element associated with two of the determinants of manufacturing FDI in developing countries identified by Root and Ahmed (1979): the ratio of commerce, transport and communication to GDP, and the extent of urbanisation. As mentioned above, the quality of infrastructure was also identified as the main determinant of US FDI in developing countries by Wheeler and Mody (1992). It was irrelevant in the case of developed countries. Kumar (1994) used a combined approach. His variable 'industrial capability' was built to capture skilled manpower and quality of industrial services and infrastructure. The corresponding coefficient was strongly significant, with a positive impact on the relocation of US production abroad.

This evidence suggests a conclusion very similar to that obtained for other determinants (e.g. political risk). The quality of infrastructure (or its absence) can be a deterrent of FDI - low levels of infrastructures can substantially increase operational costs. But once a certain level is attained its influence is likely to disappear.

3.3.12. Ownership and internalisation determinants

The test of the ownership determinants associated with FDI is more difficult than that of the location variables discussed above. Ownership advantages are to a great extent firm specific, but are also influenced by industry and country (Dunning, 1993a: p. 142). Two examples are Australian firms' ability to adapt foreign technology to small markets (Parry, cited in Dunning, 1993a: p.143), or the capacity of US MNEs to exploit large and fairly homogeneous markets (Dunning, 1993a: p.142). Other examples are those ownership advantages that are rooted in the culture of the home country. This is the case of some of the O-advantages of Japanese MNEs pointed by Dunning (1993a: p.143), such as their approach to human resource management or the role of Kievetsu-type relationships in reducing market failure.

In any case, country specific O-advantages can often be tested indirectly, because they frequently represent location advantages as well. One example is technological capacity, which was found by a number of studies to be a significant determinant of FDI by US MNEs (Dunning and Buckley, 1976; Lall, 1980; Owen, 1982; Pearce, 1989). This ownership advantage clearly resulted from the conversion of the home country's technological leadership, itself a significant locational determinant for inward FDI (Kogut and Chang, 1991; Ajami and Ricks, 1981). Other examples of asset based ownership (Oa)

advantages that can be tested indirectly are knowledge capital, financial asset advantages or natural resources availability. Evidence of their relevance as determinants of FDI was summarised by Dunning (1993a).

A different case is that of determinants such as the capacity for product differentiation or transaction ownership (Ot) advantages in general (e.g. economies of plant or firm size, oligopolistic behaviour, or the length of time involved in international production). Although less easy to test, there are substantial evidence in support of their role as determinants of FDI (cf. Dunning, 1993a).

As for internalisation determinants, these are largely the result of ownership advantages, depending exclusively on the decision of whether to trade them in the market. Dunning (1993a: p.145) suggests that few studies looked at the reasons behind the decision between FDI and licensing or other forms of non-equity involvement. The role of government seems to be of particular relevance in this decision (Contractor, 1984; Davidson and McFetridge, 1985; Kumar, 1990[15]). Technology was another element identified in the literature to be associated with the licensing option (Dunning, 1993a: p.167). Internalisation seems to be negatively associated with the technological capacity of the home country (Contractor, 1984), as well as with the technology's age, the industry's R&D intensity, or the licensor's previous experience in the licensing of technology (Davidson and McFetridge, 1985).

3.4. SUMMARY

Despite evidence of the importance of all the determinants of FDI analysed in this chapter, it was clear that the determinants could not all be simultaneously relevant. It was implicit in the survey (and sometimes explicit) that the relevance of each determinant depended on the home and host countries, industry characteristics, and the type of FDI being analysed.

The size and growth rate of the domestic market, as well as high levels of protectionism, were relevant variables for market seeking FDI. Investment attracted by a location's preferential access to specific export markets may also be considered as market seeking. In this case, however, variables associated with efficiency seeking investment, such as labour costs and skills, and government incentives were equally relevant. As for strategic asset

[15] All cited in Dunning (1993a).

seeking FDI, technology, a sophisticated domestic market, a highly skilled workforce, or very specialised infrastructures were all relevant factors. On the other hand, variables such as political and economic stability, an efficient legal framework, physical and cultural proximity, or good infrastructure were relevant for all types of investment.

Historically, variables associated with natural resources were the main determinants of FDI. However, the decreasing importance of natural resources in the post-war world economy, and the emergence of large locally owned firms in newly independent natural resources producers, resulted in a decline in natural resources seeking FDI (see section 2.3.5 and UNCTAD, 1998: p.106). From the end of World War II until the 1970s, market related variables assumed a dominant position, as was clear from the studies of US FDI in the EEC in section 3.2. Also important during the period was cost reducing FDI, for variables such as labour costs (UNCTAD, 1998: p.108).

In more recent years, deregulation and liberalisation gave rise to a process of global integration of national economies as well as of the operations of MNEs (with the latter eventually assuming even greater emphasis than the former). As a result, efficiency seeking and strategic asset seeking FDI became increasingly important motives of FDI (section 2.3.5), which resulted in the growing influence of created assets (e.g. skilled labour and specialised infrastructures) as the locational determinants of foreign investment (UNCTAD, 1998: p.111). In this highly integrated world, the importance of physical and cultural proximity may also increase. Physical proximity and deregulation stimulate the restructuring of MNEs' operations, whilst cultural proximity facilitate the management of cross-border mergers and acquisitions, which may be an incentive to engage in this form of operations.

The survey focused especially on country specific factors. That was due to the aims of the research project it was designed to support, which looks at foreign direct investment from a national perspective. However, it must be borne in mind that firm related factors also play a critical role in the distribution of world FDI, and that role is growing in importance. As seen above, many of these factors are rooted in the location advantages of the firms' country of origin. However, many more resulted from MNEs' ability to tap into the natural or built resources of foreign locations (their ownership advantages). A consequence of the evolution of recent years has been to increase the relevance of the factor. As MNEs

grow larger, multinationality itself and firms' own culture and history, become increasingly important determinants of the location and characteristics of FDI in the world economy.

CHAPTER 4.
FOREIGN DIRECT INVESTMENT AND THE PORTUGUESE ECONOMY

4.1. INTRODUCTION

The poorest member of the European Union as measured by GDP per capita, Portugal is often characterised as a small open economy of recent industrialisation. Unlike most other European countries, it is not possible to speak in Portugal of the modernisation of the economic structures (including industrialisation) until the second half of the twentieth century. Ironically, however, Portugal has been at the forefront of European expansion, in the fifteenth century. It has also been absent from most of the political struggles in the continent, shielded by its peripheral geographic position and an early option for overseas expansion.

The decline of the Portuguese economy started at the end of the sixteenth century. The loss of independence to Spain, in 1580, anticipated that decline of the Asian trade on which the economy had been thriving for almost a century. The strategic interests of the Spanish crown lay in Europe and in Central America, and little effort was made to retain control in Asia[1]. By the time of the 'restoration' of independence, in 1640, the strategic interests of Portugal had definitely moved to Brazil. Sugar, tobacco and exotic timber were

[1] In a short period of time, the Portuguese lost control of their many Asian possessions, with the exception of Goa (India), Macao (China) and East Timor. These territories remained under Portuguese administration until the second half of the twentieth century.

the main products traded until substantial deposits of gold were found, at the beginning of the eighteenth century (Serrão, 1993). A new period of growth followed. As before, it was essentially based on overseas trade.

Indeed, a striking feature of the Portuguese economy in this period was the low importance of manufacturing. African gold, in the fifteenth century, was obtained in exchange for products that were almost all imported from Europe or the North Africa (Castro, 1985: p. 129; Magalhães, 1993a: p. 315). In the sixteenth century, European and local (Asian) products were used in the spices trade. Magalhães (1993b: p. 287) is of the opinion that manufacturing was discouraged by the abundance of gold and silver. This is clearly an early example of the "Dutch disease"[2], and manifested itself again in the first half of the eighteenth century, with the discovery of abundant deposits of gold in Brazil.

Historians do refer to 'outbreaks of industrialisation' during the seventeenth and eighteenth centuries which, significantly, tended to coincide with periods of difficulties in the balance of payments (Serrão, 1993: p.89). One such example – probably the most significant - was the industrialisation effort conducted by the Marquis of Pombal, in the 1760s. Based on a model of import substitution, new manufacturing firms were offered substantial financial support, tax breaks, and a protected market. Many of the new firms received direct royal support (Serrão, 1993: p.92). Nevertheless, even in this case the impact on the country's economic structure was relatively small. The size of the domestic market represented an important obstacle, only partially compensated by exports to Brazil[3]. At the beginning of the nineteenth century the Portuguese manufacturing industry was already in deep recession (Serrão, 1993: p. 94; Mendes, 1993: p.356).

Despite this, all estimates suggest that the level of development of the Portuguese economy at the beginning of the nineteenth century did not differ much from that of other European countries (see Table 4.1). According to Gonçalves (1998), the roots for the low level of development of the Portuguese economy in more recent years can only be explained by the country's failure to join the European industrial revolution of the nineteenth century. Some of the elements that may have contributed to that failure were: a very liberal trade agreement with the UK conducted the Portuguese economy to specialise in the primary sector, where productivity growth is slower; scarce natural resources, which

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[2] Cf. Abdelkader (1987).

[3] Exports to Europe were also relevant in this period, benefiting from the climate created by the independence of the USA and the rivalry between the UK and France (Mendes, 1993: p. 356).

at the time represented an important element for growth; low skills of the labour force at all levels, including management; deficient infrastructure; and unfavourable political and legal arrangements (Gonçalves, 1998: p.89; Mendes, 1993: p.365)[4].

TABLE 4.1: PORTUGAL'S GDPPC AS A PERCENTAGE OF THE AVERAGE GDPPC IN SELECTED EUROPEAN COUNTRIES (1830-1950)

Year	As estimated by Bairoch (1976)	As estimated by Nunes et al. (1989)	As estimated by Lains (1995)	As estimated by Maddison (1996)
1830	95.3	81.7	-	-
1850	80.4	58.0	70.2	-
1870	63.7	49.1	53.6	54.4
1890	51.7	55.9	48.9	-
1913	39.0	38.7	38.1	38.4
1929	34.5	37.4	-	35.2
1950	32.4	37.1	-	38.3

Source: Gonçalves (1998: pp. 94, 96, 97). USD and constant 1970 PPP.
Notes: The 10 European countries used in the comparison were: Austria (Austria-Hungary until 1913), Belgium, Denmark, France, Germany, Italy, Norway, Sweden, Switzerland, UK.

This is not to say that manufacturing industries were completely alien to nineteenth century Portugal. A list of some 20 firms created before 1850 can be found in Mendes (1993). One of them (Vista Alegre, established in 1824) remains today as the leader in its industry (ceramics) and is now involved in a process of internationalisation (see chapter 6). Many more firms were established in the following years, in particular in textiles, fish preserves and cork products (Gonçalves, 1998). But this was insufficient to accompany the development of other European nations or to reduce the role of agriculture in the country's economic structure. At the beginning of the twentieth century, relative GDP per capita in Portugal was down to about 38 or 39 per cent of that of the most developed European nations (see Table 4.1).

The relative decline of the Portuguese economy continued through the first half of the twentieth century, even if to a less dramatic extent (see Table 4.1). The first years of the republic, installed in 1910, were marked by great political, social and economic turmoil. Amid an incredibly high rotation of governments[5], total GDP shrunk and inflation rocketed. Not surprisingly, the autocratic coup of 1926 was welcomed by a majority of the population. But the subsequent economic recovery was slow. Concentrated on the elimination of the main cause of concern over the previous years, the new government put the emphasis on economic stability, but at the expense of economic growth (Neves, 1994).

[4] Several changes were registered in the second half of the century in terms of the legal framework and public investment in education and infrastructure (Mendes, 1993). However, they were not sufficient to stop the relative decline of the Portuguese economy (Gonçalves, 1998: p.91).
[5] Sixteen governments between 1910 and 1916 alone (Neves, 1994: p.49).

The end of the 1940s and beginning of the 1950s marked the starting point for the transformation of the Portuguese economy into what it is today. Although reluctantly (Rollo, 1993), the authorities started to promote the development of the manufacturing industries by investing in infrastructure (e.g. electricity generation) and in industries such as steel or cement. As with many governments at the time, the model of growth adopted was based on import substitution and the positive discrimination of domestic investors. Industrialisation yielded its results, and the economy registered an annual growth rate of 4.1 per cent between 1950 and 1960. However, the strategy was unsustainable in the medium and long run due to the small size and low sophistication of the domestic market. Furthermore, albeit high, the growth rate was lower than that, for example, of Greece or Spain in the same period (Lopes, 1996: p.44)[6].

It was after 1960 that the catching up of the Portuguese economy did take off. Between 1960 and 1973 real GDP per capita registered an annual growth rate of 6.9 per cent (Lopes, 1996: p.15). In comparison to the most developed European countries, it leaped from about 32 per cent in the early 1950s to 50 per cent in 1973 (Table 4.2). This is particularly remarkable since the period corresponds to the 'golden age' of the European economy, with all countries experiencing very strong growth.

TABLE 4.2: PORTUGAL'S GDPPC AS A PERCENTAGE OF THE AVERAGE GDPPC IN SELECTED EUROPEAN COUNTRIES (1950-1995)

Year	As estimated by OECD	Year	As estimated by OECD
1950	32.6	1975	45.5
1960	33.3	1980	47.8
1965	36.9	1985	44.5
1970	42.4	1990	49.1
1973	49.5	1995	49.2

Source: Gonçalves (1998: pp. 94, 96, 97). USD and constant 1970 PPP.
Notes: The 10 European countries used in the comparison were: Austria, Belgium, Denmark, France, Germany, Italy, Norway, Sweden, Switzerland, UK.

The abandonment of import substitution policies and the promotion of exports was the element behind this transformation. Despite the political regime, Portugal was admitted in 1960 as a founding member of EFTA, accompanying its main trading partner - the UK. The following year Portugal joined the GATT, which entailed a reduction of tariffs with non-EFTA members. The Portuguese authorities managed to negotiate the country's participation in EFTA in very favourable conditions. The remaining EFTA members agreed to take into consideration the much lower level of development of the Portuguese

[6] Gonçalves (1998: p.94) refers that, when compared with the ten countries he used as benchmark, GDP per capita in Portugal registered a very small growth in the 1950s, from 32.6 to 33.3 per cent.

economy, and accepted the maintenance of high levels of protection in agriculture and several industries. In practice, tariff barriers were only eliminated for the manufacturing products that were not produced in Portugal at the time.

Despite the success registered, these policies may have produced a negative side effect (Lopes, 1996: p.113). The inevitable exploitation of comparative advantages between Portugal and its main trading partners led to an excessive specialisation in labour-intensive industries with little technological incorporation. However, it seems that the Portuguese government had little choice. The model of growth based on import substitution was not suitable for the Portuguese economy, and clearly failed to produce the expected results even in countries with a much bigger domestic market (e.g. Brazil, India). A much discussed alternative at the time was to intensify the economic relations with the colonies, or 'overseas provinces'. They represented an important source of raw materials, but their markets were small and not sophisticated. The impact on the Portuguese industrial structure would certainly had been much less significant than the 'European option'.

The year of 1974 represented the end of economic growth and was followed by a new period of divergence with the most developed European countries (see Table 4.2). The importance international trade came to assume in the economy in the previous years[7] made it much more sensible to the 1973 oil shock than to previous international crises. Imports increased in response to soaring oil prices (and to the new domestic conditions - see next), while stagnant external demand had a deep negative impact on exports. The second oil shock, in 1979, only amplified these difficulties.

By unfortunate coincidence, at the same time external forces were dragging the Portuguese economy into recession, the internal situation deteriorated as well. The democratic revolution of April 1974 was followed by a period of great political and social unrest. Only with the 1976 general election was institutional order again stabilised. In the meantime (March 1975), the main industries and all the financial services were nationalised. If the aim was to eliminate the power of the few groups that controlled the economy during the dictatorship, it created grave short term problems to the organisation of the production process. Furthermore, firms not directly affected by intervention were still affected by the new labour legislation, higher wages, and a general climate of poor labour discipline.

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[7] The degree of openness of the economy was in 1973 near 60 per cent, a substantial increase from the 1960 level - 40 per cent (Castro, 1993).

The independence of the African colonies, in the summer of 1975, represented another difficulty to the Portuguese economy. Trade with the newly independent countries, more than 15 per cent of Portugal's international trade in 1974, was halved in just two years (Lopes, 1996: p. 25). Even more dramatic was the massive flow of population generated by the independence of the colonies. A quarter million people may have returned to Portugal during 1975 - a population increase of 7 to 8 per cent. To help the newcomers, specific support schemes were created and jobs were offered in the public sector and nationalised firms with little concern for economic efficiency. Integration was surprisingly fast and smooth, despite the stretch it put on public expenditure.

The combined impact of these external and internal factors[8] was to shape the Portuguese economy until 1985. The balance of payments deteriorated rapidly, inflation rose, and external debt reached unsustainable levels. In order to correct the imbalances, twice (1978 and 1983) the Portuguese government was forced to seek the help of the IMF. Despite their success in terms of the main objective of external equilibrium, the stabilisation programs (the second in particular) had serious consequences upon economic growth, inflation, unemployment, and the public deficit. In 1983 and 1984 the growth rate was even negative. Although the conditions were created for a more stable macroeconomic management, there was in this period a clear subsidence in the process of convergence with the most developed countries (Table 4.2). In 1985 relative GDP per capita was down to the level of 1971 (Gonçalves, 1998: p.95).

The year of 1985 marks the beginning of a new cycle of growth. The recently gained economic stability was accompanied by a much more calm political situation. The central-right minority government that took over in 1985 managed to consolidate its position with a clear parliamentary majority in the 1987 general election, which was further extended in 1991. The new government put in practice important structural reforms, including a broad privatisation program, the restructuring of the financial system, the elimination of most remaining trade barriers, and an ambitious public works program.

The adoption of these measures was, nevertheless, only possible because Portugal joined the European Union on January 1st 1986. EU membership contributed positively to the climate of stability and optimism and, more importantly, made available substantial

[8] Lopes (1996: p.24) is of the opinion that the impact of the external factors was much more relevant than that of internal ones. His opinion was based on the fact that other European economies with similar level of development (e.g. Spain or Greece) did not perform much better than Portugal in this period.

financial resources, under the form of structural funds. Also important in the second half of the 1980s was the reduction of the oil price, with a very positive impact on the energy balance and on exports in response to economic growth in Europe. By 1992 convergence with the most developed European economies put relative GDP per capita at 50.2 per cent, the highest level ever (Gonçalves, 1998: p.97)[9].

By this time, however, a new economic recession in Europe highlighted the debilities that persisted in the Portuguese economy. This was amplified by restrictive measures necessary to pursue nominal convergence with the European Union. Recession fully hit the Portuguese economy in 1993 and 1994, originating a new backward movement in the convergence indicator (cf. Table 4.2). But growth and convergence resumed in 1995. GDPpc grew seven per cent a year in Portugal between 1996 and 1998 if measured at current PPP, which compares with four per cent in the ten countries used as benchmark in Tables 4.1 and 4.2[10].

4.2. Inward Foreign Direct Investment and the Portuguese economy

Foreign direct investment has been part of the Portuguese economy at least since the country started trading in the Indian Ocean, in the sixteenth century. The very characteristics of that trade, largely based on re-exports, and the high profits generated attracted people of all nationalities to Lisbon[11]. It was, nevertheless, with the industrialisation attempt of the eighteenth century, led by the Marquis of Pombal, that FDI truly became an important part of the Portuguese economy. Matos (1973: p. 83) suggests that some 30 per cent of the manufacturing firms created in this period were owned by foreigners.

FDI was also a critical characteristic of the Portuguese economy throughout the nineteenth century and until the 1920s. Vogel (1860, cited in Matos, 1973: p.84) observed that most important manufacturing companies, banks, and commercial firms existing in the country at the time were controlled by foreigners. British investors, followed by French and Germans, were the most frequent in a list that, curiously, did not seem to include Spanish citizens (Matos, 1973: p.85). As was clear from the previous section, however,

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[9] This represents approximately 60 per cent of the average GDP per capita of the EU12 (Lopes, 1996: p.49).
[10] Own calculations based on OECD (1999a).
[11] "No foreigner visiting Lisbon will return to his country, so the city has more foreigners or their descendants than Portuguese nationals" (Vasconcelos, 1608, cited in Matos, 1973: p.82; own translation).

these flows of FDI have been clearly insufficient to permit that Portugal accompanied the industrial revolution that was taking place in other European countries.

Subjacent to this regular presence of foreign firms throughout Portuguese history was the favourable attitude of the Portuguese authorities towards FDI. However, this changed radically after the establishment of the autocratic regime, in 1926. Although the official discourse was still favourable to the presence of FDI, the policies adopted by the new regime overtly discriminated against the foreign ownership of capital[12]. As a result, FDI flows were almost insignificant during the first decades of the dictatorship (Lopes, 1996: p.167)[13]. This nationalist legislation was completely in tune with the dominant policies of the 1930s across the globe. They indirectly confirmed, nevertheless, the disproportionate weight that foreign capitals assumed in the Portuguese economy at the time.

The import substitution industrialisation policy adopted in the 1950s was still made under this nationalist setting. However, its abandonment at the end of the decade was accompanied by a new attitude towards FDI. The application of the legislation became much less restrictive, and eventually, in 1965, new legislation reinforced the guarantees offered to foreign investors and increased the number of industries open to FDI (Matos, 1973: pp. 103-107)[14].

During the 1960s, FDI flows were ten to twenty times greater than in the previous decade (Lopes: 1996: p.168). In terms of GDP, inward FDI flows represented an average of just 0.6 per cent between 1965 and 1974 (Figure 4.1). However, Lopes (1996: p.169) estimated this to be around 30 per cent of GFCF in the manufacturing industries and 20 per cent in the commercial sector. The importance of FDI flows was also reflected in the development of new segments of export oriented industries (e.g. electric equipment, pulp, chemicals) with great impact in the future productive structure (Simões, 1985: p.358). Most FDI in the period was, however directed towards labour intensive industries - clothing, footwear and electric equipment (Lopes: 1996: p.169).

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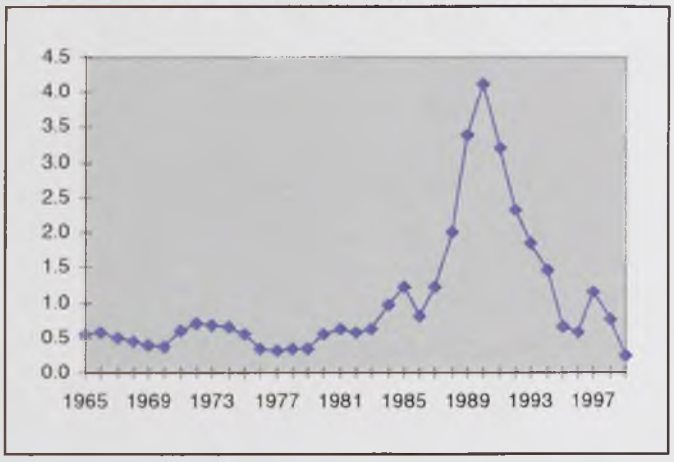
[12] The most relevant pieces of legislation were the "Law of industrial conditioning" (1937) and the "Law of nationalisation of capital" (1943) - nationalisation in the sense of ownership by Portuguese nationals, rather than public ownership. Several other laws restricted FDI in specific sectors of the economy (Matos, 1973).

[13] The poor performance of the Portuguese economy in this period certainly contributed to further discourage foreign investors.

[14] Matos (1973: p.100) suggested that the need to finance the colonial war, which started in 1961, was a decisive factor to the new attitude of the Portuguese authorities towards FDI.

FIGURE 4.1: INWARD FDI FLOWS, 1965-1999 (%GDP)



Own calculations based on Banco de Portugal (1997a, 1997b, 2000a, several)

The second half of the 1970s was marked by very small inflows of FDI (Figure 4.1). The causes lie clearly in the combination of external and internal conditions described in the previous section. The attractiveness of Portugal as a location for FDI was reduced at a time when investment worldwide had been seriously affected. The flows remained, nevertheless, positive, to which the fact that foreign firms were left untouched by the nationalisations of March 1975 has certainly contributed. New legislation in 1976 and 1977 restated the guarantees previously offered to foreign investors and admitted direct public support to individual projects, evaluated on a case by case basis (Lopes, 1996).

The flows of FDI started to recover in 1980. Despite the economic instability, the political climate was now much more stable. The attraction of big individual projects was also important. The most significant was Renault's new assembly plant, which received substantial government support and served as a symbol of the new environment foreign investors could meet in Portugal. The prospect of EEC membership further contributed to the attractiveness of Portugal in the first half of the 1980s.

In 1986 Portugal joined the European Union, and FDI inflows rocketed from 0.8 per cent of GDP to 4.1 per cent in 1990. Membership expanded the guarantees of free access to the EU markets from a low labour costs platform and worked as a reassurance of economic and political stability[15]. Lopes (1996: pp. 173-175) considered that the inflows of FDI in this period were also encouraged by the privatisation program, put into practice

[15] Commenting on a similar evolution of inward FDI in Austria after the country joined the EU, Bellak (1998: p.9) considered that "although there were not many restrictions left in trade and capital flows, it seems that the decision to join the EU gave a positive signal to investors that the business location will also be attractive in the future".

after 1988, by better infrastructure, and by (EU sponsored) incentives to new projects in manufacturing, tourism and agriculture[16].

Some of the factors that explain the growth of inward FDI after Portugal joined the EU may also explain the sharp decrease in the 1990s. If EU membership created new investment opportunities, it is reasonable to assume that they would have been exploited in the years immediately before and after Portugal joined the Union. Similarly, the privatisation program necessarily slowed down after the main companies had been sold. The external environment was also a negative factor in this period. First, the European economy entered a period of recession, which reduced investment. Second, the fall of communism in Central and Eastern Europe radically changed the geopolitical map of Europe, seriously affecting the position of Portugal.

As seen before, part of the attractiveness of Portugal has long been dependent on low labour costs and preferential access to the most developed markets in Europe. The fall of the Berlin Wall, however, eliminated the uniqueness of this situation. The former communist countries (at least the most developed among them) were fast to recover historic ties with Western Europe (Lansbury et al., 1996; Holland and Pain, 1998). In turn, EU members were more than willing to support their economic development. They expected to consolidate the new political regimes and to avoid an unwanted flow of legal and illegal immigrants. Furthermore, there was the prize of potentially big domestic markets and labour costs that were often a fraction even of those in Portugal (Podkaminer, 1998). The fact is that by 1995 FDI inflows in Portugal were again at levels prior to EU membership (see Figure 4.1, above).

The creation of the European Single Market (ESM) is a further element to take into account. Dunning (1996: p.29) argued that total FDI in Europe has risen as European and non-European firms became prepared for the new competitive conditions. This was confirmed by Agarwal (1997) and by Pain and Lansbury (1997). The latter estimated that the ESM may have risen the stock of German FDI in other EU countries by 17.5 per cent and cite similar results obtained by Pain (1997) for FDI from the UK. Still according to Pain and Lansbury (1997), Portugal and Spain benefited from this additional investment, although substantially less than the UK, the Netherlands, or Italy.

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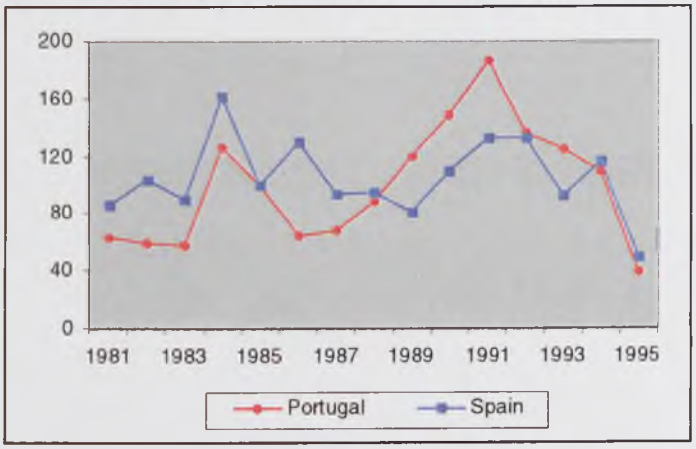
[16] The privatisation program included several restrictions to foreign participation, but they were often 'creatively avoided' (Lopes, 1996: p.161).

Two important points should be noted, however. First, Portugal's share of inward FDI in the European Union (EU12) went through an evolution similar to the weight of FDI in GDP, only to a lesser extent (cf. Figure 4.2 and Figure 4.1). Second, the behaviour of inward FDI in Spain was very similar to the one registered in Portugal (Figure 4.2). This clearly suggests that external factors were more important than internal ones in the evolution of inward FDI in Portugal.

FIGURE 4.2: SHARE OF EU12 INWARD FDI FLOWS (BASE 1985=100)



Own calculations based on OECD (1997a)

The analysis of FDI in Portugal in more recent years is complicated by a break in the statistical series (both of inward and outward FDI). In order to comply with the recommendation of several international bodies, in 1998 the Bank of Portugal organised a massive questionnaire of foreign affiliates established in the country. This permitted a long due estimation of the stock of FDI and an improvement of the estimation of the flows (Banco de Portugal, 1998b). Largely because of the new figures for reinvested earnings, the exercise resulted in a substantial upward revaluation of inward FDI flows in Portugal when compared with the previously available figures (see Table 4.3). Being a much more recent phenomenon (see section 4.5), outward flows were little affected.

TABLE 4.3: FDI FLOWS IN PORTUGAL (1996-98), OLD AND NEW SERIES

	INWARD FDI				OUTWARD FDI			
	old series	% GDP	new series	% GDP	old series	% GDP	New series	% GDP
1996	94,982	0.57	210,540	1.27	118,854	0.72	119,863	0.72
1997	201,661	1.15	447,007	2.54	337,296	1.92	340,160	1.93
1998	142,954	0.76	316,876	1.69	517,929	2.77	522,327	2.79
1999	47,602	0.24	105,515	0.54	407,585	2.08	411,046	2.09

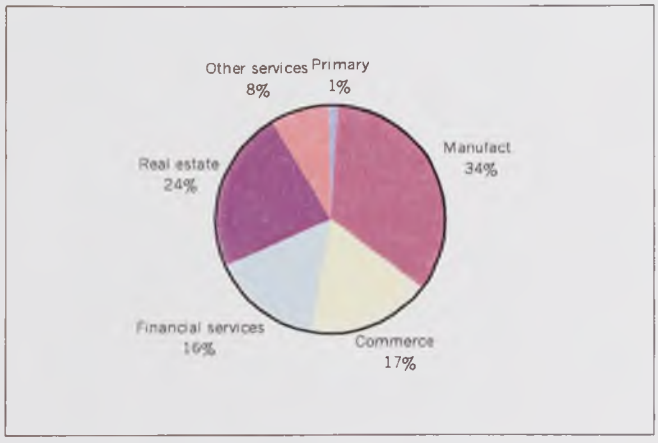
Sources: Old series: own estimations based on Banco de Portugal (1997b, 2000a, 2000b)
New series: Banco de Portugal (2000a, 2000b);

Unfortunately, new data for the period before 1996 is not yet available. And because the old series stops in 1996 inferences are risky. For the sake of coherence, Figure 4.1 (above)

was based on the old series. The values for 1997 to 1999 were estimates based on the figure for 1996 and the growth rates implicit in the new series. But it is necessary to be aware of the substantial differences between old and new data (Table 4.3). In any case, the sharp reduction of inward FDI in Portugal in 1998 and 1999 is rather evident from Table 4.3. In percentage of GDP, the latter is the lowest value since the beginning of the 1960s, which may be a cause for concern for the Portuguese authorities.

Another merit of the data on inward FDI recently made available by the Bank of Portugal (Banco de Portugal, 1998b) was the provision of long due estimates of the stocks of FDI and their distribution per industry and country of origin. Some data existed for the distribution of the flows of FDI, but it was not very reliable and remained largely unpublished. According to Banco de Portugal (1998b: p.28), the manufacturing industries represented in 1996 about one third of the stock of inward FDI in Portugal, commerce was responsible for a further 17 per cent, financial services for 16 per cent, and real estate for 24 per cent. The primary sector was associated with just over 1 per cent of the 1996 stock of inward FDI in Portugal (Figure 4.3).

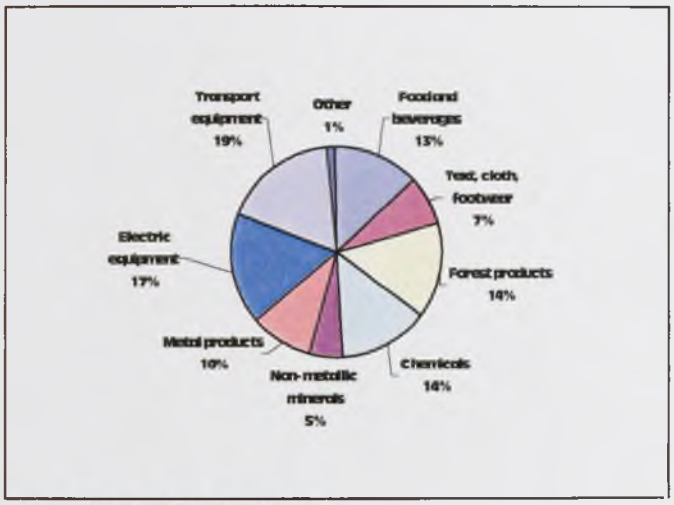
FIGURE 4.3: STOCK OF INWARD FDI IN PORTUGAL, 1996



Source: Banco de Portugal (1998b)

In terms of the distribution of the stock of manufacturing FDI (Figure 4.4), transport equipment and electric machinery represented, in 1996, respectively, 19 and 17 per cent of the stock of manufacturing FDI in Portugal. Forest products, chemicals, and food and beverages were the other industries with a share above 10 per cent. This distribution confirms the claim of Gonçalves and Guimarães (1996: p.10) that FDI is essentially concentrated in capital intensive industries. Given that domestic investment is stronger in labour intensive industries, they concluded that FDI contributes to diversify the Portuguese industrial structure.

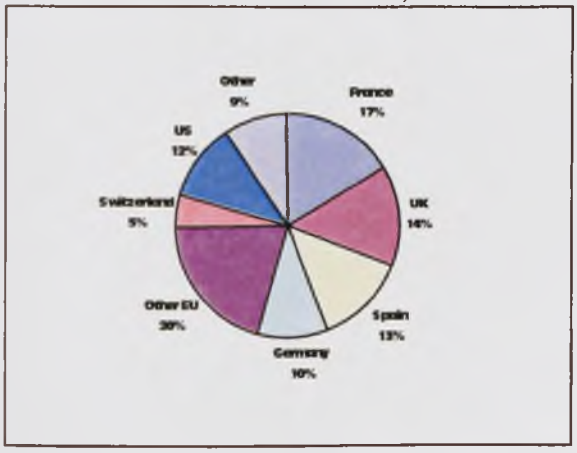
FIGURE 4.4: STOCK OF MANUFACTURING INWARD FDI, 1996



Source: Banco de Portugal (1998b)

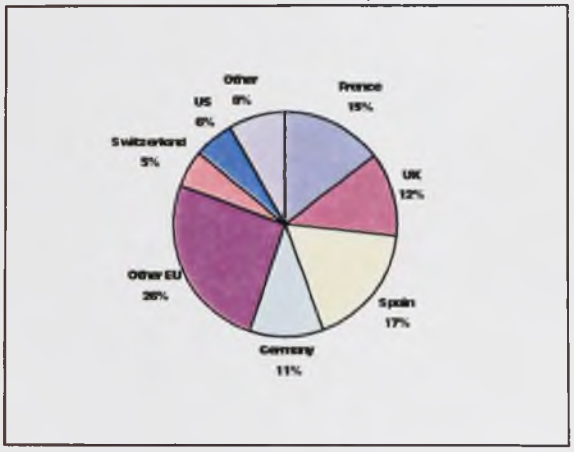
Not surprisingly, three quarters of the 1996 stock of inward FDI in Portugal originated in the European Union. France, the UK, Spain, and Germany, in that order, were the main European source countries (Figure 4.5). US multinationals were also strongly represented, but half the US investment was made through third countries (cf. Figures 4.5 and 4.6). The data suggest that Spain was the most common platform used by MNCs to invest in Portugal, but the level of aggregation does not permit the investigation of which countries most used the 'Spanish route'. All it was possible to assess was that the use of third countries was also common among French and UK firms. Apart from Spain, the most significant platforms seemed to be the Netherlands, Luxembourg and Germany (cf. Figures 4.5 and 4.6).

FIGURE 4.5: STOCK OF INWARD FDI, COUNTRY OF ORIGIN OF *PARENT FIRM*, 1996



Source: Banco de Portugal (1998b)

FIGURE 4.6: STOCK OF INWARD FDI, COUNTRY OF *DIRECT INVESTOR*, 1996



Source: Banco de Portugal (1998b)

One of the novelties of the new data published by Banco de Portugal (1998b) was information on the industrial distribution of FDI for the main investing countries. This

confirmed substantial differences. Investment from Germany is probably the most idiosyncratic, given that almost three quarters is directed to the manufacturing industries, nearly three times the overall figure (Banco de Portugal, 1998b: p.31)[17]. As a result, Germany is the main origin of manufacturing FDI, with a share of 23 per cent. France (16%) and Spain (15%) are next in the ranking (see Table 4.4). Spain is also the origin of 30 per cent of FDI in commerce, well ahead of the UK (20%), and in the financial services is second only to France (respectively, 14.6% and 15.7%).

TABLE 4.4: COUNTRY DISTRIBUTION OF THE STOCK OF INWARD FDI IN DIFFERENT INDUSTRIES, 1996

	Germany	Spain	France	UK	Netherl.	US	Other	Total
Manufacturing	23.0	14.6	15.7	4.5	6.1	4.1	32.1	100.0
Commerce	5.8	29.5	10.4	19.5	7.1	6.6	21.2	100.0
Financial services	5.5	18.9	21.6	6.4	1.8	4.3	41.4	100.0
Real estate	2.6	13.1	12.5	19.2	17.3	9.7	25.6	100.0
Other	5.1	14.1	13.4	18.7	17.2	3.6	27.9	100.0
Total FDI	*9.9*	*13.2*	*16.6*	*14.2*	*6.1*	*11.6*	*28.4*	*100.0*

Source: Banco de Portugal (1998b: p.31)

4.3. PREVIOUS WORK ON THE DETERMINANTS OF FDI IN PORTUGAL

The first thorough study of foreign direct investment in Portugal was published by Matos (1973). Political and monetary stability and a friendly environment were presented as the top advantages offered by Portugal to foreign investors. Although small and unsophisticated, the domestic market was considered another important determinant. It was protected by high tariffs and transportation costs and could also reach the colonial markets in Africa. The low efficiency of local firms was considered a further attraction for foreign investors. However, according to Matos (1973), investors also opted for Portugal because of natural resources (mining, tourism, pulp) and low labour costs; privileged access to the EFTA and EEC markets increased the attractiveness of the latter[18].

