



Contents lists available at ScienceDirect

Journal of International Management

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## Cross-national Distance and FDI: The Moderating Role of Host Country Local Demand

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### ARTICLE INFO

#### Article history:

Received 19 November 2013

Received in revised form 9 October 2014

Accepted 18 November 2014

Available online xxxxx

#### Keywords:

Cross-national distance

Host country demand

FDI

### ABSTRACT

In this paper, we draw on the demand-side perspective to suggest that host country local demand influences the relationship between cross-national distance and foreign direct investment (FDI). Using FDI outflows from the United States to a cross-sectional sample of 110 host countries over the period of 2006–2011, we find that distance negatively influences FDI, largely confirming previous research. However, our results also suggest that a host country's local demand mitigates the negative relationship between geographic, cultural and administrative distance and FDI outflows, while it aggravates the negative effect of political distance on FDI.

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### 1. Introduction

International business (IB) has long been interested in examining the effect of cross-national distance on foreign direct investment (FDI) (Kogut and Singh, 1988; Xu and Shenkar, 2002). The most prominent research stream on this subject is based on the Uppsala internationalization model (Johanson and Vahlne, 1977), which suggests that because certain potential host countries are perceived as more psychologically distant from a foreign investor's home country, internationalization through FDI in these host countries is likely to be preceded by market entry modes with less commitment such as exporting or sales subsidiaries. Where FDI does occur, it is more likely to take place in host countries with higher cultural proximity to the home country. Supporting this premise, scholars have generally found that the greater the distance (cultural, administrative, geographic, etc.) between home and host countries, the more difficult it is for home country multinational enterprises (MNEs) to operate, and hence the lower the likelihood of FDI (e.g., Dow and Ferencikova, 2010; Flores and Aguilera, 2007; Kogut and Singh, 1988).

The Uppsala model has been invaluable in its contribution to our understanding of how cross-national differences weigh on the minds of MNE executives, but it also poses a lasting challenge for MNEs in how to overcome the negative effects of distance. To address this question, prior research tends to rely on traditional firm-specific advantages or institutional theory explanations, suggesting that MNEs can either transfer these organizational or managerial capabilities to local units (Buckley and Casson, 1976; Dunning, 1979, 1980; Hennart, 1982), or mimic the organizational practices of the best performing local firms (DiMaggio and Powell, 1983; Zaheer, 1995). These studies shed unique light on the resources and institutional mechanisms necessary to mitigate the distance effect, but largely neglect the demand side factors that may also help further our understanding. It is this lack of attention to demand-side factors that provides the motivation for our paper. Currently, we know very little about whether demand factors moderate the basic premise of the Uppsala model, and if so, to what extent a host country's local demand can help to mitigate or aggravate the negative cross-national distance effect on FDI. Thus, in this paper we seek to overcome these shortcomings by examining 1) the direct effect of

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demand-side factors on FDI and 2) the moderating influence of host country demand on the negative relationship between cross-national distance and FDI.

The demand-side perspective suggests that market demand is critical to firm value creation, and firms should pay close attention to consumer demand in strategic decision-making (e.g., Priem et al., 2012). Extending this demand-side perspective to the FDI context, we argue that FDI flows will be driven in part by a host country's local demand, which we define as the market value of all goods and services purchased in a host country. Indeed, the idea of local demand as a driver of FDI has made very little traction in the IB field. What has been done to date focuses on supply-side market-seeking motivations (Dunning, 1998; Dunning and Lundan, 2008). Thus, we also contribute to the IB literature by examining the role demand-side pull factors play in motivations for FDI as a complement to the established supply-side arguments.

In this paper, we intend to build upon the recent development of the demand-side perspective to propose that a host country's demand conditions can influence FDI flows by mitigating some of the negative effects of distance on FDI. By including demand-side considerations, we help deepen and extend our current understanding of how MNEs leverage host country local demand to deal with the negative effects of distance in overseas investment. In addition, by investigating FDI outflows from the United States (US), we provide new empirical evidence on the demand-side perspective. As there has been little empirical work that examines the impact of host country local demand on FDI, or the role of demand in how firms view distant markets, this paper is among the first to examine demand-side predictions in the FDI context.

A better understanding of the role demand factors play in FDI outflows has important implications for both IB scholars and MNE strategic decision-making. For the IB community, the theoretical suggestion that host country demand mitigates the negative effects of distance suggests that there may be more to overcoming psychic distance than what is currently understood. And for MNE managers, our study shows the importance of recognizing distant markets as an opportunity to provide value to potential customers in those markets, as opposed to focusing only on efforts to avoid them due to perceived differences in the home and host countries.

The remainder of the paper is structured as follows. First, we review the relevant background literature and identify research gaps to develop theory and hypotheses. We then test the hypotheses using US FDI outflows to 110 host countries over the period of 2006–2011. Lastly, we conclude the paper with a discussion of our results, the implications of our findings, the limitations of this study, and avenues for future research.

