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**The Internationalization of Chinese
and Indian Firms: Trends, Motivations
and Strategy**

Suma Athreye

Brunel University & UNU-MERIT

Sandeep Kapur

Birkbeck, University of London

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The Internationalization of Chinese and Indian Firms: Trends, Motivations and Strategy*

Suma Athreye[♦]
Brunel University, UK &
UNU-MERIT, Maastricht

Sandeep Kapur^{**}
Birkbeck
University of London

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[♦] Suma.Athreye@brunel.ac.uk

^{**} Corresponding author: s.kapur@bbk.ac.uk, School of Economics, Birkbeck, University of London, Malet St, London WC1E 7HX, United Kingdom

1 Introduction

The last two decades have seen significant internationalization of firms from developing economies, in terms of their greater participation in international trade, growing outflows of foreign direct investment (FDI), and a recent surge in their cross-border mergers and acquisition activity. Outward investment from developing countries is not a new phenomenon but in recent years there has been a marked increase in the magnitude of flows and a qualitative transformation in their pattern. Flows of outward FDI from developing countries rose from about \$6 billion in 1989-91 (about 2.7% of global outward flows) to \$253 billion for 2007 (nearly 13% of global outflows).¹ The stock of outward FDI from developing countries rose from around \$145 billion in 1990 to \$2,288 billion in 2007 (about 8% of global stock of FDI in 1990 to 14.6% of global stock in 2007).²

Within this broad trend, the growing internationalization of firms from two fast-growing developing countries, China and India, is particularly notable. Exports have been a central feature of the growth of the Chinese economy over the last three decades and, more recently, they have made a visible contribution to Indian growth too. Outward FDI from China and India has grown rapidly in recent years, and firms from these two countries are increasingly involved in overseas mergers and acquisitions.³

Morck *et al* (2008) provide a summary of outward FDI from China. Outward FDI flows from China were around \$22.5 billion in 2007; the stock of Chinese outward FDI grew steadily, from \$4.5 billion in 1990 to \$96 billion in 2007.⁴ A significant chunk of

¹ See *World Investment Report 2008*, Annex Table A.I.8 and Table B.1. In terms of its sectoral distribution, in 2004-06, around 70% of outward FDI flows from developing countries were in the services sector (within which business services, finance, and trade were the leading categories), with manufacturing accounting for 13% and the primary sector accounting for around 8%.

² See *World Investment Report 2008*, Annex Table B.2.

³ Aggregate statistics apart, many of the firms aggressively on the path of internationalization are from China and India. For instance, two-thirds of the 100 firms identified as 'new global challengers' in a recent Boston Consulting Group (2006) report are Chinese or Indian.

⁴ See *World Investment Report 2008*, Annex Tables B.1 and B.2. When referring to China, we ignore values recorded under Hong Kong (China) and Taiwan (China). FDI outflows from China and India seem small compared to developing-country totals, but this is in part because statistically recorded totals are dominated by a handful of countries, notably Hong Kong (China) and a few offshore financial centres.

Chinese outward FDI has gone to tax havens and to Southeast Asia, but recently a substantial amount has flowed to Africa too. Sovereign wealth funds (SWFs) have become a new channel for outward FDI, with the China Investment Corporation, established in 2007, playing a significant role. Chinese overseas investment have focused on oil and petroleum (with China National Petrol Corporation and China National Offshore Oil Corporation leading the charge), but there have been significant investments in construction (China State Construction Corporation), shipping (China Shipping), telecoms (China Mobile and China Telecom) and steel (Shanghai Baosteel) too. Much of the outward investment from China is carried out by large state-owned enterprises (SOEs).

Nayyar (2008) describes outward FDI from India, whose flows grew from negligible levels in 1990 to \$13.6 billion in 2007, and stock rose from \$0.1 billion in 1990 to \$29 billion by 2007.⁵ Outward FDI from India has spanned investments in a broad range of sectors, including steel, pharmaceuticals, information technology and services, as well as food and beverages. India's Oil and Natural Gas Commission has made substantial investment in oil and energy; Indian conglomerates such as the Tata group have made overseas acquisitions in automobiles (acquiring Jaguar in the UK) and steel (the Anglo-Dutch firm Corus); Ranbaxy has made global forays in pharmaceuticals and Infosys in information technology and business processing.