Carrière and Reix (1989) and Saraiva (1993) adopted a descriptive approach similar to that of Matos (1973), and reached very much the same conclusions. Low wages, privileged access to the EU markets, and natural resources were the elements Carrière and Reix (1989) associated with inward FDI in Portugal. Saraiva (1993) ignored natural resources, but added political and social stability, financial and technological limitations of local firms, privatisations, and public incentives.

[17] The concentration of German FDI in manufacturing had already been pointed out by Simões (1989) and Câmara de Comércio e Indústria Luso-Alemã (1996).

With the support of regression analysis, Taveira (1984) exploited the dichotomy of inward FDI in Portugal advanced by Matos (1973). The suggestion that market-seeking FDI was predominant in Portugal was confirmed. Taveira (1984) found domestic market oriented FDI to be associated with the foreign firms' capacity to differentiate their products, with market size and concentration, and with government non-interference. Curiously, these variables were also relevant for export oriented industries, as were labour costs (which were insignificant for domestic market oriented investors). It seems that access to the local market was an important motivation even in the case of export oriented FDI. Natural resources were not found by Taveira (1984) to be a determinant of FDI in Portugal.

In a descriptive analysis Simões (1985) also distinguished between exporting industries and those oriented towards the domestic market. In the exporting industries, he distinguished between "traditional labour intensive industries" (textiles, clothing, footwear), "modern labour intensive industries" (electronics, transport equipment, professional goods), and resource based industries (beverages, pulp and paper, wood products). All the remaining industries were considered to be domestic market oriented.

Fontoura (1995) used regression analysis to investigate the determinants of FDI in Portugal. Predicting a two-way relationship between FDI and exports, she adopted a model of simultaneous equations[19]. The results, however, did not confirm the relationship. Furthermore, Fontoura (1995) concluded, rather surprisingly, that the exploitation of natural resources was the main reason for foreign firms to invest in Portugal. Labour costs were considered irrelevant since FDI was more common in industries with high labour costs, intensive in human capital and technology, and with substantial economies of scale. However, to infer from this that low labour costs was not a determinant of FDI in Portugal (Fontoura, 1995: p.135) seems to be abusive. It may simply reflect the industries where the Portuguese relative labour costs are lower or where the competitive advantages of foreign firms vis-à-vis local investors are stronger[20].

With a different methodology - a survey of 37 foreign firms established in Portugal - Santos (1997) obtained quite distinct results. Labour costs and access to the local market were pointed to as the main reason to invest in Portugal by, respectively, 43 and 46 per

[18] Matos (1973) suggested that stability/domestic market and natural resources/labour costs/export markets attracted distinct groups of investors, the group associated with the latter being smaller than that associated with the former.

[19] Fontoura (1995) used a cross-industry model for FDI and exports in 1991/92.

cent of the respondents. A further 30 per cent of the participants included labour costs in the top four reasons to have chosen Portugal, but only 3 per cent mentioned market access. Other relevant determinants were the international image of Portugal, labour skills, transportation costs, social and political stability, access to other markets, and geographic and cultural proximity. Natural resources were selected by only 11 per cent of the respondents (i.e., four), although always as first or second choice.

4.4. Preliminary investigation of the determinants of FDI in Portugal

As just seen, the number of empirical studies on the determinants of FDI in Portugal is quite small and their results are often contradictory. Henceforth, it may be relevant to use available secondary data to develop a preliminary econometric investigation of the phenomenon. Two regressions will be provided: a longitudinal study of the determinants of FDI in Portugal, and a cross-section analysis to include potentially competing locations. Given the level of aggregation of the data, only the locational determinants will be tested.

4.4.1. The locational determinants of FDI in Portugal

This longitudinal study of inward FDI in Portugal covers a period of eighteen years, between 1980 and 1997. The period prior to the revolution was excluded due to the unavailability of data or inconsistency between statistical series. As for the second half of the 1970s, social, political, and economic instability, plus rather small flows of FDI, reduced its relevance for the regression analysis. The proposed model (see Appendix 4A) was inspired by the results of previous studies. Four determinants of FDI were considered: attractiveness of the local market, costs reduction, economic stability, and Portugal's geopolitical position. Each was proxied by different variables, some complementary, some alternative to each other. Variables associated with natural resources were not included. Being largely constant over time they were unlikely to be relevant in a longitudinal study. Real FDI inflows were used as the dependent variable. Data sources are presented in Appendix 4A.

One important element associated with the model was the adoption of two years lags[21]. This was longer than in any other known analysis of the determinants of FDI (most macroeconomic studies adopt only one year lags), but it seemed to be more realistic. Not

[20] The concentration of FDI in capital intensive industries and that of Portuguese firms in labour-intensive sectors was confirmed by Gonçalves and Guimarães (1996).

only the decision process can be lengthy, as investment rarely takes place immediately after the decision to invest is made. A period of two years between the beginning of the analysis and the moment the investment is made seems to be a reasonable estimate.

The small number of observations represents one of the limitations of this study, a problem more acute on the face of the number of variables proposed. Several of the variables were alternative proxies for the same element, but not all of those that were supposedly complementary could be considered at one time. The solution was to test reduced specifications of the model until the final model was found (Table 4.5). The risk of this unorthodox strategy was that the eventual under-specification of the model would generate biased estimators and potentially misleading statistical tests[22]. However, all the variables that were initially found to be insignificant were later re-introduced in order to confirm that none was statistically significant (at the 10% level). Also important is that the signs initially estimated held in all these alternative models while the t-tests suffered only small changes. The impact on the significance levels was also very small.

TABLE 4.5: REGRESSION RESULTS FOR INWARD FDI IN PORTUGAL

Dependent Variable: *Real inward FDI flows*						
R	R Square	Adjusted R Sqr		F	F (sig.)	DW
0.844	0.713	0.651		11.573	0.000	1.520
		Unstandardised Coefficients		Standardised Coefficients	t-test	Signif.
		β	Std. Error	Beta	value	Level
(Constant)		192.509	189.517		1.016	.327
Real GDP		60.480	12.742	.869	4.747	.000
GDP growth rate		24.903	6.744	.550	3.693	.002
Relative labour costs		-30.601	10.181	-.555	-3.006	.009

Despite the limitations stated above, the results obtained were very interesting (Table 4.5). The regression was able to explain just under two thirds of inward FDI flows in Portugal in the period considered. The small number of observations certainly reduces its relevance, but the figure suggests, nevertheless, a reasonable fit. The results did not seem to be significantly affected by serial correlation or multicollinearity. Only three of the proposed variables were statistically significant at the 10% level (in fact, the three were significant at 1%), but they were all correctly signed. As described above, all the remaining variables

[21] As a result, the independent variables used data from 1978 onwards.

[22] If the omitted variables were correlated with those included, under-specification would cause the estimators to be not only biased but also inconsistent. On the other hand, the inclusion of unnecessary variables would result in biased (but consistent) OLS estimators. The statistical tests would, nevertheless, remain valid (Gujarati, 1988: pp. 403-404).

were progressively added to the model in Table 4.5 but were found not to be statistically significant. Infrastructure was, however, the only one not correctly signed.

4.4.2. The locational determinants of FDI in the European periphery

The cross-section analysis aimed to complement the longitudinal study described above. The main target was to confront (even if crudely) the results obtained for FDI in Portugal with data for competitive locations. For that sake, the model adopted was based on the same four locational determinants tested for Portugal. Naturally, some of the variables associated with each determinant differed in order to include those that could not be considered in the longitudinal study (e.g. distance to the most developed countries, labour skills). Political stability was not included in the model because the relevant data could not be obtained.

In order to reduce the impact of short term fluctuations, the dependent variable was calculated as the average inward FDI flow in 1995 and 1996 (see Appendix 4A). The independent variables were also computed as the average for two consecutive years, although in this case it was for 1994 and 1995. Due to data limitations, only a one year lag was used, but in the case of a cross-section this element has little impact. When data for one of the years considered was not available, the figure for the other year was adopted. Twelve countries were used in the analysis. Greece, Ireland, Portugal and Spain were at the time the less developed EU members. Finland and Austria were also selected despite their relatively high level of development. Their geopolitical position during the cold war must be considered peripheral, although they thrived by bridging East and West. The other countries in the sample were Turkey and the East European countries most advanced in the process of market reform - the Czech Republic, Hungary, Poland, Slovakia and Slovenia. The Baltic states should have probably been included, but it was not possible to obtain all the relevant data[23].

Estimation of this cross-section model faced very much the same problems that affected the study of FDI in Portugal (the number of observations was even smaller in this case). Henceforth, a strategy similar to the one described above was adopted. As in the case of the previous regression, the introduction of any of the remaining variables did not affect the signs of the estimated coefficients. The significance levels were also little affected. The

exception was the variable 'distance', which in some cases fell marginally below 10 per cent.

Four variables were found to be statistically significant at 10% (Table 4.6). The regression explained 80 per cent of inward FDI in the European periphery, although the figure is certainly influenced by the small number of observations. The interpretation of the results must bear in mind this limitation of the model, even if they are fully compatible with those of the previous section.

TABLE 4.6: REGRESSION RESULTS FOR INWARD FDI IN THE EUROPEAN PERIPHERY

Dependent Variable: *Inward FDI flows*					
R	R Square	Adjusted R Sqr	F	F (sig.)	
0.934	0.873	0.800	12.025	0.003	
	Unstandardised Coefficients		Standardised Coefficients	t-test	Signif.
	β	Std. Error	Beta	value	Level
(Constant)	-13608.27	4835.948		-2.814	.026
GDP	15.541	2.573	.953	6.040	.001
Labour costs	-43.057	11.033	-.825	-3.903	.006
Labour skills	17923.73	5468.878	.614	3.267	.014
Distance	-6.927	3.508	-2.75	-1.976	.089

4.4.3. Discussion of the results

The size and growth of the domestic market were the variables with a stronger association with inward FDI in Portugal. This should constitute no surprise on the face of what was described in section 4.3. The domestic market was found by Taveira (1984) to be a relevant determinant even for export oriented FDI. In the case of the cross-section, only the size of the market was significant. The market's growth rate did not seem to be relevant when different peripheral locations were compared. Neither was the market's level of sophistication (GDPpc). Clegg (1995) argued that total GDP is more likely to be associated with new investment, while the growth rate can be expected to be more relevant for expansionary FDI. If that is the case, the results in Table 4.6 would simply show the predominance in the European periphery of new projects over expansionary investment. Given the period of analysis this may be justifiable, but the level of aggregation of the data does not permit more than speculation.

[23] To discuss the concept of 'periphery' is out of the scope of this section. Nevertheless, the countries selected were not truly peripheral in the European economic and political scene, but rather 'semi-peripheral', in the sense that they were fully integrated in the economic structure of the continent.

Labour costs were strongly significant in both regressions. As expected, their impact was negative. A substantial body of literature in support of this result was discussed in chapter 3. It contrasts, however, with the results of previous research for Portugal, which found no statistical association between labour costs and inward FDI when using aggregate data (see section 4.3). Labour skills were also a significant determinant in the cross-section[24], and positively signed. Once again, the level of aggregation of the data limits the interpretation. It seems, nevertheless, that foreign investors seek locations with a favourable combination of labour costs and skills, very much as suggested by Santos (1997) for Portugal.

Contrarily to expectations, membership of the European Union was not found to be significant in any of the regressions, despite being correctly signed. Lorz (1993, cited in Agarwal, 1997: p.110), for example, estimated that EU membership raised the chances of receiving German FDI by 1.4 times. The result was especially surprising in the longitudinal regression due to the evolution of FDI flows immediately after 1986 (see section 4.2). It seems that after Portugal joined the EU foreign investors did seek to gain or reinforce their position in the country. However, the EU membership effect may have vanished once investors adjusted to the new conditions. Part of the explanation may be the free trade agreements that all countries included in the cross-section maintain with the European Union (despite important exceptions in agriculture and services). The same was true for Portugal before 1986. Moreover, with the exception of Turkey, the countries selected were the frontrunners for EU membership. This seemed to be the interpretation of Agarwal (1997: p.108) also.

Other geopolitical considerations were, however, found to be relevant in the cross-section analysis. Distance to the 'core' of the European Union was significant at 10 per cent and, as predicted, negatively signed[25]. The variable represents proximity to the most important export markets, but also physical and psychic distance to the major investing European countries (see Appendix 4A for the variable's definition). In a sense, there is a parallel between this result and Agarwal's (1997) investigation of German FDI in Central Europe, which he claimed to be strongly associated with geographic proximity and low cultural barriers.

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[24] The variable was not tested in the longitudinal study because the proxies available showed little changes over time.

[25] As mentioned above, however, the significance level was sensitive to the sample adopted. With the exclusion of Finland or Hungary it felt below 10 per cent, even if only marginally.

In the longitudinal study evidence of the importance of geopolitical considerations was much weaker. A dummy for the 1990s was the excluded variable with a stronger level of statistical significance (14.6%). Although this was substantially above the 10% level usually accepted by econometricians, the figure was inflated by the strong multicollinearity present in the regression. Nevertheless, this dummy may have appropriated more than the impact of the democratisation of Central and Eastern Europe upon Portugal's geopolitical position (the original aim). It is very likely that it was equally affected by other elements associated with Portugal's recent history (see section 4.3). The creation of the ESM may have been of particular relevance. In favour of this point is the fact that Portugal, Spain and Ireland, all saw their share of total FDI flows into the Union reduced after 1991/1992 (slightly less in the case of Ireland)[26].

4.5. Outward Foreign Direct Investment

On the face of the novelty of the industrialisation process in Portugal, it is hardly surprising that outward foreign direct investment is in Portugal a very recent phenomenon. The first stream of outward investment was registered in the first half of the 1970s. After a decade of very strong domestic growth (see section 4.1), several firms started to expand to the (then) African colonies, in particular Angola and Mozambique. Investment by Portuguese banks in countries with big Portuguese communities[27] was also significant in this period (Simões, 1985: p. 341). Most of the investors were large firms, usually linked with the economic groups that dominated the Portuguese economy before the revolution.

This international expansion was, nevertheless, short lived. It did not resist the dismantling of the economic groups by the new political powers and the independence of the colonies, in 1975. Almost all subsidiaries created in the Portuguese-speaking Africa between 1971 and 1974 were either nationalised by the governments of the newly independent countries or had their buildings and equipment destroyed in the civil wars that followed independence. It was also a weak movement. Between 1970 and 1974 outward flows averaged just 0.2 per cent of GDP, with a peak of 0.3 per cent in 1973 (Figure 4.7). Nevertheless, they were substantially higher than the values registered in the following

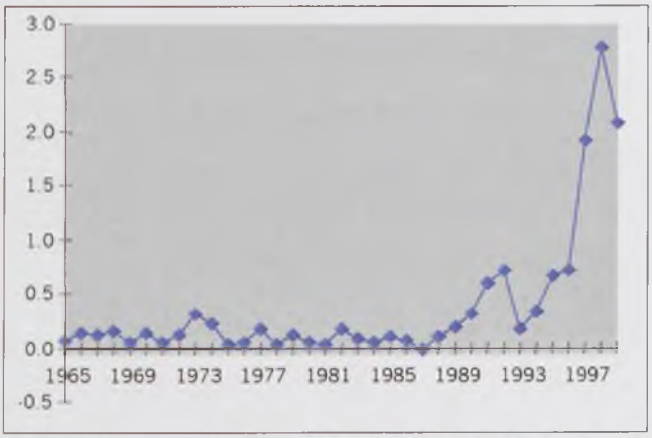
[26] Own calculations based on OECD (1997a).

[27] Lopes (1996: p.196) estimates that more than 750,000 workers emigrated between 1960 and 1973, mainly to European countries. France, Germany, and Luxembourg were the most popular destinations. Emigration to the United States, Canada, and South Africa was also important.

years. Outward FDI flows represented less than 0.1 per cent of GDP in every year between 1975 and 1989.

Only in the 1990s foreign direct investment by Portuguese firms became an important characteristic of the country's economy. Outward flows were affected by the economic crisis of 1993-94, but recovered again, to reach 2.8 per cent in 1998, the highest level ever (see Figure 4.7 and Table 4.3). In 1997 outward FDI was for the first time in the Portuguese history bigger than inward investment, and the margin seems to be widening, despite a small reduction of outward FDI flows in 1999[28].

FIGURE 4.7: OUTWARD FDI FLOWS, 1965-1998 (%GDP)



Own calculations based on Banco de Portugal (1997a, 1997b, 2000a, several)

As in the case of inward investment, the figures for outward FDI were recently revised by the Bank of Portugal using a questionnaire survey. Unfortunately, no information on stocks is available yet and the disaggregation of the flows is limited to the main economic sectors and a few investing countries. The information is, nevertheless, relevant. The services sector accounted for over 90 per cent of the Portuguese outward FDI between 1996 and 1999. However, there was a substantial change in 1999. While in previous years real estate and the financial services concentrated most investment, in 1999 it was transport and communications which made the major contribution[29]. Portugal Telecom's acquisition in Brazil of Telesp Celular, a privatised mobile operator, explains most of this surge. Manufacturing and commerce represented just 4 and 5 per cent of outward investment in

[28] According to the data previously available, outward FDI was higher than inward FDI since 1995 (Buckley and Castro, 1998). However, the most recent data suggests that this was not true until 1997 (Banco de Portugal, 2000).

[29] The 1999 data on outward FDI is strongly biased by substantial divestments in real estate in the EU (Spain, and to a much less extent France, were the only countries the data permitted to identify). 60 per cent of those divestments took place in the same month (May), which suggests that one single company may be behind most of the operations.

the period, respectively. The contribution of the primary sector was not significant and even slightly negative (Table 4.7).

Data for previous years is not comparable because of the methodological change mentioned above. Although the figures for 1996 (the only common year available) obtained using both methodologies were very similar (cf. Table 4.3), the old estimates put manufacturing FDI at 29 per cent of the total in 1996 (Banco de Portugal, 1997b), which is rather different from the new figure (cf. Table 4.7).

TABLE 4.7: OUTWARD FDI FLOWS BY SECTOR OF ACTIVITY, 1996-1999

	1996	1997	1998	1999	1996-1999
Agriculture and fishing	-0.1	0.3	0.3	0.0	0.2
Mining and quarrying	-1.8	-0.6	-0.4	-0.5	-0.6
Manufacturing	6.3	3.9	2.8	4.4	3.8
Commerce	2.6	6.9	2.6	5.8	4.6
Services	93.0	89.5	94.7	90.2	92.0
(Financial services)	28.8	20.6	14.1	5.0	14.3
(Real estate)	29.4	55.1	47.2	-6.7	31.7
(Communication, transports)	0.8	11.4	6.5	50.7	20.3

Source: Banco de Portugal (2000a, 2000b).

Brazil has been the most important destination of Portuguese FDI since 1996. In that period, it received more investment than all members of the European Union put together in every year except 1997 (Table 4.8). This is a very recent trend and is associated with the success of the stabilisation program put in practice by the new Brazilian government in 1995. The opportunities for foreign investors created by the privatisation program that started a couple years later were also important.

TABLE 4.8: COUNTRY DISTRIBUTION OF OUTWARD FDI FLOWS, 1996-1999

	1996	1997	1998	1999	1996-1998	1996-1999
Spain	9.7	14.9	10.3	-33.6	11.9	-1.5
UK	1.6	2.0	0.7	2.3	1.3	1.6
Germany	1.7	0.0	2.3	0.0	1.4	1.0
France	0.3	2.1	0.7	-0.5	1.1	0.7
Total EU15	29.3	54.1	42.4	-91.0	44.9	4.8
Brazil	32.2	25.1	46.0	53.5	37.1	41.9
PALOP[(a)]	4.8	3.8	2.0	5.3	2.9	3.6
US	6.0	2.4	2.6	2.4	3.0	2.8

Source: Banco de Portugal (2000a, 2000b)
[(a)] Portuguese-speaking African countries

As for the EU members, they represented 45 per cent of outward flows between 1996 and 1998 (cf. footnote 29). Unfortunately, the data available is very limited. Spain, which was the destination of about one quarter of the investment, is the only sizeable destination identified.

4.6. AN INVESTMENT DEVELOPMENT PATH FOR PORTUGAL

As described in chapter 2, the investment development path suggests an interaction between the country's level of development and its international investment position. Henceforth, it may help the understanding of the evolution of inward and outward FDI flows in Portugal and its implication for the Portuguese economy.

4.6.1. Data

As described in section 4.2, data on the stock of inward FDI in Portugal only covers the period after 1996 and is not compatible with existing information for previous years. Data on the stock of outward FDI is not yet available at all. In order to analyse the Portuguese IDP it was necessary to estimate historical figures on stocks using existing information for the flows of FDI (Banco de Portugal, 1997a, 1997b, 2000a). Narula (1996) was very critical of the use of FDI flows to estimate stocks. He argued that the sum-of-flows method underestimates both inward and outward investment stocks, particularly in the case of industrialised countries. But in his comparison of stocks' estimations Narula (1996: p.41) used only five year flows. In this research a much longer period was adopted. Published data existed for 1965-1998, and estimations were made to extend the data set as much as possible.

Information on medium and long term capital flows since 1943 was available from Matos (1973), but only after 1962 could the figures be disaggregated between FDI and other long term capital flows. It was, then, necessary to estimate the percentage of those capital movements that corresponded to FDI. This situation was made by computing, for 1964-1974, the ratio between the new figures for FDI (Banco de Portugal, 1997a) and the old figures for medium and long term capital movements (Matos, 1973: p.11; Taveira, 1984: p.149). The values obtained (20.0% for inward, and 8.2% for outward capital movements) were adopted as estimations of the weight of FDI on Matos' 1943-1964 medium and long term capital movements[30].

There was little information to assess the reliability of the estimations. The only comparison that could be made was with the 1996 stock of inward FDI (Banco de

[30] A similar method was used by Matos (1973) and Taveira (1984) but with a different data set. The data available (Taveira: 1984: p.149) permitted to use a longer period, but the figures suggested that the proportion of FDI in total capital movements changed considerably after the revolution, in 1974. On the other hand, the use of the new values for FDI and the old ones for capital movements in the calculation of the ratio was necessary to assure the compatibility of the estimates with the post-1965 data.

Portugal, 1998b). The value obtained with the sum-of-flows method described above was 2,441 billion Portuguese escudos, only 16 per cent lower than Bank of Portugal's figure. Despite the shortcomings of the method and of the FDI series, this was a positive indicator that these estimations of the stocks of inward and outward FDI in Portugal could be used in the investigation of the Portuguese IDP.

As for the remaining variables involved (GDP and population), the main source (1965-1995) was Banco de Portugal (1997a). The figures for the subsequent years (1996-1998) were computed using the growth rates implicit in OECD (1999b), in the case of GDP, and INE (1999) in the case of population. The growth rates were adopted instead of the actual figures because the latter were incompatible with the Bank of Portugal's data.

4.6.2. The model - an alternative specification

Dunning (1981a, 1981b, 1986a), Tolentino (1987, 1993), and Narula (1996) all used a quadratic function to describe the IDP curve. However, this option defies the very theory of the IDP. Implicit in the quadratic function is the assumption that FDI is the engine of growth. Net outward investment (NOI) per capita decreases sharply in the early stages of the IDP, reflecting high inward FDI and nil or low outward investment, while GDP per capita has a slow start. This is not in line with the IDP rationale. In the first stage of the IDP, both inward and outward FDI will be low. Governments must intervene "providing basic infrastructure and the upgrading of human capital via education and training" (Dunning and Narula 1996b: p.3). In other words, before a country can attract significant inward FDI it must develop its locational advantages, including the increase of GDP per capita[31]. Consequently, what is to be expected in the first stage of the IDP is a more rapid increase of GDP per capita than NOI per capita. Only in the second stage should the growth rate of NOI per capita be higher than that of GDP per capita. This evolution can be translated by a function of the type:

$$NOIpc = \alpha + \beta_1 GDPpc^3 + \beta_2 GDPpc^5 + \mu$$

where β_1 should be negative and β_2 positive. Having an inflection point to the left of the turning point (a minimum if the proposed signs are confirmed), it models the expected slow growth of the independent variable in the earlier stages. In a second stage the independent variable grows faster than the dependent variable. Nevertheless, it later slows

[31] Even if not a policy target in itself, GDP growth will inevitably be a consequence of such policies.

down and eventually reaches a minimum – the U-turn that corresponds to the transition between stages 2 and 3 of the IDP, when the country becomes a net outward investor in terms of flows.

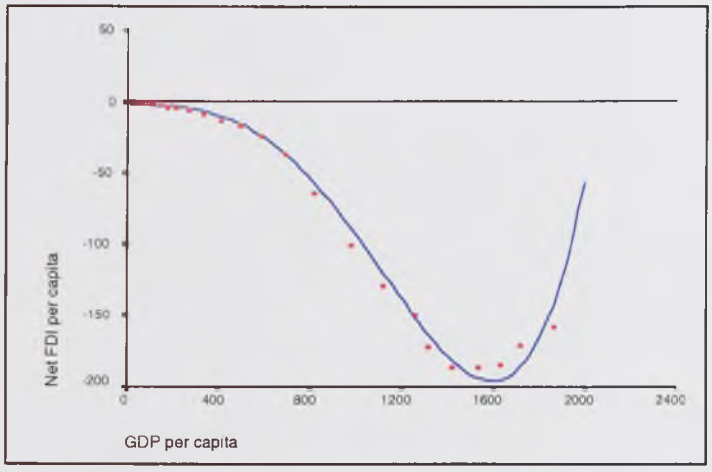
4.6.3. Estimation and comments

Using ordinary least square estimation and the 34 available observations (1965-1998), the model suggested above provided the following results:

$$NOIpc = -2.823 - 119.439\ GDPpc^3 + 28.175\ GDPpc^5$$

All coefficients, including the constant, were correctly signed and significant at 1% (5% for the constant). Adjusted R square was very high, at 99%, and the overall model significant at 1%. Fitted and real values can be compared in Figure 4.8.

FIGURE 4.8: ESTIMATION OF THE IDP FOR PORTUGAL, 1965-1998

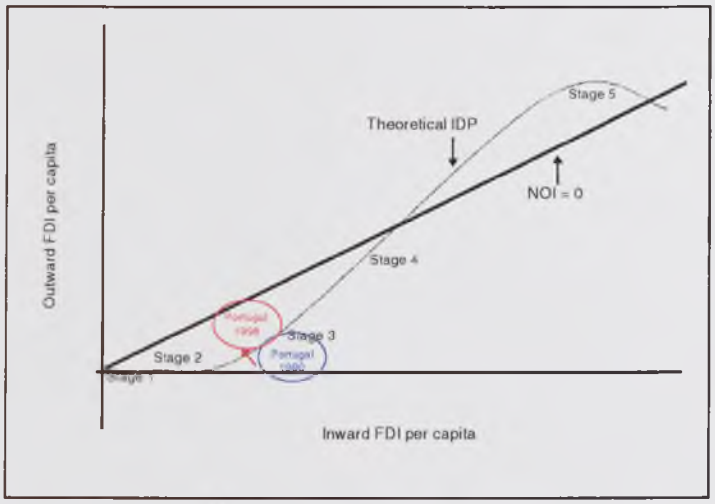


The estimation seems to support the claim that FDI follows a more or less predictable path, accompanying and influencing economic growth. From what was described in sections 4.2 and 4.5, Portugal was undisputedly a stage 1 country until the early 1960s. The transition to stage 2 of the IDP occurred during the 1960s, although Figure 4.8 suggests that it may have not been completed until the early 1980s, when GDP reached 250-300 thousand escudos (some US$2,500 at the time). Stage 3 seems to have been reached in the middle 1990s, with GDP per capita at 1,300-1,400 thousand escudos, about 10,000 US dollars.

The fact that Portugal's net stock of outward FDI has increased every year since 1995, however, must be carefully analysed (cf. previous section). At the first glance, it suggests a strong improvement of the country's competitive position. If competitiveness can be

measured in terms of local firms' ability to expand abroad, that is certainly the case. However, the use of net outward stocks of FDI conceals a decline in the country's attractiveness as a location of foreign investment. This implies that Portugal is no closer to stage 4 of the IDP than it was in the mid-1990s. Stage 4 is associated with high volumes of both inward and outward FDI (Dunning, 1981a, 1981b, 1986b), which is not the case in Portugal. Figure 4.9 depicts very clearly the real evolution of the Portuguese competitive position: a movement inside the area that corresponds to Stage 3 of the IDP.

FIGURE 4.9: AN ALTERNATIVE REPRESENTATION OF THE PORTUGUESE IDP



Source: Adapted from Úbeda (1999: p. 59)

Another element that arises from the case of Portugal is the limited potential of the IDP as a prediction mechanism. According to Narula (1996), Portugal seemed to be approaching stage 3 of the IDP both in 1975 and 1988. That was also the opinion of Úbeda (1999), who used a different methodology, for every year studied between 1975 and 1990. Despite that, not until the mid-1990s was the transition between stages 2 and 3 completed (cf. Figure 4.8). This difficulty in predicting the evolution of the countries' investment positions is to a great extent due to the influence of non-economic factors. Government policies, in particular, were recurrently identified in studies of individual countries as being of major influence (Lall, 1996). In the case of Portugal, the beginning of Stage 2 coincided with the political decision to abandon import substitution policies in favour of export promotion (around 1960). That the prediction that Portugal was entering stage 3 was not confirmed until 1990 is probably linked with the 1974 democratic revolution and with EU membership, in 1986, which changed the country's economic and geopolitical conditions. To their credit, it must be made clear that 'politics' was explicitly pointed out by Dunning and Narula (1996b) as one of the elements that make each individual IDP idiosyncratic.

Government policies are themselves a central piece of the IDP rationale (see chapter 2) Furthermore, the IDP was never conceived of as a prediction tool. This stresses, nevertheless, the need for a careful analysis of the inward and outward phenomena, which will be done in the next two chapters.

APPENDIX 4A.

THE DETERMINANTS OF FDI

VARIABLES, EXPECTED SIGNS AND DATA SOURCES

TABLE 4A1. THE DETERMINANTS OF FDI IN PORTUGAL

DEPENDENT VARIABLE		SOURCE
Inward FDI flows (constant prices)		1980-1996: Banco de Portugal (1997a, 1997b); 1997: own calculations based on Banco de Portugal (1997a, 2000a). Deflator: GFCF deflators, *in* OECD (1999).
INDEPENDENT VARIABLES	**EXPECTED SIGN**	**SOURCE**
MARKET SEEKING		
Real GDP	+	1978-1995: Banco de Portugal (1997a); 1996-1997: Own calculations - growth rates published in OECD (1999b)
Real GDP growth rate	+	1978-1995: Own calculations based on Banco de Portugal (1997a). 1996-1997: OECD (1999b).
EU15 Real GDP	+	OECD (1999b).
EU15 Real GDP growth rate	+	Own calculations based on OECD (1999b).
COST EFFICIENCY		
Relative labour costs	-	'EU=100', Own calculations based on Bureau of Labor Statistics (1998).
Infrastructure	+	'Telephones per 100 inhabitants', UN, *Statistical Yearbook*, several.
Export prices	-	OECD (1994, 1999b).
GEOPOLITICAL POSITION		
European Union membership	+	Dummy variable: '0', 1980-1985 '1', 1986-1997
1990s	-	Dummy variable: '0', 1980-1990 '1', 1991-1997
ECONOMIC STABILITY		
Public deficit	-	1978-1995: Own calculations based on Banco de Portugal (1997a); 1996-1997: OECD (1999b).
Inflation rate	-	OECD (1994, 1999b).
Interest rate	-	OECD (1999b).
Exchange rate 1999b).	-	'Effective exchange rates', in OECD (1989,
Current account deficit	-	OECD (1992, 1999b).

TABLE 4A2. THE DETERMINANTS OF FDI IN THE EUROPEAN PERIPHERY

DEPENDENT VARIABLE		SOURCE
Inward FDI flows .Million USD (1997c) .1995 and 1996, average		OECD members: OECD (1997b) Slovenia and Slovakia: OECD
INDEPENDENT VARIABLES	**EXPECTED SIGN**	**SOURCE**
MARKET SEEKING		
Nominal GDP .Billion USD, at exchange rates .1994, 1995, average	+	OECD members: OECD (1999a) Slovenia and Slovakia: own calculations based on UN (1996) and OECD (1997d)
Real GDP growth rate .1994, 1995, average	+	OECD (1999a)
GDP per capita .1994, 1995, at PPP, average (1997c)	+	OECD members: OECD (1999a) Slovenia and Slovakia: OECD
Population .1995	+	OECD members: OECD (1999a) Slovenia, Slovakia: UNESCO (1997)
COST EFFICIENCY		
Labour costs .Gross Wages per month, 1994	-	Podkaminer (1998) Turkey: Own calculations based on ILO (1996)
Labour skills .Education index, 1994	+	United Nations (1997)
Infrastructure . Telephones per 100 inhabitants, 1994	+	United Nations (1996)
Personnel in R&D . Per 100 inhabitants, latest available	+	UNESCO (1997)
GEOPOLITICAL POSITION		
EU membership .EU15	+	Dummy variable
Distance .Minutes to fly between capital city and Paris and Frankfurt, average.	+	Yahoo (1997) Turkey: Istanbul
ECONOMIC STABILITY		
Current account deficit .Percentage of GDP .1994, 1995, average	-	OECD (1997d)
Inflation rate .1994, 1995, average	-	OECD (1997d)
Interest rate .Rate of discount of Central Bank .1994, 1995, average	-	UN (1996)
Public account deficit .Percentage of GDP .1994, 1995, average	-	OECD (1997d)

CHAPTER 5.
INWARD FDI IN PORTUGAL: A QUESTIONNAIRE SURVEY

5.1. INTRODUCTION AND METHODOLOGICAL CONSIDERATIONS

It was very clear from the previous chapter that inward foreign direct investment represented one of the driving forces of the Portuguese economy during the last forty years. It was also apparent, however, that existing empirical research was not sufficient to provide a clear picture of the characteristics and motivations of foreign firms operating in Portugal. The level of aggregation, largely because of data limitations, was a major restriction (Taveira, 1984, being the exception). Another was probably the limited use of techniques other than regression analysis (here the exception was Santos, 1997). In the future, econometric studies will benefit from the availability of new and more reliable data, which at the moment remains restricted to Banco de Portugal (1998b). However, the use of different research strategies will remain necessary.

Another element that impinged on the researcher trying to investigate the FDI phenomenon in Portugal was the need to conduct the study at the firm level. In the previous chapter there were clear indications that different motivations coexist among foreign investors in Portugal. Only with data at the firm level can these differences be investigated. The motivations are likely to be associated with the industry and the country

of origin (cf. chapter 3). Company characteristics and the time of the first investment may also be important given the political, economic and geo-strategic changes the country endured over the last forty years.

In methodological terms, these considerations seem to suggest the adoption of an inductive approach, "moving from the plane of observation of the empirical world to the construction of explanations and theories about what has been observed" (Gill and Johnson, 1991: p.33). However, FDI is a phenomenon widely researched (see chapter 3), with a well established body of literature despite the coexistence of competing models (see chapter 2). The results of previous research for Portugal (cf. sections 4.3. and 4.4) albeit contradictory, could not be ignored either. Therefore, purely inductive methods would be inappropriate, making a survey based investigation a better research strategy.

Survey analysis constitutes an intermediate methodology between extreme positivistic (deductive) and naturalistic (inductive) approaches (Gill and Johnson, 1991: p.75). It also corresponds to the option for an extensive rather than an intensive research design. Furthermore, the focus on taxonomic groups permits the identification of common attributes and patterns of behaviour that can be generalised for the entire population[1] (Knell, 1996: p.35). Despite this being obtained at the expense of an in-depth knowledge of individual subjects and the causal relationships between them, it suggests that survey analysis is the appropriate research technique for the investigation of the characteristics and determinants of inward FDI in Portugal. Replicability is another advantage because it facilitates external validation.

Although different techniques can be associated with survey analysis (see Knell, 1996: p.37), a self-administered postal questionnaire was in this case the best choice. "Research methodology is always a compromise between options, and choices are frequently determined by the availability of resources" (Gill and Johnson, 1991: p.2). Without data to stratify a small representative sample, interviews (either structured or not) were impracticable because of the costs and time involved.

Surveys are usually posited as being low in ecological validity. They are particularly susceptible to problems of inadequate memory, retrospective falsification, or language ambiguity (Carroll and Johnson, 1990: pp. 33-34). In the case of self-administered questionnaires, these problems may be amplified because the respondents may relax the

[1] Albeit not for other populations.

accuracy of the responses in order to hasten the completion of the questionnaire. Non-responses are also more likely than in interviews. On the other hand, the eventual offer of anonymity may reduce the temptation to give the perceived 'right' answers rather than the true ones (Gill and Johnson, 1991: p.79).

5.2. METHOD

5.2.1. Population and sample

The population for this study comprised the subsidiaries of foreign firms operating in Portugal in manufacturing (including the agro-industries) and commercial activities. A number of sources were used to identify the population: the National Institute of Statistics (INE), the Institute for Foreign Trade and Investment (ICEP), national chambers of industry and commerce operating in Portugal, and assorted publications by leading business newspapers and magazines.

The combination of these sources provided over 5,000 different entries, albeit not all relevant for the study, since many firms belonged to the services sector or had a very small participation of foreign capital. However, in many cases only the name and address existed, which made it difficult to eliminate all non-relevant firms. This was to generate several difficulties in the administration of the questionnaire (as discussed below), and made it impossible to know the exact size of the population.

The lack of detailed information for many subjects justifies that the sample was built on 'negative' criteria. In order to guarantee foreign control, firms known to have less than 50 percent of foreign capital were excluded. The same was done to firms known to have less than 10 employees. Given it was not possible to contact the whole population, the second best option was to concentrate on the bigger firms, believed to have a stronger impact on the local economy. The option for a workforce of 10 or more permitted to include all firms not classified as 'micro' businesses by Eurostat. These criteria generated a sample of 1,517 firms, which was considered viable given the financial resources available[2].

As it turned out, a number of firms that accepted to participate in the study had less than 10 employees (see section 5.3). In a few cases the labour force had been reduced recently, but most were firms for which information on the number of employees was not available.

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[2] Of these 1517 firms, however, as many as 253 were excluded during the field work. Many had ceased operations in Portugal. Others had merged or changed their name, and had been courted twice; in others, the foreign stake had been sold to Portuguese investors.

The decision was to include them in the analysis, but keeping in mind that the sample was deliberately biased towards bigger companies and as such was less representative when it came to very small foreign subsidiaries.

5.2.2. Questionnaire

The construction of the questionnaire was very much oriented by the need to keep it as simple and short as possible in order to maximise the participation rate. With no obvious gains for the participants from cooperating in the research, it would not be reasonable to expect them to spend too much of their time completing the questionnaire. The exclusive use of closed questions was considered important to fulfil that aim. The questionnaire was, nevertheless, longer than was ideal, very much because it was necessary to account for a wide variety of the firms in terms of industry, size, or the activities undertaken in Portugal.

To test the questionnaire, interviews were conducted at eleven firms in the vicinity of Porto during May 1998, representing different industries and countries of origin. Typically, the interviewees were asked to provide a historical summary of the firm and the group and to describe their present activities, their reasons for investing in Portugal, and the major difficulties faced. They were also asked to assess the economic environment, and the behaviour of clients, suppliers, competitors, and other public and private institutions. Next, they were invited to fill out a pilot questionnaire, generally in the presence of the interviewer.

