CHAPTER 1

MULTINATIONAL MANAGEMENT IN A CHANGING WORLD

Learning Objectives

- ♦ Define multinational management
- ♦ Understand the characteristics of a multinational company
- ♦ Understand the nature of the global economy and the key forces that drive globalization
- ♦ Know the basic classification of the world's economies
- ♦ Identify the characteristics of the next generation of multinational managers

Introduction

- ♦ The global business environment is facing unprecedented changes
    - o New multinationals from emerging markets in Brazil, Russia, India, and China (BRIC) are using innovative strategies to compete effectively with their established counterparts in developed countries
    - o The nations of Colombia, Indonesia, Mexico, Poland, and Malaysia all present attractive conditions for growth. Widespread internet use and high population levels represent ideal conditions for investment
    - o In Africa, an emerging middle class, relatively young populations, significant regulatory changes, and the growth of cross-border trade are making many nations increasingly attractive to investors
- ♦ Businesses of all sizes increasingly see the entire world as a source of business opportunities
    - ● The world is becoming one connected economy
    - ● Any company from any country can become a competitor
    - ● The internet crosses national boundaries
    - ● A company's success in their home market doesn't always equate to long-term profitability
- ♦ There are significant opportunities for most companies despite challenges and threats such as terrorism, wars, and recessions.
- ♦ Managers of the next century will need to be multinational in outlook and strategies
    - ● Students of business should have at least a basic background in multinational management
- ♦ Multinational management – the formulation of strategies and the design of management systems that successfully take advantage of international opportunities and that respond to international threats
    - ●

The Nature of the Multinational Company

- ♦ Multinational company (MNC) is broadly defined as any company that engages in business functions beyond its domestic borders
- ♦ Most multinational companies are also multinational corporations; that is, publicly owned through stocks
- ♦ What kinds of activities might make a company multinational?

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- The most apparent activity is international sales
- Crossing national borders opens up more international options than simply selling internationally

Exhibit 1.1 Largest Companies in the World
(Lists the top 20 multinational corporations ranked by sales revenue)

Exhibit 1.2 Newcomers to Global 500 List
(Shows the list of newcomers and their country of origin)

The Globalizing Economy: A Changing (but Not Always Stable) Environment for Business

- Globalization – the worldwide trend of cross-economic integration that allows businesses to expand beyond their domestic boundaries.
    - Trade barriers are falling
    - World trade among countries in goods and services has grown faster than domestic productions
    - Money is flowing more freely across national borders
- Downsides of Globalization
    - Not a uniform evolutionary process, and not all economies benefiting or participating equally
    - Terrorism, wars, and a worldwide economic stagnation limit or reverse progress
    - Worrisome effects such as scarcity of natural resources, environmental pollution, negative social impacts, and increased interdependence of the world's economies
    - Widening of gap between rich and poor countries
- The Benefits of Globalization
    - Lower prices in many countries as multinationals become more efficient
    - Benefiting many emerging markets such as India and China as these countries enjoy greater availability of jobs and better access to technology
    - The major reason why many new companies from Mexico, Brazil, China, India, and South Korea are the new dominant global competitors
- Several key trends driving globalization of the world economy and driving businesses to become more multinational to survive and prosper
    - Falling borders
    - Growing cross-border trade and investment
    - Rise of global products and global customers
    - Growing use of Internet and sophisticated information technology
    - Privatization of formerly government-owned companies
    - New competitors emerging in the world market
    - Rise of global standards in quality and production

Countries of the World: The Arrived and the Arriving

Exhibit 1.3 Selected Economies of the World
(Shows some divisions of the world economies based roughly on classifications used by the United Nations and The Economist*)*

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- ♦ Developed countries – countries with mature economies, high GDPs, and high levels of trade and investment
- ♦ Developing countries – countries with economies that have grown extensively in the past two decades (i.e. Hong Kong, Singapore, and Taiwan)
- ♦ Transition economies – countries in the process of changing from government-controlled economic systems to capitalistic (i.e., Central & Eastern Europe – Czech Republic, Hungary, Poland, and Russia)
- ♦ Emerging markets – countries that are currently between developed and developing countries and are rapidly growing (i.e. India, China, Brazil, and Russia)
  - The term *emerging markets*, coined by the World Bank around 25 years ago, represents those markets that present tremendous opportunities for all multinationals
  - Emerging markets now account for 30 percent of exports, compared to only 20 percent in 1970
  - Recent trends also show that developed countries' trade with emerging markets has been growing twice as much compared to trade with each other[7]
  - While emerging markets such as Brazil, Russia, India, and China (BRIC) are now experiencing a significant slowdown in growth, they are still expected to grow at a much faster pace than developed economies
  - The slowdown of growth in the BRIC nations has focused attention on upcoming nations, such as Colombia, Indonesia, Kenya, and Malaysia[10]

Exhibit 1.4 Age Breakdown of Selected Economies
(Shows the age breakdown of the population of these nations)

Exhibit 1.5 The Globalizing Economy
(Illustrates the driving forces of the new world economy)

