SAFE IN MY BACKYARD:

STRTEGIC TRADE POLICY AND MULTINATIONAL RIVALRY

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INTRODUCTION

How can strategic trade policy influence the competitive actions of a home-country multinational enterprise (HMNE) when it expands into international markets? Drawing from the multimarket competition and strategic trade policy literatures, we argue that the greater the home government's protection of the HMNE’s "backyard" (the home market), the more aggressive HMNE can and will be when it attacks its foreign competitor (FMNE). We distinguish between two different types of strategic trade policy (STP): *defensive STP*, which uses trade barriers to protect national firms, and *aggressive STP*, which focuses on opening foreign markets to the home MNE through the removal of foreign structural barriers to entry. We argue that the type of STP has important effects on HMNE's action and FMNE’s response. We also find that liability of foreignness can play an important moderator role in shaping the competitive game.

LITERATURE REVIEW

Multimarket Competition

Firms constantly undertake offensive and defensive actions as they strive for competitive advantage (Chen & MacMillan, 1992). As the degree of multimarket contact between firms in a given market increases, their aggressiveness toward each other in that market may be tempered by the possibility of retaliation in other markets (Edwards, 1955). Competitive actions evolve over time; firms learn to take into account the expected competitive responses of rivals in their evaluation of the benefits and costs of future actions. In a multimarket context, the repeated competitive interaction provides an opportunity for the firm to strategically use deterrence and threats of retaliation to influence the incentive of a rival to attack its position (Schelling, 1960; Tirole, 1990; Chen and Miller, 1994). The multipoint competition literature, however, has only briefly examined rivalry between multinational enterprises (Gimeno, 1999). Competition across borders gives a firm the option to respond to an attack by a rival not only in the challenged market, but also in any other markets in which they both compete.

Strategic Trade Policy in Theory

The strategic trade policy literature (Brander & Spencer, 1983, 1985; Krugman, 1986, 1987, 1989) provides support for government policy intervention in markets characterized by imperfect competition, increasing returns to scale and external economies. STP theorists argued that governments could raise national welfare at other countries' expense by sheltering national firms from international competition.

Government protection can increase the competitiveness of home companies for two reasons. First, in oligopolistic competition, trade policies can extract rent from foreign firms and shift it to home firms (Brander & Spencer, 1984, 1986). Second, the protection of the domestic market can serve as a form of export promotion when two firms interpenetrate each other's home markets through reciprocal dumping (Krugman, 1989). If one firm receives protection in its home market, the immediate result will be that it will sell more and the other firm will sell less. This reduces the home firm's marginal cost, having the indirect effect of increasing the home firm's competitiveness in the unprotected foreign market.

In the STP literature, the optimal policy instrument is either an import tariff or an export subsidy to the home firm, depending on the nature of oligopolistic competition (Krugman, 1987). The purpose of the policy is to indirectly cause the foreign rival to reduce output or increase price, thus losing market share.

Strategic Trade Policy in Practice

The main US trade policies used in the past twenty years have been anti-dumping duties (ADD), countervailing duties (CVD), and Section 301 of the 1974 Trade Act (Destler, 1995). ADD and CVD are forms of administered protection, which are GATT-legal dispute settlement mechanisms. They allow local firms to petition the US International Trade Commission for tariff relief if the firms have been materially injured by import competition. Section 301 gives US firms the right to petition the US Trade Representative (USTR) for remedial action against any "act, policy or practice of a foreign country that is unreasonable or discriminatory and burdens or restricts US commerce". In response to US administered protectionism, foreign governments have often responded through ad hoc, informal measures such as voluntarily restricting their exports to the United States (e.g., the 1981 Japanese auto VERs).

Starting with the Reagan administration in 1985, the USTR began to change the thrust of US trade policy from defensive (protecting US market against imports) to aggressive (forcing open foreign markets to US exports). The first example was the Market-Oriented Sector Specific (MOSS) talks between the United States and Japan, which led to the 1986 US Semiconductor Agreement. In this agreement, the USTR negotiated a 20 percent voluntary import expansion (VIE) within five years for US semiconductor firms in the Japanese market. In 1988, the US Congress passed the Omnibus Trade and Competitiveness Act, which strengthened Section 301, empowered the US president to retaliate against unfair trade practices in foreign countries, and made retaliation mandatory (under Super 301) if unfair practices persisted.

In 1989, under the Bush administration, the USTR initiated the Structural Impediments Initiative (SII) talks, aimed at removing domestic non-tariff barriers in the Japanese economy. These perceived impediments included a variety of government regulations and business practices, such as standards and testing, intellectual property protection, health and safety regulations, corporate financial structures, and the nature of business-government relations (Tyson, 1992; Flath, 1998; Schoppa, 1998). The Clinton administration continued these discussions, taking a more aggressive approach based on numerical targets for autos and auto parts in the Japanese market. When the Japanese government stalled the negotiations, the USTR invoked Section 301 and threatened retaliation with 100 percent tariffs on Japanese luxury cars exported to the United States. The final agreement did announce targets, and provided for annual USTR monitoring of US exports of autos and auto parts to Japan (Barfield, 2001).