One reason why interviews were preferred to the postal distribution of a pilot questionnaire was time restriction. As it happened, it was possible to do what was believed to be an efficient piloting of the questionnaire in just two weeks. The alternative solution would have certainly taken much longer, making it impossible to have the final version of the questionnaire distributed at the beginning of June. This timing was critical because managers tend to have their annual holidays in July or August. Another advantage of the interview-based pilot scheme was that it allowed the evaluation of whether the questions were clear and had not been misunderstood by the respondents. The interviews also provided valuable information in helping to understand the phenomenon of foreign direct investment in Portugal and the views of those responsible for foreign subsidiaries. This insight was very important in a questionnaire where all questions were closed, which implies the anticipation of all plausible answers.

The piloting led to several changes. Some of the questions had to be rewritten and others were eliminated. A few alternative responses were added to some questions. The relevance of every question for the research project was weighted against the burden it would put on an already fairly long questionnaire. Questions requiring data difficult or very time consuming to obtain were rewritten or eliminated. Overall, the final version of the questionnaire (see Appendix 5A) was slightly simpler and shorter than the original version.

5.2.3 Field work

The questionnaire was mailed during the first week of June 1998 to the 1,517 companies that originally constituted the sample[3]. It was accompanied by a cover letter (addressed to the CEO) explaining the project and a pre-paid envelope addressed to the researcher. During July, August, and September, the biggest firms in the sample that had not yet replied were contacted by telephone. 260 companies were involved in this second phase, which entailed in most cases the questionnaire being re-sent by fax. A follow-up letter, with a second copy of the questionnaire and another pre-paid envelope, was sent in early September to those firms not contacted by telephone, and in early October to those that had not replied despite the telephone contact.

In total, 257 filled questionnaires were returned, representing a response rate of 20.3 per cent[4]. Of these, however, 19 could not be used in the analysis, either for not being correctly completed or because they corresponded to firms that, contrarily to the information previously available, did not meet all the criteria for sample selection. Another was dropped during the data analysis because several of the answers were not consistent with each other. As a result, the analysis was based on 237 answers, equivalent to 19 per cent of the adjusted sample which constitutes a fairly high response rate.

5.3. Characterisation of the sample

A number of questions in the first part of the questionnaire permitted a characterisation of the sample. In terms of the main activity developed in Portugal, the official 'code of economic activity' (CAE) identified the industry in which the subsidiaries operated. Therefore, they were classified according to their operations in Portugal, irrespective of the

[3] The version of the questionnaire sent was the Portuguese translation. The English original was only sent on request (four firms did so).
[4] From the total sample of 1,264 valid potential respondents (cf. footnote 2).

main activity of the parent company. In particular, purely commercial subsidiaries were classified as such, and not according to the parent company's industry[5].

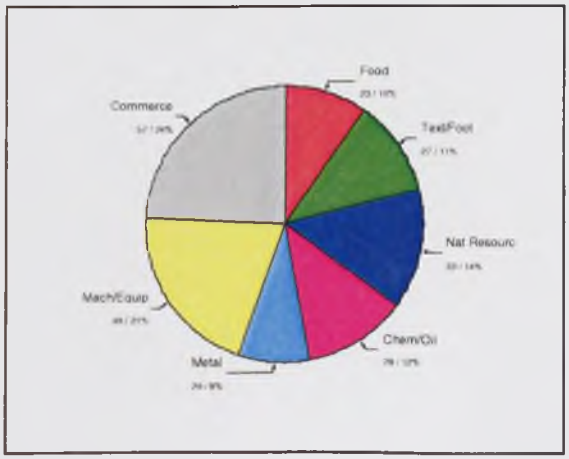
To simplify the analysis, the industries represented in the sample were divided into seven groups. The stress was on group homogeneity, but an effort was made to create as few groups as possible. The relative size of the groups was also taken into account. Table 5.1 shows how the industries were grouped and Figure 5.1 the sample distribution per industry.

TABLE 5.1: HOW INDUSTRIES WERE GROUPED

Group	Name	Industries included	CAE [a]
1	Food and beverages	Agriculture	01-05
		Food processing and beverages	15-16
2	Textiles, clothing and footwear	Textiles	17
		Clothing	18
		Footwear	19
3	Natural resources based	Mining and quarrying	10-14
		Lumber, wood and furniture	20,36
		Cork and cork products	20
		Pulp and paper	21
		Clay, glass, cement	26
4	Chemicals and oil	Oil products	23,25
		Chemicals and pharmaceuticals	24
5	Metal industries	Primary metal industries	27
		Fabricated metal products	28,36
6	Machinery and equipment	Machinery, except electric	29
		Electric and electronic machinery	30-33
		Transportation equipment	34-35,36
7	Commerce	Retailing and wholesale trade	50-52
		Printing and publishing	22

[a] ***CAE*** *Code of Economic Activity*

FIGURE 5.1: DISTRIBUTION OF THE SAMPLE PER INDUSTRY



[5] Because this classification is not always accurate, all the suspected inaccuracies were checked by telephone.

The representativeness of the sample can be asserted using data produced by the Ministry of Labour and Solidarity[6], which are summarised in Figures 5.2 and 5.3. The participating firms represented 19 per cent of those registered with the Portuguese Ministry of Labour (Figure 5.2) but 54 per cent of the employment by foreign owned firms operating in Portugal at the end of 1997 (Figure 5.3)[7]. This reflects the strategy adopted for data collection, which concentrated on the bigger firms (see section 5.2.1).

FIGURE 5.2: PERCENTAGE OF FIRMS REPRESENTED IN THE SAMPLE, PER INDUSTRY

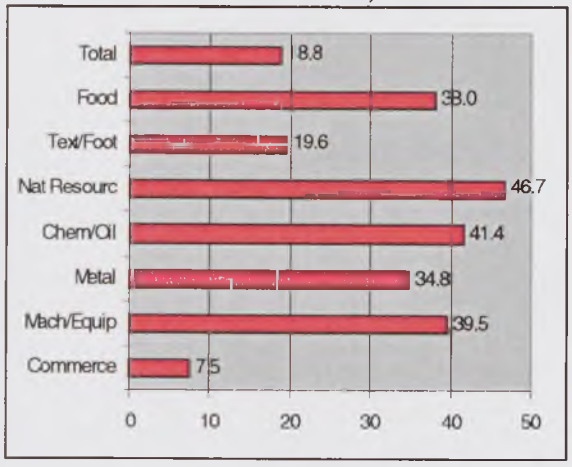
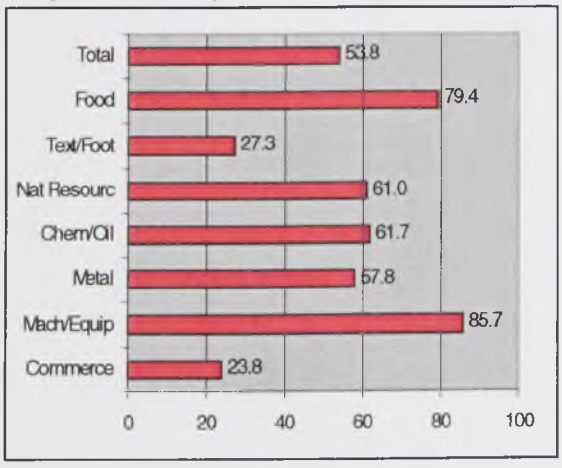


FIGURE 5.3: REPRESENTATIVENESS OF THE SAMPLE – PERCENTAGE OF LABOUR FORCE



The figures above also show that the sample was much less representative for commercial firms (24 per cent of the employment but only 8 per cent of the firms) and in textiles, clothing and footwear (27 and 20 per cent, respectively). This is probably due to the average size of firms in these industries, smaller than the average. In the manufacturing industries as a whole the sample was equivalent to 34 per cent of the firms and 63 per cent of the employment registered with the Ministry of Labour and Solidarity.

Most firms in the sample were very recent (Figure 5.4). Over two thirds were created or acquired after Portugal joined the (then) EEC, in 1986. This largely matches the evolution of FDI (see chapter 4). However, the most recent years may be expected to be over-represented in the sample. Older firms still operating in Portugal are the ones that survived the changes in the Portuguese and international markets, the evolution of relative costs across the world, and the transformations in the structure, competitiveness and strategy of the parent companies. The most recent firms, on the other hand, were not yet submitted to the tests of time.

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[6] Ministério do Trabalho e da Solidariedade, Quadros de Pessoal de 1997, unpublished.

[7] Small discrepancies may exist between the two datasets – the Ministry of Labour's data and that of the questionnaire – since the latter reports to the summer of 1998 and the former to December 1997.

FIGURE 5.4: DISTRIBUTION OF THE SAMPLE PER YEAR OF INVESTMENT

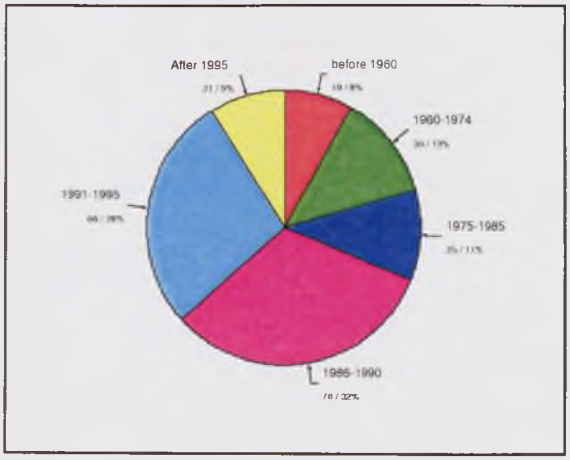
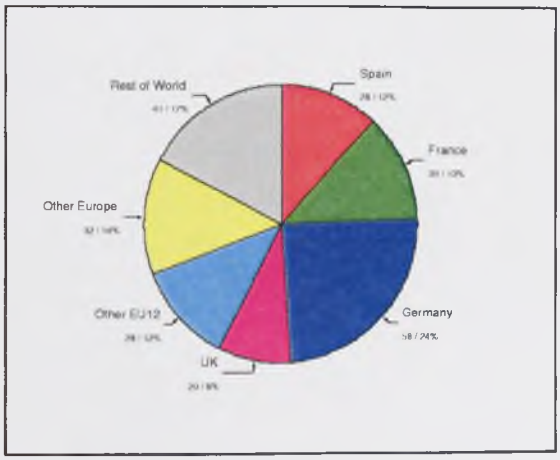


FIGURE 5.5: DISTRIBUTION OF THE SAMPLE PER COUNTRY OF ORIGIN



In terms of country of origin (Figure 5.5), Germany alone accounted for 24 per cent of all firms in the sample. This importance of German investors is frequently ignored in Portugal, but it is confirmed by Bank of Portugal's most recent data (Banco de Portugal, 1998b). Germany was in 1996 only the fifth most important source country, with 10 per cent of the total stock of inward FDI. In the case of manufacturing, however, the figure was 23 per cent, the highest for any individual country (cf. chapter 4, figure 4.5 and table 4.4). In commerce, the German share was only 6 per cent, but this sector had a much lower weight in the sample than manufacturing.

France, Spain, the UK and the USA were the other countries with a significant representation in the sample. With the exception of Spain - the only country with a border with Portugal - these are the main foreign investors worldwide. Only Japanese firms, with a negligible presence in Portugal, were absent from the list. Unfortunately, direct comparison with Bank of Portugal's data (Banco de Portugal, 1998b) was not possible for the reasons stated above.

Cross-referencing the country of origin and the year of investment (Table 5.2) revealed a more or less predictable pattern. Spanish subsidiaries were younger than the average, which shows how recent the phenomenon of economic integration in the Iberian peninsula is. Other recent investors in Portugal were the non-EU12 European countries (which included the three most recent EU members), which seem to have "discovered" Portugal in 1986. The older firms in the sample were those from the UK, Portugal's main economic partner until 1974. But even in this case the median was only two years lower than in the overall sample, and two in five subsidiaries were set up in the 1990s.

TABLE 5.2: COUNTRY OF ORIGIN *VS.* YEAR OF INVESTMENT

Country		Before 1975	1975-85	1986-90	1991-98	Total	Median
Spain	No.	3	2	10	14	29	1990
	%	*10.3%*	*6.9%*	*34.5%*	*48.3%*	*100.0%*	
France	No.	8	3	9	10	30	1989
	%	*26.7%*	*10.0%*	*30.0%*	*33.3%*	*100.0%*	
Germany	No.	13	5	18	22	58	1989
	%	*22.4%*	*8.6%*	*31.0%*	*37.9%*	*100.0%*	
UK	No.	6	2	4	8	20	1987
	%	*30.0%*	*10.0%*	*20.0%*	*40.0%*	*100.0%*	
Other EU12	No.	8	4	8	8	28	1988
	%	*28.6%*	*14.3%*	*28.6%*	*28.6%*	*100.0%*	
Other Europe	No.	4	3	9	16	32	1991
	%	*12.5%*	*9.4%*	*28.1%*	*50.0%*	*100.0%*	
Rest of the World	No.	7	6	18	10	41	1988
	%	*17.1%*	*14.6%*	*43.9%*	*24.4%*	*100.0%*	
Total	No.	49	25	76	88	238	1989
	%	*20.6%*	*10.5%*	*31.9%*	*37.0%*	*100.0%*	

Table 5.3 presents the industry distribution for different countries of origin. One immediate observation was the weight of machinery and equipment manufacturing in the investment by non-European, German, and French firms. This corresponded with those countries' worldwide positions in the sector. However, the inability of Portugal to attract Japanese investors was particularly apparent. Despite many of the biggest machinery and equipment producers in the world being Japanese, few of the non-European investors in the sample were from Japan (most were from the US). The fact that all the other dominant powers in those industries were well represented in the sample only made the absence more noticeable.

TABLE 5.3: COUNTRY OF ORIGIN BY INDUSTRY

Country		Food and beverag.	Text,cloth footwear	Natural resourc.	Chemic. and oil	Metal industr.	Machin. + equip.	Com-merce	Total
Spain	No.	4		6	1	4	4	10	29
	%	*13.8%*		*20.7%*	*3.4%*	*13.8%*	*13.8%*	*34.5%*	*100.0%*
France	No.	5	3	5	3	3	7	4	30
	%	*16.7%*	*10.0%*	*16.7%*	*10.0%*	*10.0%*	*23.3%*	*13.3%*	*100.0%*
Germany	No.	1	11	4	8	4	16	14	58
	%	*1.7%*	*19.0%*	*6.9%*	*13.8%*	*6.9%*	*27.6%*	*24.1%*	*100.0%*
UK	No.	2	3	6	2	1	1	5	20
	%	*10.0%*	*15.0%*	*30.0%*	*10.0%*	*5.0%*	*5.0%*	*25.0%*	*100.0%*
Other EU12	No.	8	2	3	4	3	4	4	28
	%	*28.6%*	*7.1%*	*10.7%*	*14.3%*	*10.7%*	*14.3%*	*14.3%*	*100.0%*
Other Europe	No.	1	6	8	4	3	3	7	32
	%	*3.1%*	*18.8%*	*25.0%*	*12.5%*	*9.4%*	*9.4%*	*21.9%*	*100.0%*
Rest of the World	No.	2	2	1	6	2	15	13	41
	%	*4.9%*	*4.9%*	*2.4%*	*14.6%*	*4.9%*	*36.6%*	*31.7%*	*100.0%*
Total	No.	23	27	33	29	20	50	56	238
	%	*9.7%*	*11.3%*	*13.9%*	*12.2%*	*8.4%*	*21.0%*	*23.5%*	*100.0%*

Among the remaining industries, textiles, clothing and footwear were particularly important for German and non EU12 European investors (of which Switzerland represented a

substantial proportion). The percentage assumed by the food industries in the investment by 'other EU12 countries' was to a large extent due to Dutch firms. Finally, the high percentage of commercial subsidiaries among Spanish firms probably reflects geographic proximity. In many industries it is perfectly possible to supply efficiently the whole Iberian market from one single productive location (see chapter 6). However, non-European firms also included a high percentage of purely commercial subsidiaries, which seems contradictory.

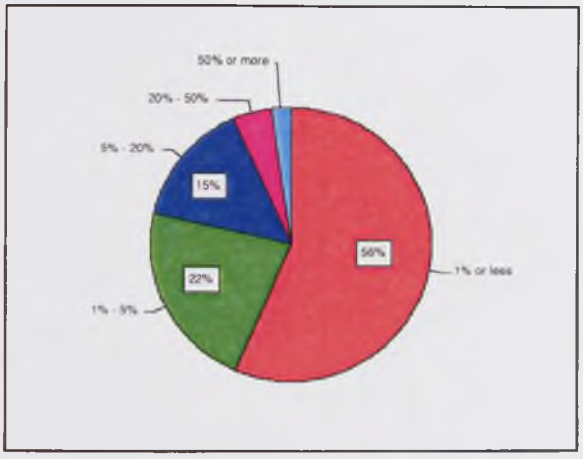
In terms of turnover and number of employees the sample was quite diversified (Table 5.4). Turnover ranged from nil, corresponding to five firms that only started operations in 1998, to 160 billion PTE (about US$900 million). Over half the firms in the sample had a turnover above 1.6 billion PTE (US$9 million), and one quarter had a turnover above 7 billion PTE (some US$40 million). As for the number of employees, the sample reflected the small scale of firms operating in Portugal. The median was only 98 employees, and one quarter of the firms in the sample had a labour force of less than 30.

TABLE 5.4: TURNOVER AND EMPLOYMENT: DESCRIPTIVE STATISTICS

Descriptive Statistics		Turnover 1997 *(million PTE)*	Labour Force 1997
Mean		7,884	303
Std deviation		19,369	793
Minimum		0	2
Maximum		160,000	7,455
Percentiles	25%	540	29
	50%	1,664	98
	75%	6,851	266

In general, the Portuguese subsidiaries contributed very little to the worldwide turnover of the parent company (Figure 5.6). Of those that provided this information (136 firms), 56 per cent generated one per cent or less of the group's worldwide turnover, and only 7 per cent more than one fifth. There was also the suspicion that firms with a small contribution were less likely to provide the information. That being the case, the true percentage of those representing less than one per cent of the group's turnover could be even higher. The figures changed only slightly when analysed in terms of labour force, and reflect the relative size of Portugal in the world economy. In the case of Spanish subsidiaries, however, the picture was substantially different. 71 per cent contributed more than five per cent of the group's turnover and 21 per cent more than one fifth. This suggests that the Portuguese subsidiaries may in many cases have been the only foreign venture of the parent firm.

FIGURE 5.6: SUBSIDIARY'S CONTRIBUTION TO GROUP'S TURNOVER



Foreign subsidiaries established in Portugal showed a very strong export propensity. Predictably, the European Union was the main destination. For manufacturing firms, exports to the EU (including Spain) were equivalent to sales in the local market (respectively 44% and 45% of the subsidiaries' turnover). Nevertheless, differences between industries were substantial (Table 5.5 and Figure 5.7).

TABLE 5.5: MARKET DISTRIBUTION OF SALES ACROSS INDUSTRIES

Markets / *Industry (N)*	Portugal	Spain	Other EU15	Other Europe	Rest of the World	Home country
Food and beverages (22)	49.1	6.0	35.1	.8	8.9	25.2
Textile, clothing, footwear (26)	13.8	3.3	62.4	16.3	4.2	51.2
Natural resources based (29)	57.8	8.5	22.9	4.2	6.6	13.8
Chemicals and oil (28)	70.1	4.9	21.3	.5	3.2	6.9
Metal industries (20)	49.1	12.0	30.0	3.7	5.3	17.5
Machinery and equipment (46)	34.2	10.5	42.0	2.7	10.6	16.9
All manufacturing (172)	***45.0***	***7.7***	***36.0***	***4.5***	***6.9***	***21.0***
Commerce (54)	***84.4***	***1.9***	***9.3***	***1.3***	***3.1***	***6.0***

The textile, clothing and footwear segments were the most export oriented, selling only 14 per cent of their production in Portugal. Exports to the parent country represented in this case over half the production. Machinery and equipment manufacturers were the other group of firms that exported much more than they sold in Portugal. But contrarily to textiles and clothing, only 17 per cent of the output was sold in the home country. Access to the EU market seemed to be much more relevant for these industries. The manufacturing industries in the sample most oriented towards the Portuguese market were the chemicals and oil producers, whose exports represented only 29 per cent of the subsidiaries' turnover.

FIGURE 5.7: MARKET DISTRIBUTION *VS.* INDUSTRY

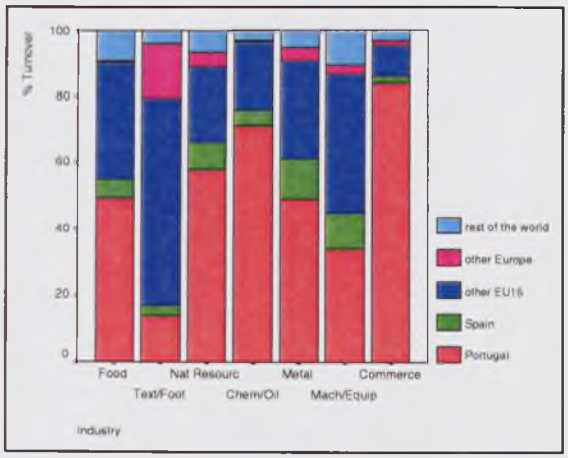
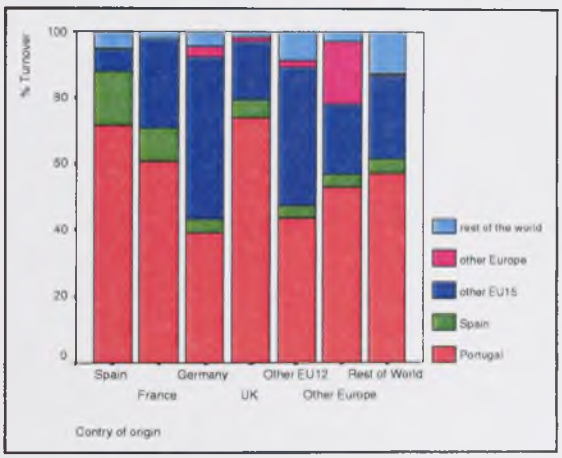


FIGURE 5.8: MARKET *VS.* COUNTRY OF ORIGIN



In terms of country of origin (Table 5.6 and Figure 5.8), the most export oriented manufacturing firms were those from Germany. Only 29 per cent of their output was sold in Portugal, against 38 per cent that was exported to the home country. By contrast, the most local market oriented firms were those from the UK and from Spain. This predominance of market oriented FDI was not easy to explain in the case of British firms. For Spanish subsidiaries, however, it seems to support a suspected low degree of internationalisation of the parent companies (see above). With little foreign experience, their ability to sell outside the Iberian peninsula may be limited.

TABLE 5.6: MARKET DISTRIBUTION OF SALES ACROSS COUNTRIES

Markets / *Country of origin*	Portugal	Spain	Other EU15	Other Europe	Rest of the World	Home country
Spain (18)	60.4	22.4	9.2	.1	7.8	22.4
France (23)	55.7	11.3	30.1	.3	2.6	19.9
Germany (41)	29.2	4.9	59.7	2.9	3.3	38.4
UK (13)	64.0	7.6	24.2	1.6	2.6	15.3
Other EU12 (24)	45.1	3.2	41.8	1.9	7.9	19.7
Other Europe (25)	43.9	4.4	25.5	22.4	3.8	14.6
Rest of the World (28)	41.2	6.2	33.1	.8	18.8	5.0
All manufacturing (172)	***45.0***	***7.7***	***36.0***	***4.5***	***6.9***	***21.0***

Note: *Commercial subsidiaries not included.*

It should be noted that, for most firms in the sample, the Spanish market was less important than their home market. The only exception were non-European firms, probably due to the geographic distance to the home country. What is interesting is that this fact suggests a surprisingly low level of integration of activities by MNCs in Portugal and Spain; at least for those with production capacity in Portugal.

The influence of size in the export propensity of manufacturing firms was another interesting element (Figure 5.9). Smaller subsidiaries tended to be more concentrated in the local market, while bigger ones sold much more in other EU markets than in Portugal. The

trade-off between the local market and the EU market was highlighted by few sales outside the European Union by firms of all sizes. It was, nonetheless, even lower for the smallest firms in the sample.

FIGURE 5.9: MARKET DISTRIBUTION *VS.* FIRM'S SIZE

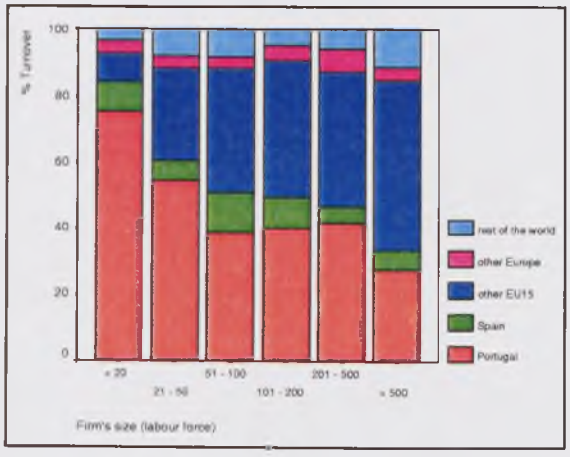
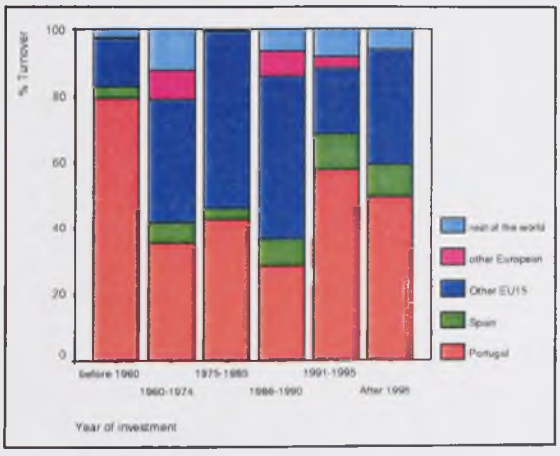


FIGURE 5.10: MARKET DISTRIBUTION *VS.* FIRM'S AGE



The analysis of the export propensity of firms established during different periods of Portugal's recent history was also revealing (Figure 5.10). The most export oriented subsidiaries were those created or acquired in the years immediately after Portugal joined the then EEC. The second group in terms of level of exports corresponded to the subsidiaries created between 1960 and 1974, the period that followed the creation of EFTA and which corresponded to a substantial liberalisation of Portugal's international trade (see chapter 4).

Less expected was the fact that firms created between 1975 and 1986 were more export oriented than those created after 1990. The explanation may lay with the small relevance of the EU market for the most recent foreign subsidiaries, especially for those created and acquired in the first half of the decade. It seems, though, that the fall of inward FDI in recent years is particularly associated with export oriented, or efficiency seeking investment (cf. chapter 4), more so in the first half of the decade than in the second.

5.4. THE INVESTMENT DECISION

5.4.1. Reasons to invest in Portugal

To analyse the determinants of investment in Portugal, the participants in the survey were presented with two inter-related questions. First, 32 potential determinants were proposed and the participants were asked to classify each one using a 5-point Likert scale where 1 corresponded to irrelevant and 5 to very important (see Appendix 5A). Next, the

participants were asked, out of the same 32 determinants, to single out the one they considered the most important reason for the firm to have invested in Portugal. Table 5.7 summarises the results. Because the differences between manufacturing and commercial firms were substantial, separate rankings were produced.

TABLE 5.7: WHY INVEST IN PORTUGAL

Table 5.7a Manufacturing firms

Rank	Reason	Mean[a]	Main reason[b] N	%
1	Reduction labour costs	3.49	41	26.6
2	Increase group's turnover	3.09	11	7.1
3	Economic stability	3.06	1	.7
4	Political stability	3.06	1	.7
5	Quality of labour force	3.03	5	3.2
6	Reaction to competitors	2.59	1	.7
7	Market expected growth	2.54	8	5.2
8	Competition home market	2.50	2	1.3
9	Transportation costs	2.49	2	1.3
10	Public incentives	2.43	8	5.2
11	Portugal's image	2.42	0	.0
12	Local firm for sale	2.34	15	9.7
13	Follow customers	2.32	13	8.4
14	Establish sales network	2.31	11	7.1
15	Market diversification	2.23	0	.0
16	European Single Market	2.21	0	.0
17	Local infrastructure	2.12	1	.7
18	Quality of local cluster	2.11	3	1.9
19	EU market	2.10	4	2.6
20	Market size	2.01	2	1.3
21	Invitation	1.98	6	3.9
22	Cultural proximity	1.97	0	.0
23	Geographic proximity	1.95	4	2.6
24	Complementarity locals	1.89	1	.7
25	Reduce depend. agents	1.86	0	.0
26	Access natural resources	1.84	8	5.2
27	International experience	1.70	1	.7
28	Acquire technology	1.68	1	.7
29	Avoid barriers	1.67	2	1.3
30	Reduce depend suppliers	1.64	1	.7
31	Inefficiency of agents	1.58	1	.7
32	Inefficiency of suppliers	1.32	0	.0

Table 5.7b Commercial firms

Rank	Reason	Mean[a]	Main reason[b] N	%
1	Establish network	3.80	14	31.8
2	Increase group's turnover	3.42	10	22.7
3	Follow customers	3.34	3	6.7
4	Market growth	3.27	2	4.5
5	Political stability	3.11	0	.0
6	Economic stability	3.11	1	2.3
7	Market diversification	2.84	2	4.5
8	Reaction to competitors	2.83	1	2.3
9	Reduce depend. agents	2.67	1	2.3
10	Portugal's image	2.59	1	2.3
11	Market size	2.52	1	2.3
12	Competition home market	2.33	0	.0
13	Inefficiency local agents	2.20	0	.0
14	International experience	2.17	0	.0
15	Geographic proximity	2.04	0	.0
16	European Single Market	2.00	0	.0
17	Quality of labour force	1.98	0	.0
18	Quality of local cluster	1.91	0	.0
19	Reduction of labour costs	1.89	1	2.3
20	Local firm for sale	1.87	4	9.1
21	Complementarity locals	1.82	1	2.3
22	Cultural proximity	1.80	1	2.3
23	Local infrastructure	1.77	0	.0
24	EU market	1.73	0	.0
25	Invitation	1.73	1	2.3
26	Reduce depend suppliers	1.59	0	.0
27	Inefficiency of suppliers	1.55	0	.0
28	Transportation costs	1.53	0	.0
29	Acquire technology	1.50	0	.0
30	Public incentives	1.40	0	.0
31	Avoid barriers	1.40	0	.0
32	Access natural resources	1.16	0	.0

[a] *Mean of a scale that ranged from 1 (irrelevant) to 5 (very important).*
[b] *Number of respondents that chose it as the 'most important reason to have invested in Portugal'.*

In the case of manufacturing firms (Table 5.7a), five determinants were rated well above all the others. However, the reduction of labour costs was unquestionably the top answer - it recorded the highest mean in the 5-point scale and was chosen as the most important reason by more than a quarter of the respondents. The quality of the labour force was also among the top five determinants, but was chosen as the main reason by only 3 per cent of the participants. It seems that the location decision was largely a response to labour costs, the quality of the labour force being relevant but secondary.

The second most important variable in terms of the overall mean was to increase the group's turnover. It was also considered the top reason by seven per cent of the respondents. This should not be a surprise since it simply reinforces the argument that internationalisation is a special case of the growth of the firm (Buckley, 1993b). Economic and political stability were the other top determinants in Table 5.7a, but only two managers selected them as the main reason to invest in Portugal. This result is consistent with the findings of other survey-based studies (see chapter 3). For most managers, these were highly valued characteristics of the country, probably a precondition for the investment decision. But other determinants were more decisive to the location choice. Interestingly, there was a group of variables in the opposite position: their overall ratings were low but they were seen as the main rationale by a substantial number of firms. These included the existence of a local firm for sale (10%), following customers (8%), to establish a distribution network (7%), and access to natural resources (5%). These are strong but specialist reasons – they were very important for some firms but not generally important in the overall population.

As for purely commercial subsidiaries (Table 5.7b), the establishment of a distribution network was, not surprisingly, the main reason to invest in Portugal. Not only was its mean well above all the others, but it was singled out as the main reason by 32 per cent of the participants. It was followed by the need to increase the group's turnover (chosen as the main reason in 23 per cent of the responses), to follow customers, and market growth. As above, economic and political stability were among the top reasons but were rarely chosen as the main reason to invest in Portugal. Another similarity with manufacturing firms was that the existence of a local firm for sale was the main determinant of investment for 9 per cent of the commercial subsidiaries; but in overall terms its influence was small.

5.4.1.1. Factor analysis

Despite these preliminary conclusions, the analysis of the determinants of FDI in Portugal was seriously hampered by the high number of variables involved. This called for the use of data reduction techniques, such as factor analysis (Hair et al., 1998: p. 90). Factor analysis permits a reduction in the number of dimensions to be used in further tests, simplifying the investigation. Normally, it entails the loss of some information, since the new factors do not fully represent the original variables. In this case, however, the aim was not to create new variables based on the factor loadings. Factor analysis was simply a tool to investigate the way the variables were grouped by the respondents.

The number of factors to extract was a difficult choice. Two common criteria are to select the factors with an eigenvalue above unity or to base the decision on the observation of the scree plot (Hair et al., 1998). These suggested nine and eight factors, respectively. However, factor cohesion was particularly critical for this study. If they were to represent the determinants of FDI in Portugal, the factors needed to be plausible within existing understanding. The representativeness of the factors extracted (total variance explained) was of secondary importance but not irrelevant. Taking all these elements into account, the decision was to extract ten factors, which accounted for more than two thirds of total variance. With fewer factors some individually relevant determinants would be combined, making the analysis confusing. With more factors the theoretical interpretation of some of the determinants would be difficult.

The results of this first model can be found in Appendix 5B. It turned out, however, that the behaviour of 'transportation costs' had little in common with any of the factors in the analysis. It presented a low communality and dispersed factor loadings irrespective of the number of factors extracted (see Appendix 5B). This does not necessarily mean that transportation costs were irrelevant. Table 5.7, above, showed that they were important for some firms, in particular in manufacturing. Nonetheless, the association with any of the factors (factor 2 in this case) was spurious and an alternative model, without transportation costs, was adopted (Appendix 5C).

This new model differed very little from the original one (cf. Appendices 5B and 5C). The ten factors were exactly the same that were obtained before, the only differences being the obvious absence of transportation costs and a slightly higher percentage of variance explained (69.8%). These factors constitute a theoretically consistent list of the determinants of foreign direct investment in Portugal (Table 5.8). They include locational determinants (stability, local market, labour conditions, proximity), internalisation determinants (upstream and downstream integration, market diversification) and strategy determinants (home conditions, passive expansion). However, before they could be used in a more detailed analysis, some adjustments were needed.

It was particularly interesting that public incentives were consistently associated with labour costs and skills. This suggests that public incentives have attracted essentially efficiency seeking FDI to Portugal and will be further exploited later. However, if the aim is to investigate the relevance of labour conditions as a determinant of FDI the variable public incentives cannot be associated with labour quality and costs. A similar reasoning applies to

the variable 'to increase the group's turnover'. Its association with the local market is easy to understand. It is only reasonable to assume that the host country's market size and growth are important variables when (market) growth is a major motivation for internationalisation. But the turnover variable cannot be part of a proxy for the importance of the local market in attracting inward FDI. Both 'public incentives' and 'to increase the group turnover' were excluded from the subsequent analysis[8].

TABLE 5.8: FACTORS (DETERMINANTS) ASSOCIATED WITH INVESTMENT IN PORTUGAL

Factor	Variables included	Factor	Variables included
Political and economic stability	Political stability Economic stability International image	*EU market*	Access to the EU market Reaction to European Single Market Need to avoid barriers
Upstream integration	Acquisition of technology Reaction to suppliers' inefficiency Access to natural resources Reduce dependency on suppliers Local cluster Local infrastructure	*Labour conditions*	Reduction of labour costs Quality of labour force (Public incentives)
		Geographic and cultural proximity	Geographic proximity Cultural proximity
Downstream integration	Reduce dependency on agents Reaction to agents' inefficiency Establishment distribution network Following customers	*Passive expansion*	Invitation from a local Local firm for sale Search complementarity with locals
		Market diversification	Market diversification Acquisition international experience
Local market	Market growth Market size (Increase turnover)	*Home conditions*	Increased competition at home Reaction to competitors' move

The importance of the new determinants was assessed by computing the mean of the respective variables (cf. Table 5.8). Like the originals, these new variables had a minimum of 1 (when all the variables of the determinant had received the lowest rating in the Likert-scale) and a maximum of 5 (when all received the top rating). Table 5.9 presents the ranking of the ten determinants. The respective means are inside brackets on the first line of the table.

TABLE 5.9: RANK OF DETERMINANTS OF INVESTMENT IN PORTUGAL: ALL FIRMS AND BY INDUSTRY

Determinants of FDI *Industry*	Labour condit.	Stabi-lity	Compe-tition	Local market	Down-stream	Market Divers.	Passive expan.	EU market	Proxi-mity	Up-stream
All firms[a]	**1** *(2.87)*	**2** *(2.81)*	**3** *(2.54)*	**4** *(2.39)*	**5** *(2.25)*	**6** *(2.05)*	**7** *(1.95)*	**8** *(1.90)*	**9** *(1.88)*	**10** *(1.72)*
Food, beverages *(20)*	1	4	7	2	3	6	5	10	9	8
Text, cloth, foot. *(20)*	1	2	3	5	10	9	8	4	7	6
Natural resources *(19)*	3	2	1	4	5	6	8	10	7	9
Chemicals and oil *(23)*	4	1	2	3	5	7	6	8	10	9
Metal industries *(17)*	1	3	2	4	7	9	5	8	6	10
Machinery/equip. *(42)*	1	2	3	5	9	6	8	4	7	10
All manufact. (141)	***1***	***2***	***3***	***4***	***5***	***7***	***6***	***8***	***9***	***10***
Commerce (39)	***7***	***3***	***4***	***2***	***1***	***5***	***8***	***9***	***6***	***10***

[a] *Inside brackets, in the first row, the mean of a scale that ranged from 1 (irrelevant) to 5 (very important).*

[8] If these two variables were excluded, the remaining variables would still be grouped exactly as they are presented in Table 5.8. The results associated with this third model can be found in Appendix 5D.

As mentioned in the preliminary analysis, there were marked differences between commercial and manufacturing firms. For the former, downstream integration (the internalisation of the sales function - Buckley and Casson, 1976) - was the main motivation. It was followed by access to the local market, economic and political stability, and competitive conditions at home. Market diversification was also relatively important for purely commercial subsidiaries. For manufacturing FDI, labour conditions and economic and political stability were clearly the dominant determinants. Competition in the home country, access to the local market, and downstream integration were next in importance. This combination of determinants confirms the duality of motivations (efficiency seeking and market seeking) suggested in the previous chapter. The differences between industries, however, were more important than it is immediately apparent in Table 5.9.