Disintegrating Borders: The World Trade Organization and Free Trade Areas

- ♦ General Agreement on Tariffs and Trade (GATT) – tariff negotiations among several nations that reduced the average worldwide tariff on manufactured goods
  - Beginning in 1947, negotiations began which ultimately reduced average tariffs on manufactured goods from 45% to less than 7%
- ♦ World Trade Organization (WTO) – a formal structure for continued negotiations to reduce trade barriers and a mechanism for settling trade disputes
  - Continued negotiations in Uruguay from 1986 – 1993 established the WTO
  - There are over 150 nations now in the WTO, including 29 of the UN-classified least developed countries. Thirty more countries, including Russia, seek WTO membership
- ♦ In March 1997, trade ministers from countries representing 92% of world trade in IT products agreed to end tariffs on trade in software, computer chips, telecommunications equipment, and computers
  - The immediate result was that, with tariffs eliminated, high-tech exports to Europe from Asia and the United States doubled
  - Developing countries also benefited, as prices began to go down on products such as phones, faxes, and computers produced in tariff-free locations[13]
- ♦ The Doha Round represents the most significant trade negotiations since the WTO was established

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- The trade talks of December 2013 resulted in the 'Bali Package,' leading to trade facilitation via simplified customs procedures and duty-free, quota-free access for least developed nations to export to wealthier nations
- Is free trade working?
  - The WTO thinks so – data shows that world trade has grown at more than four times the world's gross domestic product
  - Critics argue that the WTO favors more developed nations because poorer nations have more difficulty competing in an unregulated environment
  - Environmentalists argue that commercial interests have priority over environment, health, and safety
  - Labor unions warn of migration of jobs to lower-wage countries
- <u>Regional trade agreements</u> – agreements among nations in a particular region to reduce tariffs and develop similar technical and economic standards (also called *free trade areas*)
  - Such agreements have usually led to more trade among the member nations but are criticized for harming poorer nations who are left out of agreements
- The three largest groups – EU, NAFTA, and APEC – account for nearly half of the world's trade
  - <u>European Union (EU)</u> – includes 28 members, namely Austria, Belgium, Britain, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, and Sweden.
  - Since 1992, the EU countries allow goods and services to move across borders without customs duties and quotas
  - EU adopted a unified currency called the Euro
  - <u>North American Free Trade Agreement (NAFTA)</u> – a multilateral treaty that links the United States, Canada, and Mexico in an economic bloc that allows freer exchange of goods and services
  - The Free Trade Area of Americas (FTAA) will expand NAFTA to include most of the other Caribbean, Central American, and South American nations
  - <u>Asia-Pacific-Economic Cooperation (APEC)</u> – a confederation of 21 nations with less specific agreements on trade facilitation in the Pacific region. However, the ultimate goal calls for total free trade in the Pacific Region by 2020.

Exhibit 1.6 Regional Trade Agreements Around the World
(Shows all the major regional trade agreements and their member countries)

Sell Anywhere, Locate Anywhere: Trade and Foreign Investment are Growing but Setbacks Are Part of the Challenge

- World trade among countries (imports and exports) grew at an average rate of 6.5% per year between 1990 and 2000, but slowed to 4% by 2004, and grew again to 6 percent in 2005
- World trade grew by 8.5 percent in 2006
- The latest available figures suggest that trade subsequently slowed down due to the economic recession, remaining sluggish in 2013, and will likely to continue to be lethargic in 2014
- The latest report from the WTO suggests the following trends:
  - Emerging markets continue to show dramatic trade growth, thereby reducing income inequality between countries and increasing general well-being factors in these countries
  - Developing nations have played a more important role in international production networks known as Global Value Chains (GVC)

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- Commodities such as energy and minerals have doubled between 2003 and 2008, and countries are finding they can develop growth strategies based on commodities
- Macroeconomic shocks seem to affect all countries

♦ Foreign Direct Investment (FDI) – multinational firm's ownership, in part or in whole, of an operation in another country
- FDI, or cross-border ownership, occurs because multinational companies build global networks that link R&D, supply, production, and sales units around the globe
- FDI soared between 1996 and 2000 but had been declining, in part due to the declining rate of mergers and acquisitions
- Despite these declines, the importance of emerging markets is reflected in the growth of FDI in these economies
- After further declines in 2003, FDI then grew to its highest level in 2007; since 2007, FDI has seen both growth and declines[25]
- The latest data suggests that global FDI flows increased significantly the last two quarters of 2014 by 9% relative to the first half of that year

♦ Developing countries provide great opportunities, but pose significant risk
♦ Two types of risk
- Political risk – anything a government might do (or not do) that might adversely affect a company
- Economic risk – all factors of a nation's economic climate that may affect a foreign investor

The Internet and Information Technology Are Making It All Easier

♦ Companies and individuals can shop and sell anywhere because anyone in the world can access any Web site.
♦ Electronic communication vehicles allow communication around the world, and information technology expands the global reach of an organization
♦ Organizations are becoming virtual – linked by networks of computers
♦ Information technology is also spurring a borderless financial market
♦ Information technologies make available many new tools that facilitate business operations
- Developments in computing technology will eventually enable the manufacturing sector to move to highly automated machine tools, operated by computer

- The development of the 3D printer will allow prototypes to be printed easily and cheaply, allowing engineers, stylists, and even customers to collaborate with minimal costs

The Rise of Global Products and Global Customers

♦ Needs of customers for many products and services are growing more similar
♦ Global customers search the world for their supplies paying attention to price and quality without regard for national boundaries

New Competitors are Emerging

♦ Current trends suggest that two new forms of competitors are having dramatic influences on global business:
- Powerful emerging market competitors using new techniques and strategies to compete successfully in their local markets

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- Formidable state competitors—companies that are often well run but can also rely on the state for financial support; some state multinationals have also invested aggressively in other countries and have been active in industries beyond oil and energy