Firms from China and India have been involved in significant and growing levels of mergers and acquisitions abroad. Over the period 2005-07, cross-border purchases by Chinese firms average about \$3.5 billion per annum, while those by Indian firms averaged \$1.5 billion per annum. To the extent M&A activity is financed with funds raised in international markets or in the host economy the acquisitions are not fully recorded in measured FDI outflows. Hence measures of outward FDI probably underestimate the extent of internationalization of firms from these two countries.

The patterns of internationalization of Chinese and Indian firms suggest some common elements. Both countries have experienced rapid growth in recent decades, which led to large inflows of FDI and portfolio capital. These inflows, combined with high rates of domestic saving, created large reserves of capital at the macroeconomic

⁵ See *World Investment Report 2008*, Annex Tables B.1 and B.2.

level, which in turn led to relaxation of policy restrictions on capital outflows. Policy regimes that had previously prohibited capital outflows at the corporate level became increasingly permissive. Much of the recent outflows took place within the context of easy credit conditions in global financial markets, though this situation has changed dramatically since the summer of 2007.

These similarities should not mask the important differences in the patterns of internationalization of Chinese and Indian firms. While Chinese overseas acquisitions are more commonly carried out by state-owned enterprises, Indian outward FDI involves mostly private-sector firms, typically the large, diversified, business houses. Chinese overseas investments are more likely to have been in primary sectors, notably minerals and energy, while Indian investments are more distributed across a range of sectors, including steel and pharmaceuticals at one end to information technology and business services at the other.

These differences are probably related to differences in the policy environment that have guided the industrial evolution in these economies. Despite the economic liberalization that started in China in the 1980s, state-owned enterprises continue to play an important part in the Chinese industrial sector. Given the dependence of the economy on sustained exports, many of the Chinese overseas investments aim to secure access to critical raw materials, especially energy. India's industrial sectors, in contrast, went through many policy gyrations. India was remarkably open to inward FDI all through the 1950s, allowing a substantial stock of foreign capital to build up. Through much of the 1960s the policy of import-substituting industrialization allowed considerable scope for private enterprise, creating a significant pool of private firms. Economic liberalization in the last two decades allowed a cadre of professionally-run Indian firms to emerge in skill-intensive sectors such as information technology and pharmaceuticals, and these have firms have been particularly active in overseas markets.

However, these trends towards growing internationalization of China and India must be kept in perspective. Even as outward FDI has grown for both countries, the flows remain paltry relative to the size of these economies and relative to global FDI flows. Outward FDI flows as fractions of gross fixed capital formation were only 1.6% for China and 3.5% for India for the year 2007. Compare these to 6.4% for the developing countries as a whole and 16.2 for the corresponding global ratio. Outward FDI stock as a

share of annual GDP was 3% for China and 2.6% for India in the year 2007. The corresponding value for all developing countries was 16% and for the world economy was 29%.⁶

So why have these fledgling flows commanded so much attention? For one, both China and India are large and populous developing countries and their recent growth spurt has captured the popular imagination. Further, the emerging outward orientation of these countries reflects a distinct break from their historical trajectories – both China and India were inward-looking economies for much of the post-War period, and recent trends may presage their arrival on the international scene.

The newfound outward orientation is notable for some its qualitative aspects too, of which two stand out in particular. One, the time profile of flow of FDI does not conform to the conventional predictions of the ‘investment development path’ taken by developing countries. Traditional theories envisage developing countries graduating through various stages, starting from a stage where inward FDI allows domestic firms to acquire technology and other manufacturing capabilities, then graduating to a stage where domestic industrial capability allows these firms to export their output, only eventually investing overseas, and typically only in economies lower down in the stage of development. By design of their economic regimes, both China and India developed their industrial bases through policies of import-substitution without recourse to massive inflows of FDI in the early stages. And for both countries, outward FDI flows have emerged much sooner than expected, whether compared to the trajectory of early industrializing nations or more recent industrializers such as South Korea. Two, some of the capital outflows and acquisitions have been to developed economies rather than, as is often expected, to less developed economies. Tata, the large business conglomerate from India, has made high profile investments in the UK, while China’s Lenovo and Haier have made substantial inroads in the US.