Analysis of the determinants' mean for each industry presents a clearer picture. Table 5.10 (see over page) shows that labour conditions and stability were even more important for textiles, clothing and footwear, and machinery and equipment (the most export oriented industries) than for the other industries in the sample. Access to the EU market was also above average importance in these industries, being in both cases the fourth most important determinant. The local market, on the other hand, was much less important in these industries than in any other group of firms, and downstream integration was completely insignificant.

TABLE 5.10: THE DETERMINANTS OF INVESTMENT IN PORTUGAL BY INDUSTRY: MEAN VALUES

Determinants of FDI	Labour condit.	Stabi-lity	Compe-tition	Local market	Down-stream	Market Divers.	Passive expan.	EU market	Proxi-mity	Up-stream
Food, beverages	3.1	2.3	2.2	2.5	2.4	2.3	2.3	2.0	2.0	2.1
Text, cloth, footwear	3.9	3.0	2.9	1.9	1.5	1.6	1.6	2.1	1.7	1.8
Natural resources	2.4	2.7	2.8	2.3	2.3	2.3	2.1	1.7	2.2	1.8
Chemicals and oil	2.8	2.9	2.8	2.8	2.5	2.2	2.2	1.9	1.7	1.8
Metal industries	3.0	2.5	2.6	2.4	1.9	1.4	2.2	1.7	2.0	1.3
Machinery/equip.	3.5	3.0	2.2	1.9	1.7	1.9	1.8	2.1	1.8	1.7
All manufacturing	***3.2***	***2.8***	***2.5***	***2.3***	***2.0***	***1.9***	***2.0***	***1.9***	***1.9***	***1.8***
Commerce	***1.8***	***2.9***	***2.5***	***2.9***	***3.1***	***2.4***	***1.8***	***1.8***	***1.8***	***1.6***

Note: *Mean of a scale that ranged from 1 (irrelevant) to 5 (very important).*

There was, nevertheless, an important difference between the two groups of firms. In the case of machinery and equipment, labour conditions and stability can almost be considered to be the only relevant determinants since there was a very big difference for the next two determinants (competition and the EU market). In textiles, clothing and footwear, however, competition was only slightly less important than stability, though well above the EU market. Both cases represent efficiency seeking FDI. However, the 'push' factors appear to be very different. Competitive conditions in the home country were critical in the

decision of textiles, clothing and footwear producers to invest in Portugal, a politically and economically stable low cost location that is part of the European Union. Machinery and equipment manufacturing are more global industries, in which competitive conditions operate at a different level.

Inevitable, industry level analysis hides differences in terms of the strategies of individual firms. These differences are due to firm specific characteristics, but also to the fact that the industries are not homogeneous. Figure 5.11 shows very clearly that most firms in textiles, clothing and footwear and in machinery and equipment fell in the fourth quadrant. This corresponds to an above average rating of labour conditions and a below average rating of the importance of the local market. In other words, their investment can be classified as efficiency seeking[9].

FIGURE 5.11: LABOUR CONDITIONS *VS.* LOCAL MARKET

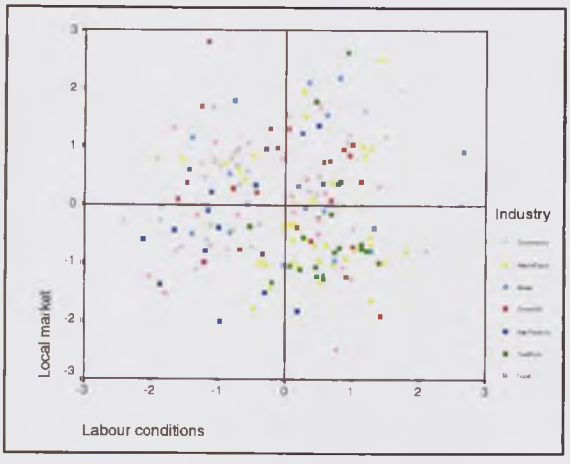
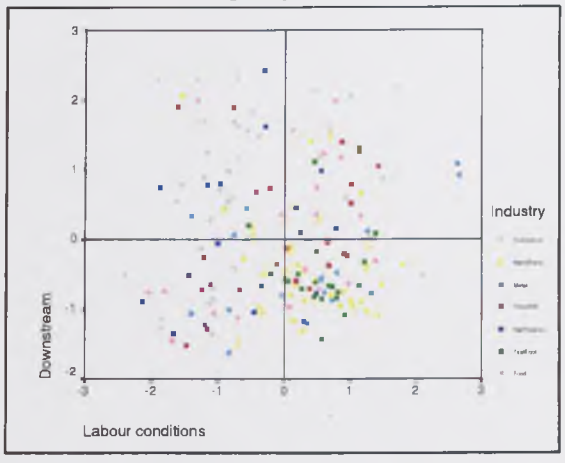


FIGURE 5.12: LABOUR CONDITIONS *VS.* DOWNSTREAM



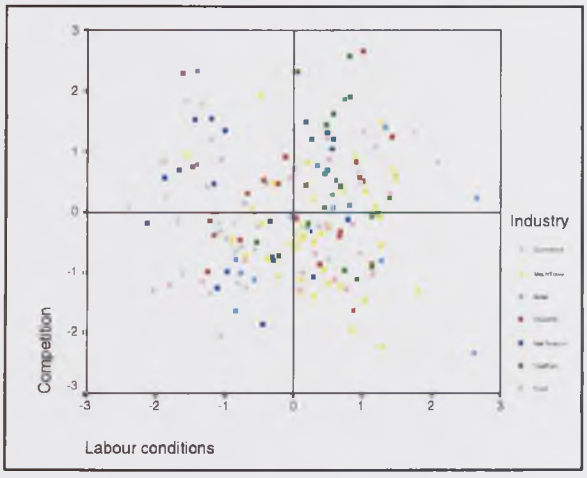
When the local market variable was replaced with downstream integration (Figure 5.12), however, almost all firms in these export oriented industries fell into quadrant 4. This suggests that locational determinants were more important than internalisation. Even when the local market was an important determinant of FDI, to internalise the sales function was not a priority. As for the presence of firms from other industries in quadrant 4 of Figure 5.11, it conveys that there were export oriented segments (or individual companies) in all industries. As an example, all firms in the oil and chemicals group in quadrant 4 in these conditions were manufacturers of plastic products.

The differences between textiles, clothing and footwear, and machinery and equipment mentioned above are further illustrated in Figure 5.13. Almost all textiles, clothing and

[9] The figures are based on Model 3 (Appendix 5D) and use the factor loadings rather than the determinants' means.

footwear producers appear in quadrant 2. Most machinery and equipment manufacturers are represented in quadrant 4. The difference corresponds to the role of the home country competitive conditions to the decision to invest in Portugal. Figure 5.13 also shows that textiles, clothing and footwear represent a much more homogeneous group than machinery and equipment.

FIGURE 5.13: LABOUR CONDITIONS *VS.* COMPETITION



The comparison of the determinants of investment in Portugal according to the country of origin is presented in Table 5.11. As could be expected, the largest differences were found in the assessment of cultural and geographic proximity. This was the second most important determinant for Spanish firms, only behind the conditions in the local market. It was also relevant for French and Italian firms (the latter included in 'other EU12'), but irrelevant for all the other[10]. Also predictable was that access to the EU market was more important for firms from outside the Union.

TABLE 5.11: RANK OF DETERMINANTS OF INVESTMENT IN PORTUGAL BY COUNTRY OF ORIGIN

Determinants of FDI / *Country*	Labour condit.	Stabi-lity	Compe-tition	Local market	Down-stream	Market Divers.	Passive expan.	EU market	Proxi-mity	Up-stream
All firms	***1***	***2***	***3***	***4***	***5***	***6***	***7***	***8***	***9***	***10***
Spain *(21)*	6	4	3	1	5	7	8	10	2	9
France *(24)*	3	1	2	5	6	8	7	10	4	9
Germany *(48)*	1	2	3	5	4	6	8	7	10	9
UK *(16)*	2=	2=	5	4	1	6	8	10	9	8
Other EU12 *(19)*	1	2	6	5	9	7	4	8	3	10
Other Europe *(21)*	1	3	2	4	7	8	5	6	10	9
Rest of the world *(31)*	2	1	3	4	6	8	8	5	10	9

According to Table 5.11, Spanish firms are essentially market seekers. This was the only source country for which local market was the main determinant. Labour conditions, on

[10] Brazilian companies also ranked this determinant very high, but they were too few to exert a significant influence over their group's mean.

the other hand, were of relatively little importance. UK investors differed from the rest of the sample in the role of downstream integration. The UK was until 1974 the main trading partner of Portugal. This position is now less relevant, but the results obtained suggest a deeper involvement of British firms in Portugal, which over the years may have internalised their operations, replacing exports with FDI. It should be noted, however, that the groups obtained using the firms' country of origin were very heterogeneous in terms of their motivations. Much more so than in the case of industries, explaining why so few differences were found in Table 5.11. The only determinants that seem to be country specific are those with a geopolitical connection, namely proximity and access to the EU market[11].

Not many differences in the determinants of FDI can be attributed to the size of the subsidiaries (Table 5.12). In fact, the differences found reflect different market orientations associated with size (cf. Figure 5.9). Smaller firms (less than 50 employees) were particularly concerned with the conditions in the local market and with the sales function (downstream integration). For bigger firms the main determinant of FDI in Portugal was labour conditions. Rather interestingly, the importance of the local market and downstream integration decreased linearly with the size of the firm, while labour conditions registered a linear increase with size (all statistically significant at 10%).

TABLE 5.12: RANK OF DETERMINANTS OF INVESTMENT IN PORTUGAL FOR FIRMS OF DIFFERENT SIZES

Determinants of FDI / *Labour force*	Labour condit.	Stabi-lity	Compe-tition	Local market	Down-stream	Market Divers.	Passive expan.	EU market	Proxi-mity	Up-stream
All firms	***1***	***2***	***3***	***4***	***5***	***6***	***7***	***8***	***9***	***10***
Less than 20 *(31)*	9	3	4	2	1	5	8	7	6	10
21 to 50 *(28)*	5	2	1	3	4	6	7	9	10	8
51 to 100 *(30)*	1	2	3	4	7	10	6	5	9	8
101 to 200 *(34)*	1	2	3	4	6	5	7	9	8	10
201 to 500 *(32)*	1	2	3	4	7	5	6	9	8	10
More than 500 *(25)*	1	2	3	5	10	6	7	4	8	9

The differences in the determinants of FDI that could be associated with the year of investment were particularly interesting. Table 5.13 suggests that two periods in Portugal's recent history saw efficiency seeking being replaced by market seeking as the main motivation for inward FDI. The first was the decade that followed the 1974 revolution, which was also associated with a worldwide economic crisis. The second was the period after 1995, which seems to consolidate the trend of the first half of the 1990s. The latter is

[11] This was also the conclusion reached with cluster analysis. The clusters obtained were very heterogeneous in terms of country of origin. They were somewhat more coherent in terms of industries, but even in this case not sufficiently homogeneous to be useful for this research.

particularly worrying since it confirms that the recent decrease of inward FDI in Portugal (see chapter 4) affected efficiency seeking FDI in particular. This is reinforced by the decreasing importance of competition as a determinant of FDI. Foreign investors seem to be searching for the solution to stronger competition in the domestic market in other locations.

TABLE 5.13: RANK OF DETERMINANTS OF INVESTMENT IN PORTUGAL BY YEAR OF FIRST INVESTMENT

Determinants of FDI / *Year of investment*	Labour condit.	Stabi-lity	Compe-tition	Local market	Down-stream	Market Divers.	Passive expan.	EU market	Proxi-mity	Up-stream
All firms	***1***	***2***	***3***	***4***	***5***	***6***	***7***	***8***	***9***	***10***
Before 1960 *(11)*	3	1	2	5	4	9	7	10	6	8
1960 to 1974 *(25)*	1	2	3	4	6	5	7	8	9	10
1975 to 1985 *(15)*	4	1	3	2	5	6	10	8	7	9
1986 to 1990 *(58)*	1	2	3	4	5=	7	5=	8	9	10
1991 to 1995 *(51)*	2	1	4	3	5	6	7	8	9	10
After 1995 *(20)*	4	1	5	2	3	7	10	8	6	9

At face value, this trend is not necessarily negative for the Portuguese economy. Economic development and its resulting higher production costs tend to reduce a country's ability to attract footloose efficiency seeking investments. However, this evolution (which in the previous chapter was described as transition from stage 3 to stage 4 of the IDP – see section 4.6) should result in a growing importance of internalisation variables over localisation. In terms of the determinants identified here, this would mean the growing importance of downstream and upstream integration, which was not the case.

5.4.2. Alternative locations

The decision to invest in a foreign country should normally involve the consideration of alternative locations. In the sample, however, only 42 per cent of the respondents (88 firms) claimed to have analysed other locations before investing in Portugal. Most of these, however, considered more than one alternative. Eastern Europe and Spain were the most common alternatives considered (46 and 44 firms, respectively), followed by the most developed EU members (considered by 40 of the respondents). Ireland and Greece were considered by a much smaller number of the firms in the sample (Table 5.14).

In general, the European locations were positively correlated, which suggests they were frequently considered simultaneously. The exception was the correlation coefficient (Spearmans's rho) between Spain and Eastern Europe, which was negative and statistically significant at 10%. That is, Spain and Eastern Europe did not seem to be, in general, alternatives to each other. Finally, non European locations were positively correlated with

Eastern Europe and negatively with Spain. But the level of statistical significance of these relationships was rather low, impeding further speculation.

TABLE 5.14: ALTERNATIVE LOCATIONS FOR INVESTORS THAT CHOSE PORTUGAL

		Strong alternative	Considered	Total
Eastern Europe	N	33	13	46
	%	*72%*	*28%*	*100%*
Spain	N	35	9	44
	%	*80%*	*20%*	*100%*
Ireland	N	10	8	18
	%	*56%*	*44%*	*100%*
Greece	N	6	9	15
	%	*40%*	*60%*	*100%*
Other EU	N	24	15	39
	%	*62%*	*38%*	*100%*
Other locations	N	13	12	25
	%	*52%*	*48%*	*100%*

The differences in the ranking of the determinants of FDI between firms that considered alternative locations and those that only considered Portugal for their investment were less marked than anticipated (Table 5.15). Nevertheless, labour conditions and EU market were much more important for firms that considered alternative locations than for those that did not. The opposite was true for local market and downstream integration[12]. This suggests that efficiency seeking investment was more common among firms that considered alternative locations, and market-seeking among those that did not. But the two types of investment coexisted in both groups.

TABLE 5.15: RANK OF THE DETERMINANTS OF INVESTMENT IN PORTUGAL[a]

Determinants of FDI	Labour condit.	Stabi-lity	Compe-tition	Local market	Down-stream	Market Divers.	Passive expan.	EU market	Proxi-mity	Up-stream
No alternative location considered	**2** *(2.58)*	**1** *(2.76)*	**4** *(2.51)*	**3** *(2.54)*	**9** *(1.74)*	**6** *(2.14)*	**5** *(2.50)*	**7** *(2.00)*	**8** *(1.96)*	**10** *(1.71)*
Alternative location considered	**1** *(3.36)*	**2** *(2.93)*	**3** *(2.61)*	**4=** *(2.21)*	**4=** *(2.21)*	**6** *(1.99)*	**7** *(1.96)*	**8** *(1.92)*	**9** *(1.76)*	**10** *(1.75)*
Spain considered	**1** *(3.04)*	**2** *(3.02)*	**4** *(2.51)*	**3** *(2.53)*	**5** *(2.21)*	**7** *(2.14)*	**6** *(2.19)*	**8** *(2.06)*	**9** *(1.74)*	**10** *(1.72)*
Eastern Europe considered	**1** *(3.61)*	**2** *(3.16)*	**3** *(2.83)*	**5** *(2.29)*	**4** *(2.39)*	**6** *(2.22)*	**9** *(1.84)*	**7** *(2.11)*	**10** *(1.69)*	**8** *(1.92)*

[a] *Inside brackets, the mean of a scale that ranged from 1 (irrelevant) to 5 (very important).*

Equally surprising was that only small differences were found in the determinants associated with firms that considered Spain as the alternative location and those that considered Eastern Europe (Table 5.15). The suspicion was that efficiency-seeking investment should be more common when Eastern Europe was the main alternative, and market-seeking investment dominant when the main alternative was Spain. However, the evidence to support this was weak. Firms that considered Eastern Europe the main

[12] The ANOVA test showed all these differences to be statistically significant at 5%.

alternative location did rate labour conditions higher and local market and downstream integration lower than those that considered Spain, but this is far from conclusive evidence.

5.4.3. Type of investment

Greenfield development was the most common mode of entry in the Portuguese market, adopted by 56 per cent of the firms in the sample (Appendix 5E). This option was particularly popular among firms in textiles, clothing and footwear, machinery and equipment, and commerce. The former was especially relevant, since textiles, clothing and footwear are industries with a strong presence of local investors. It seems, nevertheless, that FDI in these industries contributed to increase the country's production capacity in these traditional sectors, rather than replacing local producers. In terms of national differences, greenfield developments were especially favoured by Spanish firms, while French and UK firms were those more active in acquisitions, in particular of locally owned firms (Appendix 5E).

A different decision was the choice between joint ventures and wholly owned subsidiaries. Foreign investors in Portugal seemed to prefer the latter. Only 31 per cent of the firms in the sample reported entering the Portuguese market with a joint venture. The partners were predominantly from either the home country or a local investor (40% and 36%, respectively). In the case of Spanish firms, as many as three quarters of the partners in joint ventures were from the home country. All the remaining were Portuguese. German firms were the other investors to prefer partners from their home country (63%). On the other hand, non-European investors chose a Portuguese partner in 70 per cent of the joint ventures created.

It seems that the acquisition of minority partners was frequent among the firms in the sample. 78 per cent of the participant firms were, in 1997, wholly owned by the parent company, compared with just 69 per cent that reported having entered the country as a wholly owned subsidiary.

5.4.4. Public incentives

It was seen above that, as a determinant of FDI, public incentives were consistently associated with labour costs and skills. This was interpreted as evidence that they have attracted essentially efficiency seeking FDI - projects that exploited Portugal's relatively low labour costs but reasonable labour skills. This idea was reinforced by the fact that public incentives were especially valued as a determinant of investment by the export oriented

industries: textiles, clothing and footwear, and machinery and equipment. On the other hand, in the sectors most oriented towards the local market (commerce and chemicals and oil), public incentives were completely insignificant. Furthermore, there was a positive linear relationship (statistically significant at 1%) between the importance of public incentives and firm size (no statistically significant differences were found when the firms were grouped by country of origin or year of investment).

These characteristics reflect very much the public policies towards FDI, particularly concerned with attracting big industrial projects with a stronger impact in employment and public opinion. The official website of ICEP, the institution responsible for promoting Portugal as a location of FDI, is very clear about what Portugal can offer to foreign investors. "Imagine a country with the lowest labour costs in Europe (...). Add to this a stable political environment (...) and low criminality" (ICEP, 2000).

As many as 38 per cent of the manufacturing firms in the sample that agreed to examine this topic in more detail reported having received public incentives to invest in Portugal[13]. Public support was especially high in machinery and equipment, where 55 per cent of the subsidiaries received some sort of public support. On the other hand, in the natural resources based industries only one in five firms was supported by the local authorities (Figure 5.14). Since foreign investment qualifies for support from the European Union's structural funds, the high incidence of public support in the most recently created firms should be expected (Figure 5.15).

FIGURE 5.14: % OF FIRMS THAT RECEIVED PUBLIC INCENTIVES, BY INDUSTRY

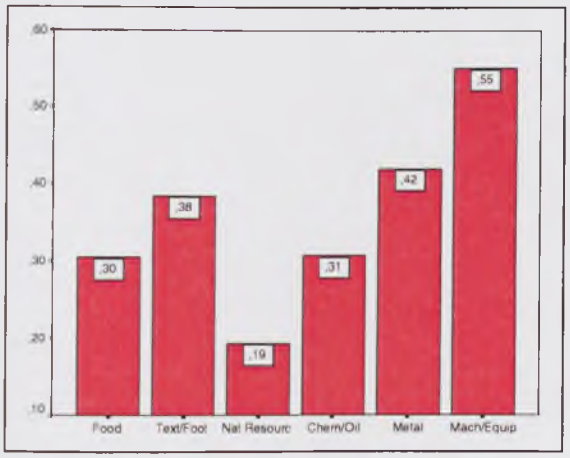
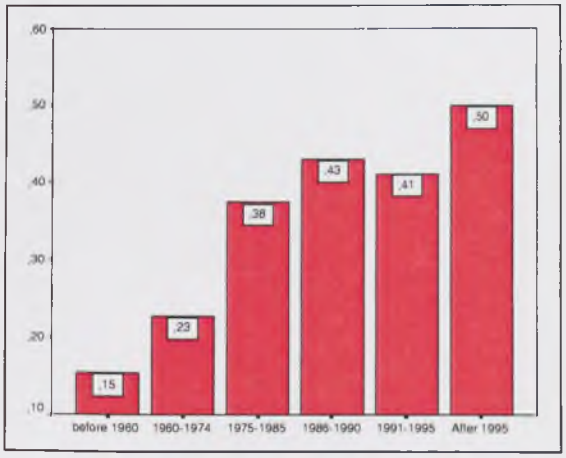


FIGURE 5.15: % OF FIRMS THAT RECEIVED PUBLIC INCENTIVES, BY YEAR OF INVESTMENT



[13] The overall figure was 30 per cent, since only 6 per cent of the commercial subsidiaries received some kind of public incentives.

Despite the number of projects that received public support, only 11 per cent of the respondents claimed that without public incentives they would not have invested in Portugal (Figure 5.16)[14]. 54 per cent would have invested less than they did, but in 35 per cent of the cases public support was no more than a bonus for the investors – i.e. they claimed that the investment would have been exactly the same even without public incentives. This result seems to confirm UNCTAD's (1998: p.104) suggestion that public incentives have a far greater impact on the location of FDI within a country than on the decision to invest in the country. Nevertheless, the opinion of the biggest firms (with more than 500 employees) was somewhat different. One third would have not invested in Portugal without incentives, and a further half would have invested on a smaller scale.

FIGURE 5.16: IMPACT ON INVESTMENT IF PUBLIC INCENTIVES HAD NOT BEEN OFFERED

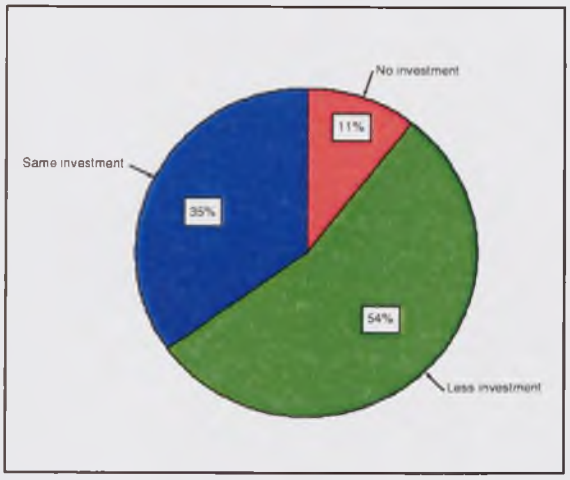
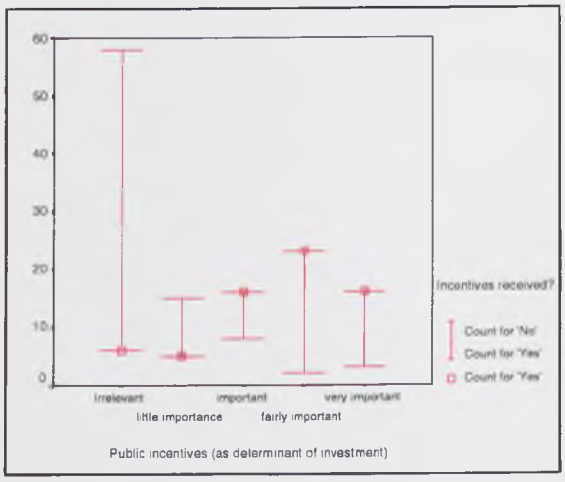


FIGURE 5.17: ASSESSMENT OF 'PUBLIC INCENTIVES' AS A DETERMINANT OF FDI



Interestingly, there was a very strong correlation between having received incentives and considering public incentives a significant determinant of FDI (Figure 5.17). However, it was difficult to identify whether this represented a bias of the respondents - incentives were considered important because their firms benefited from them - or evidence that more public incentives would have attracted more foreign firms to Portugal. Unfortunately, the number of firms that received public incentives was not big enough to compare the impact of those incentives in different industries.

5.5. PROBLEMS FACED BY FOREIGN FIRMS OPERATING IN PORTUGAL

To investigate the problems faced by foreign investors in Portugal a strategy was adopted similar to the one used for the determinants of FDI. In this case, 34 potential problems were proposed (see Appendix 5A), the respondents being asked to rate them from 1

[14] These figures did not consider commercial firms.

(irrelevant) to 5 (very important). They were then invited to single out the most important of the 34 proposed problems. Separate results for manufacturing and commercial firms are presented in Table 5.16.

TABLE 5.16: MAIN PROBLEMS AFFECTING INVESTMENT IN PORTUGAL

Table 5.16a Manufacturing firms

Rank	Problem	Mean[a]	Main problem[b] N	%
1	Legal system/bureaucracy	3.20	15	9.7
2	Competition export markets	2.89	17	11.0
3	Availability skilled workers	2.76	18	11.6
4	Competition local market	2.71	19	12.3
5	Tax regime	2.68	9	5.8
6	Small local market	2.46	18	11.6
7	Attitude local workers	2.38	2	1.3
8	Firm's HR restrictions	2.35	5	3.2
9	Firm's size	2.30	5	3.2
10	Labour costs	2.29	6	3.9
11	Local infrastructure	2.28	1	.6
12	Stagnant local demand	2.17	3	1.9
13	Changes Eastern Europe	2.17	3	1.9
14	Insufficient public incentives	2.13	5	3.2
15	Limited product range	2.07	3	1.9
16	Related/support industries	2.07	4	2.6
17	Stagnant export markets	2.04	3	1.9
18	Portugal's image	2.01	0	.0
19	Exchange rates	1.98	1	.6
20	Firm's financial restrictions	1.97	4	2.6
21	Develop. local banking	1.96	1	.6
22	Economic situation Portugal	1.92	1	.6
23	Coordination/management	1.77	2	1.3
24	European Single Market	1.77	1	.6
25	Limited capacity of agents	1.76	1	.6
26	Divergence with partners	1.73	1	.6
27	Cultural differences	1.71	2	1.3
28	Political/social situation	1.68	2	1.3
29	Establishment of network	1.63	0	.0
30	Information on investment	1.61	2	1.3
31	Reduction external tariffs	1.60	0	.0
32	Inform. business opport.	1.58	0	.0
33	Identification local partner	1.50	0	.0
34	Market knowledge	1.44	1	.6

Table 5.16b Commercial firms

Rank	Problem	Mean[a]	Main problem[b] N	%
1	Competition local market	3.39	3	6.5
2	Legal system/bureaucracy	3.23	7	15.2
3	Small local market	2.98	12	26.1
4	Tax regime	2.55	2	4.3
5	Stagnant local demand	2.49	2	4.3
6	Limited product range	2.37	3	6.5
7	Firm's HR restrictions	2.33	0	.0
8	Limited capacity of agents	2.30	0	.0
9	Firm's size	2.20	2	4.3
10	Economic situation Portugal	2.15	3	6.5
11	Availability skilled workers	2.13	2	4.3
12	Divergence with partners	2.06	1	2.2
13	Exchange rates	2.02	2	4.3
14	Inform. business opport.	2.02	2	4.3
15	Establishment of network	1.96	1	2.2
16	Attitude local workers	1.89	0	.0
17	Insufficient public incentives	1.87	0	.0
18	Identification local partner	1.86	1	2.2
19	Local infrastructure	1.85	0	.0
20	Develop. local banking	1.85	0	.0
21	European Single Market	1.85	1	2.2
22	Portugal's image	1.81	0	.0
23	Labour costs	1.79	0	.0
24	Changes Eastern Europe	1.77	0	.0
25	Firm's financial restrictions	1.75	1	2.2
26	Cultural differences	1.75	0	.0
27	Information on investment	1.72	2	4.3
28	Coordination/management	1.72	0	.0
29	Related/support industries	1.68	0	.0
30	Competition export markets	1.67	0	.0
31	Stagnant export markets	1.61	0	.0
32	Market knowledge	1.56	0	.0
33	Reduction external tariffs	1.51	0	.0
34	Political/social situation	1.43	0	.0

[a] *Mean of a scale that ranged from 1 (irrelevant) to 5 (very important).*
[b] *Number of respondents that chose it as the 'most important problem faced in Portugal'.*

In the case of commercial firms, two groups of variables topped the list of the main problems faced in Portugal: the characteristics of the local market and the legal and fiscal system. The five variables that could be included in these groups were picked as the main problem by more than half (56%) of the commercial subsidiaries that participated in the study. Curiously, these same variables were also near to the top of the concerns of manufacturing subsidiaries. But in this case all but the legal system were less important than competition in export markets (completely irrelevant for purely commercial firms) and the availability of skilled workers. Interestingly enough, labour costs were only tenth in this list

and singled out as the main problem by just 4 per cent of the respondents. The availability of skilled workers, on the other hand, was third in the ranking and considered the main problem by 12 per cent of the respondents.

As above (section 5.4) the number of variables represented a handicap to understanding and factor analysis was used to reduce the number of dimensions. In this case, however, the association between the variables was less strong than in section 5.4, which was reflected in the low communalities associated with many of the variables. Furthermore, though there were many variables with factor loadings below .6 or even .5 (often adopted in factor analysis as elimination criteria – Hair et al., 1998), the existence of almost a continuum of values (see Appendix 5F) made the use of these figures largely arbitrary. As such, the decision was to ignore the factor loadings and the communalities and concentrate on factor homogeneity. The latter was the only criterion used in the decision of whether to maintain or eliminate variables. Nonetheless, the overall impact of the decisions made was very limited. Despite the low factor loadings, the associations between variables were very stable. Very few changes were registered when a different number of factors was extracted or when observations were excluded, which is supportive of the results obtained.

Seven factors were finally extracted (Table 5.17). Because of the importance given to factor homogeneity, two variables were eliminated: "limited capacity of agents" and "firm's human resources restrictions". Both are obviously firm level variables, but were associated with location factors. The results obtained with the new model were, nevertheless, exactly the same as presented in Table 5.17 (cf. Appendices 5F and 5G).

TABLE 5.17: PROBLEMS FACED BY THE RESPONDENTS IN PORTUGAL

Factor	Variables included
Investment conditions	Information on investment
	Insufficient public incentives
	Informat. on business opportunities
	Development local banking industry
	Legal system and bureaucracy
Country risk	Economic situation
	Political and social situation
	Portugal's international image
	Tax regime
Labour and infrastructure	Availability of skilled workers
	Attitude of Portuguese workers
	(Firm's HR restrictions)
	Infrastructure
	Labour costs
	Related and support industries
Firm's financial capacity and size	Firm's financial restrictions
	Firm's size
Market access and control	Problems to establish network
	Coordination and control
	Problems to identify local partner
	Limited product range
	Limited market knowledge
	Cultural differences
	Divergence with partners
Exports competitiveness	Competition in export markets
	Stagnant export markets
	Reduction external tariffs
	Evolution of exchange rates
	European Single Market
	Changes in Eastern Europe
Characteristics of local market	Small local market
	Stagnant local demand
	Strong competition in local market
	(Limited capacity of agents)

Two groups of firm related problems were identified: those that result from the firm's size and financial capacity, and those associated with market access and control. For country related problems, the five groups identified using factor analysis were: the investment conditions (including insufficient information and incentives, the banking and the legal system, and bureaucracy), country risk (which included the tax regime), labour and infrastructure, export competitiveness, and the size and dynamism of the local market.

As in the previous section, these problems were analysed by computing the mean of the respective variables. The results for the whole sample and by industry can be seen in Table 5.18. When all the participants were considered, the characteristics of the local market was the main problem identified by foreign investors in Portugal, followed by labour and infrastructure. Market access and control, on the other hand, was in general of very limited importance. Only small differences existed in the means associated with the remaining variables.

TABLE 5.18: RANK OF PROBLEMS FACED BY FOREIGN FIRMS: ALL FIRMS AND BY INDUSTRY

Problems / *Industry*	Character. of local market	Labour and infra-structure	Financial capacity and size	Investment conditions	Country risk	Export competiti-veness	Market access and control
All firms[a]	**1** (2.51)	**2** (2.21)	**3** (2.08)	**4** (2.06)	**5** (2.05)	**6** (1.98)	**7** (1.72)
Food and beverages (18)	1	2	6	4	5	3	7
Text., cloth., footwear (19)	7	1	5	4	3	2	6
Natural resources (27)	2	3	1	5	4	6	7
Chemicals and oil (24)	1	6	3	2	4	5	7
Metal industries (18)	1	2	3	4	7	5	6
Machinery/Equipment (46)	2	1	6	5	3	4	7
All manufacturing (152)	***1***	***2***	***3***	***6***	***4***	***5***	***7***
Commerce (45)	***1***	***6***	***4***	***2***	***3***	***7***	***5***

[a] *Inside brackets, the mean of a scale that ranged from 1 (irrelevant) to 5 (very important).*

When analysing the data at the industry level, the differences seemed to be very much associated with market orientation. Being the most export oriented group, it was no surprise that textiles, clothing and footwear manufacturers were much more concerned with export competitiveness than the rest of the sample. On the other hand, and unlike all the other investors, they were completely indifferent to the characteristics of the local market. The latter actually constituted the main difference between the problems identified by textiles, clothing and footwear producers and machinery and equipment manufacturers, the other predominantly export oriented group of firms. It should be remembered, however, that market diversification was irrelevant as a determinant of FDI by textiles, clothing and footwear producers, but of some importance for machinery and equipment manufacturers (cf. Table 5.9.)

Market orientation, in this case towards the local market, is also the explanation of the strong similarities between firms in chemicals and oil and purely commercial subsidiaries. Investment conditions (legal framework, information, financing) were for these firms the second most important problem, second only to the characteristics of the local market. As expected, labour and infrastructure, and export competitiveness were at the bottom of their concerns.

When the firms were grouped by their country of origin, the differences in terms of the problems faced were surprisingly small (see Table 5.19). This seems to confirm that market orientation is the main element behind the firms' perceptions of difficulties; market orientation is much more associated with industrial sector than country. Spanish firms, however, diverged slightly from the norm. Their evaluation of problems arising from financial capacity and size was especially surprising given that the average Spanish firm was more than three times smaller than the average firm in the whole sample[15]. Spanish firms were also more critical of the investment conditions in Portugal, which may be explained by the fact that many did not seem to have previous international experience prior to expanding to Portugal[16].

TABLE 5.19: RANK OF PROBLEMS FACED BY FOREIGN FIRMS IN PORTUGAL, BY COUNTRY OF ORIGIN

Problems / *Country of origin*	Character. of local market	Labour and infra-structure	Financial capacity and size	Investment conditions	Country risk	Export competiti-veness	Market access and control
All firms	***1***	***2***	***3***	***4***	***5***	***6***	***7***
Spain (25)	1	2	7	3	4	6	5
France (27)	1	2	6	5	3	4	7
Germany (48)	2	1	3	4	5	6	7
UK (18)	1	5	2	6	4	3	7
Other EU12 (20)	1	3	2	4	5	6	7
Other Europe (26)	1	4	2	5	3	6	7
Rest of the world (33)	1	2	3	4	5	6	7

5.6. EVALUATION OF THE INVESTMENT

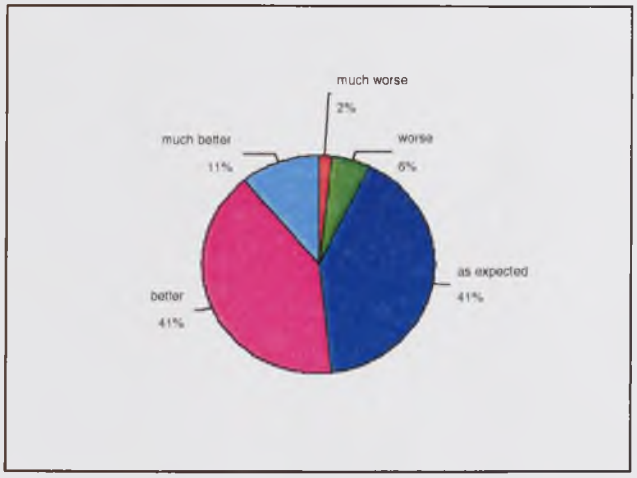
The evaluation made by the participants of the investment in Portugal was largely positive, at least if compared with the expectations (see Figure 5.18). Only 8 per cent of the respondents considered the experience to be 'worse' or 'much worse' than expected. This is even less than the 11 per cent that considered that, overall, the result of the investment in

[15] Sample mean: 303 employees per firm; Spanish firms: 90 employees; non-EU12 European firms: 125; UK firms: 228; non-European firms: 600; all the other groups were very close to the sample's mean.

[16] The importance of previous experience is reinforced by the fact that firms created after 1990 were especially critical of the investment conditions in Portugal

Portugal was 'much better' than expected. A further 41 per cent evaluated the investment as 'better' than expected.

FIGURE 5.18: RESPONDENTS' EVALUATION OF INVESTMENT



Interestingly, all firms that considered the experience in Portugal to be below expectations invested after 1986 (in particular between 1986 and 1995). However, a simple explanation may be that older underperformers could have already been abandoned by the parent firm. In any case, even among the most recent investors the number of respondents that considered the experience to be better or much better than expected outnumbered by four to one those evaluating it negatively. Spanish firms were the most positive about their experience in Portugal. In terms of industries, commerce, machinery and equipment, and chemicals and oil were the most positive groups.

It seems, however, that the participants' overall evaluation of the investment was very much dependent on profitability and turnover (see Table 5.20). The creation of new business opportunities and international experience showed little correlation with the remaining evaluation items. Furthermore, and contrary to the other items, the answers associated with the latter were largely balanced between positive and negative opinions.

TABLE 5.20: CORRELATION OF DIFFERENT EVALUATION ITEMS

Correlation coefficient: Spearman's rho	Overall evaluation	Evaluation of turnover	Evaluation of profitability	Evaluation of new opportunities	Evaluation of international experience
Overall evaluation	1.000	.608	.616	.298	.254
Evaluation turnover	.608	1.000	.576	.219	.176
Evaluation profitability	.616	.576	1.000	.194	.145
Evaluation new opportunities	.298	.219	.194	1.000	.431
Evaluation international experience	.254	.176	.145	.431	1.000

5.7. PRODUCTION IN PORTUGAL

The sample included 181 firms with production capacity in Portugal. In 67 per cent of the cases the technology used in Portugal was said to be similar to that used in the home country. But 28 per cent of the respondents said that it was more labour intensive. In the metal industries and in machinery and equipment as many as 47 and 39 per cent of the firms, respectively, used more labour intensive technologies in Portugal than in the home country. Only 5 per cent of the respondents said the technology used in Portugal was more capital intensive than in the home country, most of them associated with the natural resources based industries. Quite surprisingly, in textiles, clothing and footwear 81 per cent of the respondents reported using in Portugal technology similar to the one used at home. Subsidiaries of non-European firms were those that used relatively more labour intensive technologies in Portugal. The opposite was true for Spanish firms. As expected, the use of more labour intensive technologies tended to increase as the firms' size increased, suggesting a stronger presence of efficiency seeking FDI.