## 2. Background literature and hypotheses

### 2.1. Cross-national distance and FDI

Explaining FDI flows is a common theme in IB research. According to the Organisation for Economic Co-operation and Development (OECD), FDI is defined as a “cross-border investment by a resident entity in one economy with the objective of obtaining a lasting interest in an enterprise resident in another economy. The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the direct investor on the management of the enterprise” (OECD, 2013). In his heavily cited thesis, Stephen Hymer (1976) is among the first to suggest that FDI is a preferred method of market entry because it enables firms to transfer knowledge and other assets without relinquishing ownership or control.

However, Hymer (1976) also notes that a foreign MNEs physical presence in a host country can create problems and conflicts that increase with the distance between home and host countries, now commonly referred to as the *liability of foreignness* (Berry, 2010; Johanson and Vahlne, 2009). Differences between MNEs and host countries create liabilities and increase distance because local workers of MNEs foreign subsidiaries are often unfamiliar with or even openly opposed to the established management practices imposed by MNE headquarters (Slangen et al., 2011). These and other differences such as communication styles (Adler, 1986) are likely to negatively influence performance and impact foreign entry decisions (Flores and Aguilera, 2007; Hennart et al., 2002).

Researchers at the University of Uppsala were among the first to develop the liability of foreignness concept into a distinct construct they referred to as *psychic distance*, defined as the factors that make foreign markets difficult to understand (Johanson and Vahlne, 1977). The basic premise is that as distance increases, MNEs will find it more challenging to gain knowledge of the domestic market, which places them at a competitive disadvantage over local firms (Hymer, 1976; Zaheer, 1995). Similarly, when cultural and geographic differences are high, foreign MNEs often have far greater difficulties in establishing and maintaining local business relationships (Caves, 1996; Slangen et al., 2011). They may also find that large national differences increase the costs of adapting their goods and services to local tastes and preferences (Miller and Eden, 2006), and the difficulty in overcoming discrimination and lawsuits (Hennart et al., 2002; Mezas, 2002). By analyzing FDI patterns, Uppsala scholars conclude that foreign investment tends to start in host markets that are psychically similar to the home market, and then gradually enters other more psychically distant markets (Johanson and Vahlne, 2009; Kogut and Singh, 1988).

Following the Uppsala perspective, we examine four general types of distance that are well accepted in prior cross-national distance and FDI studies: cultural, administrative, political and geographic distances. We provide a brief review of each of these distances in the context of FDI research to derive our *baseline* hypothesis that cross-national distance and FDI are negatively related.

First, culture is one of the most oft-cited and empirically validated factors contributing to psychic distance. Although it has been used in many fields to answer a multitude of research questions, its greatest impact is on the FDI literature (Shenkar, 2001). The most popular approach to cultural distance is based on the work of Geert Hofstede, who proposes several key aspects that distinguish national cultures (Berry et al., 2010). Kogut and Singh (1988) quantify Hofstede's cultural dimensions and provide empirical evidence that MNEs are less likely to invest in more culturally distant host countries from their home country. Likewise, other studies find a

negative relationship between cultural distance and foreign market entry (Barkema et al., 1996; Berry et al., 2010; Hennart and Larimo, 1998).

Second, administrative and political differences are also commonly cited factors that impact cross-national distance. Researchers argue that administrative factors such as colonial ties (Frankel and Rose, 2002), language (Brewer, 2007; Johanson and Vahle, 1977), religion (Ghemawat, 2001), or legal systems (Berry et al., 2010; La Porta et al., 1998) strongly influence a firm's strategic decisions. Political differences, on the other hand, emphasize the differences in political systems (Delios and Henisz, 2003; Henisz, 2000), democratic character (Jensen, 2003), and trade relationships (Brewer, 2007; Fratianni and Oh, 2009). The literature on the effect of administrative and political distance on foreign market entry shows a consistent negative relationship (Berry et al., 2010; Brewer, 2007; Guler and Guillén, 2010).

Finally, international business and international trade scholars frequently use geographic distance to study the international activities of firms (Anderson, 1979; Bevan and Estrin, 2004; Deardoff, 1998). The costs of transportation and communications, the costs of sending personnel abroad, and the costs associated with overcoming cultural, language and regulatory differences all increase with geographic distance (Berry et al., 2010; Bevan and Estrin, 2004; Ghemawat, 2001). Based on the above arguments, we can derive our *baseline* hypothesis:

**Hypothesis 1.** Cross-national distance (cultural, administrative, political, and geographic) has a negative effect on FDI.

## 2.2. Local demand in host countries and FDI

Despite the negative effects of distance on FDI, prior scholars note several factors that may have a positive impact on MNEs' foreign investment. In their highly cited book, John Dunning and his protégé note there are four major "motives for foreign production" which is used interchangeably with motives for FDI (Dunning and Lundan, 2008: 63): resource-seeking, efficiency-seeking, asset/knowledge-seeking, and market-seeking. When host countries are endowed with factors that are attractive to potential foreign investors such as abundant natural resources, low production costs and technological expertise, they are more likely to attract FDI (Dunning, 1998; Makino et al., 2002).