The Rise of Global Standards

- Increasingly, especially in technical industries, global product standards are common
- Why? Cheaper to produce fewer product versions, gains in product design efficiencies
- The company that can establish its standard as dominant will have a tremendous strategic advantage
- Consistency in quality has also become a requirement to do business in many countries
- <u>ISO 9001:2000</u> – the current name for the technical and quality standards of the International Organization for Standardization (ISO) in Geneva, Switzerland
- <u>ISO 14000</u> – the current name for the environmental protection standards of the International Organization for Standardization
- In 1992, ISO compliance became part of product-safety laws in many European countries

Corporate Social Responsibility and Business Ethics

- Multinationals are under increased scrutiny by both the media and the public to be socially responsible.
- Companies that do not pay attention to issues such as climate change, environmental degradation and pollution, sweatshop conditions, and bribery can suffer significant loss in terms of both reputation and finance.
- Ethics rankings, such as the annual survey of the world's most ethical corporations as produced by Geneva-based Covalence, are important to multinationals

Exhibit 1.7 Ethisphere's Most Ethical Companies (by Industry and Nationality)
(Shows the list of the top most ethical companies as determined by the Ethisphere Institute)

The Next Generation of Multinational Managers

- The next generation of successful multinational managers must have the following characteristics:
  - <u>*Global mindset*</u> – mindset that requires managers to think globally, but act locally
  - *Emotional intelligence* – the ability to manage one's emotions prepares the manager to better adjust to and deal with new cultures and people
  - *A long-range perspective* – successful companies must be persistent if they are to overcome the complexities of dealing with the international environment
  - *The talent to motivate all employees to achieve excellence* – always a hallmark of leadership, they will also need to develop motivational strategies that transcend cultures
  - *Accomplished negotiating skills* – leaders in the global economy will spend considerable time negotiating cross-culturally
  - *The willingness to seek overseas assignments* – they will demonstrate management skills and success in more than one cultural environment
  - *An understanding of national cultures* – multinational managers will often need to learn two or more additional languages as well as the nuances of local cultural differences
  - *Three forms of capital*:

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- *Intellectual capital* — the general willingness to learn and build one's knowledge base regarding cultural differences and how to adapt to such differences
- *Psychological capital* — the ability to be receptive to new ideas and experiences
- *Social capital* — the ability to develop networks of individuals who are different from one's self

Exhibit 1.8 Forms of Capital Needed to be a Successful International Leader
(Shows some ways to build the intellectual, psychological, and social capital needed to succeed as an international leader)

Multinational Management: A Strategic Approach

- ♦ Why should you study multinational management? Foreign competition and doing business in foreign markets are daily facts of life for today's managers.
- ♦ Multinational managers must take a strategic approach to multinational management, namely how they formulate and implement these strategies
  - Strategy – the maneuvers or activities that managers use to sustain and increase organizational performance
  - Strategy formulation – process by which managers select the strategies to be used by their company
  - Strategy implementation – all the activities that managers and an organization must perform to achieve strategic objectives
- ♦ Strategies must include maneuvers that consider multiple countries and cultures, as well as opportunities and competition located anywhere in the world
- ♦ Several trends will shape the future business environment
  - *Blurring of industry boundaries* – information and other communications technologies make industry boundaries less clear, and harder to identify and understand competitors
  - *Flexibility matters more than size* – increased outsourcing, alliances, and partnering allow conversion of fixed costs to variable costs, making scale less useful
  - *Finding your niche* – companies are finding they can do well by finding and satisfying the needs in a niche, as opposed to being the leader in their respective industries
  - *Hypercompetition* – the new environment is characterized by intense competition coming from companies located in all parts of the world
  - *Emphasis on innovation and the learning organization* – multinationals will need to develop the appropriate mechanisms and systems to integrate the local knowledge to produce value for the company
- ♦ Multinationals will need new strategies to compete with emerging market multinationals and will need to avoid the following traps:
  - ♦ Ignoring the low- and middle-market segments
  - ♦ Failing to fully commit when entering emerging markets
- ♦ A fundamental assumption of this book is that successful multinational management requires managers to understand their potential competitors and collaborators
- ♦ This text devotes several chapters to comparative management – the comparison of management practices used by people from different nations

Exhibit 1-9 Differences Betwdeen Emerging Market Multinationals and Traditional Multinationals
(Shows how each type of multinational addresses various aspects of success in markets)

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Summary and Conclusions

- This chapter covered the following items:
  - Key background information that supports the study of multinational management
  - Definitions of multinational management and the multinational company
  - Forces that drive globalization
  - Key characteristics of successful multinational managers
- Global mindset is perhaps the most encompassing characteristic of successful multinational managers.
- After reading this text, you should have the foundation for understanding the latest challenges and practices of multinational management.

Answers to In the News Questions From MindTap

Chapter 01: You're Still Welcome: Foreign Firms in China

1. This case discusses the case of India and the potential impact of the new government's reforms on the future of India. The case discusses some of the factors that have prevented India from growing faster while also emphasizing the need for reforms. Answer the following questions:

Why have foreign firms have a difficult time in China? What are some of the major factors that make doing business in China difficult?

Suggested Answer: Answers will vary. Growth in China is officially slowing down. Data states that the growth rate is the slowest in 24 years in China. China has led an anti-corruption drive that has made it difficult for anyone seeking government employees willing to look the other way. Pharmaceuticals and other firms that had hoped their "guanxi" or connections offered them protection from competition but that has not been the case. China has, in the past, set up a system of restrictive and complex rules highlighting how multinationals can invest there. Under some of these rules, foreign companies investing in industries deemed "strategic" for the government can only invest using a joint venture and must transfer the technology involved to the local partner. This makes it difficult for foreign firms to do business in China.