Less than two thirds of the manufacturing firms in the sample provided information on the origin of the inputs used in Portugal (excluding labour). The results were, nevertheless, surprising. On average, only 42 per cent of the inputs were obtained locally. A further 11 per cent came from Spain and another 36 per cent from other EU countries. In the case of textiles, clothing and footwear, and machinery and equipment, only one quarter of the inputs were acquired in Portugal (Figure 5.19). The home country was the main source of inputs in both cases, with respectively 38 and 32 per cent (Figure 5.20).

FIGURE 5.19: ORIGIN OF INPUTS, BY INDUSTRY

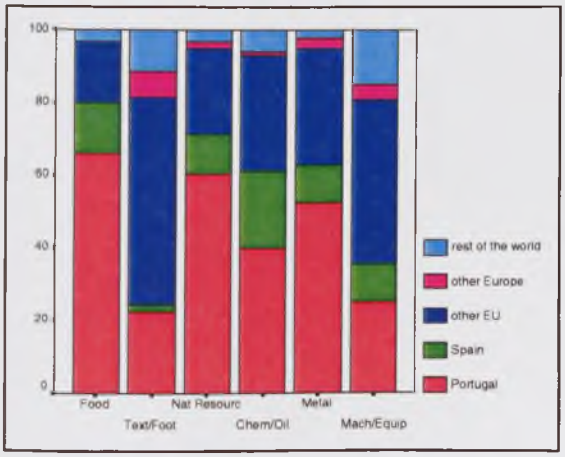
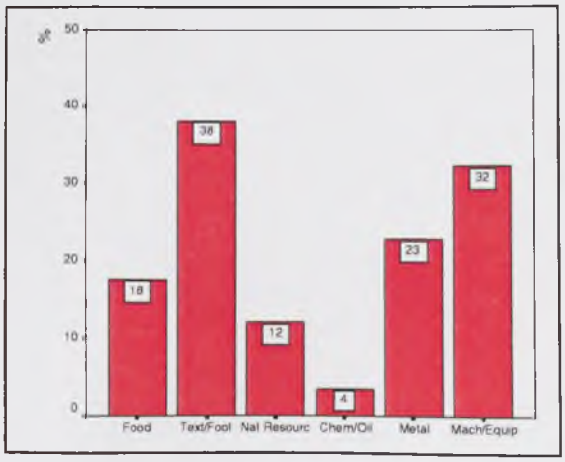


FIGURE 5.20: PERCENTAGE OF INPUTS FROM THE HOME COUNTRY



German firms seemed to be particular averse to buying their inputs locally (Figure 5.21), clearly preferring inputs imported from Germany (Figure 5.22). Given that 64 per cent of the German subsidiaries used inputs produced by the group in the home country, there is clear evidence of a strong integration of activities between the Portuguese subsidiary and the parent company.

FIGURE 5.21: ORIGIN OF INPUTS BY INVESTING COUNTRY

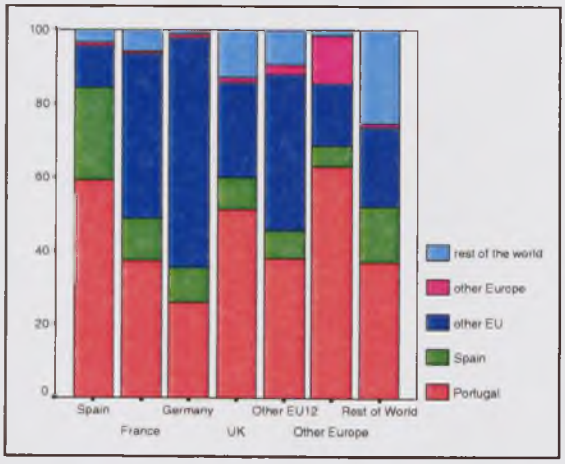
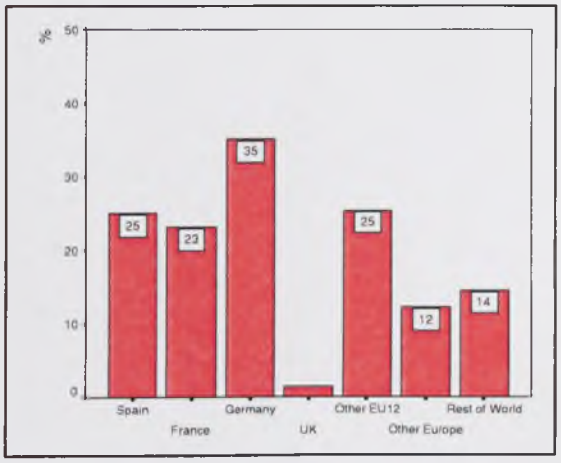


FIGURE 5.22: PERCENTAGE OF INPUTS FROM THE HOME COUNTRY



However, many Portuguese subsidiaries of German firms seemed to be no more than production platforms, with most decisions being taken in the home country. Only 11 per cent undertook the conception and design of their products in Portugal, 51 per cent distributed their own production, and 44 per cent had after sales services in Portugal. Even the purchasing of inputs and the storage of the production was done by less than two thirds of German subsidiaries in Portugal (Table 5.21).

TABLE 5.21: PERCENTAGE OF MANUFACTURING FIRMS DEVELOPING IN PORTUGAL THE FOLLOWING ACTIVITIES, BY COUNTRY OF ORIGIN

Country	Conception and design	Purchasing	Storage	Distribution and sales	After sales services
Spain	62	92	92	92	92
France	37	63	79	75	67
Germany	11	62	67	51	44
UK	62	100	100	77	69
Other EU12	26	70	83	83	68
Other Europe	20	72	76	56	56
Rest of World	31	81	85	74	67
All firms	***30***	***73***	***80***	***69***	***62***

In terms of industries, firms in textiles, clothing and footwear present a very similar pattern to that of German firms, irrespective of their country of origin (Table 5.22). If anything, the predominance of assembly platform investment is much stronger. The distribution of the products was the responsibility of the Portuguese subsidiary in just 23 per cent of the

the products was the responsibility of the Portuguese subsidiary in just 23 per cent of the cases, and after sales services existed in only 27 per cent. The predominance of off-shore production in this group of industries is not surprising, however, and is fully consistent with the determinants of investment identified above (section 5.4). Nevertheless, it should be noted that no more than 30 per cent of the subsidiaries in the whole sample undertook the conception and design of their own products. Spanish and UK firms were the only groups where this phase of the value chain was more likely to exist in Portugal than not (cf. Table 5.21).

TABLE 5.22: PERCENTAGE OF MANUFACTURING FIRMS DEVELOPING IN PORTUGAL THE FOLLOWING ACTIVITIES, BY INDUSTRY

Industry	Conception and design	Purchasing	Storage	Distribution and sales	After sales services
Food and beverages	33	67	90	81	50
Textiles, clothing, footwear	19	42	54	23	27
Natural resources based	45	80	83	74	70
Chemicals and oil	21	83	92	83	71
Metal and metal products	44	78	83	83	83
Machinery and equipment	21	82	80	73	68
All firms	***30***	***73***	***80***	***69***	***62***

The case of machinery and equipment manufacturers was also worth of note. It was mentioned above that only 25 per cent of the inputs used by foreign subsidiaries in these industries were acquired in Portugal. As in the case of textiles, clothing and footwear, the home country was an important origin of inputs (a further 32% of the total). In this case, however, as many as 90 per cent of the respondents said they used components produced by the group outside Portugal in the production process. This compares with just 54 per cent for textiles, clothing and footwear, and 62 per cent in the whole sample (Figure 5.23). This represents a high degree of integration of these firms' international activities.

FIGURE 5.23: % FIRMS USING INPUTS PRODUCED BY THE GROUP OUTSIDE PORTUGAL

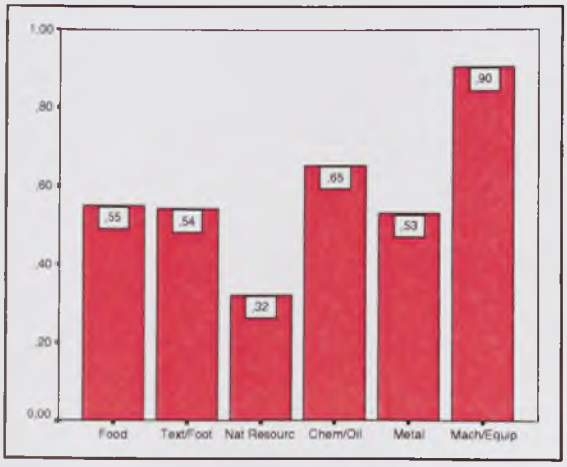
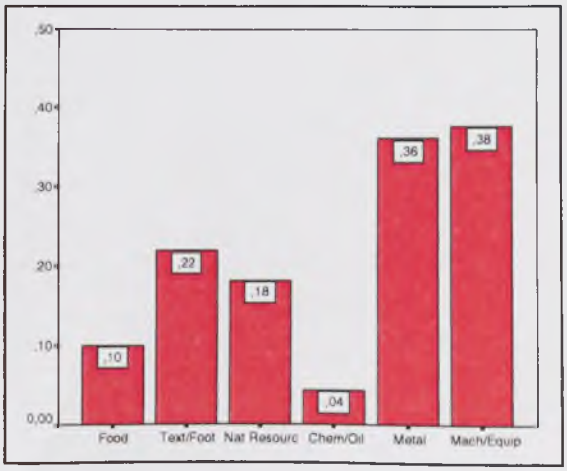


FIGURE 5.24: % OF NON-FINISHED GOODS IN THE SUBSIDIARY'S OUTPUT



More evidence of the segmentation of the production process in these industries and its distribution through different countries was that 38 per cent of the output in machinery and equipment was made of non-finished goods (Figure 5.24). The average for the whole sample was 23 per cent.

There was a direct association between the percentage of local inputs and the size of the subsidiary (Figure 5.25). Smaller firms used far more local inputs than larger ones. This relates in part to their respective market orientation (bigger firms were more export oriented) but also to the difficulties smaller firms face in acquiring inputs worldwide. Economies of scale in transportation is one reason. Another is that smaller subsidiaries are more likely to be part of groups less geographically diversified.

FIGURE 5.25: ORIGIN OF INPUTS BY FIRM'S SIZE

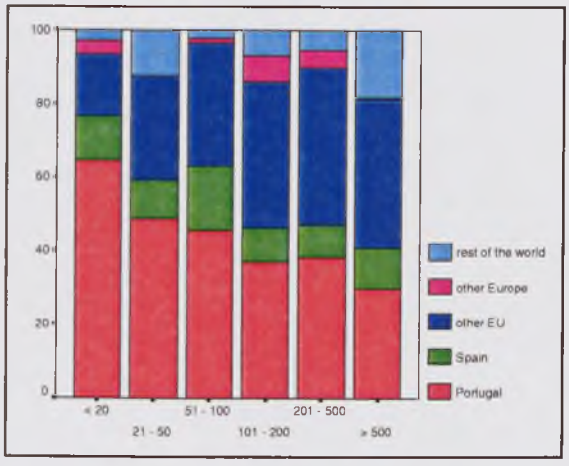
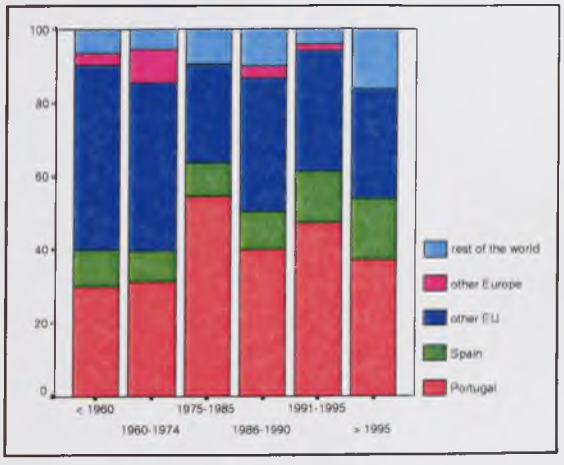


FIGURE 5.26: ORIGIN OF INPUTS, BY YEAR INVESTMENT



Less expected was that the percentage of inputs acquired locally by older firms was much below average (Figure 5.26). This was difficult to understand. The distribution of older firms in terms of industry or country of origin, for example, were not a sufficient explanation. However, these older subsidiaries may be associated with the more mature MNEs, which can be expected to have well established global purchasing networks.

5.8. CONCLUSION

The results presented in this chapter suggest a number of interesting conclusions regarding foreign direct investment in Portugal. With the support of factor analysis, labour costs and skills, economic and political stability, and the characteristics of the local market were identified as the main locational determinants. The competitive conditions in the home country and the internalisation of downstream activities were other important reasons associated with FDI in Portugal.

Differences across industries were, nevertheless, substantial. In particular, there was a strong cleavage between the most export oriented industries (textiles, clothing and footwear, and machinery and equipment) and the rest of the sample. In the case of the former, labour conditions and political and economic stability were even more important than in the overall sample. The EU market, largely irrelevant in the rest of the sample, also assumed an important role. Access to the local market, on the other hand, was secondary (but not irrelevant). Clearly, whilst market seeking was the dominant motivation to invest in Portugal in the other industries, for textiles, clothing and footwear, and machinery and equipment, the main reason was costs reduction. The data suggested that labour costs in particular was the variable foreign firms sought to minimise. Labour skills were also important, but apparently only complementary to the location decision. Interesting was the fact that public incentives were strongly associated with these two variables. In other words, firms that considered public incentives to have been important in their investment decision tended to be those attracted by the country's labour conditions.

Unfortunately, the data did not permit an investigation of whether there was any positive evolution of the value added of this type of investment over time. There was, nevertheless, evidence that Portugal's position as a location of FDI is eroding. The importance of the determinants associated with efficiency seeking investment decreased steadily in the 1990s. In the same period, Portugal registered a sharp decline in terms of inward FDI (see previous chapter). It seems that the country is losing its attractiveness as an export platform but has so far been unable to attract alternative projects.

In the case of textiles, clothing and footwear there was strong evidence that Portuguese subsidiaries were no more than assembly platforms. Three quarters were not responsible for the distribution and sales of their products, 58 per cent did not control the acquisition of inputs, and in 46 per cent of the cases even the storage of the production was not done in Portugal. In this respect, machinery and equipment manufacturers seemed to be more integrated, and did not differ much from the rest of the sample. As for conception and design, it was present at only 19 per cent of the subsidiaries in textiles, clothing and footwear, but the corresponding figure for the whole sample was no more than 30 per cent. This rather small presence of the first stages of the value chain in Portugal point more to the country's limited R&D capacity than to the strategic options of foreign firms.

The country of origin of the investing firm was much less relevant than the industry to the determinants of FDI. Geographic and cultural proximity was, as expected, the only

The country of origin of the investing firm was much less relevant than the industry to the determinants of FDI. Geographic and cultural proximity was, as expected, the only determinant clearly country-related. The surprise was probably that proximity seemed to induce market seeking investment, rather than efficiency seeking FDI. However, the explanation may lay simply on the fact that the countries more engaged in the latter, notably Germany, Switzerland, and the Nordic countries, are all relatively 'distant' from Portugal.

Eastern Europe and Spain were, according to the participants in the study, the locations more likely to compete for foreign investments with Portugal. The two seemed to compete for different projects, but the evidence was not clear in terms of the expected differences despite hints that Spain was more commonly a competing location when market access was the main motivation, whilst Eastern Europe was more often considered in the case of efficiency seeking FDI. The fact that the investigation did not cover firms that did not invest in Portugal restricted the analysis.

As for the problems faced by foreign firms in Portugal, they were essentially associated with market orientation. Firms in the industries identified as export oriented were concerned especially with labour and infrastructure and with export competitiveness. The characteristics of the local market were the main problem for the other industries. Quite revealing was that the legal system (including bureaucracy) was, overall, the major obstacle to doing business in Portugal. It was ranked in the whole sample much above any other individual problem considered by the surveyed firms. This result was particularly ironic since the Portuguese authorities publicise the country as "a flexible economy with little bureaucracy and low taxes" (ICEP, 2000).

APPENDIX 5A.
QUESTIONNAIRE

FACULDADE DE ECONOMIA

UNIVERSIDADE DO PORTO

FOREIGN DIRECT INVESTMENT IN PORTUGAL

Responses to this questionnaire are absolutely confidential.

Thank you for your cooperation in this study!

Contact:
Francisco Barros Castro
Faculdade de Economia do Porto
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email: fcastro@fep.up.pt

Leeds and Porto, June 1998

This postal survey is part of a Doctoral project in International Business

ABOUT THE PERSON COMPLETING THIS FORM

Name _____ Position in the firm _____

Telephone _____ Fax _____ E-mail _____

Would you like to receive a summary of this study's conclusions? Yes |__| No |__|

PART I - INFORMATION ON THE FIRM

1. NAME _____ 2. YEAR OF ACQUISITION/INCORPORATION |__|__|__|__|

3. MAIN ACTIVITY _____ CAE |__|__|__|__|__|

4. PARENT COMPANY (or main foreign investor):

Name _____ Nationality _____

Is the parent company the immediate investor or does it use an affiliate?

Immediate investor [ ] Uses affiliate [ ] ⇒ Name of affiliate _____

Nationality _____

5. CAPITAL STRUCTURE

	Now	At acquisition or set-up date
Foreign Investors		
Parent firm (directly or indirectly)	|__|__|__| %	|__|__|__| %
Other	|__|__|__| %	|__|__|__| %
Private Sector Portuguese Investors	|__|__|__| %	|__|__|__| %
Public Sector Portuguese Investors	|__|__|__| %	|__|__|__| %

6. LABOUR FORCE

	Now	31.Dez.1992 [a]
• With the affiliate, in Portugal	|__|__|__|__|__|__|	|__|__|__|__|__|__|
• With the Group, worldwide	|__|__|__|__|__|__|	

[a] *Or set-up date, if later.*

7. LOCALISATION OF MAIN SITES DIRECTLY OR INDIRECTLY OWNED IN PORTUGAL

Town	Type of Operation [a]	Year of creation	Labour force	Name of immediate investor (if not the firm itself but an affiliate)

[a] *Mainly commercial; Mainly production activity; Both commercial and industrial activities; Services (except commercial activity); Holding, etc...*

8. TURNOVER IN 1997

(a) What was the affiliate's turnover in 1997? |__|__|__|.|__|__|__| million PTE

(b) What percentage of the turnover in Portugal corresponded to:

	1997	5 years ago [a]
1. Production that took place in Portugal?	%	%
2. Exports to other Group firms?	%	%
3. Exports to unrelated companies?	%	%

[a] *Or set-up date, if later*

(c) What percentage of the 1997 turnover was spent in research and development:

– by the affiliate, in Portugal? |__|__|__| % – by the Group, worldwide? |__|__|__| %

(d) What was the contribution of the Portuguese affiliate to the Group's turnover in 1997:

– In Europe |__|__|__| % – Worldwide |__|__|__| %

9. MARKET ORIENTATION

How important are/were for the firm each of the following markets:

	Now	5 years ago
1. Portugal	___ %	___ %
2. Spain	___ %	___ %
3. Home country of parent firm (if not Spain)	___ %	___ %
4. Other European Union markets	___ %	___ %
5. Other European markets	___ %	___ %
6. Other	___ %	___ %
	100 %	100 %

10. PERFORMANCE IN PORTUGAL

Does the parent company expect from the Portuguese operations a rate of return different from that of the Group worldwide?

Expects higher Profitability ☐ Expects same profitability ☐ Expects lower profitability ☐

11. DOES THE PORTUGUESE FIRM HAVE ITSELF INVESTMENTS IN OTHER COUNTRIES

	No	Yes	
– in the European Union?	☐	☐	⇒ Where? _____
– outside the European Union?	☐	☐	⇒ Where? _____

12. FUTURE IMPORTANCE OF OPERATIONS IN PORTUGAL

What are your expectations for the contribution of the Portuguese affiliate to the Group's worldwide turnover in 5 years time as compared to today?

Much lower ☐ Lower ☐ About the same ☐ Higher ☐ Much higher ☐

13. EVOLUTION OF THE **GROUP**'S OPERATIONS IN PORTUGAL

When did the Group your firm belongs to started the following operations in Portugal:

	Year
1. Regular exports to Portugal	
2. Establishment of local office without juridical autonomy	
3. Creation/Acquisition of sales affiliate	
4. Creation/Acquisition of industrial affiliate	
5. Regular exports from Portugal	
6. Licensing, franchising, management contracts	
7. Other _____	

14. PARENT FIRM'S INVESTMENTS WORLDWIDE

In which countries does the Group directly or indirectly own **industrial units**, apart from Portugal?

1. Spain	☐	5. Hungary / Poland / Czech Rep.	☐
2. Ireland	☐	6. Other Eastern European countries	☐
3. Italy/Greece	☐	7. Other European countries	☐
4. Other European Union countries	☐	8. Other	☐

15. MAIN COMPETITORS IN THE WORLD MARKETS

What is the relevance of the following as competitors of the parent firm in the **world markets**:

[1 - *irrelevant* ... 5 - *very important*]

1. Portuguese firms	1	2	3	4	5
2. Other home country firms operating in Portugal	1	2	3	4	5
3. Other foreign firms operating in Portugal	1	2	3	4	5
4. Other firms from the home country	1	2	3	4	5
5. Other European Union firms	1	2	3	4	5
6. Firms from other European countries	1	2	3	4	5
7. Firms from North America or Japan	1	2	3	4	5
8. Other_____	1	2	3	4	5

PART II - THE INVESTMENT DECISION

1. REASONS TO INVEST IN PORTUGAL

What was the influence of each of the following elements in the decision to invest in Portugal?

[1 - *irrelevant* ... 5 *very important*]

1. Size of the Portuguese market	1	2	3	4	5
2. Expected growth of the Portuguese market	1	2	3	4	5
3. To increase the Group's turnover	1	2	3	4	5
4. To establish/acquire your own distribution network	1	2	3	4	5
5. Follow up of customers in their entry into the Portuguese market	1	2	3	4	5
6. Reaction to competitors' move	1	2	3	4	5
7. Increased competition in the home market	1	2	3	4	5
8. Need to reduce dependency from sales agents	1	2	3	4	5
9. Need to reduce dependency from suppliers	1	2	3	4	5
10. Reaction to the inefficiency of sales agents	1	2	3	4	5
11. Reaction to the inefficiency of suppliers	1	2	3	4	5
12. Need to reduce risk through market diversification	1	2	3	4	5
13. Reduction of labour costs	1	2	3	4	5
14. Quality of labour force	1	2	3	4	5
15. Transportation costs	1	2	3	4	5
16. Access to natural resources	1	2	3	4	5
17. Need to avoid tariff or non-tariff barriers	1	2	3	4	5
18. Quality of local infrastructure	1	2	3	4	5
19. Quality/density of the Portuguese *cluster* relevant to the firm	1	2	3	4	5
20. Acquisition of technology / catch up with technological developments	1	2	3	4	5
21. Search for complementarity with local partners	1	2	3	4	5
22. Acquisition of international experience	1	2	3	4	5
23. Good opportunity to buy local firm	1	2	3	4	5
24. Invitation/suggestion of Portuguese individual or firm	1	2	3	4	5
25. Easier access to the European Union market	1	2	3	4	5
26. Reaction to the new conditions set by the European Single Market	1	2	3	4	5
27. Public incentives to foreign investment in Portugal	1	2	3	4	5
28. Cultural proximity between Portugal and the home country	1	2	3	4	5
29. Geographic proximity between Portugal and the home country	1	2	3	4	5
30. Economic stability in Portugal	1	2	3	4	5
31. Political stability in Portugal	1	2	3	4	5
32. International image of Portugal	1	2	3	4	5
33. Other _____	1	2	3	4	5

- Which of the previous elements would you single out as the most important? |__|__|

2. DID THE FIRM CONSIDER ALTERNATIVE LOCATIONS BEFORE INVESTING IN PORTUGAL?

No		Yes		⇒

1. Spain	1	2	3
2. Ireland	1	2	3
3. Greece	1	2	3
4. Other European Union countries	1	2	3
5. Eastern European countries	1	2	3
6. Other _____	1	2	3

[1 - *not considered*; 2 - *considered*; 3- *strong alternative*]

3. TYPE OF INVESTMENT

What was the strategy chosen to invest in Portugal?

1. Total or partial acquisition of existing Portuguese owned firm	
2. Total or partial acquisition of existing foreign owned firm	
3. Greenfield development	
4. Other _____	

4. IF INVESTMENT BY ACQUISITION OF EXISTING FIRM

Did any pre-acquisition relationship exist **with the acquired company**?

No		Yes	⇒	1. Agent of parent firm
				2. Customer of parent firm
				3. Supplier of parent firm
				4. Competitor of parent firm
				5. Licensee of parent firm
				6. Other _____

5. IF JOINT-VENTURE INVESTMENT

(a) What was the home country of the partners in the investment?

1. Portugal	
2. Spain	
3. Home country of parent firm (if not Spain)	
4. Other European Union countries	
5. Other _____	

(b) Did any pre-acquisition relationship exist **with the partners in the joint-venture**?

No		Yes	⇒	1. Agent of parent firm
				2. Customer of parent firm
				3. Supplier to parent firm
				4. Competitor of parent firm
				5. Licensee of parent firm
				6. Common investments in other countries
				7. Other _____

6. PUBLIC INCENTIVES TO INVESTMENT

Did the firm receive any public incentives to invest in Portugal?

No		Yes	⇒ Would the firm had invested in Portugal if public incentives had not been granted?

1. No	
2. Yes, but the investment would have been lower	
3. The investment would have been the same	

7. AFFILIATE'S AUTONOMY

What is the level of autonomy of the affiliate in the following areas:

[1 - *all decisions made by the parent firm* ... 5 - *all the decisions made in Portugal by the affiliate*]

1. Quantities produced	1	2	3	4	5
2. Product mix	1	2	3	4	5
3. Price	1	2	3	4	5
4. Purchasing policy	1	2	3	4	5
5. Marketing strategy	1	2	3	4	5
6. Human resources management	1	2	3	4	5
7. Training	1	2	3	4	5
8. Financing	1	2	3	4	5
9. Research and Development	1	2	3	4	5

8. PROBLEMS AFFECTING THE RECENT DEVELOPMENT OF OPERATIONS IN PORTUGAL:

What might has been the relevance of the following elements as **problems affecting the recent development** of the firm's operations in Portugal [1 - *irrelevant* ... 5 - *very important*]?

1. Size of the firm	1	2	3	4	5
2. Insufficiency of the firm's financial resources	1	2	3	4	5
3. Insufficiency of the firm's human resources	1	2	3	4	5
4. Difficulty to adapt/enlarge products' range	1	2	3	4	5
5. Problems of co-ordination and management control	1	2	3	4	5
6. Problems to establish a distribution network in Portugal	1	2	3	4	5
7. Problems to identify local partner	1	2	3	4	5
8. Limited knowledge of the Portuguese market	1	2	3	4	5
9. Small size of the Portuguese market	1	2	3	4	5
10. Stagnant demand in the Portuguese market	1	2	3	4	5
11. Strong competition in the Portuguese market	1	2	3	4	5
12. Limited capacity of the sales agents'	1	2	3	4	5
13. Divergent strategies/opportunistic behaviour of business partners	1	2	3	4	5
14. Cultural differences between Portugal and the home country	1	2	3	4	5
15. Underdevelopment of related and support industries in Portugal	1	2	3	4	5
16. Availability and quality of infrastructure	1	2	3	4	5
17. Availability of skilled workers in Portugal	1	2	3	4	5
18. Labour costs	1	2	3	4	5
19. Attitude of Portuguese workers	1	2	3	4	5
20. Stagnant demand in the export markets	1	2	3	4	5
21. Strong competition in the export markets	1	2	3	4	5
22. Evolution of exchange rates	1	2	3	4	5
23. Lack of information on business opportunities in Portugal	1	2	3	4	5
24. Lack of information on investment conditions in Portugal	1	2	3	4	5
25. Level of development of the Portuguese banking industry	1	2	3	4	5
26. Insufficient public incentives to foreign investors in Portugal	1	2	3	4	5
27. Reduction of external tariffs by the European Union	1	2	3	4	5
28. Changes imposed by the European Single Market	1	2	3	4	5
29. Recent political and economic changes in Eastern Europe	1	2	3	4	5
30. Political and social situation in Portugal	1	2	3	4	5
31. Economic situation in Portugal	1	2	3	4	5
32. Tax regime in Portugal	1	2	3	4	5
33. Legal system in Portugal (including bureaucracy)	1	2	3	4	5
34. International image of Portugal	1	2	3	4	5
35. Other _____	1	2	3	4	5

- Which of the previous elements would you single out as the most important? |__|__|

Note: If the company is purely commercial, or if it subcontracts all its production, please go straight to page 7, question 17.

9. WAS PORTUGAL THE LOCATION OF THE FIRST FOREIGN INVESTMENT OF THE PARENT FIRM **EXCLUSIVELY NON COMMERCIAL**? Yes ☐ No ☐ ⇒ Which country was it? _____

10. PRODUCTION IN PORTUGAL

(a) What are the main products/services produced by the affiliate in Portugal? _____

_____

(b) When production started in Portugal, were the products/services produced already the same?

Yes		No		⇒ What products/services were produced then? _____

_____

(c) About the production in Portugal:

	Yes	No
1. The production represents an expansion on the Group's range of products/services?		
2. The affiliate uses components produced by the Group in the home country?		
3. The affiliate uses components produced by the Group in other countries?		

(d) What percentage of the production in Portugal is the following:

- Components/ Unfinished goods |__|__|__| %
- Final goods |__|__|__| %
- Services |__|__|__| %

11. Operations Developed in Portugal by the Affiliate

	Yes	No		Yes	No
1. Conception and design			4. Storage		
2. Purchasing			5. Distribution and sales		
3. Production			6. After sales services		

12. Development of the Goods/Services Produced in Portugal

(a) What percentage of the products currently produced were developed in Portugal? |__|__|__| %

(b) For the development of products/services in Portugal, does the firm maintain some form of cooperation with any of the following:

[1 - *no cooperation*; 2 – *some cooperation*; 3 - *very important cooperation*]

1. Customers	1	2	3
2. Suppliers	1	2	3
3. Competitors	1	2	3
4. State's research laboratories or Universities	1	2	3
5. Other _____	1	2	3

13. Impact upon the Portuguese Industrial Structure

How do you rate the impact of your firm upon the following elements

[1 - *irrelevant* ... 5 - *very important*]:

1. Attraction of new investments	1	2	3	4	5
2. Technological spillover and development	1	2	3	4	5
3. Spillover of new management techniques	1	2	3	4	5
4. Improvement of labour qualifications	1	2	3	4	5
5. Modernisation of existing firms	1	2	3	4	5
6. Creation of new firms by former employees	1	2	3	4	5
7. Development of cooperative networks	1	2	3	4	5

14. Inputs

What is the percentage of inputs (excluding labour) originating in:

	Now	5 years ago
1. Portugal	|__|__|__| %	|__|__|__| %
2. Spain	|__|__|__| %	|__|__|__| %
3. Parent firm's home country *(if not Spain)*	|__|__|__| %	|__|__|__| %
4. Other European Union countries	|__|__|__| %	|__|__|__| %
5. Other European countries	|__|__|__| %	|__|__|__| %
6. Other	|__|__|__| %	|__|__|__| %

15. TECHNOLOGY

How would you compare the technology used in Portugal by the affiliate with that used by the parent firm in the **home country**?

Identical		More labour intensive		More capital intensive	

16. SUBCONTRACTING

Does the affiliate subcontract part or all the production to local producers?

No		Yes		⇒ What percentage? |__|__|__| %

Note: If the company does not sell its products in the Portuguese market, please go straight to question 19.

17. PRESENCE IN THE PORTUGUESE MARKET

What is the importance of the following factors for the current position of the affiliate in the Portuguese market [1 - *irrelevant* ... 5 - *very important*]:

1. Price	1	2	3	4	5
2. Quality	1	2	3	4	5
3. Range of products/services offered	1	2	3	4	5
4. Product/service innovation	1	2	3	4	5
5. Distribution network	1	2	3	4	5
6. Technical support/after sales services	1	2	3	4	5
7. Marketing	1	2	3	4	5
8. International image of products/services	1	2	3	4	5
9. Ability to honour delivery deadlines	1	2	3	4	5
10. Fast reaction to new orders	1	2	3	4	5
11. Technological capacity	1	2	3	4	5

18. IMPACT UPON THE PORTUGUESE MARKET

What was the impact of your firm's presence in the Portuguese market upon the following elements [1 - *irrelevant* ... 5 - *very important*]:

1. Demand for the products/services the firm sells	1	2	3	4	5
2. Price of the products/services in the market	1	2	3	4	5
3. Quality of competitors' products/services	1	2	3	4	5
4. Range of products/services available in the market	1	2	3	4	5
5. Consumers demand for quality of the products/services	1	2	3	4	5
6. Demand of products/services related with those sold by the firm	1	2	3	4	5

19. EVALUATION

Regarding the parent firm's expectations for the investment in Portugal, how do you evaluate the experience [1 - *much worse than expected* ... 5 - *much better than expected*]?

1. Overall evaluation	1	2	3	4	5
2. Turnover	1	2	3	4	5
3. Profitability	1	2	3	4	5
4. Creation of new business opportunities	1	2	3	4	5
5. International experience	1	2	3	4	5

20. FINAL COMMENTS

Are there any further comments that you think might be useful to help understanding or to complement the information in this questionnaire? _____

_____

_____

_____

_____

APPENDIX 5B.

THE DETERMINANTS OF FDI

MODEL 1 (ALL VARIABLES INCLUDED)

TABLE 5.B1: COMMUNALITIES

Variables	Initial	Extraction	Variables	Initial	Extraction
Market size	1.000	.644	Avoid barriers	1.000	.620
Market growth	1.000	.744	Local infrastructure	1.000	.635
Increase turnover	1.000	.645	Local cluster	1.000	.642
Establish network	1.000	.659	Acquiring technology	1.000	.628
Follow customers	1.000	.645	Complementarity locals	1.000	.715
Reaction to competitors	1.000	.649	International experience	1.000	.595
Competition at home	1.000	.676	Local firm on sale	1.000	.573
Reduce depend. agents	1.000	.777	Invitation	1.000	.687
Reduce depend. suppliers	1.000	.722	EU market	1.000	.727
Inefficiency agents	1.000	.718	European Single Market	1.000	.667
Inefficiency suppliers	1.000	.687	Public incentives	1.000	.657
Market diversification	1.000	.631	Cultural proximity	1.000	.694
Reduction labour costs	1.000	.769	Geographic proximity	1.000	.801
Quality of labour	1.000	.781	Economic stability	1.000	.866
Transportation costs	**1.000**	**.461**	Political stability	1.000	.881
Access natural resources	1.000	.624	International image	1.000	.734

Extraction Method: Principal Component Analysis.

TABLE 5.B2: TOTAL VARIANCE EXPLAINED

Compo Nent	Initial Eigenvalues			Extract. Sums Squar. Loadings			Rotat. Sums Squar. Loadings		
	Total	% of variance	cumula-tive %	Total	% of variance	cumula-tive %	Total	% of variance	cumula-tive %
1	6.288	19.650	19.650	6.288	19.650	19.650	3.043	9.511	9.511
2	3.741	11.690	31.339	3.741	11.690	31.339	2.942	9.194	18.705
3	2.719	8.496	39.835	2.719	8.496	39.835	2.564	8.012	26.717
4	1.716	5.363	45.198	1.716	5.363	45.198	2.349	7.342	34.059
5	1.613	5.040	50.237	1.613	5.040	50.237	2.097	6.553	40.612
6	1.530	4.783	55.020	1.530	4.783	55.020	1.951	6.096	46.708
7	1.273	3.977	58.998	1.273	3.977	58.998	1.862	5.819	52.527
8	1.079	3.373	62.371	1.079	3.373	62.371	1.797	5.616	58.143
9	1.049	3.277	65.648	1.049	3.277	65.648	1.700	5.312	63.455
10	.945	2.954	68.602	.945	2.954	68.602	1.647	5.148	68.602
11	.895	2.797	71.399						
12	.844	2.638	74.037						
13	.725	2.266	76.303						
14	.707	2.211	78.514						
15	.673	2.102	80.616						
16	.602	1.883	82.499						
17	.573	1.790	84.289						
18	.548	1.714	86.003						
19	.511	1.597	87.600						
20	.485	1.516	89.116						
21	.462	1.444	90.560						
22	.435	1.359	91.919						
23	.399	1.247	93.166						
24	.324	1.011	94.177						
25	.314	.980	95.158						
26	.304	.949	96.107						
27	.274	.856	96.963						
28	.258	.805	97.768						
29	.239	.747	98.514						
30	.204	.636	99.151						
31	.186	.583	99.733						
32	.009	.267	100.000						

Extraction Method: Principal Component Analysis.

