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Foreign direct investment (FDI) in China: analysis of a case study.

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Abstract

The globalisation of markets and the increase in competition are powerful forces for firms to enlarge their activities and the geography of their investments. This paper examines the establishment of a manufacturing concern in China (Juangsu province). We investigate the reasons that induced such constitution, which are mainly due to access to new markets (so called “horizontal FDI” see, e.g., [1]) and only in a limited part to a reduction in production costs (so called “vertical FDI”; regarding the various FDI strategies, see [2]). Then we turn our attention to the critical aspects the firm has to face in making business in China (management of human resources, environmental aspects, tax system, trend of costs) and to the business strategy the firm develops in order to cope with them.

Keywords: Foreign Direct Investments, human resources, business strategy

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1 Introduction: Investing abroad

The globalisation of markets, the increase in competition and consequently the reduction of life-cycle products, are powerful forces for firms to enlarge their activities and the geography of their investments.

The choice of dividing firm's activities in many countries presents pro and cons. The costs may concern the loss of economies of scale and/or of integration¹. If the firm decides to "duplicate" abroad a part or the totality of its production process², then it may lose, for example, scale economy (if they can be exploited) at plant level. If the investment involves a splitting of the value-added chain, and the by transferring abroad certain activities previously executed at home³, then it may result for the firm a loss in economies of integration. Other costs may involve the environmental factors of host country (e.g. political stability, risks in tax structure and other regulations changes, cultural differences...).

Turning our attention to the reasons that underlie the splitting of firm's activities between several countries⁴ and following Dunning (1993, ch. 3), we may distinguish between four main strategies:

- Resource seekers.

Thanks to foreign investments, resource seeking firms aim at reaching resources at lower costs than in their domestic markets, in order to minimize their costs and become more competitive. Concerning the kind of resources, they can be subdivided in:

physical resources such as mineral, raw materials, agricultural products;

labour: manufacturing firms in developed countries with higher labour costs may have an incentive to invest in those countries with available unskilled labour at lower wages⁵;

resources in high technology sectors: in this case the reason for the foreign investment is to reach skills, capabilities, technological expertise which are not available in home country.

A Resource seeker firm, usually, makes a sort of "disintegration" of its vertical chain of production. For example, it may decide to produce a standardized component or to transfer a function abroad in order to attain a factor cost saving. The foreign direct investment (FDI) that the firm makes is called a *vertical* FDI.

- Market seekers.

The aim of market seekers firms is to invest and produce abroad in order to access to new markets. The advantage to produce abroad may depend on the reduction of transport costs and the avoidance of trade barriers, tariffs, import controls and so on. Secondly, a direct presence in foreign markets may facilitate the penetration in such markets, because of a higher sensitiveness to local tastes and other requirements. A market seeker firm decides to establish a plant in a foreign country in order to serve this country's market. In this case the investment is *horizontal* FDI: it is called *horizontal* since it consists in a duplication of a production plant already existing in the domestic country. If the firm previously served the foreign market by exports, the horizontal FDI replaces exports.

¹ See Barba Navaretti, Venables (2004, ch. 2)

² This kind of investment is called a *horizontal* FDI, see also Shatz, Venables (2000).

³ This kind of investment is called a *vertical* FDI, see also Shatz, Venables (2000).

⁴ See, among others, Barba Navaretti, Venables (2004, ch. 2), Dunning (1993, ch. 3).

⁵ However, investments usually do not go to those countries with the lowest labour costs; more likely they go to those countries with abundant labour with at least some basic education (see, Barba Navaretti, Venables, 2004, p. 29).

- Efficiency seekers.
Efficiency seekers firms' aim is to rationalize the governance of plants, activities and structures dispersed in different areas. Gains come from "cross-border product or process specialization, the learning experience that result from producing in different cultures and the opportunities for arbitraging cost and price differentials across the exchanges."⁶ Usually efficiency seekers firms are global multinational firms (larger and already internationalized firms).
- Strategic asset or capability seekers.
A strategic asset investment aims at enriching the portfolio assets in order to enhance firm's competitive advantage. Usually, this is done by acquiring existing assets of foreign firms (or by acquiring the foreign firms itself) and because of the need of financial resources in order to buy assets' firms, it is likely to affect larger firms.

With reference to small and medium firms, it may be worth noting that the decision to invest abroad depends often, also on the availability of certain internal resources. These kinds of resources, which are called by Etemad (2004) "*the push forces*", have an entrepreneurial nature and may operate, for example, if the firm has an innovative attitude (innovative products, and so on) and/or works in saturated domestic markets.