Of the four types of FDI, our theoretical arguments are most closely aligned with the market-seeking type of FDI, but with some important distinctions. According to Dunning and Lundan (2008: 69), market-seeking enterprises are those "that invest in a particular country or region to supply goods or services to markets in these or adjacent countries." Although Dunning recognizes the role of host country market size in attracting market-seeking FDI, his work mainly focuses on developing firm-specific advantages that can then be transferred abroad (see Dunning, 1988, 1998; Dunning and Lundan, 2008). In this sense, market-seeking in Dunning's work is based on the assumption that the availability of foreign markets provides new opportunities for MNEs to maximize the effects of economies of scale and scope by supplying their products and services outside the domestic market.

This supply-side market-seeking argument helps explain an important primary motivation for FDI; however, it overlooks the demand-side drive for MNEs to seek global expansion. We argue that although theoretically similar in that both are motivations for FDI, supply-side market potential and demand-side potential are distinct concepts with different antecedents and mechanisms. Demand-side scholars have recently received more attention in the strategy literature (Priem, 2007; Priem et al., 2013). This perspective considers value creation as also key to explaining firm competitive advantage, determined by consumer willingness to pay—as opposed to the more developed supply-side arguments that focus on the role of resource ownership in value capture (Priem et al., 2012). They point to the work of Edith Penrose (1959), who argues that only those companies that attend to the needs of their consumers succeed, and Peter Drucker (1954: 37) who states that "the customer is the foundation of a business." This stream of research proposes a reorientation away from solely focusing on competitive advantage and value capture within the firm to a more encompassing model that views both upstream competitive markets and downstream consumer markets as crucial to explaining firm performance.

The distinction between market potential and demand potential for FDI is similar to the differences demand-side scholars place on their work with supply-side arguments. As stated above, Dunning's market potential for FDI focuses on the best locations for an MNE to leverage its firm-specific ownership or internalization advantages abroad (Dunning, 1998; Dunning and Lundan, 2008). Conversely, demand potential for FDI analyzes opportunities abroad to fill unsatisfied local demand for foreign goods and services. Thus, while similar, we argue that an explication of the theoretical differences adds further understanding to the motivations for FDI.

The importance of demand-side factors as motivations for FDI can be reflected in the fact that despite growing attention from emerging markets, Western Europe, with its large market size and high purchasing power, is still the most popular destination for US FDI (OECD, 2013; Sethi et al., 2003). Also, theoretically it follows that host country local demand will influence to a large extent the success of foreign entrants; FDI will therefore be associated positively with growth in demand (Asiedu, 2002; Buckley et al., 2007; Sethi et al., 2003). Therefore, combining both the supply and demand-side perspectives, we argue that host country local demand has a positive effect on FDI. Accordingly,

**Hypothesis 2.** Host country local demand has a positive effect on FDI.

## 2.3. Moderating effect of demand on cross-national distance and FDI

As noted above, MNEs with market-seeking motivations for investment face a number of challenges arising from the unfamiliarity of environments that are psychically distant from their own home country, which should decrease their propensity to invest in

these countries. However, we argue here that when host country local demand is great enough this can offset some of the negative effects of cross-national distance. In previous research, there appear to be two main streams of thought in overcoming the negative effects of distance: MNEs must either (1) have firm-specific advantages (i.e. superior organizational or managerial capabilities) that can be transferred to their subsidiaries (Buckley and Casson, 1976; Dunning, 1979, 1980; Hennart, 1982), or (2) mimic the organizational practices of local competitors (DiMaggio and Powell, 1983; Mezas, 2002; Zaheer, 1995).<sup>2</sup>

As a complement to these more traditional firm-specific advantage and institutional theory explanations, the demand-side approach suggests that MNEs are motivated to create value by engaging an international consumer base in two major ways. First, as a country's demand conditions indicate the level of market segmentation, defined as the distribution of demand for particular product varieties, and the level of sophistication of a country's consumers (Porter, 1990; Smith, 1956), they provide more opportunities for firms, including foreign entrants, to create value by diversifying product portfolios to finer market segments and to increase innovativeness to satisfy the new market demands. Thus, we argue that the greater the overall host country local demand, the higher the level of consumer sophistication and market segmentation, which provides more opportunities for investment.

Second, entering foreign markets with robust local demand may strengthen competitiveness in the global arena. As Porter (1990) noted in his diamond model, one of the key drivers of the competitiveness of regional clusters is local market demand. Local firms and clusters will benefit from strong market demand, as they will nurture a healthy competitive ecosystem for firms in those regions. For MNEs, joining such regional clusters will help them to develop alliances and benefit from the spillover effects created in the cluster.

In these cases, differences in consumer demands and market segments as well as the benefits from regional clusters may offset the perceived psychic distance between home and host countries as foreign investors may view these differences as potential outlets to create value for host country consumers and themselves. This may also increase their understanding of how consumers in host countries with high local demand perceive goods and services from distant markets. Therefore, combined with the above argument, we hypothesize that host country local demand positively moderates the relationship between distance and FDI. Accordingly,

**Hypothesis 3.** Host country local demand positively moderates the relationship between cross-national distance and FDI such that the negative effect of cross-national distance on FDI will be weakened when host country local demand is high.