THEORY DEVELOPMENT

We argue in this paper that, with the spread of globalization, the multimarket competition literature should be centered in an international, rather than a domestic market perspective. In addition, the roles that government can play in fostering and shaping multimarket rivalry needs to be further developed. The strategic trade policy literature offers a rich menu of ideas that can help achieve both objectives. From the above short review, it is clear that there are two types of strategic trade policy. We call the first *defensive STP* because it is designed to protect the home firm's market (its "backyard") from foreign competitors. The second type is *aggressive STP* (a.k.a. *aggressive unilateralism*) because it is designed to force open the foreign MNE's "backyard". Boddewyn (1986) argued that firms could use government policies as a new type of competitive strategy, which he called the "fourth generic". In practice, STP has been used as a fourth generic strategy by US firms to protect the US market from imports and force open foreign markets to US exports. In this section, we suggest some theoretical propositions linking strategic trade policy to multimarket competition.

Defensive STP and Firm Competitive Activity

We assume two governments (home and foreign) and two multinationals, home (HMNE) and foreign (FMNE).

The Home Multinational (HMNE)

Defensive strategic trade policy usually takes the form of an ADD or CVD levied by the home government or a VER enforced by the foreign government. As noted by Salorio (1993), efforts to make strategic use of trade policies are important because they offer firms an opportunity to shape the competitive environment in such a way as to improve their position versus foreign rivals. Government intervention provides the firm with the opportunity to pursue defensive strategies aiming at discouraging competitors' activities (Averyt & Ramagopal, 1999). We hypothesize that defensive STP provides HMNE with a "safe backyard", again penetration by foreign firms, either through exports or foreign direct investment (FDI). Protection of one's own "backyard" then enables HMNE to expand more aggressively into its foreign rival's markets.

> Proposition 1: The higher the level of protection offered by the home government's defensive STP, the more aggressive HMNE can and will be when expanding to FMNE's markets, *ceteris paribus*.

The Foreign Multinational (FMNE)

If the home government protects HMNE's local market through defensive STP, how is that likely to affect the competitive response of the foreign multinational? Here we will analyze the reaction of foreign firms from both their entry mode and entry pattern in the home market.

For the MNE, the selection of a mode of entry into the foreign market depends on various considerations: market access, market potential and risk, socio-cultural concerns, company experience, local regulation, concern for proprietary technology (Bartlett & Ghoshal, 1987; Chen & Stucker, 1997). Government policy can be a significant predictor of entry mode. For example, high tariff barriers tend to encourage *tariff jumping*; that is, switching from exports to inward FDI as a way to protect market share. In contrast to firms expanding through acquisition or joint ventures, new wholly owned subsidiaries do not possess well-developed local networks. Hence, they are likely to be more vulnerable when attacked by a protective policy. Depending on the home country's views on inward FDI, a wholly owned subsidiary may or may not be welcomed. In such cases, taking on a local partner in a joint venture might lessen the discrimination to some extent.

> Proposition 2: The higher the level of protection offered by the home government's defensive STP, the more likely FMNE will use a joint venture or acquisition as the preferred mode of entry into HMNE's market, *ceteris paribus.*

Building on evolutionary theory and the organizational learning perspective, the entry and exit activities undertaken by the MNE can be understood as a continuous search and selection process aiming at improving performance. Firms learn from their past experience and attempt to approach the next competitive move in a more focused and directed way (Chang, 1996). In the highly protective home-country market, where FMNE does not know in advance how to operate efficiently, it might be better for FMNE to start with a small-sized entry and then gradually move into larger investments. This sequential entry strategy has been widely adopted by Japanese firms, for example, where Chang (1995) finds that instead of making a one shot, full-scale aggressive entry like American companies, Japanese firms generally prefer to first entering a host country with their core businesses at a small scale. By learning from their early entry and other firms' experience, they can gradually overcome the liability of foreignness and then begin to expand their activities. This leads us to propose that:

> Proposition3: The higher the level of protection imposed by the home government's defensive STP, the more likely that FMNE will pursue an sequential entry into the home-country market, *ceteris paribus.*

Aggressive STP and Firm Competitive Activity

The Home Multinational (FMNE)

Aggressive strategic trade policies, such as the voluntary import expansion (VIE) under the US Structural Impediments Initiative (SII) talks with Japan, are designed to improve the home firm's competitive position against its foreign rivals. While defensive STP emphasizes the importance of restricting foreign firm's access to the home market (HMNE's backyard), aggressive STP strives for a better competitive environment for HMNE in the host country (FMNE's backyard).