At one level, the outward flow of capital from developing countries to acquire assets in developed countries presents a conundrum. Ordinarily, we should expect the rate of return on capital to be higher for investments in a fast-growing developing economy rather than for overseas ventures in industrially-advanced economies. To put it simply,

⁶ See *World Investment Report 2008*. Both countries also rank quite low in terms of UNCTAD’s outward FDI performance index, which measures a country’s outward FDI relative to its GDP.

the ‘uphill flow’ of capital from labour-rich developing countries to the developed world does not fit textbook economic theory.

One possible explanation is contextual. Liberalization may have given firms an opportunity to diversify their real investment portfolios. The logic of diversification may make it rational for a firm to expand overseas even when the return on such investment is lower, as long as returns domestically and overseas are less than perfectly correlated. The Indian firms that have led the internationalization process are those that were well diversified across domestic industrial sectors: consider the Tata group, whose interests range from manufacturing steel to food & beverages, and running hotels to business process outsourcing. In the past, regulatory constraints on diversification abroad often compelled these firms to diversify domestically, beyond levels that can be explained by technological economies of scope. Once policy becomes suitably accommodating to outward FDI, international diversification followed quite naturally. In many cases the firms’ quest for economies of scale also motivate them to invest abroad. This is particularly true in sectors such as steel and metals.

At the same time, some of the overseas investments may have been prompted by ‘push factors’: policies that distort the rates of return on capital at the enterprise level create an imperative to venture abroad. In China, distortions in the financial intermediation process, combined with a high rate of private savings may have driven down the rate of return on domestic investments, forcing firms to look overseas for more lucrative opportunities. As Morck *et al* (2008) put it, “China’s recent outward FDI surge is probably a manifestation of its inability to reinvest its high corporate and individual savings efficiently.”

2. Motivations

While a more permissive economic regime is necessary for firms to venture abroad, it is not sufficient. What, then, motivates firms to invest overseas? A leading theoretical approach, the so-called ownership-location-internalization (OLI) theory, explains the internationalization activity of multinational corporations (MNCs) as their attempts to extend their *ownership* advantages (e.g., proprietary access to a superior production technology or a valuable brand) to overseas markets by exploiting *locational* advantages

(locating abroad to access low cost inputs or better serve local markets), and *internalising* the efficiency gains from economies of scale and scope by integrating the firm's activities across borders. In short, FDI enables firms to exploit their existing firm-specific assets. This standard explanation has limited traction when analysing the internationalization activity of MNCs from developing countries. Typically, these firms have only limited technological or ownership advantages to exploit.

Rather, the internationalization activity of firms from developing countries may reflect attempts to *acquire* strategic assets, such as new technologies and brands, and to gain secure access to raw materials and to distribution networks. In sum, rather than exploiting existing assets, FDI may reflect attempts to acquire or augment these assets. In principle technological assets can be acquired through arms length contracts such as licensing, or generated through domestic R&D, but market imperfections may imply that acquisition is more effective through FDI. For instance, Child and Rodrigues (2008) have argued that Chinese firms have internationalized not so much to exploit competitive advantages, but to address the competitive *disadvantages* incurred by operating in exclusively domestic markets.

The *linkage, leverage and learning* model developed by Matthews (2006) aims to capture the idea that 'latecomer firms' will use their overseas investments and global linkages to leverage their existing cost advantage and learn about new sources of competitive advantage. If so, internationalisation may contribute to the building of ownership advantages rather than merely being an outcome of existing advantages. This is not necessarily reversing received wisdom: empirical research has found that the relationship between ownership advantages and outward FDI is often weak (see, for instance, Belderbos and Sleuwaegen, 1996). One may also argue that the rationale for vertical FDI is similar to that of vertical integration: securing stable supply, avoiding coordination problems and reducing transaction costs – this does not need ownership advantages in the form of proprietary assets.

Kumar (2008) has argued that the term ownership advantage should be enlarged to include the specific capabilities of developing country firms. Some firms from India and China have acquired a niche in 'frugal engineering' – the ability to manufacture low cost versions of goods for mass markets. Some Indian firms may have developed skills in managing multi-plant operations across regions that are heterogeneous in their ethnic,

linguistic and cultural makeup. It could even be that forms of corporate governance forged to cope with restrictive regulatory regimes in domestic economies may have endowed Indian and Chinese firms with a resilience that proves a comparative advantage in alien markets with weak legal institutions and insecure property rights.^{7,8}

What, then, are the proximate reasons for firms from China and India to venture abroad, and what factors have enabled them to do so with any degree of success? One important fact is to gain access or proximity to overseas markets. In a major survey of transnational corporations from developing countries carried out by UNCTAD, a majority of firms from China and India reported seeking overseas markets a major motivation for investing abroad. While Chinese manufacturing firms can gain access to international markets through exports, in some cases overseas investments are a means of improving access to markets or pre-emptively securing access against potential protectionist barriers. Similarly, Indian IT firms report proximity to potential clients as an important reason for investing abroad.