### 3. Methodology

#### 3.1. Data and sample

To examine our hypotheses, we use the FDI data from the OECD international direct investment database, which has been used previously in other similar studies (Bénassy-Quéré et al., 2007; Cuervo-Cazurra, 2008). The dataset includes statistical information on OECD member countries' inward and outward FDI flows with host countries, is updated annually and available for a large number of countries. The data are converted into US dollars to compare across all host countries in the sample dataset.

We also collected other country-level data sources, including the cultural dimensions developed by Hofstede (1980) to create the cultural distance variable, the administrative, geographic and political distance data developed by Berry et al. (2010), and the remaining variables from the World Bank's World Development Indicators (WDI, 2013). After merging the data and dropping the observations with missing values, our final sample is composed of 110 host countries.

#### 3.2. Variables and measures

##### 3.2.1. Dependent variable

Specifically for our dependent variable, we use US FDI outflows for the period of 2006–2011. There are three main reasons we use FDI outflows and particularly US FDI outflows in our study. First, we choose to study FDI over other internationalization modes such as exporting as the former is perceived as requiring higher levels of commitment and risk (Cassiman and Golovko, 2011; Johanson and Vahlne, 1977). In addition, as the primary indicator of physical presence in a host country, FDI is more conducive than exporting in allowing MNEs to access desired local knowledge such as host country demand conditions (Madhok, 1997). Therefore, it effectively reflects the demand-side argument in market entry. Second, the US is frequently used in distance research as the base comparison country with the rest of the world (Berry et al., 2010; Flores and Aguilera, 2007; Kogut and Singh, 1988) and it remains the largest single investing country world-wide, accounting for 25 percent of all global outflows (OECD, 2013). Third, by studying the outflows of FDI from one country, the US, we can better control for the home country effects in the distance and FDI relationship. Also, following previous research (Globerman and Shapiro, 2003; Sethi et al., 2003), US FDI outflows to a given host country acts as a proxy for the investment efforts of US MNEs in that host country.

Given that the most recent year available for many of our country-level explanatory variables is 2005, we collected our dependent variable based on FDI outflows since that year. To test our hypotheses, we coded the dependent variable over different period lengths (i.e. the average value of FDI outflows based on 1, 3, and 5 years), but only report the results based on average FDI outflows from 2006 to 2011 (i.e. the average over the 5 year window). We chose this window to report in part as an effort to control for the relatively

<sup>2</sup> We focus on these two methods because of their dominance in the distance literature. However, as one reviewer rightly pointed out, there are certainly other ways to overcome distance that have not been as thoroughly explored. Some include learning through internal or external experience, conforming to institutional pressures, or through collaboration with local firms.

volatile period of global economic uncertainty in the middle of this time span. The results based on other lengths of observation are largely the same and will be available upon request.

### 3.2.2. Independent variables and moderator

**3.2.2.1. Cultural distance.** To operationalize cultural distance, we use a composite measure based on Hofstede's (1980) four cultural dimensions: individualism, power distance, uncertainty avoidance, and masculinity. His dimensions have been widely used among IB researchers (e.g., Berry, 2010; Slangen et al., 2011). The data provides dyadic country comparison scores between the US and 80 host countries for each of the cultural dimensions. There are a number of host countries that receive US FDI but are not covered in Hofstede's data. For those countries in the sample where no cultural information is provided, we fill in missing culture comparison scores using a regional average of countries where comparison scores are available. The dyadic distance between countries is calculated using the Kogut and Singh (1988) cultural distance index, which measures the differences in scores of Hofstede's cultural dimensions between each host country and the US.

**3.2.2.2. Administrative distance.** To account for administrative differences between the US and each host country, we use the administrative distance variable made available by Berry et al. (2010), which is a composite of information on whether the host and home countries share a colonial tie, the percent of the population between the countries that share the same religion, and whether they share the same legal system. The data on colonial ties and shared religion are from the CIA Factbook, and information on legal systems is provided by La Porta et al. (1998). The variable is computed using the Mahalanobis distance formula, which allows for scale variance and is superior to other distance calculations (Berry et al., 2010). The dyad is US to each host country in the dataset.<sup>3</sup>

**3.2.2.3. Political distance.** For the political differences between the countries, we use the political distance variable also from the Berry et al. (2010) dataset, which is an aggregation of each of the following variables: (1) political stability measured as the number of independent institutional actors with veto power within each host country from the Political Constraint Index dataset, (2) the size of the government relative to the overall economy from the WDI, and (3) world and regional trade agreements information from the World Trade Organization (WTO). This variable is also computed using the pooled Mahalanobis distance formula.

**3.2.2.4. Geographic distance.** The geographic distance variable is calculated using the total greater circle distance between two countries, measured from the geographic center of the home country (US) to the geographic center of each host country. Geographic coordinates are supplied by the CIA Factbook and calculated by Berry et al. (2010).

**3.2.2.5. Host country local demand.** We operationalize local demand by using the final consumption expenditure over GDP in a given host country. The World Bank defines consumption expenditure as the market value of all goods and services purchased by households and government entities. This measure is more comprehensive in confirming the overall consumption power of an economy than GDP per capita, as it includes not only individual consumption but also government consumption. In addition, we use the ratio of final consumption over GDP to control for the size of a country's overall economy. In this way, it better captures the importance of consumption in a given country's economy, i.e., the extent to which a country's economy is driven by local consumption, which is the largest component of a country's aggregate demand (Keynes, 1936).