Another important aspect concerns the mode of entry in a foreign market⁷. If the firm decides to invest abroad, it may choose between:

- a 'joint-venture' which involves (in case of FDI) the creation of a new entity with a foreign partner. By a joint venture, the firm has therefore the possibility to access foreign resources provided by the local partner.
Benefits of such choice concern: 1) to circumvent government or market access restrictions (and let better relationships with local governments); 2) to have access to new technologies; 3) to benefit from pooling resources when partners are specialized in particular activities; 4) to benefit from cultural advantages (higher sensitivity to local tastes...) because of the presence of the local partner.
Weakness concern: 1) Problems of governance of the joint-venture, i.e. conflicts among partners; 2) loss of know-how and competitive advantages (since the knowledge is shared with host country firm);
- a 'sole-venture'. In the sole-venture the resources (e.g. equity) for the foreign investment are totally provided by the investing firm.
The benefits of a 'sole venture' are: 1) to preserve the know-how and competitive advantages; 2) the firm has a total control of its activities and, therefore, the problems of governance are reduced with respect to joint-venture.
Weakness: 1) a 'sole venture' involves higher investment and thus higher risks; 2) these risks increase when cultural distances between host countries and home country are considerable.
A 'sole venture' may be carried out in two ways:
 - a *greenfield* investment if the investing firm establishes a new plant. The most important weakness of a *greenfield* investment concerns the fact that it requires a long period of time to enter in the foreign market.

⁶ Dunning (1993, p.59).

⁷ See, among others, Argawal and Ramaswami (1992) and Brouthers (2002).

- a *merger & acquisition* if it decides to acquire an existing firm (or decides to merge with an existing one). The advantages of an *acquisition* concern the reduction of time of entry in the foreign market, the access to new technologies, the acquisition of brands, the elimination of a competitor and so on. However, it is usually more expensive than a *greenfield* investment⁸.

2 Presentation of the case study

The case study we focus on is a small group of firms, Faam Group. Faam Spa (formerly Srl) was established in 1974 in Monterubbiano (near Ascoli Piceno) and started its activity with the production of electric accumulators for starter, stationary and traction batteries. During the eighties it was opened a new factory for the production of ecological vehicles EVF Spa. In the nineties, after a period of constant growth, Faam started producing industrial batteries in the South of Italy by establishing a new manufacturing concern named IBF Spa in Manfredonia (near Foggia). In 2000 it was opened a small assembly plant in Uruguay (named Fedesir) and the last investment was a new plant in China in 2006. Nowadays, the group makes a total turnover (sales) of about 80 million euros and gives occupation to 500 employees all around the world. To sum up, the productive sites are located:: two of them in Monterubbiano (EVF and Faam), one in Manfredonia (IBF) one in Uruguay and one in Yixing, Jiangsu Province, China, named YIBF (see fig. 1).

In this paper we will focus our attention on the plant established in China.

The main reason of this localisation was due to the strategy of expanding activities in new markets, since Italian and European markets presented limited possibilities of expansion. Furthermore, the productivity capacity of Italian plants was about all employed to supply the domestic markets (italian and european). In other words, it was not sufficient to support the growth of new potential markets.

It was decided, thus, to open a plant in China (and not in Italy) mainly for:

- to access a new potentially interesting market (Chinese market);
- to have an “export platform” for other eastern markets (Australia, Singapore, India, Japan);
- the costs of the plant and the costs of the labour were significantly lower than Italian ones.

It was also decided to carry out a ‘sole venture’ in order to have a total control of activities and preserve know-how and competitive advantages. Given the cultural distances between European society and Chinese one, in order to circumvent these difficulties, it was decided to have a Chinese manager as President of the society. This Chinese (woman) manager works with Faam from more than 10 years and so she developed a considerable attachment to the firm.

The project started in 2006 with the renting of a small building of about 1.000 m² in which Italian and (on training) Chinese workers began to assembly elements and batteries, using the semi-finished products (plates) purchased by the Italian plants.

This first phase lasted about one year. During this time, the group’s management by monitoring the eastern market demand and by trying to forecast its trend of growth, judged it feasible to start the production of the whole process, from the raw materials to the final products. For this

⁸ Aswathappa (2006, p. 15).

reason in the middle of 2007 it was started the building of a new 10.000 m² plant. After the opening ceremony in October, the 28th, the number of workers started increasing until forty units; the turnover is about 12 million RMB (1^o semester 2008), almost equal to total turnover 2007⁹ and the pieces produced are about (1^o semester 2008) 25.000.

PEOPLE'S REPUBLIC OF CHINA (PRC)



Figure 1.