2. What are some of the proposed reforms? How will these reforms make it easier for foreign firms to do better?

Suggested Answer: Answers will vary. The proposed reforms promised the global business elite that China would treat Chinese and foreign companies as equals and reject protectionism by easing its restrictions on foreign investment. The draft reforms, which are now open for comment, would include scrapping most of these restrictions. Additionally, foreign firms would be treated the same way as the national ones rather than the current system of case-by-case approvals. This will be replaced by a simpler "negative" list, which will help investors know which particular industries are viable to invest in or not.

3. Why would local firms still have an advantage despite these reforms? What does that tell you about doing business in other countries?

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Suggested Answer: Answers will vary. The proposed reforms, while indicating that foreign investment will still be welcome in China, there is very little that they can do to help multinationals compete with well-connected domestic companies. This is due to the subsidies favoring Chinese companies and restrictions on foreign ownership of sectors such as Internet providers and finance. This shows us that other countries are happy to accept capital but are protective of nationally important areas of business.

Chapter 01: Feeling Green: The Mighty Dollar

1. This article discusses the rise of the dollar and the problematic impact it places on many countries. Discuss the following questions:

Why is the dollar's rise so problematic for many countries?

Suggested Answer: Answers will vary. Globally, the dollar has a huge impact on the economies of many countries. Most of this impact comes from borrowings by companies outside the United States of America. The dollar rate should increase in value due to an increased growth rate in the US. When the Federal reserve raises its rate on debts, which is expected, the debts associated with the dollar will increase in value, making it more problematic for companies outside the US to pay back their debts.

2. What role do currencies play in terms of global trade?

Suggested Answer: Answers will vary. Globally, currencies have different values, which allow capital to flow from country to country. Stronger currencies are used more often in international trade. Most of the international trade takes places in dollars, with the biggest growth being in emerging markets.

Chapter 01: A Chance to Fly: India's Economy

1. This case discusses the case of India and the potential impact of the new government's reforms on the future of India. The case discusses some of the factors that have prevented India from growing faster while also emphasizing the need for reforms. Answer the following questions:

What are some of the factors that show that India has lots of promise to shine among the emerging market economies?

Suggested Answer: Answers will vary. Nearly half of India's 1.25 billion population is under 25, poor, and possess an entrepreneurial spirit. Prime Minister Narendra Modi and the Bharatiya Janata Party won the recent elections on the back of a promise of an economic revitalization. They promised reforms across the board making India more financially stable and less corrupt. In addition to this, the International Monetary Fund (IMF) has been showing a progressive increase in India's growth rate. These are some of the factors that shows India's promise among the emerging market economies.

2. What are some of the factors that are preventing India from achieving its full potential? Why was China able to achieve such economic growth more easily than India?

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Suggested Answer: Answers will vary. India has to encourage reforms in nearly every sector of its governance if it aims to achieve its full potential. China's rise to global economic heights was due to manufacturing for exports. India, while not able to follow in China's footsteps, can achieve this growth by balancing its surplus of unskilled labor by focusing on educating them and providing labor for service sectors like information technology. There is also the question of providing widespread political reform and a strong anti-corruption stance to weed out the harmful aspects that slow down India's economic growth.

3. What are some of the tough reforms that India has to go through in order to succeed?

Suggested Answer: Answers will vary. There a lot of reforms that India needs in order to succeed. One of these is a reform on how electricity and electricity generation need to be improved to meet larger demands. A lack of power hurts India's economic potential. The majority of state and national laws in India are nebulous when it comes to taxes, labor, and licensing. A unifying law for the entire country would be able to encourage more trade and growth. A lot of archaic and arcane laws that are outdated need to reviewed, changed, or removed. Lastly, the purchase of land is a complex situation and needs to be free of political influence before it can be legally streamlined.

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CHAPTER CASE

Foreign Direct Investment in the Middle East: Riyadh and Dubai

F. JOHN MATHIS, TIM ROGMANS, RAJA ALMARZOQI ALBQAMI

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Introduction

"Follow the money" and it will lead you to business opportunities. Several times during the past decade, oil prices have reached record highs, pouring petro-dollars into the Middle East, and now—May 2011—is one of those times. Thus, we visited the Middle East, particularly Riyadh, Saudi Arabia, and Dubai, United Arab Emirates, to research a sample of the foreign companies that have invested there, examine why they have done so, and determine what their business model is. Our specific focus was primarily on the financial service sector, and secondarily on other selected foreign investments in the service sector. The resulting survey data are aggregated to protect the companies interviewed, which included (alphabetically) for financial services: Barclays (UK), Credit Suisse (Swiss), Robeco (Dutch), and for other services: FedEx (U.S.), Hay Group (U.S.), Yum Brands (U.S.), and Maersk (Denmark). The research identified what changes these companies considered important to improve their operations and performance now that they have been functioning in the region for some time.

We examined the key drivers of foreign direct investment in the region. Our research had three objectives:

- To show how laws, requirements, and regulations have changed and become more receptive to foreign investment in recent years by comparing several business environmental characteristic indices and their change over time.
- To examine the exchange arrangements and framework for financial and capital transactions in the countries.
- To determine the experiences of several companies in the financial services and other sectors that invested in the region by looking at the key drivers of foreign direct investment from the company's perspective.