### 3.2.3. Control variables

In an effort to isolate the effects of other factors that may influence FDI outflows, we control for the most common country characteristics used in previous FDI studies. Although some scholars have suggested an economic distance dimension (see Berry et al., 2010; Ghemawat, 2001), these factors are typically used as control variables in FDI studies (e.g. Sethi et al., 2003). Thus, we follow the FDI literature and use the following economic variables as controls: income (*GDP per capita*), measured in constant 2005 US dollars (Ali et al., 2010; Loree and Guisinger, 1995; Robertson and Watson, 2004), the annual economic growth rate in the host country (*GDP growth*) (Fan et al., 2009; Jensen, 2003; Li and Resnick, 2003) and market size (*Ln population*) (Cuervo-Cazurra, 2006; Fan et al., 2009; Henisz, 2000). We take the natural log of total population to reduce multicollinearity with other variables.

We also control for a number of other variables typically cited as influencing a host country's overall attractiveness. Economic openness (*Trade*) is operationalized by total exports and imports as a percent of GDP (Fan et al., 2009; Globerman and Shapiro, 1999; Jensen, 2003). For the rate of price change in the host country economy (*Inflation*), we use a GDP deflator, measured as the ratio of GDP in current local currency to GDP in constant local currency (Berry et al., 2010). To measure *infrastructure*, we use the number of telephone lines per 100 people, which includes integrated services digital network channels and fixed wireless subscribers (Ali et al., 2010; Asiedu, 2002; Azémar and Desbordes, 2009; Fan et al., 2009).

### 3.3. Model specification

We use cross-sectional OLS regression with robust standard errors to test our hypotheses. Given the stability in the variance across time in the cultural distance, administrative distance, and geographic distance variables, we choose cross-sectional OLS instead of a

<sup>3</sup> A more detailed explanation of the data source, including the specific distance formula for Mahalanobis distance (Appendix 2) can be found at the University of Pennsylvania's CIBER website at <http://lauder.wharton.upenn.edu/ciber/research/faculty.php>.

**Table 1**  
Descriptive statistics and correlation matrices<sup>a</sup>.

Variable	Mean	Std. dev.	1	2	3	4	5	6	7	8	9	10	11
FDI outflows	2414.48	7643.16											
GDP per capita	11,287.97	16,510.74	0.54										
GDP growth	4.81	3.26	−0.11	−0.18									
Ln (population)	16.05	1.77	0.08	−0.12	0.16								
Trade (% of GDP)	87.66	53.65	0.24	0.27	0.02	−0.40							
Inflation	7.50	7.25	−0.18	−0.13	0.30	0.10	0.01						
Infrastructure	18.91	19.26	0.46	0.83	−0.23	−0.03	0.21	−0.34					
Cultural distance	10.93	5.17	−0.34	−0.39	0.23	0.07	−0.01	0.25	−0.40				
Administrative distance	10.33	14.00	−0.05	0.19	−0.07	0.10	−0.13	−0.09	0.14	0.02			
Political distance	4611.97	864.53	0.08	0.12	0.02	0.26	0.23	−0.25	0.18	0.09	−0.03		
Geographic distance	9925.55	3662.02	−0.19	−0.20	0.02	0.05	0.06	0.18	−0.34	−0.18	−0.09	0.12	
Host country local demand	79.87	19.54	−0.16	−0.41	−0.26	−0.03	−0.23	−0.43	0.29	−0.02	0.02	−0.08	−0.04

<sup>a</sup> All correlations greater than 0.15 or less than −0.15 are significant at the 0.05 level.

longitudinal panel study as our statistical model. We employ robust standard errors to control for possible bias caused by non-constant error variance. All continuous independent variables are measured in year 2005, as we are trying to predict the pattern of US FDI outflows in the period of 2006–2011. This lag between the independent and dependent variables helps mitigate the possibility of the error term being correlated with the independent and dependent variables.

## 4. Results

### 4.1. Main results

Table 1 presents the descriptive statistics and correlation matrices for the variables. The average bilateral US FDI outflows over the 2006–2011 period is US\$2414 million. Additionally, in order to provide a finer perspective on US FDI outflows, we separate the data into two groups: host countries with higher than average per capita income and host countries with lower than average per capita income. For those host countries with higher than average per capita income, the average bilateral FDI outflow is US\$7377 million and for those with lower than average per capita income, the average bilateral FDI outflow \$466 million, which suggests that US FDI outflows still heavily favor high income host countries.<sup>4</sup> We found no serious multicollinearity issues as the variance inflation factor (VIF) tests from the full model average 2.23, well below the rule of thumb cutoff for regression models of 10 (Ryan, 1997). We also mean-center the interaction terms to further minimize the potential for multicollinearity (Aiken and West, 1991).