A second motivation for firms to invest abroad is to secure access to resources, especially natural resources and raw materials. As security of access to essential raw materials is considered important for economic growth, state-owned enterprises have been at the forefront of acquiring ownership stakes in overseas mining and energy sectors. China National Petrol Corporation and China National Offshore Oil Corporation are typical firms in this category, but also India's Oil and Natural Gas Commission has made substantial forays abroad.

Some investments are technology-seeking in intent. Of course, the use of foreign investment as a technology-acquisition strategy is not peculiar to China and India: Korean firms such as Samsung and Hyundai combined foreign investment with international technology licensing to build their technological capabilities.⁹ However, the

⁷ Morck *et al* (2008) point out that when the Canadian-owned PetroKazakhstan exited from Kazakhstan due to its inability to enforce its contractual dues, China National Petroleum Corporation acquired its assets and subsequently was far more successful in enforcement.

⁸ In fact, more contemporary forms of the OLI theory recognize that investment may be motivated by the search for strategic assets in the form of technology, market access, and even the desire to access a particular institutional context: see Dunning and Lundan (2008) for an elaboration of the argument, and Dunning and Lundan (2009) for an attempt to study Lenovo-IBM as an example of such an institutional hybrid.

⁹ See Lee and Slater (2007) and Matthews (2006) for an elaboration of this point.

stronger IPR regimes that have emerged in recent years could have created a bias towards technology-seeking overseas acquisitions rather than arms-length technology acquisitions. In part this is so because ownership of technology assets allows more experimentation. Technology is an important element in the internationalization of Indian pharmaceutical and software companies. In many cases this is complemented with the desire to acquire brands and distribution networks, which can better appropriate returns to technology investments: Lenovo's acquisition of IBM assets and Haier's investments in the US provide examples. Notably, some Chinese firms have tried to use their toeholds in overseas markets to develop their own brand identity. In some sectors, such as Indian firms' investments in steel, overseas acquisitions may enable firms to exploit economies of scale and scope. In that sense, some overseas investment may be efficiency seeking.

Some explanations of increased internationalization fall outside the above categories. For some firms the rush to go overseas is fuelled by the desire to steal a march over domestic rivals: there appears to be a strong competitive element in overseas acquisition strategies of Indian business houses.¹⁰ In other cases, outward FDI is seen as a part of a 'national strategy', but this is probably exaggerated and captures the anxiety of some in recipient economies.

Somewhat distinct from the motivations that lead firms to venture abroad, there is the question of the business strategies that internationalizing firms adopt. The choice of 'how to internationalize' is likely to depend on the modes of internationalisation available (often directly determined by policy restrictions on forms of outward and inward FDI) and the competitive environment the firm faces in the global market. In addition, Ramamurti and Singh (2009) argue that the stage of internationalisation may also matter, pointing out that the existing literature in international business strategy has very little to say about the early internationalisation strategies of firms.

3. Studying the Internationalization of Chinese and Indian Firms

Some recent research offers insights into the pattern of internationalization of firms from China and India, and the strategies adopted by these firms on their path to internationalization.

¹⁰ An early version of this argument was made by Stephen Hymer.

Fortanier and van Tulder (2008) compare the pattern of international expansion of large firms from China and India with those from developed countries. They examine the level, pace, variability, and temporal concentration of internationalization activity of 256 large firms over the period 1990 to 2004. They find that Chinese and Indian firms in their sample have internationalised more rapidly and more recently so have a more volatile trajectory of internationalization relative to developed country firms. Significantly, they also conclude that Chinese and Indian firms are not as internationalized as sometimes thought: much of their capital assets and sales remains located in their domestic economies. They find that the sectoral distribution of internationalization activity for the two categories – developed country firms vs firms from China and India – shows limited overlap. Some sectors, such as food & beverages and retail distribution are largely the preserve of developed country multinationals. Others such as steel, materials, shipping and construction have seen a surge of internationalization activity by Chinese and Indian firms. Both developed and developing country multinationals are active in sectors such as chemicals and pharmaceuticals, oil and petroleum, and telecommunications.