Financial and Political Context

Political and economic conditions tend to be quite volatile in the Middle East, as evidenced by the 2007-2009 global financial crisis and a severe worldwide recession accompanied by falling oil prices, followed by rising but volatile oil prices in 2010-2011. More recently (at the time of writing this case, mid-2011), political unrest occurred in North Africa and throughout much of the Middle East, including Iraq, Iran, Bahrain, Yemen, and Syria. The global financial crisis of 2007-2009 caused several changes to be made in macroeconomic policy management in Saudi Arabia and the UAE in order to reduce the impact of the global crisis on the local economy.

The United Arab Emirates and Saudi Arabia stimulated their economies with monetary and fiscal policy, but because Saudi Arabia is less integrated with global financial markets than the UAE, their approaches differed. Saudi Arabia made concerted attempts to attract FDI for natural gas investment and the petrochemical

industry. This effort in Saudi Arabia reflected an attempt to reduce dependency on export of oil to increased domestic demand-led growth, stimulated by expansive economic policy and an attempt to attract investment inflows. In contrast, in the UAE, when Dubai's real estate bubble burst in 2009, initially causing capital flight, the government quickly made successful fiscal moves to ensure financial stability.

Additionally, a major structural change impacting the Middle East has been the globalization of financial flows. As financial markets worldwide liberalized, developments in information technology and telecommunications accelerated the size and volatility of global money flows. As a result, there has been an increase in the competition for funds (both portfolio investment and FDI) between countries. Open financial markets attract foreign capital inflows, and Asia and Latin America have been recent benefactors. These inflows can bring benefits in the form of technology and knowledge transfer. But there can sometimes also be an economic cost—inflation and the potential for financial crisis. Thus, the significant change in the global financial environment has affected the Middle East region.

Changing Significance and Structure of Global Capital Flows

A recent study of the impact of global capital flows in causing a financial crisis provided the following three-step analytical framework:[1]

- Identify the determinants of the size of the shock,
- Identify the nature and quality of the cushion or, alternatively, the factors affecting the absorption of the impact, and
- Evaluate the response to the impact.

Regarding the possible channels for the impact, the degree of economic globalization needs to be considered. This is based on financial and investment-related links and the level of cross-border capital flows, both foreign direct investment and portfolio flows, into financial instruments. It is also a function of trade-related links. Finally, consumer confidence-related links such as the strength or weakness of the currency are also important. Regarding the nature and quality of the shock safety net, countries with sound monetary and fiscal policies and more diversified economies tend to be insulated from impact. The degree of a state's control on its economy is also important in absorbing the impact of financial inflows. In responding to the global financial crisis, policies that work best include a shift from export-led to a domestic demand-led growth and a diversion of economic links.

The degree of the macro-financial linkages and the impact of the global financial crisis on Saudi Arabia might have at first been thought to be small because of its lower degree of economic integration. Economic activity in Saudi Arabia is more tightly controlled by the government than is Dubai, for example (see below), although the private sector is now developing rapidly. However, Saudi Arabia is very dependent on the oil sector, which accounts for roughly 86% of budget revenues, 46% of GDP, and 90+% of export earnings as of 2010. Therefore, in some respects, Saudi Arabia could be considered to be more globally vulnerable than the economy of the United Arab Emirates.

Although the United Arab Emirates is more open to various activities, it may be only indirectly impacted by external financial events and more dependent on local financial events. Thus, in Dubai in 2009, there was a local real estate and foreign investment crisis that resulted in a significant outflow of funds and a subsequent $10 billion rescue loan from Abu Dhabi. Overall, real GDP growth was slightly higher in the UAE compared to Saudi Arabia during the period 2007 to 2010.

In an article by Dell'Ariccia et al. (2008),[2] the mechanisms for transmission of financial globalization are identified as:

- Well-developed domestic financial markets which can moderate boom/bust cycles triggered by sudden stops in financial flows by efficiently allocating foreign financial flows to competing investment projects,
- Stronger financial institutions shift the composition of financial flows toward FDI and portfolio equity, thereby enhancing growth and macroeconomic stability, and the stronger the institutions, the greater the economic growth benefits from financial integration,
- Lack of sound macroeconomic policies in international financial integration may lead to excessive borrowing, debt accumulation, and possibly crisis, and
- Trade openness and integration facilitate recoveries from financial crisis and mitigate adverse growth effects.

These factors would tend to support greater FDI flows to Dubai, which has more advanced and more sophisticated financial services sector than Saudi Arabia. "Recent empirical research supports the view that financial sector development amplifies the growth benefits associated with FDI flows, with some authors

finding that a threshold level of financial sector development is necessary for a country to realize any growth benefits from FDI."[3] See also Hermes and Lensink (2003), Alfaro et al. (2004), and Durham (2004). Furthermore, financial development (deepening of robust financial markets) has a positive impact on macroeconomic stability, which tends to be attractive to further capital inflows.[4] Better-developed financial institutions help reduce volatility from external capital inflows. The share of FDI in a country's capital inflows is negatively associated with the probability of a currency crisis. But more rigid or fixed exchange rate regimes can be more vulnerable to crisis. So countries like Saudi Arabia and UAE, which both have fixed exchange rates, will—if they have more open financial flows—feel greater pressure on other policies and structural features of the economy and are prone to experience currency crises.[5]

Environmental Scan: Recent Improvements

When we examined various ratings of countries based on a range of risk factors, the ranking of Saudi Arabia and the UAE were stable or improving in recent years. The country risk rating reported by A.M. Best Company focusing on comparative political and economic conditions for insurance purposes showed Saudi Arabia and the UAE both at a CRT-3—about average country risk. A multifactor model created by Barra, Inc., measured the overall risk associated with a security or credit risk relative to the market. Barra Risk Factor Analysis incorporated more than 40 data metrics, including earnings growth, share turnover, and senior debt rating. The model then measured risk factors associated with three main components: industry risk, risk from exposure to different investment themes, and company-specific risk. The Barra risk rating for Saudi Arabia was BBB to single B for political risk and BB for banking sector risk. The UAE's rating was slightly better at BB overall, and several measures were a single B due to economic factors and more diverse economic and banking sector factors. In general, as reflected in Table 1, most country risk rating agencies, and even the AT Kearney FDI Confidence survey of executives, show the UAE to be rated more positively than Saudi Arabia. In part, this difference is due to tighter regulations in Saudi Arabia than in the UEA, as discussed in the next section.