In Table 2, Model 1 we include only the control variables. Among these variables, GDP per capita, population, and trade are positive and significant ( $p < 0.05$  for GDP per capita and trade;  $p < 0.01$  for population), and inflation is negative and significant ( $p < 0.05$ ). This suggests that countries with higher income, more potential customers and more liberalized economies receive more US FDI, while countries with higher inflation receive less US FDI. Because income and population are often cited as key market demand factors and proxies for market size (Asiedu, 2002; Flores and Aguilera, 2007; Sethi et al., 2003), the positive effect of both variables adds additional validity to the important role for demand-side motivations of FDI.

Models 2–5 include each of the main independent variables separately. As hypothesized, cultural distance, administrative distance and geographic distance are all negative and significant ( $p < 0.05$  for cultural distance and geographic distance,  $p < 0.01$  for administrative distance), suggesting that psychic distance in a number of different forms does indeed lead to lower levels of US FDI. Political distance is negative but not significant. In Model 6, the main effect of the moderation variable, host country local demand, is positive but not significant; indicating that US FDI is not solely concerned with demand factors, but other variables must be taken into account as well.

In the full Model 7, we add all variables including the interaction terms. We find some support for Hypothesis 3. As predicted, host country local demand has a positive moderating effect on the relationship between administrative distance and US FDI outflows ( $p < 0.05$ ) and for geographic distance ( $p < 0.05$ ). The interaction between cultural distance and host country local demand is positive and marginally significant ( $p < 0.10$ ). These results suggest that host countries with high local demand can help offset some of the negative distance effects on US FDI. Interestingly, the interaction between political distance and host country local demand is negative and significant, suggesting that high local demand increases the intensity of the negative relationship between political distance and US FDI.

We report standardized coefficients in an effort to allow for direct comparisons of effect sizes. As shown in Table 2, the main effects of cultural, administrative and geographic distance on FDI outflows are similar in size (−0.20, −0.16, and −0.21 respectively). However, for the interaction between cultural distance and host country local demand (0.21) and geographic distance and host country local demand (0.27) are larger than administrative distance and host country local demand (0.06). We use a Wald test (Cameron and Trivedi, 2010) to test whether or not the effect sizes are statistically different and find that the size of the interaction between geographic distance and host country local demand and the size of the interaction between administrative distance and host country

<sup>4</sup> We would like to thank an anonymous reviewer for suggesting this additional descriptive information that aids the reader in understanding where US FDI outflows are concentrated.

**Table 2**Results of OLS regression (dependent variable = average FDI outflows 2006–2011)<sup>a</sup>.

Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)
GDP per capita	0.55* (2.56)	0.50* (2.45)	0.61** (2.87)	0.55** (2.73)	0.58* (2.61)	0.58** (2.63)	0.61** (2.99)
GDP growth	−0.03 (−0.57)	−0.02 (−0.33)	−0.04 (−0.63)	−0.03 (−0.52)	−0.05 (−0.79)	−0.01 (−0.28)	−0.03 (−0.45)
Ln (population)	0.21** (2.89)	0.23** (3.13)	0.23** (2.96)	0.27** (2.70)	0.23** (3.00)	0.23** (2.95)	0.32** (2.96)
Trade (% of GDP)	0.19* (2.09)	0.22* (2.49)	0.17+ (1.93)	0.24* (2.33)	0.21* (2.37)	0.21* (2.27)	0.29** (2.79)
Inflation	−0.10* (−2.12)	−0.07 (−1.62)	−0.12* (−2.26)	−0.13* (−2.18)	−0.09* (−2.10)	−0.05 (−1.01)	−0.03 (−0.53)
Infrastructure	−0.07 (−0.47)	−0.09 (−0.67)	−0.09 (−0.68)	−0.06 (−0.47)	−0.14 (−0.88)	−0.05 (−0.31)	−0.20 (−1.53)
Cultural distance (CD)		−0.18* (−2.52)					−0.20** (−2.65)
Administrative distance (AD)			−0.16** (−3.24)				−0.16** (−3.38)
Political distance (PD)				−0.14 (−1.65)			−0.08 (−0.86)
Geographic distance (GD)					−0.12* (−2.24)		−0.21*** (−3.51)
Host country local demand						0.10 (1.49)	0.08 (1.08)
CD × host country local demand							0.21+ (1.74)
AD × host country local demand							0.06* (2.09)
PD × host country local demand							−0.47* (−2.16)
GD × host country local demand							0.27* (2.29)
Observations (# of host countries)	110	110	110	110	110	110	110
Adj. R-square	0.31	0.33	0.33	0.32	0.32	0.31	0.36

<sup>a</sup> Standardized regression coefficients are reported with robust *t*-statistics in parentheses. \*\*\*  $p < 0.001$ , \*\*  $p < 0.01$ , \*  $p < 0.05$ , +  $p < 0.1$ .

local demand are statistically different ( $p < 0.05$ ). The difference between host country local demand interacting with culture distance and administrative distance is not statistically significant ( $p > 0.10$ ), however; this suggests that host country local demand has a higher significant influence on mitigating geographic distance than it does for administrative distance.

Fig. 1a illustrates the interaction effect for geographic distance and host country local demand. As the figure demonstrates, high host country demand diminishes the negative effect of cross-national geographic distance on FDI. This is also representative of the graphs for culture distance and host country local demand, as well as administrative distance and host country local demand. Fig. 1b illustrates the interaction effect for political distance and host country local demand. As suggested in the regression analysis, the figure shows that in contrast to the other types of cross-national distance, high host country local demand actually amplifies the political distance effect on FDI.