The group's policy is to create a local Chinese management because the relationships between Chinese people of same culture are easier to be managed and, thus, more economically convenient for foreign companies (see, e.g., *guanxi* in section 3.2). Moreover, since the middle of 2007 until the middle of 2008 three Italians people (one plant manager, one technician and one sales manager) made the training of all the Chinese employees and the start-up of the new factory. Nowadays, there are only the technician who is finishing the training of the "blue collars" workers and the sales manager who is organising the commercial networks and strategies. For the end of this year it is foreseen that the technician will return in Italy, since the local employees should be able to carry out the activity by themselves. The sales manager has to continue his commercial activity *in loco* for at least two years, in order to expand the commercial network. This does not mean that Chinese management will be "left alone". Indeed there will be a constant turnover of Italian managers in order to be sure that the quality of the production, processes and job conditions are kept at the present levels.

⁹ YIBF is growing step by step.

3 Some focuses:

3.1 Localization

The decision to invest in China was justified both by long term and short term aims.

Long period aims concern the fact to access a new potentially important market, not yet well developed, but in fast growth¹⁰.

Short term reasons are mainly due to:

- a reduction of production costs, in particular concerning labour costs and costs of plant;
- access to eastern markets, in order to face saturating domestic markets: in this perspective China is considered a sort of “export-platform” for markets such as India, Australia, Singapore, Korea and so on (see § 2).

Starting from these “macro strategic” considerations, in the choice of the “micro-location” of the plant, the management concentrated its attentions in the following guidelines:

- economics and logistics;
- political and fiscal.

Concerning the economic and logistics aspects, the choice of Jiangsu Province, was determined by its nearness to important communication networks (airports, ports, railways stations, motorways) and to important business centres (Shanghai, Nanjing). Further, Jangsu Province is a quite developed zone, and constitutes one important district for the production of batteries.

With reference to political and fiscal aspects, the Yixing municipality is less developed than the other cities in Jiangsu Province. For this reason, although having the same logistic advantages of the others Jangsu municipalities, YIBF enjoys greater benefits because of its contractual power. This means a lower labour cost (if compared to Shanghai and/or Nanjing), a lower cost for the land of the plant, and a series of other side-benefits. For example, in industrialized Chinese sites, electric black-outs are quite frequent: YIBF in Yixing enjoys a particular treatment (if the electric power is too low YIBF is the last firm in Yixing to stop working¹¹). Other benefits have a fiscal nature: for example there is a fiscal discount (on taxes) of 100% for, at most, the first five years of activities and of 50% for others five years and a tax rebate of VAT on expenses for machinery and production equipment.

3.2 Guanxi

Guanxi is one of the most important characteristics of Chinese culture and society. It is quite hard for a Western person to understand in a deep way its real meaning and, consequently, to find the right behaviour in order to cope with it. In a very simple and surely unsatisfactory way, we may say that *guanxi* concerns the set of relationships that a person creates during his life. These relationships include at the same time family, business, social contacts, and have a strong influence on the behaviour of individuals also in business relationships.

As noted by So and Walker (2006, p.3):

¹⁰ Indeed, Chinese domestic market of industrial cells in 2007 was about 450.000 units, which is less than the whole market of Lombardia. However it is constantly growing.

¹¹ Being the YIBF a small firm, if it was in Nanjing, it should have stopped its activities earlier than (or together with) the Chinese companies.

“Business relationships in Western economies oil the wheels of business; they are not a method of economic organization or a substitute for commercial law. In Chinese society *guanxi* serves all these purposes.

In the West business relationships are based on a business culture and can be personal or purely pragmatic (utilitarian). Other relationships e.g. social, family, have their own culture.

But *guanxi* is the totality of any relationship. It is indivisible, pragmatic, or personal and pragmatic, but essentially utilitarian.”

Since *guanxi* permeates also all the business activities, it is important to face with it in a proper way and try to build a strong network in order to help the success of the investment.

The most natural way through which a *guanxi*¹² can be build by two persons comes from some kind of commonality. This commonality may concern, e.g., the same family, village, the attendance of the same school, and so on. If such commonality does not exist (and this is, usually, the situation of Western firms), then it is necessary a *guanxi* reference. This implies that in order to enter in *guanxi* with someone (e.g. individual *i*), I have to ask to someone else (e.g. individual *j*) to play the role of introducer: *j*, obviously, has a *guanxi* both with me and with *i*¹³.

It is also important to point out that the intermediary expects a return from me for his service.