Beyond the effects of simply opening the foreign market, aggressive STP also serves the purpose of strategic disruption. According to Averyt and Ramagopal (1999), strategic disruption refers to a firm's intentional manipulation of a competitor's transactions cost structure in an attempt to destroy the competitor's alignment of the governance structure. Through aggressive STP, the home multinational can break apart the foreign firm's well developed institutional and supplier relationships with a purpose of triggering harmful alignment drift. Therefore, in this action-and -response game, HMNE can be very aggressive due to the lack of retaliatory threat from its foreign rival.

> Proposition 4: The higher the level of foreign market opening negotiated by the home country government, the more aggressive HMNE will be when expanding into the foreign market, *ceteris paribus.*

The Foreign Multinational (FMNE)

If the home government's aggressive STP is successful at forcing the foreign government to open FMNE's backyard to HMNE, how will the foreign MNE likely respond? According to strategy researchers, the firm's response to a competitive move can be predicted by factors such as attributes of the attack, degree of the attacker's commitment, and significance of the markets being challenged (Chen & McMillan, 1992, 1994). In international competition, any actions taken by a firm always provide direct or indirect indication of its intentions, goals or internal situation to its rivals. Therefore, in order to prevent competitors from retaliating aggressively, the firm that takes action must communicate a high level of perceived commitment to its intended competitive move (Heil & Robertson, 1991).

Because HMNE has directly resorted to the fourth generic strategy of inducing its government to engage in aggressive STP, the competitive actions targeted by the aggressive STP negotiations are likely to be used by HMNE as credible signals to discourage retaliation by the foreign multinational. In addition, since in most cases, the foreign government has very limited bargaining power in lodging official protests against the trade policies of the home country (outside of the WTO dispute settlement process), aggressive STP negotiations tend to end with the compromise of the foreign government. Not surprisingly, in this unilateral game, the FMNE finds itself in a very disadvantageous position. Therefore, we conclude that aggressive STP favoring HMNE, the strong commitment signaling by HMNE's competitive actions and increasing pressure imposed on FMNE by its government, together should greatly discourage the foreign multinational from retaliating against HMNE's challenge.

> Proposition 5: The higher the level of foreign market opening negotiated by the home country government, the less likely that FMNE will aggressively retaliate against HMNE's competitive moves, *ceteris paribus.*

Liability of Foreignness as a Moderator

As the acceptance of the organization by its environment, organizational legitimacy has proved to be vital for MNE survival and success (Dowling & Pfeffer, 1975; Hannan & Freeman, 1977; Kostova & Zaheer, 1999). On the other hand, foreign MNEs are not familiar with the host environment. Cultural differences and psychic distance impede the information flow between these firms and the market, giving insiders that have a well-developed local network a significant advantage. Since the foreign firm is not automatically entitled to the same rights and privileges as domestic firms, nor can a home government offer the same protection abroad as at home, the MNE is dependent on the host country for legitimacy. As a result, foreign firms should be at a competitive disadvantage relative to their local rivals when they enter the host market; this is the *liability of foreignness (LOF).*

Furthermore, since the entry of a foreign-owned firm intensifies the competition, in order to maintain market share and squeeze the rivals out, the home firm will intentionally sharpen the insider-outsider distinction in the eyes of the government and general public (Eden & Molot, 1993). This will also increase the liability of foreignness for the foreign MNEs. In addition, as the “stranger in a strange land”, the MNE is always a potential target of different interest groups in the host country (Zaheer & Kostova, 1999).

Hence, acting as a type of “soft” entry barrier (as compared to “hard” entry barriers such as tariffs) the liability of foreignness can have an important impact on the relationship between the home government’s trade policy and firm competitive activities. Therefore, we propose that:

> Proposition 6: The home government’s defensive strategic trade policy will have stronger effects at discouraging FMNE’s entry when the liability of foreignness is high in the home market, *ceteris paribus*.

CONCLUSION

This paper contributes to the literature on multimarket rivalry by exploring the cross-border competitive interaction between a home multinational and its foreign rival, using the lens of strategic trade theory. Including government policy as a "fourth generic" strategy for the home firm, the paper categorized two different types of strategic trade policy (defensive and aggressive) and analyzed their implications for firm competitive behavior. Liability of foreignness was an important moderator of firm competitive strategies.

Further extensions of this work should take into account possible retaliation by the foreign government, the extension of the analysis to third countries and firms (e.g., automotive policies of the US, Japan and European Union), and the possibility that defensive STP could backfire as shelter strategies (Rugman, 1989).

We conclude that strategic trade policy offers an interesting approach to developing an international perspective on multimarket competition. Do governments matter? Our paper shows that governments can and do matter-- particularly in oligopolistic markets dominated by multinational enterprises.

References Available from the Authors