Kumar and Chadha (2008) examine the recent evolution of steel industry in China and India. Unlike many developed countries where stagnant or declining demand for steel has forced the exit of many manufacturing firms, the demand for steel is buoyant in China and India. Large scale investment in steel manufacturing was a common feature of early industrialization in both countries allowing firms to develop the necessary expertise. A more liberal regime towards outward FDI has allowed Chinese and Indian firms to venture overseas, both in the form of greenfield investments and acquisitions. However they find crucial differences in the underlying motivation across the two countries: Chinese outward FDI aims predominantly to secure access to raw materials for expanding domestic steel production, with very few international production operations. In contrast, Indian steel firms have ventured abroad to seek markets and strategic assets, both to exploit economies of scale and economies of scope across steel-dependent manufacturing sectors such as automobiles. In the Chinese case, state-owned enterprises have been most active abroad, while in India private sector firms have led the drive to internationalization (the Indian public sector steel monolith, SAIL, has been noticeably inward-looking).

Niosi and Tschang (2008) compares the trajectories adopted by Chinese and Indian firms in the software industry. They conclude that the internationalization process differs for Chinese and Indian MNEs, but these are related to the different sub-sectors they have chosen to operate in. Chinese software firms have focused on their domestic market by working with foreign MNCs and focusing on regional markets in Japan Taiwan and Korea, while Indian firms continue to expand overseas using a customised-services model shaped by the US market. In both cases greenfield investments have been the dominant form of investment, although acquisitions have increased in importance for Indian firms in recent years. Both Chinese and Indian firms have found it easier to grow and internationalise in small niches that lack competition from US and European firms-outsourcing services and the use of the kanji font. In cases where competition has been more head-on – e.g. software products for the finance sector -- the success of Indian and Chinese firms has been less assured.

Athreye and Godley (2008) compare strategies adopted by firms at the early stages of their internationalization. They demonstrate that there are many similarities in the leapfrogging strategies adopted by US pharmaceutical firms in the 1930s, at the cusp of the antibiotics revolution, with the current strategies adopted by Indian pharmaceutical firms. Both groups used internationalisation as a strategy to gain a technological edge and to acquire firm-specific advantages but the paper emphasizes the significant role played by international acquisitions in the Indian case. They speculate that this difference might be explained by the larger technological gap faced by Indian firms and the climate of stronger intellectual property protection which is likely to favour acquisitions. Their paper also suggests that sector specificities and the economic environment can explain internationalization strategies when the stage of development is controlled for.

The three sector studies thus offer contrasting ideas about the motivation and modus operandi of internationalisation. Some Indian pharmaceutical firms might be motivated to emulate the technological leapfrogging achieved by US pharmaceutical producers in the past, but while US firms relied on international alliances Indian firms have depended on joint ventures and acquisitions. In the steel sector where scale economies are crucial to international competitiveness India and China appear to be gaining market shares through acquisitions but their motivations differ. In the software sector, Indian and Chinese firms diverge in both motivation and strategy.

Duysters, Jacob, Lemmens and Jintian (2008) look at two of the large internationalising conglomerates, the Haier group from China and the Tata group from India. Conglomeration is natural in the corporate evolution of many developing countries, although China and India have different histories in this regard.¹¹ Many Indian business houses have had a long history of corporate evolution whilst Chinese groups are relatively young and their rapid growth in recent years is partly due to active state support. They point out that Haier has used a ‘walking on two legs strategy’ – on one hand replicating in overseas markets the innovations developed to cater for the needs of large domestic market and at the same time acquiring related technological expertise internationally in order to grow from a single-product to a multi-product company. On the other hand they draw on work by Goldstein (2008) on the Tata group to show that Tatas have used internationalization to become more specialised in their operations and to increase value from a few chosen lines of business. Although the industry sectors that comprise the group firms are different, the paper shows that in both countries the groups have used globalization to exploit economies of scale and scope.

4. Policy Implications

These analyses pose a natural question: what is the economic impact of such emerging internationalization for China and India, and for the advanced economies that have served as hosts to investment flows. Relatedly, we could ask, what policy implications arise from our assessment of the likely impact?