Summary of Regulations and Capital Controls

This section of the case offers a detailed description of the exchange arrangements and exchange controls that existed in Saudi Arabia and the United Arab Emirates in 2010. It includes regulations on any financial flows into or out of the country, trade restrictions, and regulations that impact operation of a financial service company in either country. Table 2 summarizes the differences between the two areas.

TABLE 1 Sample Country Risk Ratings for UAE and Saudi Arabia

March 2011	Country Risk	Political Risk	Corruption	Economic Risk	Credit Risk	Banking Risk
A.M. Best	UAE—3 KSA—3				UAE—3 KSA—3	
Barra	UAE—BB KSA—BBB	UAE—BB KSA—B		UAE—B KSA—BBB		UAE—B KSA—BB
Transparency Intl.			UAE—28 KSA—50			
Euromoney	UAE—33 KSA—38	UAE—59 KSA—52		UAE—67 KSA—72	UAE—8/10 KSA—8/10	
S&P						
OECD	UAE—3/10 KSA—2/10					
A.T. Kearney FDI Rankings	UAE—1.29/3 KSA—1.26/3					

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Saudi Arabia[6]

Exchange Rate—The exchange rate of the Saudi riyal is a conventional peg to the U.S. dollar at the official rate of SRl 3.75 per $1, and is set by the Saudi Arabian Monetary Agency (SAMA). The rate has been stable since June 1986. Banks may charge up to 0.125% above the official rate. Commercial banks have an active forward market to cover exchange risk for up to 12 months. Transactions with and use of Israeli currency are prohibited. Controls on payments and receipts are administered by SAMA. No payment arrears are permitted. There are no controls on export and import of bank notes. Foreign exchange accounts are permitted domestically and abroad, and domestic currency accounts are convertible into foreign currency, but no domestic currency accounts are permitted abroad. All of these accounts must be approved.

Imports and Import Payments—Import restrictions on a few commodities are maintained for religious, health, and security reasons. Trade with Israel is prohibited. A maximum of 5% tax is applied on most dutiable goods. For a few goods, the rate is 12% and 20%, and for tobacco products, the tax is 100%. Imports from GCC members are exempt. There is no state import monopoly.

Exports and Export Proceeds—There are no repatriation, financing, or documentation requirements. The re-export of certain imported items benefiting from government subsidies is prohibited. There are no export taxes. There are no controls on payments for invisible transactions and current transfers. There are no repatriation requirements or restriction on the use of funds for proceeds from invisible transactions and current transfers.

Capital Transactions—There are controls on capital transactions, but there are no requirements on repatriation. Under the regulations for the licensing of both bank-affiliated and nonbank brokerage and investment companies (released by the Capital Market Authority), four categories of companies are allowed to engage in brokerage and investment fund management: (1) local bank subsidiaries, (2) Saudi Arabian joint stock companies, (3) subsidiaries of Saudi Arabian joint-stock companies that are engaged in the financial services business, and (4) subsidiaries of foreign financial institutions that are licensed under the Banking Control Law issued by Royal Decree No. M/5 dated 22/2/1386H (June 11, 1966).

Shares—Resident foreign nationals may invest in shares of listed KSA joint-stock companies. Nonresident foreign nationals are limited to indirect investment through authorized mutual funds. Nonresidents must seek permission of the minister of commerce and industry and the Capital Market Authority to sell or issue securities in KSA. There are no controls on the repatriation of proceeds from the sale of securities issued by nonresidents. Residents may purchase or sell nonresident securities via brokerage services offered by licensed brokerage firms. In the case of a KSA joint-stock company, the rules on the purchase locally by nonresidents apply.

Bonds—Purchase locally by nonresidents: there are no controls on portfolio investment in government securities by foreign nationals. Sale or issue locally by nonresidents: the regulations governing shares or other securities of a participating nature apply. For money market instruments, the sale or issue locally by nonresidents: the regulations governing shares or other securities of a participating nature apply. For sale or issue abroad by residents: in the case of collective investment securities when the underlying assets are shares of KSA joint-stock companies, the regulations governing shares or other securities of a participating nature apply. For controls on derivatives and other instruments: the regulations governing shares or other securities of a participating nature apply.

Controls on Credit Operations—For commercial credit to nonresidents: KSA banks must seek permission from the SAMA. To residents from nonresidents: the SAMA's permission is required for riyal-denominated loans made through KSA banks. For financial credits: the SAMA's permission is required for all financial credit operations. For guarantees, sureties, and financial backup facilities by residents or nonresidents: SAMA's permission is required. But for these facilities to residents from nonresidents: financial institutions that give guarantees to government projects must appear on the SAMA-approved list.