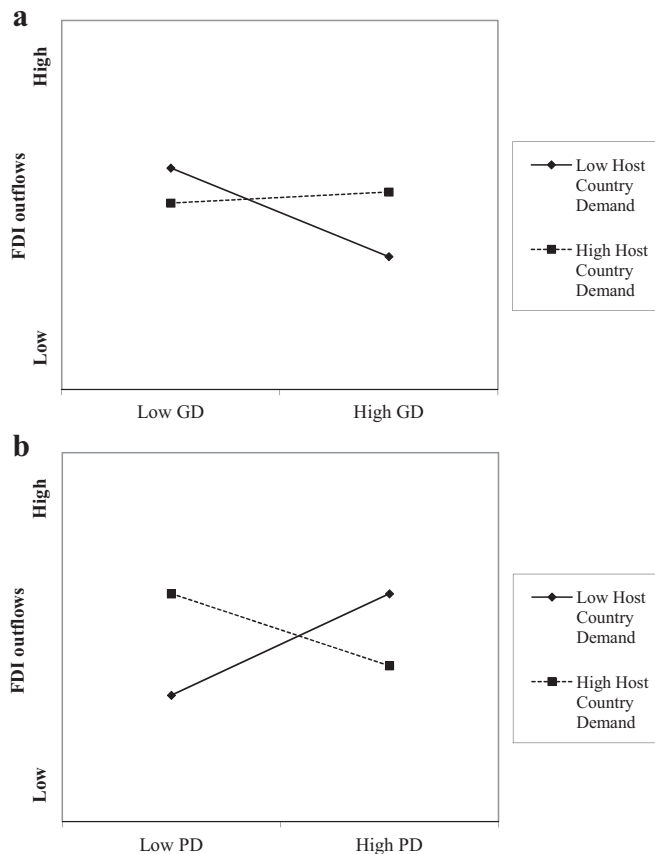
#### 4.2. Robustness checks

To ensure the robustness of the results, we perform several robustness checks. First, we replace the dependent variable, average FDI outflows, with outward stocks for 2006 with the independent variables again lagged one year. The results of this analysis are quantitatively consistent with what is reported in this study. Second, it has been demonstrated that prior foreign experience is an important determinant in FDI (Barkema and Drogendijk, 2007; Chang, 1995; Erramilli, 1991). Although we were not able to access firm-level variables to measure prior experience, we use the previous year US FDI outflows as a proxy to control for the overall prior FDI patterns in the regression model. The variable itself is not significant, but the results are stable overall. Third, to better capture the different facets of the construct of local demand, we use per capita income as an alternative, which relates more to the ability to consume than actual consumption. Regardless, we run further regression models with the distance-FDI relationship moderated by per capita income and obtain results consistent with our initial tests.

## 5. Discussion and conclusion

### 5.1. Contributions and implications

Our study is one of the first attempts to systematically study the implications of the influence of host country local demand for the Uppsala internationalization model. Contrary to our expectation, we were unable to find support for the main effect of host country



**Fig. 1.** a The effect of geographic distance on FDI outflows at high and low levels of host country local demand. b The effect of political distance on FDI outflows at high and low levels of host country local demand.

demand on FDI. This suggests that local demand may not influence FDI directly, but rather may be a catalyst that aids in addressing other reasons for not engaging in FDI. In particular, we find that host country local demand significantly mitigates the negative distance effect (i.e., geographic, administrative and cultural distances) on FDI, lending support for the notion that when MNEs are motivated to create value by satisfying host country local demand through FDI, it may be possible to lessen some of the cross-national distance barriers usually facing foreign firms. These results help us better understand the boundary conditions of the Uppsala internationalization model, and how it interacts with demand-side factors in predicting FDI. Thus, while the Uppsala model may hold in general, if host country local demand is high enough, foreign investors may still be willing to invest despite the high costs associated with psychic distance.

In addition, contrary to expectation, we find that host country demand actually strengthens the negative relationship between political distance and FDI. This implies that a host country with strong local demand—an indicator of economic power—but not politically welcoming to US or other similar home country investors can actually amplify the negative distance effect. We have some speculative ideas as to why this may occur. For example, in countries where political stability is low and state involvement in the economy is high (such as Russia or Venezuela), government may have a profound effect on both citizen consumers' and its own willingness to demand goods and services from a politically distant country such as the US. On the one hand, host country consumers may be hesitant to buy foreign goods and services because of the uncertainty around how citizen demand for these goods will be perceived by the host government, and on the other due to the politically strained relationship between the countries, the host government itself may also be less likely to demand goods and services from politically distant countries.

Equally uncertain are the potential foreign investors, who may see highly sophisticated and demanding consumers in politically distant countries as likely to be indifferent towards goods and services from the home country. In this case high demand can exacerbate the liability of foreignness and amplify the negative political distance effect. Also, political differences are the most obvious to host country consumers and are typically highlighted more frequently in the media than other types of cross-national distance. This may provide the impetus for local host country firms to increase political support against foreign products and services.