Once the *guanxi* is established, it is necessary to maintain it through a proper behaviour. The word *renqing* denotes the person’s obligation towards the other party¹⁴ and the loyalty to the cultural and social norms of behaviour. It requires a continued interaction and contacts over time with the other party, which involves not only an expenditure of money, but also an expenditure of time¹⁵.

Another important characteristic is that *guanxi* is always a personal relationship. Even if business is done between firms, *guanxi* concerns always persons who maintain their responsibility; therefore if a firm loses an employee endowed with high social respect and a lot of *guanxi*, it risks also to lose the *guanxi* established through his intermediation.

3.3 Human resources management

Human resource management is one of the most complex aspects to face for a Western firm in China, because of the great cultural differences¹⁶.

One of the first difficulties YIBF met concerned the “manpower quality”. This difficulty can be seen under different points of view.

During the selection phase, there is a difficulty to assess the real capabilities of the candidates (the main reason is due to a lack of communication: Chinese candidates usually don’t speak fluent English and Italian selectors can’t speak Chinese). Since Yixing is not a so industrialized area, it is possible to find easily manpower, but often technical skills are not suitable with Western firms’ requirements and standards¹⁷.

Given this lack of technical skills, a training phase is necessary. After the training phase, it often happens that the employee decide to change job¹⁸. Roughly speaking, in China manpower

¹² About the following aspects, see, for a deeper analysis, So and Walker (2006, ch. 3).

¹³ When we say that individual *j* has a *guanxi* with *i*, this implies not only that *j* knows *i*, but also that *j* “has some influence” on *i*.

¹⁴ A Chinese common expression says that “*renqing* debt should be more urgently repaid than a monetary debt” (quoted in So and Walker 2006, p. 13).

¹⁵ Spending time together involves mutual knowledge, mutual understanding which are fundamental in a *guanxi* relationship, since the personal relationship is a sort of guarantee of the business one.

¹⁶ About Italian firms in China facing these problems see, among others, Cappuccitti, Sammarra, Secchi (2007).

¹⁷ These considerations hold, *mutatis mutandis*, for technicians, employees, managers and workers.

¹⁸ This phenomenon is called “job hopping”. Concerning Italian firms in China, see, Arduino, Bombelli (2006).

turnover is very high. This turnover is due, among others, to the following reasons: a considerable availability of alternative jobs for workers, a lack of attachment to the firm (at least to foreign firms)¹⁹. Another important reason of this turnover is sometimes due to a particular aspect of Chinese culture, the so-called “losing face”. When an employee feels to be not suitable for his job or some manager shows him his mistakes too directly or in presence of other Chinese colleagues, the employee often prefers to change job rather than remain in the present position. In order to cope with these “cultural characteristics”, Faam decided to put at the head of the firm (see § 2) a Chinese manager. This solution has pro and cons. On one side it gave the solution to the “communication problem” with Chinese employees; on the other side, it presents the risk that the process of selection can be influenced by the *guanxi*. This means, for example, that one worker can be employed not for his skills or abilities, but for an “obligation” of the selector (*renqing*).

Further, in order to cope with the lack of attachment to the firm by the workers, YIBF tried to make a policy oriented to fidelity. Until now, this policy has regarded the creation of fund in which YIBF deposits monthly a small sum of money for three years and for each worker. If a worker leaves YIBF before the three years, this sum of money will be used for the training of a new worker; otherwise he will earn the total amount.

With reference the “remuneration policy”, we can see in Table 1 that the total salary consists of:

- a basic salary which is the minimum set by the Government (central and/or local);
- a presence premium with the aim to reduce the periods of unjustified absence from work²⁰;
- a productivity bonus introduced as soon as the production became more stable in order to increase the number of pieces produced and meet the planned productions;
- a duty allowance to make feel to the employee his “importance” and make him more responsible.

	basic salary	presence premium	productivity bonus	duty allowance	total
worker	¥ 850	¥ 150	¥ 300		¥ 1.300
technician	¥ 850	¥ 150	¥ 300	¥ 200	¥ 1.500
junior manager	¥ 1.500	¥ 500	¥ 500	¥ 800	¥ 3.300

Table 1

This remuneration policy implies a higher labour cost than the average salary paid in the province in which YIBF operates.

3.4 Sales and Costs

With reference to sales, the biggest difficulty YIBF had to tackle is to organize a commercial network in the eastern market. Nowadays, YIBF’s sales are divided in domestic (Chinese) market (for about 80%), and in the rest of the world (for the remaining 20%).

With reference to the exports, YIBF established a sale office in Singapore, in Australia, in Korea, in India and in Japan. These offices let a diffusion of YIBF’s products and the turnover

¹⁹ In YIBF’s experience, it happened that workers changed job just for little wage’s improvements.