Among potential recipients of foreign direct investments from China and India, many developed economies have long espoused openness to inflows. Greenfield investment by foreign firms has been seen by many governments (especially in the UK and the EU) as a valuable channel for expanded investment and employment generation. Further, inward foreign investment may improve domestic productivity through spillovers of technology, through the demonstration effect of better management practices, and also because competition from MNEs provides stimulus for efficiency improvements in domestic firms.

¹¹ Khanna and Yishay (2007) argue that this is on account of institutional voids and missing markets.

However, many Indian and Chinese multinationals have entered international markets through acquisitions of existing assets rather than greenfield investment. This is, of course, consistent with the observation that Chinese and Indian firms have fewer ownership advantages. However, a study by Mata and Portugal (2000) of the closure and divestment of 1000 foreign-owned firms that started operating in Portugal during the period 1983-1989 shows that the mode of entry – greenfield vs. acquisition – affects the longevity of the investment. They argue that greenfield investments are more asset-specific and dependent on the ownership advantages, and likely to be more durable. In contrast, acquisitions often involve the purchase of a complementary but non-specific asset. The non-specific nature of the acquired asset results in a lower exit threshold – say, if international expansion plans falter or if there is a strategic re-orientation within the acquiring firm – and also is easier to sell to someone else. If so, it would be rational to find a policy preference for greenfield investment over acquisitions as the mode of entry.

Public reaction to these acquisitions – and the political economy behind these reactions – is mixed. In many cases, acquisitions have been of failing firms. Bertoni *et al* (2008) find, for instance, that Chinese acquisitions in Europe are more likely to be of poorly performing firms. Recent notable acquisitions by India's Tata group include those of Corus and Jaguar, both firms in different degrees of financial distress. In all such cases, it is likely that the post-acquisition rationalization of these firms will result in labour retrenchment rather than employment generation. To the extent these were firms in distress, some retrenchment would have happened regardless of foreign takeover, but whether overseas firms are seen to be 'saviours' or 'asset-strippers' depends on careful enunciation of corporate strategy. Tata, with a credible record of successful labour relations are well placed to cope with this, but may yet need to tread carefully.

The potential of productivity-enhancing spillovers from the operation of Chinese and Indian firms requires a more cautious assessment. As Driffield *et al* (2008) point out, the potential for technological spillovers is low when FDI inflows are technology-seeking rather than technology-exploiting. Nonetheless, the entry of foreign firms could well increase the degree of competition in the industry, with potential gain in productivity.

Public perceptions of Chinese and Indian MNCs are inevitably tied up with reactions to the recent growth of these countries. While most people consider China's success in low-cost manufacturing for global consumers to be a positive development, the

inevitable rise of China and India as significant economic players causes consternation by challenging the established order of industrial hegemony. Consider, the growing unease with the entry of large sovereign wealth funds, and the concerns that these are largely instruments of an overbearing Chinese state. Of course, the dominance of state-owned enterprises in Chinese internationalization may be structural: unlike Indian business houses, a poorly developed domestic capital market might imply that state sponsorship is critical for Chinese firms' overseas ventures. But at the same time it creates the perception that these firms are beneficiaries of 'unfair state aid', and argument that resonates with old debates about strategic trade policy.

The implications of internationalization for the home economies, that is, for China and India, are also subject to debate. One view expresses concern that outward FDI can deprive developing countries of scarce capital, including human capital in the form of managerial resources. This is reminiscent of early concerns about brain-drain, but a more balanced position has come to understand that what starts as brain drain can become a part of two-way 'brain circulation', and in any case, even if these flows are perverse, it is hard to control them in an increasing globalizing world. An alternatively view sees the emerging internationalization as the 'coming of age' for Chinese and Indian corporate sector and a measure of their ability to compete globally on equal terms. However, this more celebratory approach carries risks too: when competitive foreign acquisitions become an end in itself, they carry the risk of irrational excess. It is conceivable that many of the acquisitions currently being celebrated as badges of success will result in corporate failure, especially as the world struggles with a financial crisis that is likely to persist. Nonetheless, analysing the internationalization of Chinese and Indian firms should provide rich rewards for research, and till the process is better understood, it would be sensible to call for a relatively neutral policy towards their internationalization.

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