Regarding the different effect sizes, the findings suggest that the influence of host country local demand on distance is most pronounced for geographic distance. We have some thoughts as to why this may occur. Due to recent declines in transportation and communications costs, host country demand even in highly distant markets can now be satisfied more cheaply and easily, profoundly lessening the negative effects of geographic distance. Although the role of host country local demand in offsetting



administrative distance is significant, it may have a much smaller effect on bridging differences such as colonial ties, language, and religion. Thus, administrative distance is mitigated by host country demand to a lesser degree than geographic distance. We see the differences in effect sizes as an interesting and potentially insightful avenue for future research.

Our results also have implications for international managerial practices. Our country-level analysis confirms that some distant host countries with high local demand still present valuable opportunities for expansion. It implies that the value to MNEs in increasing their international consumer base can mitigate the costs involved in entering more distant markets. Thus, MNEs should look not only to supply-side factors in resource deployment, but also “downstream” to consumers as they seek to overcome or mitigate these negative effects. For managers, to recognize the competing motivations of both upstream supply-side factors and downstream demand factors in the FDI decision making process is critical to enhancing the probability of success when entering psychically distant markets.

In this study, we also develop a demand-side argument on the motivations for FDI to complement the well-established supply-side literature. Demand-side perspectives recognize FDI as a value creating activity driven by MNEs' objectives to satisfy a more diversified global demand. Thus, demand-side arguments differ from the current supply-side point of view on FDI motivations, which tends to focus on leveraging MNEs' best practices to a broader market worldwide. This has been a point of emphasis within this study: that introducing demand-side perspectives to an IB context helps us better understand FDI flows beyond supply-side market-seeking motivations that have provided the primary explanation for FDI in previous research. Though beyond the scope of our current study, we encourage future researchers to not only distinguish between demand-side and supply-side factors theoretically, but also empirically. For example, home country industry growth is likely to determine some industry-specific outward FDI as firms in saturated markets may be more likely to search for new investment opportunities abroad. Also, analyzing the relationship between market segmentation and/or consumer sophistication with FDI at lower levels of analysis could provide further complementary understanding to the more commonly used supply-side empirical factors.

Finally, we did find that although our operationalization of host country local demand—consumption as a percentage of GDP—may not have a direct impact on FDI, other demand factors, such as GDP per capita and population, play a largely positive role in attracting FDI. This adds some validity in an international context to [Priem et al.s' \(2012, 2013\)](#) conclusions on the importance demand factors play in the formation of firm strategy.

## 5.2. Limitations and future research

We identify several limitations, which represent opportunities for future research. First, we focus on FDI because of the perceived benefits of having a physical presence in the host country ([Madhok, 1997](#)). However, concentrating on FDI could raise concerns about the generalizability to other stages of internationalization. According to the Uppsala internationalization model, firms move through different stages of internationalization, first through exporting, then by establishing sales subsidiaries and finally through outward FDI ([Johanson and Vahlne, 1977](#); [Xiao et al, 2013](#)). Hence, IB research has used these stages, along with international expansion, interchangeably to represent internationalization as both a process and as static stand-alone decisions (e.g. [Alcantara and Mitsuhashi, 2012](#); [Buckley and Hashai, 2009](#); [Johanson and Vahlne, 1977](#)). However, we recognize using FDI may limit the applicability of this study to the final stage of the internationalization process. Similarly, we do not compare these results with other internationalization stages that are lower in commitment such as exporting, which the Uppsala model suggests MNEs use to avoid some of the costs associated with psychic distance. We see these as avenues for future research, which should explore the effect of host country local demand on earlier stages of internationalization and how/if the process changes when focusing on downstream factors.

Second, this study focuses only on country-level demand factors, but there may be more specific differences in the relationships studied here when adding firm- or industry-level factors. For instance, [Dunning's \(1988, 1998\)](#) resource-seeking motivations for FDI are significantly different from efficiency or asset-seeking motivations; therefore, demand factors would likely have varying influence over these motivations. Thus, future research should consider host country local demand at the firm- or industry-level, which would provide a more complete model to demonstrate how specific industry-level demand factors moderate the distance-FDI relationship.

Third, we focus on only the distance between the US and host countries receiving US FDI outflows. We recognize that this may limit the generalizability of our results to countries that are culturally similar to the US. Specific cultural differences such as individualism and collectivism could possibly play a large role in determining the impact of demand. Future research should examine the distance-FDI relationship by culturally or administratively similar regions or country-groups to explore further the influence of demand and add more external validity to the findings here.

In conclusion, our study sets out to address the gap in the literature by seeking to answer the research questions: What is the direct effect of host country local demand on FDI flows, and does local demand have a moderating influence on the negative relationship between cross-national distance and FDI? Our study is somewhat inconclusive on the positive direct effect of demand side factors on FDI, but strongly supports the argument that host country demand mitigates the negative distance effect on FDI. As one of the first to extend demand-side perspectives to IB, this study is inevitably subject to its limitation. But we hope that future researchers can further refine and test demand-side arguments in IB research to generate additional fruitful insights.

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