Controls on Direct Investment—Approved foreign investments in KSA enjoy the same privileges as domestic capital. The foreign investment law allows foreign investors to make direct investment in most of the country's economic sectors—with or without local participation—and imposes a tax rate of 20% on most foreign company profits, with two exceptions: (1) an 85% tax rate is charged on profits of investment in the oil and hydrocarbon sector, and (2) a basic rate of 30% is imposed on profits of investment in the natural gas sector as long as the internal rate of return (IRR) of the project does not exceed 8%. For investments with an IRR exceeding 8%, a sliding scale of

higher tax rates apply with a maximum rate of 85% for an IRR exceeding 20%. The Supreme Economic Council has issued a list of economic sectors that remain off limits to foreign investors. The list is reviewed regularly and includes projects related to exploration, drilling, and production of oil; production of military equipment and uniforms; production of explosives for civil purposes; certain printing and publishing activities; certain telecommunications services; land and air transportation; real estate investment in Mecca and Medina; services involving fishing; distribution services, including wholesale and retail trade and commercial agencies; and a few other sectors. In accordance with the Cooperative Insurance Companies Control Law, the SAMA accepts licensing applications from insurance companies transacting insurance and reinsurance business in KSA. Under the regulations, foreign insurance companies are allowed to own up to 49% of these local companies. There are no controls on the liquidation of direct investment.

Controls on Real Estate Transactions—For real estate purchased locally by nonresidents: in principle, the purchase of real estate is restricted to KSA nationals, Saudi corporations, Saudi institutions, and nationals of GCC member countries. However, under the foreign investment law, foreign investors are allowed to purchase real estate as needed for their business, including housing for their staff. In addition, nonresidents are allowed to purchase real estate for conducting real estate business in all cities except Mecca and Medina, provided the investment in the real estate business is not less than SRI 30 million.

Controls on Personal Capital Transactions—Price earnings are transferable; gambling is prohibited.

Provisions Specific to the Financial Sector—Lending to nonresidents: KSA banks require SAMA's permission to lend to nonresidents, except for interbank transactions and commercial credits. In the case of deposits originating from foreign banks, only domestic currency deposits are subject to SAMA's reserve requirement. SAMA's approval is required for KSA banks only; domestic currency deposits are subject to SAMA's reserve requirement. SAMA's approval is required for Saudi banks to acquire shares in foreign companies. There is a limit of 40% of capital and permission of the authorities for nonresidents to invest in KSA banks. Open foreign exchange positions are monitored by means of prudential reports.

Provisions Specific to Institutional Investors—Foreign insurance companies may open branches in KSA subject to the Law on Supervision of Cooperative Insurance Companies and to the Insurance Implementing Regulations issued by SAMA. These regulations impose certain restrictions on investments by insurance companies. Existing insurance companies had until March 2008 to bring their operations into conformity with these regulations. SAMA guidelines for KSA branches of foreign insurance companies are, in effect, requiring minimum levels of investment locally in riyals; maximum limits on investment in foreign equities and foreign bonds, both government and corporate; and adherence to Articles 59 and 61 of the Insurance Implementing Regulations. There is a limit on securities issued by nonresidents of 20% unless approved by SAMA. In addition, a limit of 10% applies to foreign currency-denominated investments and 5% to foreign government bonds and bonds issued by foreign companies. Regulations regarding limits on investment portfolios held abroad are related to nonresidents only. The limits on investment portfolios held locally are 50% of the total assets in riyals. Moreover, unless otherwise approved by SAMA, insurance companies and branches are required to keep 20% of their investments in authorized banks and 20% in KSA government bonds for companies and branches engaged in property and life insurance.[7]

United Arab Emirates[8]

Exchange Measures and Arrangement—There are no restrictions. In accordance with UN Security Council Resolution No. 1373 (2001), accounts belonging to individuals and/or organizations associated with terrorism have been frozen. Banks are required to verify identity for transfers exceeding Dhs 3,500 or its equivalent. Money changers are required to do the same for transfers exceeding Dhs 2,000. Free zones in the United Arab Emirates are required to verify the identity of persons wishing to establish businesses. The currency of the UAE is the dirham. The dirham is pegged to the dollar, the intervention currency, at Dhs 3.6725 per $1. There is no exchange tax or subsidy. The spot exchange market is operated by the Central Bank. The forward exchange market—the UAE Central Bank (UAECB)—maintains a swap facility which commercial banks may use to purchase dirhams spot and sell dirhams forward for periods of one week, one month, and three months. For each bank, maximum limits of $20 million outstanding for one-month and three-month swaps and $10 million outstanding for one-week swaps are in effect. There is also a daily limit of $3 million on purchases by each bank for

one-month and three-month swaps. This facility is designed to provide temporary dirham liquidity to commercial banks. Swap facilities are not available to banks having a short position in dirhams except for covering forward transactions for commercial purposes. Official cover for forward positions is required.

Arrangements for Payments and Receipts—There are no currency requirements, but settlements with Israel are prohibited. The UAE is a member of the GCC Customs Union. There are no payment arrears, controls on trade in gold, controls on export, and imports of banknotes.

Resident Accounts—The following are permitted: foreign exchange accounts, held domestically, held abroad; accounts in domestic currency convertible into foreign currency. Accounts in domestic currency held abroad may be maintained in offshore affiliates of domestic banks.

Nonresident Accounts—These accounts may be opened by banks and trade, financial, and industrial companies incorporated outside of the UAE that have no local branches; by branches of local institutions in foreign countries; and by embassies and diplomatic agencies. These accounts may also be opened by UAE citizens working abroad and by nonresident foreigners working in the UAE. Domestic currency accounts are allowed and may be convertible into foreign currency. There are no blocked accounts.