TABLE 5.B3: FACTORS' LOADINGS, ROTATED COMPONENT MATRIX

	Component									
	1	2	3	4	5	6	7	8	9	10
Political stability	**.906**	-.039	.013	.067	.069	.095	.045	.082	.171	.055
Economic stability	**.878**	-.035	.000	.113	.078	.126	.163	.078	.156	.038
International image	**.774**	.123	.096	.050	.067	.161	.236	-.077	-.029	.125
Acquiring technology	.068	**.696**	.066	.143	.004	.113	-.005	.103	.058	.295
Access natural resources	-.136	**.692**	.019	-.108	.097	-.025	.251	.137	.098	-.111
Inefficiency suppliers	.013	**.675**	.247	-.005	.099	.084	-.054	.153	.355	-.023
Local cluster	.359	**.586**	.043	.193	.172	-.114	-.096	.099	-.254	.072
Reduce depend. suppliers	-.121	**.579**	.286	-.040	.088	.222	-.090	.014	.446	.152
Local infrastructure	.481	**.507**	-.061	.032	.203	.133	-.034	.056	-.148	.236
Transportation costs	.262	**.372**	-.159	.167	.241	.289	.178	.093	-.096	-.097
Reduce depend. agents	.022	.177	**.837**	.031	.073	-.116	-.041	-.045	.078	.123
Inefficiency agents	.023	.175	**.807**	.012	.045	-.103	.041	.108	.034	.092
Establish network	.007	-.018	**.608**	.455	-.024	-.123	.209	-.086	.125	.009
Follow customers	.053	-.174	**.596**	.466	-.068	.003	-.065	.079	.146	-.059
Market growth	.136	.059	.156	**.818**	.022	-.136	.067	.067	.020	.012
Market size	.084	.097	.196	**.723**	.073	-.217	-.056	.074	.005	.075
Increase turnover	.017	.038	-.201	**.595**	-.053	.024	.283	-.026	.182	.363
EU market	.019	.076	-.020	.047	**.820**	.173	.020	.000	.107	.067
ESM	.219	.152	.148	.020	**.673**	.153	.263	.108	-.075	.107
Avoid barriers	.104	.191	-.005	-.042	**.628**	-.001	-.139	.209	.337	-.001
Reduction labour costs	.106	.104	-.207	-.267	.024	**.773**	-.029	-.113	-.007	.143
Quality of labour	.324	.209	-.113	-.087	.179	**.749**	.024	-.026	.037	.123
Public incentives	.104	-.093	-.015	-.162	.311	**.592**	.161	.327	-.091	-.148
Geographic proximity	.187	.051	.103	.050	-.013	.009	**.861**	-.004	-.015	.088
Cultural proximity	.162	.013	-.052	.091	.120	.070	**.761**	.142	.183	.071
Invitation	.098	.042	.058	.064	.336	-.046	-.001	**.737**	.091	-.045
Local firm on sale	.006	.213	-.068	-.032	-.124	-.019	.106	**.650**	-.110	.244
Complementarity locals	-.012	.331	.132	.226	.128	.143	.067	**.631**	.303	-.064
Market diversification	.255	.097	.156	.188	.052	-.067	.113	-.061	**.685**	.066
International experience	.045	.098	.083	.027	.268	-.043	.152	.232	**.596**	.264
Competition at home	.117	.103	.039	.003	.148	.022	.181	-.060	.125	**.759**
Reaction to competitors	.132	.069	.219	.214	-.017	.112	-.043	.209	.085	**.684**

Rotation Method: Varimax with Kaiser Normalisation. Rotation converged in 14 iterations.

APPENDIX 5C.

THE DETERMINANTS OF FDI

MODEL 2 (EXCLUDING TRANSPORTATION COSTS)

FIGURE 5.C1: SCREE PLOT

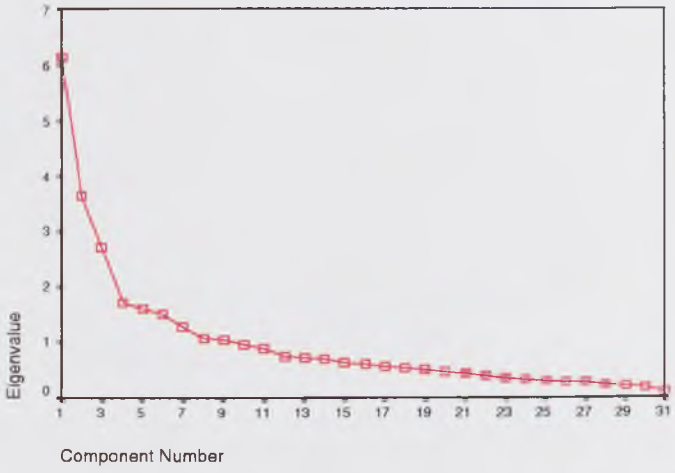

TABLE 5.C1: TOTAL VARIANCE EXPLAINED

Component	Initial Eigenvalues			Extract. Sums Squar. Loadings			Rotat. Sums Squar. Loadings		
	Total	% of variance	cumula-tive %	Total	% of variance	cumula-tive %	Total	% of variance	cumula-tive %
1	6.111	19.713	19.713	6.111	19.713	19.713	2.990	9.646	9.646
2	3.649	11.772	31.486	3.649	11.772	31.486	2.898	9.348	18.994
3	2.718	8.769	40.255	2.718	8.769	40.255	2.552	8.232	27.226
4	1.716	5.535	45.790	1.716	5.535	45.790	2.298	7.414	34.640
5	1.605	5.178	50.969	1.605	5.178	50.969	2.044	6.594	41.234
6	1.507	4.861	55.830	1.507	4.861	55.830	1.899	6.126	47.360
7	1.264	4.077	59.907	1.264	4.077	59.907	1.842	5.942	53.302
8	1.067	3.442	63.349	1.067	3.442	63.349	1.799	5.805	59.107
9	1.047	3.377	66.726	1.047	3.377	66.726	1.656	5.342	64.448
10	.941	3.035	69.761	.941	3.035	69.761	1.647	5.313	69.761
11	.873	2.818	72.579						
12	.736	2.374	74.953						
13	.725	2.338	77.292						
14	.689	2.224	79.516						
15	.625	2.016	81.531						
16	.591	1.907	83.438						
17	.555	1.789	85.228						
18	.538	1.737	86.965						
19	.510	1.646	88.610						
20	.472	1.523	90.133						
21	.435	1.403	91.536						
22	.400	1.291	92.827						
23	.337	1.088	93.915						
24	.321	1.037	94.952						
25	.304	.980	95.932						
26	.276	.892	96.824						
27	.268	.865	97.689						
28	.239	.772	98.460						
29	.204	.658	99.119						
30	.187	.603	99.722						
31	.009	.278	100.000						

Extraction Method: Principal Component Analysis.

TABLE 5.C2: KMO AND BARTLETT'S TEST

Kaiser-Meyer-Olkin Measure of Sampling Adequacy.		.770
Bartlett's Test of Sphericity	Approx. Chi-Square	2319.916
	df	465
	Sig.	.000

TABLE 5.C3: FACTORS' LOADINGS, ROTATED COMPONENT MATRIX

	Component									
	1	2	3	4	5	6	7	8	9	10
Political stability	**.906**	-.036	.012	.075	.069	.099	.043	.082	.165	.048
Economic stability	**.879**	-.043	.004	.108	.075	.120	.158	.081	.160	.044
International image	**.782**	.108	.097	.033	.069	.140	.230	-.067	-.031	.138
Acquiring technology	.071	**.712**	.048	.167	.011	.128	.012	.097	.025	.265
Inefficiency suppliers	.016	**.701**	.230	.018	.103	.099	-.041	.149	.324	-.051
Access natural resources	-.116	**.669**	.017	-.152	.097	-.074	.242	.160	.094	-.073
Reduce depend. suppliers	-.116	**.616**	.271	-.024	.095	.236	-.078	.009	.414	.127
Local cluster	.357	**.591**	.019	.237	.182	-.091	-.074	.092	-.286	.028
Local infrastructure	.483	**.511**	-.079	.064	.211	.151	-.021	.054	-.176	.201
Reduce depend. agents	.026	.189	**.840**	.017	.074	-.118	-.050	-.041	.067	.127
Inefficiency agents	.021	.191	**.806**	.016	.045	-.087	.038	.107	.021	.078
Establish network	.017	-.025	**.618**	.409	-.024	-.161	.203	-.074	.138	.051
Follow customers	.049	-.160	**.600**	.465	-.071	.006	-.059	.074	.153	-.056
Market growth	.128	.056	.155	**.830**	.018	-.129	.085	.060	.030	.011
Market size	.071	.102	.193	**.752**	.068	-.190	-.038	.064	.008	.056
Increase turnover	.028	.028	-.193	**.554**	-.051	-.015	.284	-.016	.193	.404
EU market	.023	.074	-.023	.045	**.822**	.166	.022	.007	.109	.066
ESM	.220	.163	.132	.047	**.682**	.170	.277	.105	-.092	.073
Avoid barriers	.110	.185	.001	-.060	**.622**	-.014	-.151	.223	.340	.015
Reduction labour costs	.107	.116	-.220	-.244	.027	**.788**	-.016	-.120	-.017	.117
Quality of labour	.330	.201	-.118	-.092	.176	**.738**	.029	-.022	.039	.126
Public incentives	.102	-.087	-.029	-.136	.312	**.606**	.176	.321	-.093	-.175
Geographic proximity	**.188**	.043	.105	.041	-.014	.005	**.862**	-.004	-.011	.090
Cultural proximity	.159	.022	-.057	.105	.120	.086	**.771**	.135	.181	.052
Invitation	.100	.029	.065	.050	.326	-.055	-.011	**.748**	.098	-.029
Local firm on sale	.007	.218	-.074	-.024	-.119	-.016	.109	**.647**	-.131	.232
Complementarity locals	-.009	.330	.131	.218	.119	.135	.070	**.635**	.304	-.055
Market diversification	.263	.116	.162	.165	.052	-.082	.106	-.056	**.681**	.085
International experience	.039	.135	.083	.049	.266	-.009	.154	.223	**.579**	.237
Competition at home	.122	.105	.052	-.023	.147	.020	.163	-.051	.119	**.773**
Reaction to competitors	.139	.073	.230	.186	-.017	.101	-.056	.217	.079	**.703**

Rotation Method: Varimax with Kaiser Normalisation. Rotation converged in 13 iterations.

APPENDIX 5D.

THE DETERMINANTS OF FDI, MODEL 3

(EXCLUDING TRANSPORTATION COSTS, INCREASE GROUP TURNOVER AND PUBLIC INCENTIVES)

FIGURE 5.D1: SCREE PLOT

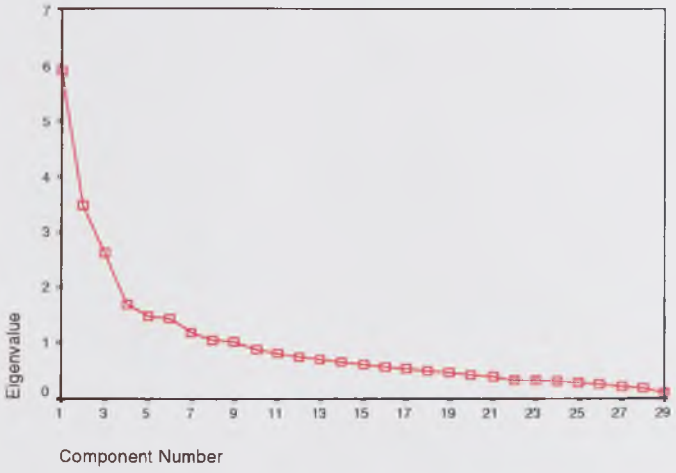

TABLE 5.D1: TOTAL VARIANCE EXPLAINED

	Initial Eigenvalues			Extract. Sums Squar. Loadings			Rotat. Sums Squar. Loadings		
Compo Nent	Total	% of variance	cumula-tive %	Total	% of variance	cumula-tive %	Total	% of variance	cumula-tive %
1	5.877	20.265	20.265	5.877	20.265	20.265	2.972	10.249	10.249
2	3.470	11.964	32.230	3.470	11.964	32.230	2.798	9.647	19.896
3	2.611	9.005	41.234	2.611	9.005	41.234	2.645	9.122	29.018
4	1.693	5.836	47.071	1.693	5.836	47.071	2.018	6.960	35.978
5	1.484	5.117	52.187	1.484	5.117	52.187	1.947	6.715	42.693
6	1.443	4.977	57.165	1.443	4.977	57.165	1.801	6.210	48.903
7	1.183	4.079	61.244	1.183	4.079	61.244	1.694	5.841	54.744
8	1.039	3.584	64.828	1.039	3.584	64.828	1.669	5.754	60.498
9	1.028	3.544	68.373	1.028	3.544	68.373	1.657	5.715	66.213
10	.873	3.011	71.384	.873	3.011	71.384	1.499	5.170	71.384
11	.802	2.766	74.150						
12	.745	2.569	76.718						
13	.698	2.406	79.124						
14	.645	2.225	81.349						
15	.593	2.044	83.393						
16	.564	1.946	85.339						
17	.528	1.822	87.161						
18	.484	1.670	88.830						
19	.466	1.607	90.438						
20	.428	1.475	91.913						
21	.385	1.327	93.240						
22	.329	1.134	94.374						
23	.321	1.106	95.481						
24	.295	1.017	96.498						
25	.279	.963	97.461						
26	.252	.870	98.331						
27	.204	.704	99.035						
28	.193	.666	99.700						
29	.009	.300	100.000						

Extraction Method: Principal Component Analysis.

TABLE 5.D2: KMO AND BARTLETT'S TEST

Kaiser-Meyer-Olkin Measure of Sampling Adequacy.		.766
Bartlett's Test of Sphericity	Approx. Chi-Square	2191.120
	Df	406
	Sig.	.000

TABLE 5.D3: FACTORS' LOADINGS, ROTATED COMPONENT MATRIX

	Component									
	1	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
Political stability	**.904**	-.014	.001	.084	.071	.052	.160	.083	.075	.044
Economic stability	**.885**	-.015	-.007	.103	.079	.163	.159	.080	.065	.043
International image	**.791**	.119	.127	-.014	.073	.203	-.063	.153	-.040	.128
Acquiring technology	.050	**.722**	.036	.159	.013	.071	.081	.132	.086	.227
Access natural resources	-.117	**.662**	.052	-.204	.099	.225	.128	-.091	.155	-.085
Inefficiency suppliers	-.003	**.652**	.261	.010	.076	-.082	.331	.200	.155	-.037
Local cluster	.326	**.633**	.011	.252	.183	-.073	-.231	-.129	.063	.056
Local infrastructure	.461	**.553**	-.111	.057	.196	.008	-.122	.153	.027	.175
Reduce depend. suppliers	-.126	**.546**	.314	-.044	.080	-.094	.398	.344	.046	.116
Reduce depend. agents	.015	.176	**.841**	.015	.078	-.073	.066	-.100	-.039	.127
Inefficiency agents	-.005	.178	**.779**	.056	.049	.023	.039	-.055	.096	.095
Establish network	.056	-.047	**.698**	.301	-.020	.162	.093	-.180	-.032	.035
Follow customers	.058	-.180	**.594**	.466	-.067	-.048	.144	.000	.083	-.046
Market growth	.122	.067	.166	**.831**	-.007	.110	.055	-.128	.042	.043
Market size	.027	.099	.170	**.825**	.039	-.004	.055	-.143	.036	.122
EU market	.043	.089	-.032	.015	**.822**	.061	.128	.106	-.001	.028
ESM	.209	.128	.168	.041	**.703**	.270	-.126	.202	.166	.047
Avoid barriers	.111	.178	.010	-.067	**.612**	-.205	.376	-.060	.192	.059
Geographic proximity	.187	.042	.109	.018	-.006	**.874**	-.013	.002	.005	.075
Cultural proximity	.168	.049	-.088	.076	.121	**.786**	.207	.018	.092	.037
Market diversification	.282	.094	.216	.098	.031	.089	**.673**	-.108	-.067	.095
International experience	.010	.116	.045	.104	.248	.210	**.630**	.028	.178	.233
Reduction labour costs	.113	.064	-.235	-.229	.064	.016	-.059	**.835**	-.056	.073
Quality of labour	.347	.170	-.128	-.108	.198	.025	.016	**.727**	.016	.121
Invitation	.088	.011	.062	.089	.337	-.024	.122	-.044	**.754**	-.040
Local firm on sale	.024	.200	-.030	-.073	-.111	.064	-.132	-.050	**.701**	.246
Complementarity locals	-.010	.331	.091	.211	.139	.152	.325	.119	**.588**	-.132
Competition at home	.091	.095	.038	.014	.110	.153	.137	.087	-.060	**.818**
Reaction to competitors	.146	.088	.223	.162	-.024	-.054	.099	.077	.200	**.694**

Rotation Method: Varimax with Kaiser Normalisation. Rotation converged in 14 iterations.

APPENDIX 5E.

TYPE OF INVESTMENT FOR DIFFERENT GROUPS OF FIRMS

TABLE 5.E1: TYPE OF INVESTMENT IN DIFFERENT INDUSTRIES

Industry		Acquisition Portuguese firm	Acquisition foreign firm	Greenfield development	Total
Food and beverages	No.	10	4	9	23
	%	*43.5%*	*17.4%*	*39.1%*	*100.0%*
Textile, clothing and footwear	No.	6	1	20	27
	%	*22.2%*	*3.7%*	*74.1%*	*100.0%*
Natural resources based industries	No.	13	5	14	32
	%	*40.6%*	*15.6%*	*43.8%*	*100.0%*
Chemicals and oil	No.	11	5	10	26
	%	*42.3%*	*19.2%*	*38.5%*	*100.0%*
Metal industries	No.	11		6	17
	%	*64.7%*		*35.3%*	*100.0%*
Machinery and equipment	No.	13	2	32	47
	%	*27.7%*	*4.3%*	*68.1%*	*100.0%*
Commerce	No.	13	5	33	53
	%	*25.5%*	*9.8%*	*64.7%*	*100.0%*
Total	No.	77	22	125	224
	%	*34.5%*	*9.9%*	*55.6%*	*100.0%*

TABLE 5.E2: TYPE OF INVESTMENT BY COUNTRY OF ORIGIN

Industry		Acquisition Portuguese firm	Acquisition foreign firm	Greenfield development	Total
Spain	No.	7	1	9	27
	%	*25.9%*	*3.7%*	*70.4%*	*100.0%*
France	No.	14	4	12	30
	%	*46.7%*	*13.3%*	*40.0%*	*100.0%*
Germany	No.	15	6	32	53
	%	*28.3%*	*11.3%*	*60.4%*	*100.0%*
UK	No.	9	2	9	20
	%	*45.0%*	*10.0%*	*45.0%*	*100.0%*
Other EU12	No.	9	3	13	25
	%	*36.0%*	*12.0%*	*52.0%*	*100.0%*
Other Europe	No.	9	3	19	31
	%	*29.0%*	*9.7%*	*61.3%*	*100.0%*
Rest of the World	No.	14	3	20	37
	%	*37.8%*	*8.1%*	*54.1%*	*100.0%*
Total	No.	77	22	124	223
	%	*34.5%*	*9.9%*	*55.6%*	*100.0%*

APPENDIX 5F.

PROBLEMS FACED BY FOREIGN FIRMS IN PORTUGAL: MODEL 1

TABLE 5.F1: COMMUNALITIES

Variables	Initial	Extraction	Variables	Initial	Extraction
Firm's size	1.000	.518	Labour costs	1.000	.569
Firm's financial restrictions	1.000	.647	Attitude Portuguese workers	1.000	.592
Firm's HR restrictions	1.000	.525	Stagnant export markets	1.000	.578
Limited product range	1.000	.360	Competition export markets	1.000	.622
Coordination/management	1.000	.478	Exchange rates	1.000	.377
Network problems	1.000	.675	Information business opport.	1.000	.612
Identifying local partner	1.000	.458	Information on investment	1.000	.754
Limited market knowledge	1.000	.435	Development local banking	1.000	.486
Small local market	1.000	.704	Insufficient public incentives	1.000	.685
Stagnant local demand	1.000	.753	Reduction external tariffs	1.000	.558
Competition local market	1.000	.636	European Single Market	1.000	.479
Limited capacity of agents	1.000	.575	Changes Eastern Europe	1.000	.394
Divergence with partners	1.000	.317	Political and social situation	1.000	.688
Cultural differences	1.000	.391	Economic situation	1.000	.784
Related/support industries	1.000	.569	Tax regime	1.000	.578
Infrastructure	1.000	.415	Legal system/bureaucracy	1.000	.483
Availability skilled workers	1.000	.668	Portugal's internat. image	1.000	.551

Extraction Method: Principal Component Analysis.

TABLE 5.F2: FACTORS' LOADINGS, ROTATED COMPONENT MATRIX

	Component						
	1	2	3	4	5	6	7
Problems with distribution network	**.761**	.085	-.069	.038	-.029	.266	.106
Coordination and management	**.602**	.125	.240	.097	.066	-.055	.162
Identification of local partner	**.600**	.125	.076	.012	.055	.181	-.202
Limited market knowledge	**.569**	.145	.170	-.077	-.100	.211	-.037
Limited product range	**.521**	.046	.129	-.035	.064	.199	.158
Cultural differences	**.504**	.072	.178	.258	.062	-.171	-.030
Divergence with partners	**.358**	.154	-.133	.194	.164	.248	.146
Information on investment	.195	**.790**	.106	.055	.146	.008	.237
Insufficient public incentives	-.003	**.772**	-.009	.065	.216	.041	.190
Information business opportunities	.311	**.679**	.166	.093	.063	.113	.030
Development local banking	.309	**.572**	.089	.174	.037	-.147	.039
Legal system/bureaucracy	.075	**.506**	.273	.256	.020	.125	-.256
Availability skilled workers	.061	.006	**.803**	.058	.024	-.036	.122
Attitude of Portuguese workers	.208	.079	**.693**	.228	.038	-.009	.089
Firm's HR restrictions	.267	.146	**.597**	-.022	-.025	.129	.242
Infrastructure	.002	.231	**.546**	.114	.153	.138	-.093
Labour costs	.008	.162	**.531**	.258	.380	-.108	.195
Related and support industries	.326	-.001	**.460**	.046	.248	.037	-.432
Economic situation	.016	.020	.128	**.866**	.026	.123	.027
Political and social situation	.157	.120	.070	**.789**	.095	-.108	-.018
Portugal's international image	.097	.264	.227	**.624**	.064	.062	.153
Tax regime	-.102	.472	.174	**.516**	.091	.083	-.181
Competition export markets	-.039	.017	.125	-.120	**.766**	-.033	-.049
Stagnant export markets	.135	.000	.155	-.052	**.700**	.092	.186
Reduction external tariffs	.109	.318	-.167	.280	**.581**	.032	-.015
European Single Market	.061	.226	-.131	.344	**.455**	.147	.246
Exchange rates	.020	.313	.109	.235	**.447**	.009	-.109
Changes in Eastern Europe	-.019	.122	.192	.234	**.435**	-.119	.290
Small local market	.076	.002	.197	-.038	-.048	**.807**	-.065
Stagnant local demand	.282	-.062	.145	.019	.077	**.795**	-.108
Competition local market	.206	.123	-.174	.088	-.023	**.718**	.157
Limited capacity of agents	.503	.079	-.094	.097	.175	**.503**	.113
Firm's financial restrictions	.186	.181	.257	.025	.124	-.042	**.704**
Firm's size	.115	.048	.278	.065	.333	.177	**.528**

Rotation Method: Varimax with Kaiser Normalisation. Rotation converged in 8 iterations.

APPENDIX 5G.

PROBLEMS FACED BY FOREIGN FIRMS IN PORTUGAL: MODEL 2

(EXCLUDING FIRM'S HR RESTRICTIONS AND LIMITED CAPACITY OF AGENTS)

TABLE 5.G1: COMMUNALITIES

Variables	Initial	Extraction
Firm's size	1.000	.537
Firm's financial restrictions	1.000	.645
Limited product range	1.000	.421
Coordination/management	1.000	.492
Network problems	1.000	.636
Identifying local partner	1.000	.436
Limited market knowledge	1.000	.445
Small local market	1.000	.735
Stagnant local demand	1.000	.759
Competition local market	1.000	.633
Divergence with partners	1.000	.325
Cultural differences	1.000	.402
Related/support industries	1.000	.557
Infrastructure	1.000	.446
Availability skilled workers	1.000	.647
Labour costs	1.000	.594

Variables	Initial	Extraction
Attitude Portuguese workers	1.000	.607
Stagnant export markets	1.000	.606
Competition export markets	1.000	.660
Exchange rates	1.000	.366
Information business opport.	1.000	.628
Information on investment	1.000	.766
Development local banking	1.000	.484
Insufficient public incentives	1.000	.685
Reduction external tariffs	1.000	.563
European Single Market	1.000	.468
Changes Eastern Europe	1.000	.391
Political and social situation	1.000	.680
Economic situation	1.000	.794
Tax regime	1.000	.579
Legal system/bureaucracy	1.000	.478
Portugal's internat. image	1.000	.550

Extraction Method: Principal Component Analysis.

TABLE 5.G2: TOTAL VARIANCE EXPLAINED

Compo nent	Initial Eigenvalues			Extract. Sums Squar. Loadings			Rotat. Sums Squar. Loadings		
	Total	% of variance	cumula-tive %	Total	% of variance	cumula-tive %	Total	% of variance	cumula-tive %
1	6.799	21.248	21.248	6.799	21.248	21.248	3.086	9.643	9.643
2	2.968	9.276	30.524	2.968	9.276	30.524	3.000	9.376	19.018
3	2.065	6.452	36.976	2.065	6.452	36.976	2.770	8.656	27.674
4	1.945	6.078	43.053	1.945	6.078	43.053	2.668	8.336	36.011
5	1.651	5.160	48.214	1.651	5.160	48.214	2.382	7.443	43.454
6	1.343	4.198	52.412	1.343	4.198	52.412	2.332	7.289	50.742
7	1.241	3.877	56.288	1.241	3.877	56.288	1.775	5.546	56.288
8	1.176	3.675	59.964						
9	1.071	3.346	63.309						
10	.984	3.075	66.384						
11	.968	3.024	69.408						
12	.903	2.821	72.230						
13	.831	2.597	74.827						
14	.808	2.524	77.351						
15	.713	2.227	79.577						
16	.647	2.023	81.601						
17	.592	1.851	83.452						
18	.578	1.807	85.259						
19	.537	1.677	86.936						
20	.475	1.486	88.422						
21	.459	1.433	89.855						
22	.429	1.341	91.195						
23	.406	1.268	92.464						
24	.376	1.174	93.637						
25	.357	1.115	94.753						
26	.337	1.052	95.805						
27	.298	.932	96.737						
28	.268	.838	97.575						
29	.227	.710	98.286						
30	.208	.650	98.936						
31	.179	.560	99.496						
32	.161	.504	100.000						

Extraction Method: Principal Component Analysis.

FIGURE 5.G1: SCREE PLOT

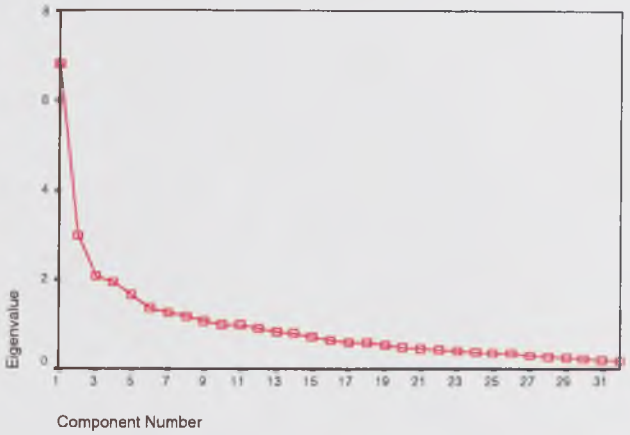

TABLE 5.G3: KMO AND BARTLETT'S TEST

Kaiser-Meyer-Olkin Measure of Sampling Adequacy.		.770
Bartlett's Test of Sphericity	Approx. Chi-Square	2319.916
	Df	465
	Sig.	.000

TABLE 5.G4: FACTORS' LOADINGS, ROTATED COMPONENT MATRIX

	Component						
	1	2	3	4	5	6	7
Information on investment	**.805**	.181	.061	.096	.106	.004	.247
Insufficient public incentives	**.780**	-.008	.077	-.015	.199	.029	.175
Information business opportunities	**.679**	.320	.092	.181	.029	.131	.074
Development local banking	**.558**	.329	.188	.064	.044	-.150	.022
Legal system/bureaucracy	**.471**	.114	.273	.278	.056	.097	-.279
Problems with distribution network	.111	**.733**	.031	-.090	-.041	.256	.103
Coordination and management	.109	**.632**	.115	.164	.079	-.045	.180
Identification of local partner	.144	**.576**	.006	.082	.063	.178	-.201
Limited product range	.017	**.571**	-.009	.040	.092	.224	.184
Limited market knowledge	.163	**.561**	-.088	.161	-.118	.237	-.002
Cultural differences	.061	**.521**	.252	.179	.055	-.168	.003
Divergence with partners	.158	**.352**	.209	-.177	.180	.232	.123
Economic situation	.002	.030	**.871**	.119	.021	.128	.048
Political and social situation	.111	.156	**.786**	.088	.079	-.105	.006
Portugal's international image	.253	.115	**.632**	.206	.053	.050	.161
Tax regime	.446	-.081	**.529**	.193	.110	.054	-.200
Availability skilled workers	.009	.084	.053	**.775**	-.011	-.028	.189
Attitude of Portuguese workers	.077	.235	.219	**.684**	-.005	.011	.175
Infrastructure	.240	.012	.099	**.582**	.111	.164	-.007
Labour costs	.188	-.003	.239	**.561**	.312	-.108	.280
Related and support industries	-.013	.341	.037	**.507**	.247	.060	-.343
Competition export markets	-.001	-.011	-.103	.128	**.794**	-.046	-.008
Stagnant export markets	-.008	.158	-.038	.135	**.697**	.094	.259
Reduction external tariffs	.339	.072	.287	-.149	**.581**	.023	-.012
Exchange rates	.309	.022	.237	.145	**.435**	.014	-.058
European Single Market	.264	.012	.343	-.131	**.425**	.138	.254
Changes in Eastern Europe	.147	-.037	.223	.206	**.391**	-.141	.321
Small local market	-.001	.094	-.026	.164	-.039	**.835**	-.022
Stagnant local demand	-.052	.278	.023	.135	.080	**.806**	-.061
Competition local market	.124	.208	.113	-.240	.008	**.701**	.117
Firm's financial restrictions	.188	.208	.037	.162	.084	-.044	**.728**
Firm's size	.078	.105	.056	.256	.268	.169	**.592**

Rotation Method: Varimax with Kaiser Normalisation. Rotation converged in 8 iterations.

CHAPTER 6.
THE INTERNATIONALISATION OF PORTUGUESE MANUFACTURING FIRMS

6.1. INTRODUCTION

The recent evolution of outward FDI flows was discussed in chapter 4. The picture presented was one of a very recent phenomenon. Only in the 1990s, and in particular in the second half, Portuguese investment abroad became relevant. But growth has been exponential and the enthusiasm was transmitted to the Portuguese authorities which made the internationalisation of domestically owned firms a political objective. It is interesting that these transformations happened at a time when foreign firms seem to be less inclined to invest in Portugal (see chapter 4). The result was a peculiar behaviour of the Portuguese IDP (section 4.6). It emulates the pattern of evolution of the most developed countries, suggesting that Portugal is joining the group of latecomers in foreign investment (together with Austria, Spain, and others). However, the Portuguese IDP conceals a loss of competitiveness in terms of the country's ability to attract foreign investment (see chapter 5). In this context, the investigation of the internationalisation of the Portuguese firms may yield important information. It is important, for example, to identify whether the growth

of outward FDI results from a new strength of national firms or it represents "escape investment", a response to an hypothetical reduced attractiveness of the domestic location.

The internationalisation process of the new Portuguese MNCs may also be important for international business theory. Foreign investors from newly industrialised countries like Portugal can be expected to be in many respects distinct from those from more developed nations. First, they are smaller than the long established MNCs they will compete with. Second, they tend to possess fewer ownership advantages, which are also likely to be very dependent on the characteristics of the home country (Dunning, 1981a, 1981b, 1986b). Third, as pioneers in their home countries in terms of internationalisation, they face explicit and implicit costs that do not affect firms from more developed nations. Following Dunning (1993a: p.64), it is not argued that the different characteristics, motivations and problems suspected to be typical of MNCs from newly industrialised small countries require a new paradigm or even new theories. But they certainly challenge existing theories in their emphasis and scope.

6.2. Methodology

The first problem that faces any researcher involved in studies of internationalisation is the definition of the concept itself. Welch and Luostarinen (1988: p.84) proposed a broad definition of internationalisation as "the process of increasing involvement in international operations". Given this definition, the internationalisation of an increasing number of Portuguese firms represents no surprise. After all, Portugal is a very open economy integrated within the biggest trading block in the world. However, most Portuguese firms do no more than exporting through agents, often with little or no knowledge at all of the market conditions for their products. Sales and production subsidiaries are rare (Simões, 1997).

The aim of this project - to study the motivations and strategies of the nascent Portuguese MNCs - suggests, however, a restrictive definition of internationalisation. The choice was to limit the analysis to companies that possessed a productive foreign subsidiary, or manifested a clear intention to create one in the near future. It was hoped that this solution would concentrate the research on those firms with a more mature internationalisation process, believed to be more relevant for the objectives of the study. As in the previous chapter, services firms were not considered because of their rather distinct characteristics (Buckley et al., 1992; Coviello and Munro, 1997). This may represent a limitation of the

study. Contrary to other countries (Dunning, 1993a), the services sector was the first to internationalise in Portugal and accounted for 90 per cent of outward FDI flows between 1996 and 1999 (see chapter 4). However, this investment was concentrated in telecommunications, real estate and financial services, which were likely to provide few clues of the evolution of the country's competitiveness.

For the same reasons presented in chapter 5, a survey analysis was considered the best methodological approach to this study of outward FDI in Portugal. In this case, however, the small size of the population (see next) permitted the adoption of a different technique. The survey was supported by semi-structured interviews and secondary data[1]. Despite being more resources intensive than a questionnaire based survey, this solution resulted in a better knowledge of the subjects being analysed as well as more flexibility. The latter was especially important due to the limited a priori knowledge of the subjects. In other words, interviews are more inductive than a questionnaire based survey (Gill and Johnson, 1991), making them in this case more suitable for the problem being analysed.

6.2.1. Population and sample

The population was identified from a mix of official (such as ICEP, FIEP and IAPMEI[2]) and non-official sources (industry associations and business journals and newspapers). Only 27 manufacturing companies could be identified as having at the time (Spring/Summer 1998) production capacity outside Portugal or clear projects to do so in the near future. All were contacted by telephone and 18 accepted to participate in the study. In all but three cases the interviewees were members of the Board of Directors. A brief characterisation of the sample is provided in Table 6.1 (see over page).

Due to unavoidable time restrictions, only one interview was conducted at each firm. Interviews took place in September 1998 with only one exception, where the interview was conducted in January 1999. They were recorded on tape when permitted by the interviewee. All interviews were conducted by the same researcher, which guaranteed homogeneity of treatment between different companies, both during the interviews and in terms of reporting.

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[1] Mainly, the companies' annual reports and assorted journal and newspaper news.

[2] ICEP – *Institute for International Trade and Investment*; FIEP - *Fund for the Internationalisation of the Portuguese Economy*, a venture capital fund led by the Portuguese government with involvement of several financial institutions; IAPMEI - *Institute for the Promotion of Small and Medium Size Manufacturing Companies.*

TABLE 6.1: THE SAMPLE

Company	Industry	Destination		Turnover 1998		Employees		Investment
		Industrial invest.	Main exports	Portugal	Total	Portugal	Total	
Arjal	Metal parts	*None*	Italy, Spain	4	4	475	475	*none*
Autosil	Electric batteries	France	Spain, Germany, Italy	5	19	270	925	6.5
Cabelte/ Cabelauto	Power, telecom and car cables	Brazil	Spain, other EU	19	19[a]	380	490	10
Cimpor	Cement	Spain, Mozambique, Morocco, Brazil, Tunisia	European Union	120	186	2,400	4,800	480
Cin	Paint	Spain, Mozambique	Angola	18	28	745	1,080	2
Colep	Metal and plastic containers	Spain, Poland	UK, France, Eastern Europe	12	15	720	80	..[b]
Dan Cake	Cookies and pastries	Hungary	Germany, UK, The Netherlands	7	..	580	610	..
Efacec	Electric and electronic equipment	Macao, China, Argentina, Malaysia, Algeria	Far-East Asia, Latin America, Persian Gulf, Southern Africa, India	30	48	2,650	..	< 1[c]
Faiart	Ceramics	Argentina	Spain, Germany, Italy, USA, Scandinavia	4	5	910	1,100	2
Neoplastica	Rigid plastic film	Netherlands, Spain, Austria, Brazil	Other European Union, Argentina	5	6.5	100	190	4
Quintas & Quintas	Ropes and nets	Brazil	European Union, United States	4	5.5	614	..	..
Renova	Tissue paper	*None*	Spain	16	16[d]	750	770	*little*
Riopele	Textiles	*None*	EU, West Africa	19	19[e]	2,800	2,800	*little*
Simoldes	Plastic parts	Brazil, Argentina, France	Spain	12	18[f]	385	870[f]	10[f]
Sodecia	Metal parts, seats	Brazil	Spain	2.5	7	..	..	..
Sunviauto	Seats	Brazil, France	European Union	5.5	5.5[g]	350	445	1[h]
Tavol	Metal parts	Brazil, Argentina, Mexico	European Union	7.5	..	..	..	9
Vista Alegre	Ceramics	Brazil	Germany, Spain, EU	17	17[i]	2,900	3,100	..

Note: *Turnover and investment in billion PTE.*

[a] *Investment in Brazil only concluded in 1998.*

[b] *Poland: 1 billion PTE*

[c] *Most foreign investment did not involve financial transfers*

[d] *Includes 3 billion PTE of exports to Spain.*

[e] *70% are exports.*

[f] *Excludes French subsidiary.*

[g] *Investment in Brazil only concluded in 1998.*

[h] *Sunviauto's share: 50%.*

[i] *50% are exports; Production in Brazil only started in 1999.*

Typically, the interviewees were invited to make a brief description of the company's history and to provide basic figures on the firm. This allowed the cross checking of information with previously collected data, thus testing the reliability of the different sources. Next, the internationalisation process was discussed in more detail. The topics proposed were the reasons for the choices made and the alternatives considered, what operations existed in each host country, and how every step affected the whole organisation in Portugal. The interviewees were then required to assess the company's competitive advantages and to describe other present or past international links of the company or its top managers.

6.3. THE INTERNATIONALISATION OF PORTUGUESE MANUFACTURING FIRMS[3]

The eighteen companies analysed presented very distinct internationalisation processes. They covered a wide range of industries and had different motivations and choices of mode of entry. The regularities are stronger when it comes to the timing of the internationalisation process and the location of foreign production subsidiaries.

6.3.1. Industries

Empirical evidence compiled by Dunning (1993a, pp. 28-40) suggests that, worldwide, the industries that are favoured by MNEs are: (i) capital-intensive processing industries, often producing natural-resources intensive products, but also differentiated consumer goods with high income elasticity; (ii) technology and human capital intensive industries; (iii) industries that can benefit from large economies of scale. The relative importance of these industries will, naturally, vary across countries due to their idiosyncrasies; different natural and created endowments, different stages of development and different industrial traditions will result in distinct structures of outward FDI.

Portugal is not only a recent exporter of capital, as it is traditionally specialised in labour-intensive industries with little product differentiation, such as textiles, clothing and footwear (Castro, 1993). Henceforth, the industrial structure of outward FDI could be expected to be quite different from that of more developed economies, home to most MNCs. However, the data collected suggested an industry distribution of Portuguese manufacturing outward investment not very different from that of more developed small countries (see Table 6.1, above). Traditional labour intensive sectors were largely absent; only one firm in the sample operated in these sectors, and its management admitted that productive direct investment remained no more than a project[4]. In contrast, capital intensive industries with significant economies of scale were dominant. The use of highly skilled labour seemed to be the rule, and a majority of the industries represented can be considered to be technology intensive.

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[3] An earlier version of this section was the basis for a referred article: "Outward FDI in Manufacturing from Portugal: Internationalisation strategies from a new foreign investor", presented at the *25th Annual Conference of the European International Business Academy* (Manchester, UK, December 1999). I would like to thank the referees and the participants in the conference for their comments and suggestions.