²⁰ This is due to the fact that often workers arrived late at work or “forgot” to come at all!

is constantly increasing. These markets are particularly selective, and each new customer wants make deep tests on the quality and the affordability of the products before to start a durable commercial relationship. Indeed, each company in order to face competitors has to satisfy customers' expectations and needs through proper and loyal relationships²¹.

Regarding the Chinese domestic market, YIBF concentrates its efforts for the 50% on the OEM²² and the remaining part on the AM²³. About the AM, in order to give an effective support to the customers all over the Chinese territory, Faam is organizing an after-sales office network, giving priority to the most industrialised regions. In fact nowadays, there exist in China ten sales (and after-sales) offices in the most important and strategic areas of the country (Shanghai, Beijing, Nanjing, Hangzhou, Shamen, Hong Kong, etc.).

In organising such commercial network, YIBF encountered several difficulties. The most remarkable ones concern:

- the large extension of the country.
- The language: Chinese people is not usually able to speak fluent English, and Faam employers are not able to speak Chinese. These shortcomings in "communication" makes difficult for the management to check the real capabilities, seriousness and technical preparation of the (Chinese) sales area managers and technical area one;
- Cultural differences. For example, while in western countries, when firms write down an agreement this become *binding* for the parties, in Chinese culture a contract tend to be *unbind* at least for Chinese firms because they tend to renegotiate agreements continuously.
- *Guanxi* in commercial relationships: for example, YIBF gained a new customer only because he was a friend of one of our existing customer. As soon YIBF lost the previous customer because it didn't give him a special discount he requested, suddenly it lost also the new customer.

This means that quality is surely an important competition factor in Chinese market, but probably, not the most important one.

In spite of these difficulties, the total turnover since 2006 is constantly growing: if we consider the turnover made during the first semester 2008, we have an increase of about 180% (compared to the first semester 2007) and of about 50% (compared to the second semester 2007).

Concerning costs, the firm experienced a considerable increase especially in the second semester 2007 due to the moving from the plant rented (1.000 m²) to the new one acquired (10.000 m²). After the opening ceremony of the end October 2007, the firm have started the production of batteries from the raw materials to the final product (while previously it made only the assembly phase). For these reasons, from first semester 2007 to second semester, indirect costs increased about 135%, the increase from the second semester 2007 to the first semester 2008 is more limited (about 16%).

Further, YIBF experienced a non expected cost concerning its exports. Chinese Finance Ministry introduced in 2007 a new measure²⁴ according to which for exports concerning

²¹ See, among others, Johnson and Gustafsson (2000), Falasco, Cardinali (2006).

²² Original Equipment Market, which concerns firms producing forklifts. In particular, YIBF supplies batteries to forklift producers. These producers are either European firms (established in China) or Chinese one.

²³ After Market concerns post-sale services.

²⁴ Export VAT Refund Rates Notice n.. 90 (19 June 2007).

productions with high risk of pollution for the environment, the VAT rebate is abolished. In other words, these kinds of exports are considered like domestic sales and therefore subject to VAT. This measure involves a considerable increase in product costs of 17%.

Nowadays the reduction in production costs compared to Italian ones is between 10% ÷ 25%. This saving can be explained by the fact that in China YIBF enjoys a reduction in labour costs and, in a more limited way, also in costs for electric power. The range 10% ÷ 25% depends on the labour intensity of the each product: the more the productions are laboured intensive, the more is the cost saving.

Since the cost of labour in China is constantly growing over time, and since Chinese Government is gradually introducing more restrictive measures in terms of job and environmental safety, the advantages in terms of costs are doomed to decrease.

4 Conclusions

We remind the reader that the present paper is just a preliminary version. There are other topics to be elaborated before reaching definitive conclusions.

Nowadays, Faam Group's management judges positively the establishment of the new plant in China with reference to the rapidity of start-up of the business and the increase of turnover, although it is probably too early to express a conclusive assessment.

Generally speaking, it seems that a FDI in China made only to enjoy the reduction of (labour) costs, is probably, at least in YIBF experience, not so advantageous, because of both the constant increasing in labour costs, and the new Government prescriptions in term of environment protection and workers safety. Although these new rules represent surely the obliged path for a more sustainable development, they also imply, from the firm's perspective, a significant increase in indirect costs.

Therefore, the investment in China, in Faam experience is justified mainly for the access to a new market with high-potentiality, and to an ancient culture whose knowledge will be more and more important in future, considering the impressive Chinese economic growth over the past two and a half decades.

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