[4] The population also included a footwear producer that invested in Cape Verde, and a clothing manufacturer with projects for Tunisia. Unfortunately, the management of both firms refused to take part in the study.

This characteristic of the Portuguese outward FDI is, however, only in part a surprise. Dunning (1981b: p.9) predicted that firms from countries in stage 3 of the IDP may "invest abroad in those sectors in which (...) their comparative location advantages are weakest". In Portugal, capital and technology intensive industries that required a highly skilled labour force may fall into this category. However, Dunning (1981b: p.9) also predicted that these "enterprises invest abroad in those sectors for which their comparative ownership advantages are strongest". And it is not clear why firms in these sectors should have stronger ownership advantages than those in sectors where domestic investors have a longer tradition.

More than the characteristics of the industry in terms of factor intensity or technological level, the internationalisation of the Portuguese firms seemed to be associated with the stage of maturity of the respective domestic markets. Over half the companies in the sample were domestic leaders in fully mature domestic markets. In itself this is evidence of strong ownership advantages. Even more so because in a small country the leader is likely to concentrate management and financial resources and to have a big market share (which explains why most industries were represented by only one firm).

Apparent exceptions to this were the auto-components producers, who comprised one third of the firms in the sample. However, auto-components is not exactly an industry, but an amalgamation of industries. Electric batteries, metal parts, plastics components, power cables and textiles are the segments represented in this sample. Auto-components producers have, nevertheless, several common characteristics. In particular, they share the final clients - the car assemblers - so they are all constrained by similar industry and market characteristics. In this global industry, Portuguese companies tend to play a secondary role, even in the domestic market. This combination of factors seems to have contributed to the internationalisation of rather small firms.

6.3.2. Location

The study of the location of foreign investment at the firm level has been strongly influenced by the works of the "Uppsala School" (e.g. Johanson and Wiedersheim-Paul, 1975; Johanson and Vahlne, 1977). These authors suggest a path of foreign expansion marked by the firm's own past experience, the size of potential markets, and, most importantly, the firm's psychic distance to each potential host country (cf. chapter 2). Psychic distance depends on factors such as differences in language, culture, political

systems, level of education, or level of industrial development. But in the case of production establishments Johanson and Wiedersheim-Paul (1975, p.29) argued that "it is hard to observe any correlation with psychic distance". Cultural proximity is strongly associated with geographic proximity. This, normally, represents low transport costs, which encourage trade but discourage investment in production capacity.

The case studies presented here, however, suggested otherwise (see Table 6.2). Psychic distance seemed to be a very strong determinant of the location of the first foreign productive venture. In the sample, Brazil and Spain were the most popular destinations (respectively 47 and 20 per cent in terms of first choices). A revealing fact was that when asked why was Brazil the destination of the first foreign investment, a frequent answer was that Angola or Mozambique were first considered but political instability, small domestic markets (despite their potential for growth), and a very unskilled workforce discouraged investment. This reference to the PALOP[5] was also common among the other firms in the sample. For those that invested in Brazil, the explanation tended to be complemented with references to language and cultural proximity[6].

TABLE 6.2: LOCATION OF THE PRODUCTION ESTABLISHMENTS

Company	1990	1992	1994	1996	1998
Autosil			France	France	
Cabelte/Cabelauto					Brazil
Cimpor		Spain	Mozamb.	Morocco Brazil	Tunisia
Cin			Spain	Spain Spain	
Colep		Spain			Poland
Dan Cake			Hungary		
Efacec	Macao		China	Argentina	
Faiart			Argentina		
Neoplástica		Netherlands Spain	Austria		Brazil
Quintas & Quintas				Brazil	
Simoldes				Brazil	France
Sodécia				Brazil	Brazil
Sunviauto					Brazil
Tavol				Brazil	Argentina
Vista Alegre					Brazil

Companies that expanded to Spain cited geographic and cultural proximity as the most important determinants. In this case, the language is not the same, but it is close enough to be understood by most Portuguese speakers. There are also strong similarities (stronger

[5] The Portuguese acronym for *Portuguese-speaking African Countries*. It comprises Angola, Cape Verde, Guinea-Bissau, Mozambique, and Sao Tome and Principe.

[6] Neoplástica represents a notable exception. It was the only company in the sample to consider expansion to Brazil as "very risky, because you will be dealing with a very different culture". Neoplástica expanded first to Europe, where its owners and top managers studied and lived for long period of their lives.

than with Brazil) in terms of political system, level of education, and level of industrial development. But geography seems to be unquestionably relevant. "The whole Iberian Peninsula is our natural market"[7] was the expression used by at least 5 of the managers interviewed and sometimes printed in the Annual Reports.

Nevertheless, it seems that, as suggested by Johanson and Wiedersheim-Paul (1975, p.29), geographic proximity was negatively affecting the number of Portuguese firms creating production establishments in Spain. Although with different levels of engagement, all 18 firms in the sample exported to Spain. For most, Spain was the first foreign market. Hence, the fact that only 22 per cent of the firms in the sample established their first productive foreign investment in Spain seems to be an underestimate of the importance of the Spanish market for the Portuguese firms. The data suggest that only when economies of scale are strong and economic resistance to transport is high does it make economic sense to supply the Spanish market from Spanish plants, very much as suggested by Johanson and Wiedersheim-Paul (1975, p.29).

There is however a strategic element to be considered. It was pointed out during some of the interviews that the acquisition of an existing firm in Spain was not simply to acquire production capacity or to reduce transport costs. Often more important was that it also permitted the acquisition of market share and the elimination of a competitor, or the prevention of competitors from expanding. In the presence of increasingly integrated economies and growing international awareness by the Portuguese firms, these strategic moves can be expected to be more frequent.

One fact that must be discussed is why other European countries have such a small presence in the sample. The explanation may be a combination of location advantages and weak ownership advantages. In the European Union, which accounts for some 80 per cent of the country's international trade, Portugal remains the lowest cost location. In labour-intensive industries, exports and sub-contracting have been growing in recent years, resulting in stronger comparative advantages. One of the ceramics producers interviewed stated that expansion in Europe (including Eastern Europe) had been considered but abandoned due to relative costs: "European retailers are sub-contracting their production in Portugal more then ever before (including to our firm). We must infer that it does not make economic sense for us to produce anywhere else in Europe".

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[7] All the citations are translations from Portuguese.

On the other hand, the economic, social and political changes registered in Portugal in recent years (cf. chapter 4) are too recent to permit the full development of local firms. Ownership advantages are still very much dependent on locational factors. This prevents Portuguese firms from engaging in expansionary strategies in the more mature European economies. Evidence comes again from the reactions when the interviewees were asked about alternative locations. Europe was immediately ruled out by a substantial number of managers with the argument that it is impossible to compete in markets dominated by long established firms from the more developed European countries[8].

Another interesting fact was that, despite the importance given to cultural proximity, all companies that expanded either to Spain or to Brazil confessed to problems in understanding the local markets and business culture. "Spain is a completely different market", "you do not sell in Spain the same way you sell in Portugal", were frequent comments. The interviewees seemed to agree that consumer behaviour and business practices are in Spain quite distinct. Markets also tend to be less concentrated than in Portugal, with obvious implications in terms of strategic behaviour. Similar observations were made for Brazil ("in Brazil, everything is different"), along with references to the problems generated by red tape and economic structures still trying to adapt to the end of hyper-inflation.

This suggests two comments. First, psychic distance may influence the location choice, but it is no guarantee of problem-free investments. In fact, proximity (geographic and/or cultural) may induce companies into overlooking the differences between host and home countries. The risks involved are well documented by O'Grady and Lane (1996) for Canadian investment in the US. They concluded that "although cultural differences were perceived by the executives to be important, (...) it was the recognition of those differences, prior to entry, that differentiated performance" (p. 401). In our sample, the failure to recognise those differences explains the collapse of Cin and Renova's first attempts in the Spanish markets, as the respective managers admitted themselves. Unfortunately, expansion to Brazil is too recent to be assessed in this respect.

A second comment concerns people's assessment of cultural differences. As referred above, it is surprising how frequently cultural proximity with the host country was mentioned, but at the same time there were complaints about the difficulties posed by

[8] The managers interviewed tended to refer explicitly to German firms. French, British, Dutch, and Italian

different market structures, different consumer behaviour, different business practices, awkward attitudes by business partners or civil servants. This can only be explained because, regardless of its complexity, perceived cultural proximity is very much influenced by one single factor - language. A strong correlation between language and culture proximity is unquestionable, not least because language similarity is almost always associated with historic ties. Moreover, being able to understand and speak the language makes it easier to grasp alien cultures and reduces the risk of misunderstandings[9]. However, when the same language is spoken, or when languages are close enough to be mutually understandable, a sense of familiarity is generated and cultural proximity tends to be overstated[10]. The risk is an erroneous sense of "being at home", reduced vigilance, and an increasing chance of cultural clash.

Among the few companies in the sample which did not start their internationalisation in Brazil or Spain, Efacec was probably the most interesting case. This producer of power generation and distribution equipment started its international expansion in the Far-East. Efacec's management explained the choice as being based on market conditions. This was the fastest growing area in the world at a time (1989) when Latin America and Africa offered very risky environments. The European market, completely dominated by MNCs several hundred times bigger than Efacec, was not considered[11]. However, Efacec had privileged contacts in the Far-East - the agents of its former (foreign) owners. Furthermore, Macao (which was returned to China in December 1999, after four centuries of Portuguese administration) was the place chosen to establish the regional headquarters and the first production subsidiary.

6.3.3. Timing

It is logical to expect that older firms start internationalisation earlier. That seemed to happen with the four cases studied by Johanson and Wiedersheim-Paul (1975), even if the more recent firms internationalised their activities faster - younger firms can learn from the experience of older firms. They are also pressed to internationalise from the earlier stages of their existence by their internationalised (domestic or foreign) competitors. These

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firms were also used as examples, but much less frequently.

[9] That "it is necessary to understand what is said in the shop floor" was one manager's explanation for ruling out expansion to Eastern Europe. The company invested in Brazil.

[10] "Brazilian people like the Portuguese"; "It is easier for a Portuguese firm to understand the Brazilian way of life" were some of the comments recorded during the interviews.

[11] Efacec's assumed strategy is to avoid any direct conflict with the world leaders.

factors, nevertheless, should guarantee a more or less homogeneous distribution of international investment over time. However, firms' internationalisation is influenced by the international political and economic conditions. There will be few new subsidiaries in periods of high protectionism (e.g. the 1930s) or economic crisis (the 1970s); the opposite will happen in periods of economic expansion and liberalisation (e.g. the 1960s). This contrast is quite clear in Johanson and Wiedersheim-Paul's (1975) sample.

The home country's level of economic development is another variable to be considered. The international expansion of companies from developed countries can be expected to be essentially dependent on the firm's characteristics and strategy. However, firms from less developed countries are more dependent on national factors. To start with, their ownership advantages tend to be connected to the characteristics of the home country (Dunning, 1981a, 1981b, 1986b). Second, less developed countries normally do not have a tradition of outward investment, which increases the risks and potential costs of venturing abroad for the forerunners.

Our sample makes the relevance of this last element very clear (see Table 6.2). Bearing in mind the analysis is concentrated on production establishments, a striking feature is that all the firms in the sample started expanding abroad in the present decade, especially the second half. This coincidence in time made many in the country argue that the whole process is simply a "fashion". This includes two of the managers interviewed, whose firms were among the first to venture abroad. Although the "band wagon" effect is a recognised internationalisation force (Aharoni, 1966, p.9), it is a limited explanation. The Investment Development Path (Dunning, 1981a, 1981b, 1986b) provides a more relevant justification.

The IDP suggests that, after several years as recipients of FDI, countries are likely to see the domestic firms developing the necessary ownership advantages to internationalise. This will eventually make the country a net foreign investor, first in terms of flows and later in terms of stocks. Portugal reached that transitional stage in the middle 1990s (chapter 4). That is, the wave of outward FDI was the result of economic development and the consequent maturity of markets, industries and firms[12]. What must be stressed is that the influence of these changes is in the case of Portugal amplified by the small size of the domestic markets. In these conditions, market maturity and industry consolidation tend to happen rather quickly. If they are to retain the growth rates of previous years, firms from

small countries are forced to internationalise sooner than those with big domestic markets (Agmon and Kindleberger, 1977). In our sample, this applies to a substantial number of the industries represented.

The opinions of the managers interviewed support this interpretation. International investment was frequently explained as "natural on the face of market conditions" or "the obvious step following the position reached in the domestic market". In the same line is the argument that international expansion was a way of making use of "managerial overcapacity". The stability of operations in Portugal reduced the need for this intangible asset, leaving firms to find new uses for the capacity created during the years of domestic growth.

Another element that was particularly important in our research was the role of economic and political conditions in potential host countries. We saw above that Portuguese managers seem to have a strong preference for Portuguese-speaking countries. Together with the apparently weak ownership advantages of the firms studied, this largely restricts investment opportunities. This is even more true in the face of the economic and political instability that traditionally afflicts Brazil and most of the PALOP. It should be remembered that the 1970s flow of investment to Angola and Mozambique was not transferred to other locations when interrupted by these countries' independence.

On the face of it, the coincidence between the recent growth of outward FDI and the economic stabilisation of Brazil after 1996 assumes particular relevance. Almost all firms in the sample that chose a destination other than Brazil started their expansion before that year. All firms that expanded to Brazil did so after 1996[13]. This dependency highlights the weakness of the Portuguese industrial structure and that of the firms in the sample as well. The automotive components producers are a case in point. They tend to explain their expansion by their clients' decisions to invest in Brazil (see next). Nevertheless, the car manufacturers have long been expanding to other markets. It seems that few Portuguese suppliers were able (possessed the ownership-advantages?) to follow their clients to other, more distant, locations. The few that managed to do so (Tavol, Simoldes) expanded first to Brazil.

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[12] Membership of the European Union may have made a substantial contribution to the remarkable speed at which economic structures adjusted and developed.

[13] The very recent emergence of Brazil as a destination of Portuguese FDI explains, for example, that Simões (1997: p.72) reported a very different map of the location of the subsidiaries of Portuguese firms from the one obtained here.

6.3.4. Motivation

There was a general belief in the sample that internationalisation was critical for a company's long term survival. All the interviewees seemed to worry about the limited potential in the domestic market and the need to gain weight to face suppliers, clients, and competitors. There were, nevertheless, different patterns of motivations among these firms. It was possible to distinguish five groups, not all equally homogeneous (see Table 6.3).

TABLE 6.3: MAIN MOTIVATIONS TO INVEST ABROAD

Saturation of domestic market - market-seeking investment? - strategic asset-seeking investment?	Autosil Cimpor Cin Colep	Efacec Faiart Vista Alegre
Following the clients	Arjal Cabelte/Cabelauto Simoldes	Sodécia Sunviauto Tavol
Defensive investment	Dan Cake Renova	Riopele
Efficiency-seeking investment	Quintas & Quintas	
Strategic-asset seeking investment	Neoplástica Autosil (?)	Cimpor (?) Cin (?)

One group is formed by those firms that started internationalisation in response to the saturation of the domestic market. This group of 'leaders in mature markets' includes Autosil, Cimpor, Cin, Colep, Efacec, and Vista Alegre. With the exception of the last, these are the companies that seemed to have a surplus of management capacity after years of expansion and consolidation in the domestic market. Despite their position in the domestic markets, these companies are fairly small in international terms, which represented in itself a powerful motivation for international expansion: the need to improve the relative position *vis-à-vis* competitors, clients, and suppliers. That is, these firms' internationalisation was as much motivated by market expansion as by strategic asset-seeking. It is interesting, however, that despite their relatively small size few of these firms relied on networks (Vahlne and Nordstrom, 1988) for their internationalisation (the exception being Colep). This contrasts sharply with the results of previous studies on the internationalisation of SMEs (see, for example: Coviello and McAuley, 1999; Chen and Chen, 1998; Gomes-Casseres, 1997).

For Efacec, internationalisation is just another vector of the company's growth strategy. For many years, Efacec was restricted to the domestic market[14]. In this period, its management anticipated the maturity of the domestic market for the company's traditional products by diversifying to related but less mature businesses. When the restrictions to internationalisation disappeared, at the end of 1987, product diversification was complemented with market diversification. The first division to be expanded abroad was power equipment, the most competitive of the mature businesses, but diversification to less mature products is now part of the strategy for foreign markets as well.

Contrary to Efacec, Cimpor, Cin, and Vista Alegre stuck to their core businesses (respectively, cement, paint, and ceramics), but expanded internationally through acquisitions. Cimpor has now over 50 per cent of its production capacity outside Portugal, largely in developing countries (cf. Table 6.3). The similarity with Efacec is that the strategic solutions adopted at home were also applied in the foreign markets. That is, being located in a foreign country is almost the only element that distinguishes international activities. Cin is another good example. Its leadership in the Portuguese market is still recent, and requires further consolidation. It has been doing so with a mix of organic growth and acquisitions. After acquiring the third biggest Spanish producer of paint, Cin transposed to Spain the mixed strategy adopted in Portugal.

A different case is Autosil. This producer of electric batteries was in the early 1990s the leader in the Portuguese market for replacement equipment for automobiles, with only a small presence in the segment of new equipment and in industrial batteries. The strategy initially drawn was to expand the main business through exports, to be supported with a small plant in France. However, the opportunity, in 1994, to buy a company in France (at the time 3.5 times bigger than Autosil) radically changed Autosil's future. Three quarters of the group's turnover is now produced in France, while the new equipment segment represents an important percentage of the sales. The initially planned greenfield investment in France has been adapted to produce industrial batteries.

Chance also played a decisive role in Colep's internationalisation strategy. As Autosil in its main investment in France, Colep (a producer of metal and plastic containers) had a largely passive role in its expansion to Spain. The suggestion came from one of Colep's clients, who had decided to sell its Spanish subsidiary. Colep has now a more pro-active attitude,

[14] Until 1987 Efacec was a subsidiary of the Belgian group ACEC, which did not allow the company to sell

which has resulted in a recent investment in Poland. But its clients still maintain a relevant role, with the guarantee of contracts since the very early stages of the project.

A second group of companies that can be identified in the sample comprises the car parts manufacturers[15]. As referred to above, this is a highly heterogeneous lot, united by the share of the downstream activities of their value chains. Their strategies are intrinsically dependent on the global trends of the automobile industry, which they do not control, and they are subjected to a fiercely competitive environment. These are the firms for which international expansion is more critical in terms of medium/long term survival. The car industry is going through a process of global concentration (Simison, 1999), and the firms' ownership advantages, including dimension, will be crucial. It must be noted that before considering production abroad, most of the car parts manufacturers already exported a very high percentage of their production to other European countries (essentially France, Spain and Germany). By and large, the interviewees attributed their competitive advantage to technical ability. But data collected by ICEP (cited in Coutinho, 1998) suggests that low Portuguese labour costs have to be considered. The importance of Portugal's specific competitive advantages seems to be supported by the growth of exports also registered by foreign firms established in Portugal. However, despite the general market success, only Simoldes created a productive subsidiary in Europe. Symptomatic is that Simoldes's investment in France does not seem to be financially motivated. Simoldes's management explained that the aim was simply to make the company more visible to its clients, and to demonstrate its technological and financial capacity. As with many other firms in the sample, Simoldes still has to fight Portugal's image as a low-tech country largely dependent on cheap unskilled labour.

The trouble with the Portuguese car parts manufacturers is that they are very small compared to the big multinationals that dominate the industry. It was a general belief among this group of firms that they were unable to defy the German or French competitors "in their backyard". This seems to include other EU countries, but also non-EU Central and Eastern Europe. In this context, the opening of Brazil to FDI was momentous. When the car manufacturers started to invest in Brazil, the Portuguese suppliers seemed to be well positioned to follow them. Psychic distance - as assessed by

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or produce outside Portugal.

[15] Autosil was excluded from this group because its main market prior to internationalisation - replacement car batteries - is very much a final product, oriented towards individual consumers, not car assemblers.

the Portuguese companies but also by their clients - and the role of language similarity (see above) seem to have played a very important role. Unlike other firms in the sample (see above), the importance of the firms' network relationships in these expansionary investments seem to have been relevant (see section 2.4.1). The industry's structure is certainly a relevant element in explaining the role of networks in the internationalisation of the Portuguese car-manufacturers. Most of these internationalisation processes are still too recent to be evaluated. It is also too soon to know if the experience in Brazil will facilitate expansion to other countries, but there are already positive signs. Simoldes has a joint venture in Argentina, while Tavol is expanding to Argentina and Mexico[16]. Not surprisingly, Simoldes and Tavol are the only companies in the group that sell directly to the car assemblers. All the others are subcontracted by the direct suppliers, normally big MNCs themselves.

Defensive investment seems to be the best description of the internationalisation of Dan Cake, Renova and Riopele (cookies and pastries, tissue paper, and textiles, respectively). The move was largely a response to the erosion of their traditional markets, under attack from cheaper imports (the main competitors are Spanish for the first two, from the Far East in the case of the latter). As could be expected, this group includes some of the companies in the sample with less successful internationalisation strategies. The problems faced in the domestic markets absorbed important - and scarce - managerial and financial resources. Renova is the exception. It met with serious problems in its first approach to the Spanish market, but it seems to have been able to correct it with the adoption of a new market strategy.

Faiart, Neoplástica and Quintas & Quintas are the last three cases to be discussed. Quintas & Quintas is the only firm in the sample which had a clear objective of reducing labour costs. Portugal is one of the last producers of ropes in Europe, and the sector's cost competitiveness is still eroding. Quintas & Quintas management believes the solution to be the progressive delocalisation to Brazil, a source of raw materials with much lower labour costs than Portugal, and the development of more value added products for the plant in Portugal. Brazil's market was, nevertheless, a secondary motivation in the investment decision. The country's population is 17 times that of Portugal, and Petrobras (the main oil producer and distributor) is one of the world's biggest consumers of the most value added

[16] In both cases the companies are following their main client in Europe, respectively Renault and General Motors.

products manufactured by Quintas & Quintas. This includes anchorage cables for oil platforms, the firm's newest and most promising product.

Faiart's motivation was very similar to that of the companies in the first group identified - market expansion in a mature industry. The difference for that group is that Faiart is not market leader in Portugal. A medium size ceramics producer, it preferred foreign expansion to acquisitions in Portugal, where it would have to face some of its bigger domestic competitors. Neoplástica's is also an original case. It is one of the few Portuguese companies that expanded to Europe before considering other locations. Equally atypical was that its first foreign investment, in the Netherlands, had a very strong emphasis on the marketing function. The creation of productive facilities was essentially for visibility. As Simoldes realised several years later, having a plant "in the heart of Europe" (sic) is the most efficient way of overcoming the barrier that Portugal's image often represents. Neoplástica's expansion is a clear example of strategic-asset seeking investment (Dunning, 1993a), even if an intangible one - marketing capacity.

6.3.5. Constraints

"The first foreign investment decision is to a large extent a trip to the unknown. It is an innovation and development of a new dimension" (Aharoni, 1966). For that very reason, it is management intensive (Buckley, 1989, p.105), which may be a serious liability, in particular for small firms (a classification that applies to most of the firms in the sample). First, small firms rarely have specialist managers to face the new conditions. Second, limited management time and personalised decision making processes limit their ability to evaluate all the possible investment alternatives both in terms of location and of mode of entry. This may lead to sub-optimal decisions. Third, smaller firms are normally family owned and run. Reluctance to loosen up family control is normally a restriction on the expansion of management skills and to the very growth of the firm.

Shortage of capital is another factor that may affect foreign investment by smaller firms. Access to the capital markets is much more difficult than for big firms, while self-financing is limited by the size of the firm. When they do receive financial support, smaller firms are often made to pay a premium, the cost of being less known to the markets and potentially more vulnerable to competitors. Nevertheless, Buckley (1989) argues that financial constraints tend to be secondary to managerial constraints.

This was clearly supported by our sample. Capital constrains were considered much less important than skilled management shortages by almost all the managers interviewed[17]. There was, nevertheless, a close association between the two: when financial restrictions were considered relevant, management constraints were normally assessed as very restrictive. In general, those firms classified above as "defensive" in their motivation to internationalise were more severely affected by financial restrictions. The same can be said of those auto components manufacturers which had less stable relationships with their customers. Not surprisingly, there seems to be a strong negative correlation between success in the domestic market and the impact of capital constraints on the internationalisation of the firm. This does not mean, however, that financial restrictions were irrelevant to the other firms in the sample. Two examples seem to be the entry strategies of Vista Alegre, assumedly on a less than optimal scale, and Efacec, based on minority participation (see below).

The shortage of skilled management seems to have been far more important in the sample. However, the bigger firms, identified above as "leaders in mature domestic markets" (Autosil, Cimpor, Cin, Colep, Efacec, but also Neoplástica and Simoldes) represent exceptions. In fact, excess management capacity was among the motivations for internationalisation (see above). For the remaining firms, however, internationalisation created a management problem. International expansion stretched the often already overloaded management function. Many had grown very fast in the three or four years before international expansion, and few have fully adjusted their management teams to the new conditions. A recurrent complaint in the interviews was that internationalisation had either diverted management's attention from the domestic market or was not being followed as efficiently as it ought to be because of the management's concentration on domestic affairs.

Part of the problem is that many companies are reluctant to hire locals for top management positions in the foreign subsidiaries. This may represent weaknesses that can be associated with earlier stages of internationalisation. Lacking international experience, new MNCs may find it too expensive and risky to recruit locally. These costs include the time needed to efficiently identify and evaluate potential candidates and to monitor their

[17] It must be borne in mind that the firms in the sample are those that managed to gain the funds necessary to internationalise. That is, the sample is naturally biased against those firms that could not overcome financial restrictions to their expansion.

performance. On the other hand, there seems to be a shortage of experienced managers in Portugal, even more so when the position involves working as an expatriate. Companies like Simoldes chose to provide in house training for recent graduates, apparently more keen to work abroad. But this is necessarily slow and time consuming for the other members of the management team.

Other restrictions to international expansion were identified from the sample, but were almost always ranked much lower than the two mentioned above. Most were in fact a consequence of managerial and/or capital constraints: difficulties in obtaining information on potential destinations or on potential targets for acquisition; deficient support by government institutions; the almost non existence of true venture capital in Portugal. Another important constraint often mentioned was the prevailing image of Portugal as a poor backward country dependent on low labour costs. This was normally dealt with by inviting potential partners, potential customers, and government officials to visit the plants in Portugal and to witness the changes that the country has made in recent years. This represents a hidden cost that does not affect companies from countries long established as outward investors (and with a longer industrial tradition). The costs were well demonstrated by the investments Neoplástica and Simoldes were "forced" to make in the Netherlands and France, respectively. It may also represent a substantive cost in terms of missed opportunities for the Portuguese economy.

6.3.6. Mode of entry

The choice of the mode of entry is the subject of a vast body of research. Of particular influence have been the studies at the University of Uppsala (e.g. Johanson and Wiedersheim-Paul, 1975; Johanson and Vahlne, 1977, Johanson and Mattsson, 1988; Vahlne and Nordstrom, 1988). They suggest that internationalisation is an incremental process. Firms fight restrictions in terms of resources (e.g. capital or management) and knowledge with progressive exposure to international markets. Hence, the first internationalisation move can be expected to be exports through agents, which will successively evolve to the creation of sales subsidiaries and production subsidiaries. Each new step represents a deeper commitment and is associated with a better knowledge of foreign markets. It is also suggested that firms with international experience may be able to jump stages. The knowledge acquired in one country may facilitate the involvement in other locations.

This internationalisation path is only partially found in our sample (see Table 6.4). All firms contacted seem to have started exporting through agents, although in some cases exports were not very significant due to the resistance to transport of largely standardised products. This was normally followed by the creation of sales subsidiaries in the most important markets, often through the acquisition of the agents or in association with them[18]. However, this picture holds essentially for Europe and Asia. In the case of expansion to Brazil, the internationalisation path is much less linear.

Despite this being the most popular destination in the sample, none of the companies analysed had a sales subsidiary in Brazil before the creation of the production subsidiary. Most had never exported to that country at all. Three reasons explain this. First, exports were, and still are, discouraged by geographic distance and a punitive tax system. Second, Brazil's economic instability until 1996 made the country unattractive. Third, psychic proximity - being able to speak the local language, and a strong sense of common heritage and cultural proximity - may have permitted firms the jumping of stages in the internationalisation process.

TABLE 6.4: MODE OF ENTRY IN FOREIGN MARKETS

Company	<1975	1980	1985	1990	1995	1998
Autosil	Exp				CS PS	
Arjal		Exp				
Cabelte/Cabelauto	Exp					PS
Cimpor	Exp				PS	
Cin	Exp		CS		PS	
Colep			Exp		PS	
Dan Cake				Exp	PS	
Efacec			Exp/CS	PS		
Faiart		Exp			PS	
Neoplástica			Exp		CS/PS	
Quintas & Quintas	Exp				CS PS	
Renova			Exp	CS		
Riopele	Exp				CS	
Simoldes		Exp			CS PS	
Sodécia			Exp		PS	
Sunviauto			Exp		CS/PS	
Tavol			Exp		PS	
Vista Alegre	Exp			CS	PS	

Exp: Regular exports *CS: Commercial subsidiary* *PS: Productive* subsidiary

[18] A number of these acquisitions were forced by the need to avoid the agents' closure due to bankruptcy or personal problems. In at least two cases this represented the firm's first foreign venture, which reflects rather passive internationalisation processes in these earlier stages.

It is important to highlight the fact that only one example of licensing (Efacec) was registered in the sample[19], which reflects the characteristics of the firms involved and their motivations to internationalise. As discussed above, many internationalisation processes were defensive reactions to the concentration forces in the industry or to the penetration of imports. In these conditions, internationalisation was not a means to maximise ownership-advantages, but simply a way to avoid their degradation or eventually to create them[20]. Neither is licensing a solution when ownership-advantages are based on intangible assets, such as management capacity, as was the case with other firms in the sample. In fact, even Efacec is not a pure case of licensing. Its licensees are joint-ventures with local partners (usually the main customer), and are seen by Efacec's management as subsidiaries. Although the company's stake rarely exceeds one third of the joint venture's capital, Efacec's management argue that control is exerted through the firm's role as supplier of the technology.

Efacec's mode of entry seems to support the internalisation model (Buckley and Casson, 1981), even if with adjustments[21]. Efacec follows an explicit strategy of progressive involvement in each foreign market that always starts with exports through agents and evolves to the establishment of sales subsidiaries in the most promising markets. In this strategy, licensing seems to be an intermediate solution between the sales subsidiary and the production subsidiary. The choice of minority joint ventures as licensees allows the investing firm to obtain a certain degree of control with a minimum of capital requirement[22]. Efacec's management argue that a local partner is absolutely necessary in an industry where the major clients are normally government controlled utilities. But the strategy adopted also suggests a limited financial capacity, unable to sustain the high fixed costs associated with a majority stake in a production subsidiary.

Another characteristic of the sample was that acquisitions were preferred to greenfield developments (see Table 6.5). However, this seems to be determined more by industry characteristics than by the firm's choice. First, the sample includes a substantial number of

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[19] This is not very different from Simões (1997), who found none. Efacec was part of the sample, but its foreign involvement was not considered to be licensing.

[20] Which stresses the intrinsic dynamic nature of the concept of ownership advantages (Buckley, 1990; Dunning and Rugman, 1985).

[21] Buckley and Casson's (1981) reference to licensing and FDI seems to imply only production. Consequently, the model does not distinguish between exports through agents and through a sales subsidiary.

[22] In fact, Efacec rarely transfers capital to the subsidiaries. Its shares normally result from technology transfers.

firms operating in mature industries, where overcapacity is frequent. Second, it is biased by the conditions in Brazil. Several years of hyper-inflation created an industrial structure completely oriented towards the financial function, where production, stock management, and sales were almost irrelevant. Most of these companies could not adjust fast enough to the new economic conditions, and in just two years many were facing bankruptcy. Several managers in the sample claimed to be studying the possibility of a greenfield investment when they came across the opportunity to buy an existing firm in favourable conditions, even after paying off the huge debts (which most did immediately). In at least one case the initial project was not even to invest in production capacity but to create a sales subsidiary. It was abandoned when an existing company with a reasonably efficient plant turned up for sale.

A different aspect of the mode of entry is the choice between joint ventures and wholly owned subsidiaries. The former was only chosen by four companies[23] (see Table 6.5), and capital restrictions were always the main reason given by their managers. The Portuguese firms provided the technology, while local partners were expected not only to provide capital but also to supply information on labour markets, bureaucracy and the product markets. That is, a local partner was a short cut to avoid the time consuming task of acquiring the necessary information to invest and market in a foreign country.

TABLE 6.5: TYPE OF INVESTMENT IN PRODUCTIVE ESTABLISHMENTS

Company	1990	1992	1994	1996	1998
Autosil			Acq.	GF	
Cabelte/Cabelauto					GF
Cimpor		Acq.	Acq.	Acq.	Acq. Acq.
Cin			Acq.	Acq.	Acq.
Colep		Acq.			GF
Dan Cake				Acq.	
Efacec	GF		GF/JVm		Acq./JVm
Faiart				Acq.	
Neoplástica		GF	GF	Acq.	GF
Quintas & Quintas				Acq.	
Simoldes				Acq./JVe[a]	GF
Sodécia					Acq. GF
Sunviauto					GF/JVe
Tavol					GF GF
Vista Alegre					Acq.

GF: Greenfield Investment *Acq.: Acquisition* *JVm: Joint Venture (minority participation)*
Jve: Joint venture (equal partnership)
[a] *100% ownership since 1998*

[23] A fifth - Arjal - aborted its internationalisation program.

The small size of the firms involved may explain the limited number of joint ventures registered in the sample. That was the suggestion of Buckley et al. (1988), who found a similar result for a sample of small UK firms. Buckley (1989, p.107) claims that "whilst such operations [joint-ventures and licensing] economise on capital outlay, they tend to be management-intensive and this may choke off the ability of small firms to enter into the more complex forms of such arrangements".

One last point is the frequent claim in the sample that internationalisation started well before exports took place. This belief is particularly common among those firms that have or had as clients big MNCs established in Portugal (e.g. the auto-components segment) and is also reported by Simões (1997, p.139). In fact, sales to the subsidiaries of leading MNCs can be compared with exports, given that these supply contracts are normally obtained in purely international markets. Even the advantage of being a local firm is frequently just theoretical, since the competitors are often Portuguese subsidiaries of foreign firms.

The suspicion is that this "extra-light form of internationalisation" will be common in countries long established as hosts of FDI. Its importance may even be growing with the increased relevance of business networks in the world economy (Buckley and Casson, 1998). The case of Simoldes is paradigmatic. Its present success is based on the position acquired as direct supplier to Renault. This was gained before exports were significant, when Simoldes's produced essentially for Renault's assembly plant in Portugal. Most auto-components producers in the sample claimed that if they are internationally competitive today it is because, to become suppliers of MNCs in Portugal, they were forced long ago to improve quality and to develop products and technology.

Autosil and Cin argued that their internationalisation began well before their products started crossing the Portuguese border. The argument presented by both firms is that they always had to face the competition from multinationals in the domestic market. In other words, they had to become internationally competitive before they compiled the capital and management resources necessary to sell their products across borders. In both cases the claim was that the benchmarking they were able (and forced) to make against those foreign competitors was a major determinant of the development of the competitiveness (ownership advantages) that later allowed them to enter foreign markets.

6.3.7. Government policies

The attitude of the Portuguese authorities towards the internationalisation of the local firms has always been very positive. In a 1996 speech, the prime minister Antônio Guterres (cited in Simões, 1997: p.37) claimed, for example, that "it is necessary to strengthen our own economic groups and to facilitate their presence in international markets. (...) The conditions must be created for their effective internationalisation, supporting the acquisition of distribution networks and other forms of international expansion". The following year the Portuguese government defined the basis for a "new internationalisation policy" (Presidência do Conselho de Ministros, 1997). In the introduction to the document it could be read: "[i]nternationalisation represents a strategic vector of Portugal's economic development. (...). The Portuguese firms, facing new and mounting competitive pressures, need to build and acquire a new international initiative and a permanent presence in the most dynamic international markets and decision centres"[24].

The "new economic policy" suggested a passive role for the government in this new process. The government's task was defined as being to develop the necessary infrastructure and to create a stable macroeconomic environment in order to facilitate the internationalisation strategies of individual firms However, a new set of mechanisms to actively support the internationalisation of domestic firms were created and existing ones restructured. In particular, the activity of ICEP was reorganised, a new venture capital fund for internationalisation was created (FIEP), and internationalisation was made a priority in the context of the existing (EU financed) structural funds (Presidência do Conselho de Ministros, 1997). A more active 'economic diplomacy' was also put in practice, with the ministry of the economy organising business trips to "strategic countries" led by the minister himself and to include Portuguese entrepreneurs with a potential interest in the country.

The institutional approach to the internationalisation of local firms suffered, however, an interesting strategic adjustment. In 1995/1996, when the phenomenon was still a novelty, the official view was that the Portuguese firms should expand commercially to more developed countries and invest in production capacity in the PALOP and other ACP countries (ICEP, cited in Simões, 1997: p.37). However, the document defining the "new internationalisation policy" (Presidência do Conselho de Ministros, 1997) mentioned

[24] All citations in Portuguese in the original.

explicitly the need to "abandon the frequently artificial distinction between productive and commercial projects" (p.7) in the promotion of the internationalisation of domestic firms.

More important was, probably, the evolution in terms of the geographic priorities. Brazil, in particular, went from being totally ignored in the official approach to internationalisation in 1995/96 to an intermediary position in the list of priority markets and regions in the "new internationalisation policy". The mention of Brazil was in the latter preceded by references to the European Union (with an emphasis in Spain), the new democracies in Central and Eastern Europe, and the United States/NAFTA (Presidência do Conselho de Ministros, 1997: p.5). By 1999, however, Brazil was considered by the Minister for the Economy "the new priority of the Portuguese external policy" (Pina Moura, 1999).

What was not clear from this evolution was whether it corresponded to a dogmatic adjustment of the government's strategy or it was evidence of a reactive attitude of the Portuguese authorities to internationalisation. The latter was the opinion of Bessa (2000). He claimed that the government has long been simply following the investors in the definition of Portugal's geostrategic priorities. The evolution of the references to the PALOP and to Eastern Europe in official sources in recent years seems to be further evidence of this passive behaviour.

The opinion of the interviewees regarding the efficiency of government policies was mixed. In general, they considered that the existence of public funds to support internationalisation strategies was important. However, all were keen to say that their firm's internationalisation was not dependent on these funds. Public financial support was welcomed and did contribute to reduce the risk of the investments made abroad, but the internationalisation processes would apparently have been very much the same even without those funds. The claim was that the funds available for internationalisation were too small to have a significant impact upon the overall internationalisation of Portuguese firms[25].

Nevertheless, the managers interviewed normally (but not always) agreed that other forms of public support had a positive even if indirect effect on the internationalisation of domestic firms. The support that all firms in the sample seemed to have received (with more or less extent) in the context of programs of quality certification, training of the

[25] Two managers considered that they should not exist at all. They claimed that private financing was more efficient because it forced a rational use of capital and avoided the adoption of very risky projects.

labour force, or the modernisation of productive equipment, on the one hand, increased their local and international competitiveness and, on the other hand, freed valuable financial resources that were used in the internationalisation process.

One important institutional element in the internationalisation of the Portuguese firms seems to be ICEP delegations abroad. In the opinion of many of the interviewees ICEP delegations played an important role in their firms' expansion, although several considered they could often do more. ICEP delegations have often helped to identify potential partners or services providers (e.g. local lawyers) and to obtain information on the local business environment. In general, the opinions on ICEP's efforts were rather positive and were considered to have improved in recent years. However, there were several complaints about the way some of the delegations worked. It was a general opinion that the delegations were too dependent on the personal commitment and proficiency of the respective directors and that not all the local directors were sufficiently motivated for the tasks they were given. This latter criticism was even more acute in the case of the Portuguese embassies, accused of being "too political, with no interest in business whatsoever". A substantial number of the managers interviewed compared the attitude of the Portuguese diplomatic representations with that of Spanish diplomats, apparently much more aware of local business conditions and ready to lobby in favour of Spanish owned firms. US embassies were also frequently pointed as being very good role models.

6.3.8. Summary

The results presented above can be summarised in a few points:

1. Most Portuguese nascent MNCs operate in capital-intensive industries. Internationalisation in traditional labour-intensive industries is incipient.

This is a partial surprise given the specialisation of the Portuguese economy in labour-intensive industries. It seems that the success the latter enjoy as passive exporters discourages international expansion. As for the former, internationalisation may be a way to overcome relatively weak location advantages.

2. Efficiency-seeking FDI is still rare in Portugal.

Portugal seems to maintain a cost-advantage in the European context, which is supported by the sustained success of traditional exporters (Portuguese or foreign owned). So far, few

Portuguese firms found it necessary to move operations to lower costs locations. There was only one case of an efficiency-seeking investment in the sample, in Brazil.

3. The concept of asset-seeking investment must be broadened.

There was only one company in the sample clearly engaged in strategic-asset seeking investment. However, in other cases, it proved very difficult to distinguish this from market-seeking FDI. Internationalisation was often presented by the managers interviewed as a question of survival for their companies. That is, market expansion provided an important strategic asset - size. At least for those firms that expanded to more developed countries, there seems to be an unavoidable element of strategic asset-seeking in their market oriented investments.

4. Portuguese firms are increasingly engaging in market-seeking investment in less developed or adjacent territories.

As predicted by Dunning (1981a, 1981b, 1986b), the most common destination of market-seeking investment are countries less developed than Portugal or neighbouring territories, notably Brazil and Spain. However, the firms involved are small in international terms. As argued above, it is never clear whether they are seeking to maximise their existing resources, or they seek in new markets the size on which they will build their competitive advantages in the future.

5. Psychic distance, and language in particular, proved to be a major location determinant of FDI.

It is strongly suggested by the statements made in the interviews that, more than any other element, language determines psychic distance. Furthermore, language and cultural distance were critical determinants in the location of foreign subsidiaries. With very few exceptions, the managers interviewed had a very strong preference for Portuguese-speaking countries. Spain and Spanish-speaking Latin America, in that order, were next in this ranking.

6. Political and economic stability are critical location determinants of FDI. Once a certain 'level of stability' is attained they cease being deterrents to FDI (Tu and Schive, 1995).

Although assessed as relevant location determinants in the sample, political and economic instability only overshadowed psychic distance or market size when risk was very high. Before the stabilisation program of 1996, economic and political risk were indeed deterrents to foreign investment in Brazil. The same can be said of present instability in

Angola, another much favoured location. Brazil is now perceived has a much more stable location, but the interviewees seemed to agree that risk remains high. Despite that, they now prefer Brazil to less risky alternatives.

7. Labour skills are relevant as location determinants of FDI.

The attractiveness of Brazil is very much influenced by its huge potential market (see number 4), but also by its long industrial tradition. This is attested to by acquisitions in the sample, and the good assessment made of the subsidiaries' production capacity. By contrast, Mozambique is still attracting little manufacturing FDI despite its recent economic and political stability. The explanation seems to be in part its small domestic market, but also the very low skills of the labour force.

8. Inward FDI had an important role in the development of the ownership-advantages of Portuguese firms.

Several firms in the sample highlighted the role of foreign firms operating in Portugal in the development of their international competitiveness. Foreign subsidiaries can force the Portuguese firms to develop new capacities and strengths when they buy their products, but also when they compete with them for the Portuguese market.

9. Portugal seems to be following an investment path similar to the one proposed by Dunning (1981a, 1981b, 1986b).

The simultaneous internationalisation of a substantial number of Portuguese firms seems to coincide with the maturity of domestic markets and industries. This is consistent with Portugal being in stage 3 of the IDP (chapter 4). The relevance of the IDP is further supported by point number 8.

10. The major constraint to internationalisation faced by small firms is the shortage of skilled management (Buckley, 1989).

Most companies in the sample agreed that a shortage of management skills was the major obstacle to internationalisation. Nevertheless, this opinion was not shared by a small number of (bigger) firms which saw internationalisation as the way of making use of the management overcapacity created during the years of rapid domestic growth.

11. Psychic proximity (language?) allows firms to 'jump stages' in the internationalisation process, in particular when geographic distance is relevant.

Very few of the companies in the sample that invested in Brazil had ever exported to the country. Distance and tariff barriers seem to have been an effective deterrent. However, this does not seem to have affected their ability to invest in production subsidiaries. In the case of European and Asian countries, however, firms seemed to follow a more traditional internationalisation path.

12. Licensing and joint-ventures are not popular among small firms new to internationalisation.

There was only one case of licensing in the sample, and just four firms were involved in joint-ventures. That both are management intensive deals (Buckley, 1989) may be the explanation. Nevertheless, for smaller firms, licensing seems to be an entry mode that represents an intermediary stage between the establishment of commercial and productive subsidiaries (Buckley and Casson, 1981).

6.4. Conclusion

A first interesting conclusion was that Portugal's nascent MNEs were not associated with the country's traditional industrial structure. Labour intensive industries, which dominate Portuguese exports, seem to be largely absent from the internationalisation process that is gaining momentum among Portuguese manufacturing firms. This probably explains why efficiency-seeking investment is still rare. The first Portuguese companies to expand production abroad operate in capital intensive industries with small mature domestic markets. Especially in the case of the market leaders, this came to represent a threat to their very survival because of the difficulties associated with an efficient use of the resources available to the firm. Internationalisation was, before anything else, the solution to reach a critical scale in terms of the ability to compete with foreign firms, both abroad and at home.

The current internationalisation process needs consolidation. Several elements revealed that the firms involved still possess few ownership advantages. First, the number of countries chosen as a destination of FDI was very small. Two thirds of the firms expanded either to Brazil or to Spain. Second, psychic distance, and language in particular, assumed a powerful role in the choice of those locations. The managers interviewed manifested in general a very strong preference for Portuguese-speaking countries, followed by areas

where Spanish is the official language. Third their was in the sample a recurrent shortage of management skills, especially among smaller firms. The risks of this constraint on the internationalisation process cannot be underestimated. These firms are likely to rely upon less than optimal decision-making processes, ignoring more profitable alternatives and/or not assessing all the costs and risks associated with their decisions.

That Brazil concentrated such a high percentage of the investments represents an additional threat. This is a country prone to economic and political instability. Despite recent successes, the definitive stabilisation of the country is still not guaranteed. In the event of a very negative evolution of the Brazilian economy, no matter how unlikely it seems today, the whole process of internationalisation of the Portuguese economy could suffer severely. Many of the firms in the sample invested in Brazil a substantial percentage of their resources. A failure of their Brazilian subsidiaries could put the whole company at risk. Furthermore, one of the implications of the limitations described in the previous paragraph is that investments in Brazil might not be easily transferable to other countries. Regardless of the differences, this brings to mind the scenario of the failure of the first process of internationalisation of Portuguese firms, in the first half of the 1970s (see chapter 4).

As for other results, an important conclusion was that psychic proximity does help firms to 'jump stages' in the internationalisation process. Contrary to Europe or even Asia, investment in production establishments in Brazil was in most cases the first form of involvement in the country. It is true that geographic distance and high tariffs often reduced the alternatives to: (A) ignore the Brazilian market; or (B) establish a production subsidiary. Nonetheless, psychic distance facilitates entry in foreign markets when exports or sales subsidiaries are not efficient solutions or are not possible at all.

Another result regards the concept of strategic-asset seeking FDI (Dunning, 1993a). The study clearly suggested it must be broadly interpreted when analysing investment by relatively small firms. For big MNEs, market oriented FDI enables the firm to maximise the use of proprietary assets, such as technology, international brands or management skills. However, smaller firms, and in particular those from small countries, possessing few ownership advantages often internationalise from a vulnerable position. Frequently, international expansion is the means to gain the size necessary to be competitive, both

abroad and at home. Despite being market oriented in essence, these investments fit better the concept of strategic-asset seeking than that of market-seeking.

Finally, the sample provided support for the interaction between inward and outward FDI, and between these and the level of economic development of the country (the investment development path, Dunning, 1981a, 1981b, 1986b). The importance of foreign firms in the development of the ownership-advantages of Portuguese firms was clearly assumed by a very high percentage of those interviewed. Foreign subsidiaries represented that role not only when they were clients but also when they were the main competitors of local firms. In both cases Portuguese firms were forced to upgrade products, technology, and production and management processes. When the stagnation of demand due to the maturity of domestic markets was matched with this 'forced' development of internationally competitive Portuguese firms, the recipe for foreign expansion was assured. A more direct relationship was revealed by three of the eighteen firms interviewed, which were created as subsidiaries of foreign companies.

CHAPTER 7.
CONCLUSION: FDI AND THE COMPETITIVENESS OF PORTUGAL

7.1. INTRODUCTION

Having failed to accompany successive industrial revolutions, Portugal has long been one of the poorest countries in Europe. At the end of World War II (in which Portugal did not participate) much of the country did not have electricity, running water or paved roads. About half the working population were engaged in agriculture and only 24 per cent in the manufacturing industries (Rosas, 1994a: p. 25). Furthermore, agriculture recorded very low levels of productivity due to the persistence of ancient practices and much of the manufacturing industries were artisans or very low technology, small plants (Rosas, 1994b, 1994c).

In the 1950s, the Portuguese authorities encouraged a push towards industrialisation. However, with severe restrictions to investment - both foreign and domestic - and a very limited local market, the adopted model of import substitution was doomed to failure. It was only after 1960 that industrialisation did take off in Portugal. The creation of EFTA, of which Portugal was a founding member despite its political regime, was the trigger for these transformations. Portugal was guaranteed free access to the markets of the other EFTA countries in exchange for opening its markets to imports of manufactured products (agriculture and services remained highly protected). At the same time, restrictions to

domestic investment were progressively eliminated and almost all manufacturing industries were opened to foreign direct investment.

The results of the new policies were impressive. In the less than fifteen years between 1960 and 1973, Portuguese GDP per capita grew from one third to half that of the most developed European countries (Gonçalves, 1998: p. 96). However, the exploitation of comparative advantages between Portugal and its much richer trading partners may have led to an overspecialisation of the Portuguese economy in labour intensive industries. If the exploitation of low Portuguese labour costs was inevitable and probably desirable, the excessive opening of Portuguese markets at the early stages of development of domestic manufacturing industry may have frustrated the subsequent diversification into higher value added segments (Lopes, 1996: p.113).

The following ten years represented a new period of divergence between Portugal and the most developed European countries. The oil shock of December 1973 and the world recession that followed, severely hit a now much more open Portuguese economy. At the same time the internal situation deteriorated. The democratic revolution, in April 1974, was followed by almost two years of social and political instability with an inevitably negative impact upon the economy. Moreover, the economic order established during the 48 years of dictatorship was greatly transformed by new labour laws, nationalisation, and the independence of the African colonies. As a result of these internal and external factors, the balance of payments rapidly deteriorated, inflation soared, and external debt reached unsustainable levels. In 1978, and again in 1984, the Portuguese government was forced to seek IMF support and to put into practice highly restrictive economic policies.

It was not until 1985 that relative GDP per capita returned to 1971 levels (Gonçalves, 1998: p.97). The economy was finally stabilised and Portugal managed to join the European Union in the following year. A new period of economic growth began, supported by the EU structural funds and other transfers, a booming world economy, and a national consensus on much needed economic reforms, including privatisation. However, a new economic recession in Europe at the beginning of the 1990s highlighted the persistence of several weaknesses in the Portuguese economy. Nevertheless, growth and convergence resumed in 1995, and by 1998 Portugal's GDP per capita - measured at PPP - was 68 per cent of that of the most developed European countries, the highest level this century (own calculations based on OECD, 1999a).

7.2. Foreign direct investment and the Portuguese economy

Foreign direct investment has always played an important role in the Portuguese economy. All the short spells of industrialisation registered in Portugal's history were associated with important inflows of foreign capitals (Matos, 1973). The picture suffered a radical change in the late 1920s when a new autocratic regime was installed after a popular military coup. Officially the new authorities welcomed foreign capital, but in practice new legislation severely restricted inward investment. Until the end of the 1950s, the weight of FDI in the Portuguese economy was insignificant (Lopes, 1996: p. 167).

The opening of the Portuguese economy in the 1960s was accompanied by a new policy towards FDI. The reaction of foreign investors was swift. Inward FDI was twenty times higher during the 1960s than in the previous decade, and may have represented as much as 30 per cent of GFCF in manufacturing and 20 per cent in commerce (Lopes: 1996: p. 169). Much of this investment was directed towards labour intensive industries, particularly clothing and footwear). But FDI was also important in the development of new industries (e.g. electric equipment, pulp and chemicals), effectively diversifying local industrial structures (Simões, 1985: p. 358; Gonçalves e Guimarães, 1996: p. 10).

The 1974 revolution left foreign owned firms untouched. Nonetheless, the political, social and economic transformations of the second half of the 1970s had a negative impact upon FDI flows. The authorities tried to counter the loss of confidence of foreign investors with new legislation that established a clear legal framework for FDI (Simões, 1985: p. 342) and by direct negotiation with potential big investors. The results started to appear in 1979, with inward FDI rising steadily over the following years. With the prospect of EU membership, the levels of the previous decade were soon overtaken, reaching a peak of 4.1 per cent of GDP in 1990, four years after Portugal actually became an EU member. But the 1990s were to be a period of decline for inward FDI in Portugal, which in 1999 reached its lowest level since the 1950s (see chapter 4). The slowdown of the privatisation program (in place since 1988), the completion of MNEs' preparations for the European Single Market, economic recession in Europe, and the opening of the Eastern bloc may all have contributed to this decline.

In the 1990s, however, a new factor made its appearance in the Portuguese economy. During that decade, outward FDI flows grew at an astonishing rate, reaching 2.8 per cent of GDP in 1998 (they decreased slightly in 1999, to 2.1%). The main destinations were

Brazil and Spain (about half the FDI outflows between 1996 and 1998). This new trend was most impressive since outward FDI had not been above 0.1 per cent of GDP before, except briefly between 1970 and 1974. Following a decade of strong economic growth, a number of Portuguese firms started to expand abroad in the early 1970s. The then African colonies were the main destination, but there were also investments by financial firms in countries with large Portuguese communities (Simões, 1985: p. 341). In any case, even in this period outward FDI flows averaged no more than 0.2 per cent of GDP (with a maximum of 0.3 per cent, in 1973).

7.3. The determinants of inward FDI in Portugal

Previous work on the determinants of FDI in Portugal (Matos, 1973; Carrière and Reix, 1989; Taveira, 1984; Simões, 1985; Saraiva, 1993; Santos, 1997) suggested a dichotomy of motivations. Investment in export oriented industries aimed to exploit Portugal's low labour costs and privileged access to some of the most developed markets in Europe. However, the dominant motivation seemed to be access to the local market. When aggregate data was analysed, the relevance of labour costs was eclipsed by market related variables. The importance of natural resources in attracting FDI received limited support.

As a preliminary for a more thorough investigation of the motivations of foreign investors in Portugal, the dichotomy between efficiency seeking and market seeking FDI was tested using regression analysis of more recent data than in previous studies. Two complementary models were investigated: a longitudinal study of FDI in Portugal, and a cross section of several 'peripheral' European countries. Despite the limitations associated with the use of aggregated data, the results were encouragingly consistent.

Very much as in previous studies, the size and growth of the domestic market were the variables most strongly associated with inward FDI into Portugal. However, relative labour costs were also found to be statistically significant (and negatively signed), which did not happen in any of the previous studies using aggregated data (e.g. Taveira, 1984). This difference suggests that the weight of efficiency seeking FDI may have increased in Portugal over the last fifteen years.

The comparison across 'peripheral' locations, both members and non-members of the EU, supported the former results. Although GDP growth was not found in this case to be significant, the size of the domestic market was the determinant most strongly associated

with inward FDI in the twelve countries considered. Labour costs were also strongly significant, as were labour skills (which could not be tested in the longitudinal study). The signs were, as expected, respectively negative and positive. These three variables were the elements that investors were most likely to consider when analysing alternative locations for European investments. In none of them is Portugal's position very reassuring: Portugal's domestic market is relatively small, its relative labour costs are rising, and foreign and domestic investors frequently complain about a shortage of skilled workers.

Geopolitics also seem to be unfavourable to Portugal. With the fall of the Berlin Wall, the geopolitical centre of Europe moved towards the North and East of the continent, making Portugal more peripheral. A measure of distance to the 'European core' (proxied by the average time to fly from each country's capital to Frankfurt and Paris) was found to be significantly associated with FDI in the countries investigated. And Portugal was one of the most "distant" countries in the sample[1]. The Portuguese authorities expect that the early adoption of the Euro and the experience of fourteen years of EU membership may attenuate the geographic (and historical) element. However, the evolution of inward FDI in very recent years was not very encouraging.

To complement this analysis, a more thorough investigation of foreign direct investment in Portugal was devised. Using a postal questionnaire the managers of foreign subsidiaries operating in Portugal were asked about the characteristics of their firms and the motivations and problems associated with the investment. The results confirmed most of the previous knowledge, but provided a much more detailed picture of inward FDI in Portugal, impossible to obtain with secondary data.

The respondents' evaluations of a number of potential reasons to invest in Portugal permitted the identification of ten determinants of FDI, all referenced in the literature: labour conditions, political and economic stability, competition in the home country, access to the local market, downstream integration, market diversification, passive expansion, access to the EU market, geographic and cultural proximity, and upstream integration. This list of determinants represents a combination of location variables, internalisation determinants and push factors. However, when only manufacturing firms were considered there was a substantial cleavage between the first four determinants and

[1] A dummy variable for the 1990s was introduced in the longitudinal study for Portugal as a proxy for the impact of the geopolitical changes. It was negatively signed, but with a significance level of only 15 per cent, which is fairly low even considering the presence of multicollinearity.

the others. In the case of purely commercial subsidiaries, downstream integration (the internalisation of the sales function), access to the local market and stability seemed to dominate.

Not surprisingly, a first conclusion was the confirmation of the coexistence in Portugal of market seeking and efficiency seeking investment. Natural resources seemed to have a very limited influence. However, much more interesting was the investigation of investment conditions in different industries. As could be expected, the determinants associated with the most export oriented industries (textiles, clothing and footwear, and machinery and equipment) were substantially different from the others. In particular, labour conditions and stability were even more important than in the rest of the sample, and access to the EU market (largely irrelevant for the other industries) was the fourth most important determinant. On the other hand, access to the local market was much less important than in the rest of the sample, and downstream integration completely irrelevant.

Despite these similarities, it was possible to confirm Simões's (1985) distinction between "traditional" and "modern" labour intensive industries. Both groups saw Portugal as a stable low cost location with easy access to the EU markets. However, in textiles, clothing and footwear, competition in the home country was also a major motivation. There was also strong evidence that, more than in any other industry, many of these foreign subsidiaries were little more than specialised assembly platforms. Three quarters were not responsible for the distribution and sale of their products, less than half were responsible for the acquisition of their own inputs, and only 54 per cent sent their production directly to the final clients. The dominant market orientation in these industries was also typical of cost reduction investment to overcome rising costs at home: 51 per cent of the output was sold in the home country and only 14 per cent in Portugal. This compares with, respectively, 17 and 34 per cent for machinery and equipment manufacturers, and 21 and 45 per cent in the whole sample.

As for the remaining industries, market access seemed to be dominant as a motivation for FDI. But exports were also important for a number of firms. On average, the local market represented 49 per cent of the sales in food and beverages and in the metal industries, and 58 per cent in the natural resources based industries. The highest figure was obtained in the chemicals and oil industries, which sold 70 per cent of their output locally. In fact, all industries seemed to have export oriented segments (e.g. fabricated plastic goods in the

chemicals and oil industries) or at least individual firms. For that very reason, an attempt to aggregate the subjects using cluster analysis produced fairly poor results, since the clusters showed little homogeneity in terms of the industries represented in each cluster.

This heterogeneity of the clusters was even more clear in terms of the country of origin of the subsidiaries. That explains why the determinants of FDI were very similar when the different source countries were compared. One notable exception were Spanish firms which were the only group to be primarily attracted by the local market and by geographic and cultural proximity[2]. Spanish investors were also distinct in the low importance given to the local labour conditions in their decision to invest in Portugal. As expected, firms from outside the European Union ranked access to the EU market well above the average, as did German firms, though to a much lesser extent. German firms were the most export oriented in the sample, selling only 29 per cent of their output in Portugal (against 38 per cent in the home country).

In terms of the year of investment, export propensity seemed to be especially associated with firms established or acquired in two periods of Portugal's recent history: 1960 to 1974 and 1986 to 1990. The determinants of FDI associated with these periods reinforced this. Unlike the other periods considered, labour conditions was the main determinant. Access to the local market was also less important than in the rest of the sample. Surprisingly, foreign subsidiaries established between 1975 and 1985 showed a stronger export propensity than those established in the 1990s. However, the rank of the determinants for both groups reflected the predominance of market orientation. Finally, there was a positive linear relationship between the size of the firm and export propensity. As before, that was reflected in the determinants of FDI. The bigger the firm, the more importance was given to labour conditions and the less to access to the EU market and downstream integration.

The Portuguese legal system and bureaucracy were almost unanimously considered the main problem faced by foreign firms established in the country. Other problems were determined by the firms' market orientations. In the export oriented industries, labour and infrastructure (in particular the availability of skilled workers), and the country's export competitiveness were the main concerns. In the other industries, firms were more worried about the characteristics of the local market. The differences between the two groups of export oriented industries mentioned above were also reflected in the evaluation of the

[2] Brazilian, Italian and French investors were the other groups to attribute a significant role to proximity.

problems. The characteristics of the local market were one of the concerns for machinery and equipment manufacturers, but completely ignored by textiles, clothing and footwear producers.

Eastern Europe and Spain were for the respondents to the questionnaire the main alternatives to Portugal as locations for FDI though, interestingly, they did seem to compete with Portugal for different projects. However, few differences could be found in the determinants associated with firms that considered either alternative location before deciding to invest in Portugal. In any case, it must be acknowledged that this analysis was seriously limited by the fact that firms that decided not to invest in Portugal after considering several alternative locations were not included in this research project.

7.4. Outward FDI in Portugal

Few studies have been published on the internationalisation of Portuguese firms. Simões (1997) constitutes a notable exception[3]. The picture presented was of a substantial number of firms involved in international activities but few adopting forms of internationalisation other than exporting through agents. Foreign direct investment was rare (cf. chapter 4). Even in the case of services, which represented a high percentage of Portuguese outward FDI in recent years, most of the investment was the result of a very small number of firms. This research project concentrated on manufacturing FDI. With the aim of investigating the most advanced processes of internationalisation by Portuguese nascent MNEs, the focus was put on firms with productive capacity abroad, or at least clear plans to do so in the near future. 27 Portuguese owned firms were identified in these conditions, of which 18 agreed to participate in an interview based study.

A first result was that few of the firms identified operated in the labour intensive industries that traditionally dominate the Portuguese industrial structure and exports[4]. It seems that the success enjoyed as (largely passive) exporters has been a disincentive to adopt other internationalisation strategies. As a result, efficiency seeking FDI was rare in the sample. A much more common motivation was the search for new markets. A substantial number of the firms in the sample were domestic leaders in mature markets, often in capital intensive industries. The small domestic market was seen as an impediment to the efficient use of the resources available to the firm, representing a threat to the very survival of the firm.

[3] See also Simões (1996, 1998).
[4] Cf. Castro (1993).

Internationalisation was in these conditions the solution to reach an economically efficient scale, necessary to compete successfully with foreign firms both at home and abroad.

An important implication of this was that the concept of asset seeking FDI (Dunning, 1993a) should be broadened. Despite being market oriented in nature, the investments described above corresponded to the acquisition of a critical asset: size. In other words, small firms, and especially those from small countries, may internationalise with very few ownership advantages, their primary aim being to obtain the means to retain their competitiveness in the domestic market. This implies that small countries may be involved in outward FDI at a relatively early stage of their economic development.

Brazil and Spain hosted most of the Portuguese productive investment abroad. As expected, this represents expansion to less developed or neighbouring territories (Dunning, 1981a, 1981b, 1986b), as well as psychic proximity (Johanson and Wiedersheim-Paul, 1975; Johanson and Vahlne, 1977). However, it seemed that psychic distance was much more influenced by language than by any other factor usually associated with cultural distance. Nevertheless, this sense of proximity permitted the jumping of stages in the internationalisation process. Few of the firms in the sample that are now producing in Brazil had ever exported to the country before. By contrast, geographic proximity may reduce the attractiveness of FDI as an internationalisation strategy. It represents low transportation costs, which can become particularly relevant in the liberal trade environment of the European Union.

The timing of investment was very much linked to location. The internationalisation of a growing number of Portuguese firms may be associated with Portugal's level of economic development (see next section). However, the economic stabilisation of Brazil in 1996 and the subsequent opening to FDI was in this case equally decisive. Almost all firms in the sample that chose a destination other than Brazil (only a minority) started their expansion before 1996. All firms that expanded to Brazil did so after 1996. Given the strong preference for Portuguese speaking countries implicit in the interviews (probably evidence of limited ownership advantages), it is legitimate to assume that the evolution of Portuguese outward FDI would have been very different had the economic conditions in Brazil been different. Moreover, the importance that Brazil assumes in total FDI outflows represents a risk for the internationalisation of the Portuguese economy. Although a

deterioration of the situation in Brazil seems unlikely at the moment, the country's long term stability is still far from assured

Another important result of this research regarded the role of political and economic stability. This was considered a potential deterrent to FDI by the interviewees. Brazil before the stabilisation program, Mozambique during the civil war, or Angola nowadays[5] are but three examples. However, once a certain level of stability is attained any direct relationship between FDI and instability seems to disappear. This was suggested by Tu and Schive (1995), and is supported by the volume of FDI Brazil received in recent years. In the opinion of the managers interviewed Brazil remains a risky location. It seemed, nevertheless, that psychic proximity compensated the relative instability of Brazil when compared with alternative locations, such as Mexico, Eastern Europe or North Africa.

Finally, most companies in the sample considered that a shortage of management skills was the major obstacle to internationalisation, more so than, for example, financial restrictions. This limitation was especially felt by the smaller firms, which seemed to face many difficulties in recruiting experienced managers (cf. Buckley, 1989). Moreover, Portuguese managers seem to be reluctant to work as expatriates, which may not be independent of the apparent shortage of skilled managers even to work locally. Interestingly, many companies considered the image of Portugal abroad to be an important constraint to their international expansion. Most seemed to overcome it simply by inviting potential clients or business partners to visit Portugal and their factories. Nevertheless, it represents nevertheless a serious burden to these nascent MNEs in terms of extra costs and the potential loss of investment and business opportunities.

7.5. The competitiveness of Portugal

The notion of national competitiveness has been the subject of serious dispute at least since the publication of Michael Porter's (1990) *The Competitive Advantage of Nations*. It is not in the scope of this project to engage in a theoretical discussion of the concept of competitiveness[6]. However, there is an empirical interest in the connection between national competitiveness and foreign direct investment. Porter (1990) had a dualistic view of FDI. Outward FDI was seen as the desirable outcome of the competitiveness of

[5] The interviewees often compared with Angola and Mozambique when analysing their location decisions, which constitutes further evidence of the importance of psychic distance.
[6] For a thorough survey and analysis see Freire de Sousa (1999).

domestic firms. By competing internationally, local firms can expand their competitive advantages. This bolsters local clusters, reinforcing the competitiveness of the home country. Inward FDI, by contrast, was seen as a threat to national competitiveness. It was presented as a vehicle at the disposal of foreign firms to 'infiltrate' the local cluster and transfer to their own home base the advantages developed in the context of the "national diamond".

Rugman and Verbeke (1993), among others, showed the limitations of this interpretation. In some circumstances Porter's view of inward FDI may be true. However, it must be admitted that in many more cases foreign firms can contribute to the development of the local diamond. Several examples of this positive role were obtained during the interviews described in chapter 6. Cin and Autosil considered the rivalry imposed by foreign owned firms of major importance to their own development. All the car components manufacturers in the sample were linked to Renault's assembly plant, which created a new market for car parts in the early 1980s. Three of the firms (Arjal, Dan Cake and Efacec) were created as subsidiaries of foreign companies. Unquestionably, FDI contributed decisively to the development of whole new industries (Simões, 1985, Bessa, 2000).

The level of development of the country being analysed is not irrelevant in this discussion. If only the most developed countries are considered, Porter's view of inward FDI is much more likely to hold. The latter are the countries with the most developed local clusters and better endowed with created assets. FDI allows foreign firms to become part of these clusters, benefiting from location advantages that may not exist in the home country. The examples given for Portugal, however, evidenced a country with few and thin local clusters, in need of foreign investment to bring in capabilities that were not locally available. This represents clearly a very different situation. The concept of the investment development path (Dunning, 1981a, 1981b, 1986b) permits a better understanding of the difference between these two realities.

Using the IDP, the former can be put in different terms. Firms from all sorts of countries have in the acquisition of strategic assets a major motivation to invest in the most developed economies (stages 4 and 5 of the IDP)[7]. Porter's (1990) negative evaluation of inward FDI seems to stem from the belief that locally developed strategic assets (or advanced factors as he calls them) should be used exclusively by domestically owned firms

[7] Dunning (1993: p.61) considers this to be the fastest growing motivation of FDI.

in order to guarantee their predominance in international markets. In the case of a stage 3 country like Portugal (cf. chapter 4), however, strategic asset seeking inward FDI is unlikely. Instead, market access and relative costs are normally the dominant motivations, with the former progressively replacing the latter (chapter 5). And there is no reason to imagine that these investments are harmful to the receiving country.

Chapter 4 showed that the evolution of FDI stocks in Portugal fits very well with the IDP framework, in particular under the new polynomial function proposed[8]. Portugal had all the characteristics of a stage 1 country until the end of the 1950s, with very low inflows of inward FDI and almost no outward investment at all. It was after 1960 that inward FDI started to rise, in response to a radical change in government policies (see above). Cost reduction was the main motivation for foreign investors in the following years, as confirmed in chapter 5, but some market seeking investment was also registered[9].

Portugal's move from stage 2 to stage 3 was, however, very slow. The failure of the first internationalisation movement of local firms, in the early 1970s (when it seemed that Portugal was making that transition), highlighted the weaknesses of the local industrial structure despite fifteen years of strong economic growth. The domestic firms' ownership advantages were essentially country specific (privileged access to the colonial markets) and they were not able to adapt to the changes in their home base (the revolution and the independence of the colonies). On the other hand, new internal and external conditions in the 1980s (political stability and EEC membership) gave way to a new economic cycle, including a new and stronger wave of inward FDI.

As in the 1960s, cost reduction was the main motivation for inward FDI in this expansionary period. This was hardly surprising since Portugal still enjoyed the lowest labour costs among its main trading partners. Outward FDI remained negligible, as is typical of a stage 2 country. Nevertheless, major transformations in the country's economic structure seem to have occurred in this period, and transition to stage 3 was completed during the 1990s (chapter 4). Efficiency seeking FDI has dropped steadily from 1990 (chapter 5), but local firms became increasingly involved in outward investment. Economic development and thirty years of a strong presence of foreign firms in Portugal were strongly associated with this transformation (chapter 6).

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[8] As explained in section 4.6, the quadratic function traditionally used to test the IDP, incorporates a violation of the very principles of the IDP. Henceforth, a new polynomial function was proposed in section 4.6, and shown to be much more consistent with the IDP rationale.

It is at this point that the issue of national competitiveness arises with some pertinence. A cursory interpretation of the data may lead to the conclusion that Portugal's international competitiveness has increased substantially in recent years, at least if it is accepted that competitiveness goes hand in hand with the level of development. The IDP function (section 4.6) suggests that Portugal is now approaching stage 4 of the five levels of development predicted. But this correspondence with the theory is more apparent than real (cf. chapter 4).

Dunning (1981b: p.9) suggests that in stage 4, "depending on the amount of [international investment] specialization, outward investment may be associated with substantial or little inward FDI". Portugal being a small open economy, it is likely and desirable that it registers a high level of specialisation "in which it seeks to attract inward direct investment in those sectors in which comparative location advantages are stronger but the comparative ownership advantages of its enterprises are weakest, while its own enterprises invest abroad in those sectors in which their comparative ownership advantages are strongest but their comparative location advantages are weakest" (Dunning, 1981b: p.9). This implies large FDI inflows in stages 3 and 4 of the IDP, which have not been happening in Portugal in recent years. As seen above, inward FDI flows were in 1999 at their lowest level since the 1950s, pointing to a sharp erosion of the country's competitiveness as a location for FDI. The results obtained suggest that Portugal lost attractiveness as an export platform (as predicted by the IDP) but has so far been unable to attract alternative investments (chapter 5). This is particularly worrying in terms of the long term prospects of the country because FDI has been instrumental in the diversification of the Portuguese industrial structure (Simões, 1985; Gonçalves and Guimarães, 1996). It contributed to the development of new clusters and to the expansion of existing ones.

As for outward FDI (chapter 6), the growth in recent years must be interpreted as a sign of the favourable evolution of the country's competitiveness. On one hand, it shows that the ownership advantages of the Portuguese firms are increasing (Dunning, 1981a, 1981b). On the other hand, it can be expected that outward FDI will improve local clusters and with them the competitiveness of the country (Porter, 1990). Nevertheless, the international expansion of the domestic firms is still at an early stage, as would be expected in a 'stage 3 country'. Their ownership advantages remain very much dependent on the characteristics of the home country. Language, Portugal's colonial past and EU membership still assumed

[9] Compare this analysis with the description of the IDP, in chapter 2.

a major role in the location decision. Many of these first movers are also very exposed to the evolution of the Brazilian economy, with inherent risks for the whole internationalisation process.

An alternative, less optimistic view of the recent evolution of outward FDI is that it simply represents more evidence of the erosion of the country's locational competitiveness, just like the decline in inward FDI. In this perspective, the internationalisation of the Portuguese firms represents a threat to the domestic economy because it corresponds to investment diverted from the domestic economy (e.g. Bessa, 1998, 2000). However, this hypothesis was not confirmed in the research described in chapter 6. Cost reduction was a rare motivation amongst the firms surveyed (although it was a growing concern). Instead, most seemed to be engaged in strategic asset seeking FDI, being the acquisition of marketing capacity or simply the search for new markets to support the firm's growth. This is just the kind of investment that can be expected to improve the competitiveness of local clusters.

It seems that Portugal is at a crossroads. Inward FDI flows have been declining, and outward investment still exhibits many signs of weakness. At this stage, the role of the government may be critical to guarantee the necessary conditions for the transition to a fully developed economy (Dunning, 1981a: p.41). Much of this involves the development of created assets, which requires increased expenditure on education, vocational training and innovatory activities (Dunning and Narula, 1996b: p.5). Successive governments have seemed to be aware of this, and investment in these areas increased substantially over the last two decades. Direct aid from the European Union has also been of utmost importance. However, the dramatic fall of FDI inflows in recent years suggests that not enough has yet been done[10]. The same can be said of the fact that the unavailability of skilled workers was one of the main difficulties faced by foreign firms in Portugal (chapter 5). It was considered by foreign firms operating in Portugal a much more serious problem than rising labour costs, for example.

The difficulties faced by foreign investors in Portugal call for a different type of government intervention. Bureaucracy and the legal system topped the list of the main problems faced by foreign investors (it was the only problem to be considered more

[10] In terms of the quality of human resources, one of the main difficulties is, necessarily, the size of the transformations needed. Until 1974 basic education corresponded to no more than 4 years and in practice was not compulsory. In 1970, 29 per cent of the population could not read or write (Pimenta et al., 2000).

important than labour skills)[11]. The government, or successive governments, are clearly responsible for the institutional failure this suggests. Furthermore, the size of the domestic market makes the elimination of bureaucracy and the development of created assets even more critical. In bigger countries, market seeking FDI may compensate for the loss of cost advantages that normally accompany economic development. But this is unlikely to happen in countries with domestic markets the size of the Portuguese.

7.6. FUTURE RESEARCH

Although the number of possible extensions is almost overwhelming, a few appear to be particularly promising. The most obvious is probably the need to monitor the evolution of the nascent Portuguese MNEs. This process being very recent, it should be easy to follow the cases of success as well as failure, which are normally more difficult to investigate. The evolution of the whole process of internationalisation is another source of interest. Assorted data collected during the later stages of this investigation suggests that the number of Portuguese firms involved in outward FDI continues to expand. Brazil seems to remain the main destination, but there were even more examples of investments in other Latin American countries and in North Africa.

As for inward FDI, one interesting approach to complement this research would be to survey the headquarters of the investing firms. This should offer a different perspective on the attitude of foreign investors to investment in Portugal. In particular, it should reveal more clearly the differences between Portugal and other locations, whether alternative or complementary in the perspective of the investors. An investigation of the firms that divested in Portugal or that considered investing in Portugal but opted for other locations could also be important. The identification of the population would be a major obstacle in this case, however.

The data collected on inward FDI could also be used for further research. One possible avenue amongst many is a more detailed analysis of the results of the cluster analysis. The clusters identified seemed to have little homogeneity. However, they might hide similarities at the level of the firm that could not be identified above. This investigation would almost certainly require a wholly different approach to the analysis of the questionnaires, which at

[11] This contradicts the country's official marketing, which presents the Portuguese economy as "non bureaucratic and flexible" (ICEP, 2000). The offer of low taxes was also in sharp contrast with the opinion of the participants in the survey (cf. chapter 5).

a first stage needed to be analysed individually in a more qualitative manner. Eventually, the most promising clusters would require the collection of further data. The use of more inductive techniques, such as interviews may be necessary.

A study of firms that have been foreign subsidiaries but belong now to Portuguese investors seems to be another promising approach. The characteristics of the investors, the reasons for the change in ownership, and the implications of that change on the firm's strategy may provide valuable information on the changing patterns of national competitiveness both in terms of the country's location advantages and on the evolution of the ownership advantages of domestic firms.

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