Imports and Import Payments—No foreign exchange budget is required, nor is there a financing requirement for imports, or documentation requirements for the release of foreign exchange. Only licensed parties may engage in import trade. Importers may import only the goods specified in their licenses. Imports of a few products are prohibited for health, security, or moral reasons. Imports from Israel are prohibited, as are imports of products manufactured by foreign companies blacklisted by the Arab League. In accordance with the GCC Customs Union, a unified tariff of 5% applies on most dutiable goods. There is no state monopoly.

Exports and Export Proceeds—There are no repatriation requirements, financing requirements, documentation requirements, export licenses, export taxes.

Payments for Invisible Transactions and Current Transfers—There are no controls.

Proceeds from Invisible Transactions and Current Transfers—There are no repatriation requirements, or restrictions on use of funds.

Capital Transactions—There are controls on capital transactions. At least 51% of the shares of UAE corporations must be held by UAE nationals or organizations. Companies domiciled in free zones are exempt from this requirement and may be up to 100% foreign owned. Nonresidents may sell or issue stocks and bonds, and purchases by GCC residents are exempt from controls. Nonresidents may issue some mutual funds. There are no controls on derivatives or credit operations.

Controls on Direct Investment—At least 51% of the equity of companies other than branches of foreign companies must be held by nationals of the UAE. GCC nationals are permitted to hold (1) up to 75% of the equity of companies in the industrial, agricultural, fisheries, and construction sectors; and (2) up to 100% of the equity of companies in the hotel industry. GCC nationals are also permitted to engage in wholesale and retail trade activities, except in the form of companies, in which case they are subject to the company law. In free zones, foreign ownership is permitted up to 100%. There are no controls on the liquidation of direct investment. A new system of freehold properties allows nonresidents subject to each Emirate's specific conditions to own real estate. The new system was first introduced in Dubai and is now generalized to other main Emirates, particularly Abu Dhabi, Sharjah, Ajman, and Ras Al-Khaimah. There are no controls on personal capital transactions.

Provision Specific to the Financial Sector—Commercial banks operating in the UAE are prohibited from engaging in nonbanking operations. Banks operating in the UAE are required to maintain special deposits with the UAECB equal to 30% of their dirham placements with or loans to nonresident banks when these transactions have a remaining maturity of one year or less. The profits of foreign banks are subject to a profit tax levied by the local authorities at an annual rate of 20%. Banks are not allowed to lend more than 7% of their capital base to one foreign institution. Also, they are not allowed to invest more than 25% of their own funds in shares or bonds issued by commercial companies. Loans to foreign governments with a first-class credit rating and placement in such countries' financial institutions are exempt from such limits. Nonresidents may not acquire more than 20% of the share capital of any national bank. For the acquisition by nonresidents of shares of national banks, the UAE company law applies, i.e., nonresidents are allowed to acquire up to 49% of the total shares. Table 2 shows a comparative summary of exchange and financial restrictions in the two countries, the UAE and Saudi Arabia, in 2010.

TABLE 2 Summary Features of Exchange Arrangements and Regulatory Frameworks for Current and Capital Transactions in U.S., Saudi Arabia, and UAE*
(As of date shown on first county page)

	United States	Saudi Arabia	United Arab Emirates
Status under IMF Articles of Agreement			
Article VIII			
Article XIV			
Exchange rate arrangements			
No separate legal tender			
Currency board		◆	◆
Conventional peg			
Stabilized arrangement			
Crawling peg			
Crawl-like arrangement			
Pegged exchange rate within horizontal bands			
Other managed arrangement			
Floating			
Free floating	•		
Exchange rate structure			
Dual exchange rate			
Multiple exchange rates			
Arrangements for payments and receipts			
Bilateral payments arrangements	•		
Payments arrears			
Controls on payments for invisible transactions and current transfers			
Proceeds from exports and/or invisible transactions**			
Repatriation requirements			
Surrender requirements			
Capital transactions			
Controls on:			
Capital market securities	•	•	•
Money market instruments	•	•	
Collective investment securities	•	•	•
Derivatives and other, instruments	•	•	
Commercial credits		•	
Financial credits		•	
Guarantees, sureties, and financial backup facilities	•	•	
Direct investment	•	•	•
Liquidation of direct investment			
Real estate transactions	•	•	•
Personal capital movements			
Provisions specific to:			
Commercial banks and other credit institutions		•	•
Institutional investors	•	•	—

• The specified practice is a feature of the exchange system.
— Data were not available at the time of publication.
◆ Flexibility is limited vis-a-vis the U.S. dollar.
* Data are also included for Aruba (Netherlands), Hong Kong SAR (People's Republic of China), and the Netherlands Antilles.
** These items now refer to corresponding requirements for both exports proceeds, and proceeds from invisible transactions and current transfers (e.g., it would be sufficient for surrender requirement to be indicated as a feature of the exchange system if at least one of them is subject to a surrender requirement).

Source: IMF "Annual Report on Exchange Arrangements and Exchange Restrictions, 2010."

Capital Controls and Their Effectiveness—"The magnitude of cross-border financial assets has grown in recent years at a rising speed, from under 50% of world GDP in 1970 to over 300% in 2006, and doubling over the last 10 years."[9] From a country's perspective, there is concern about the risks outweighing the benefits of financial inflows and, if so, should capital inflow be regulated and controlled? Many countries in Asia are facing this question today as financial inflows have accelerated to record levels. Even so, in some cases de jure controls as presented in the IMF "Annual Report on Exchange Arrangements and Exchange Restrictions, 2010," may not represent actual de facto outcomes. Thus, Schindler (2009) found that even in countries with de jure restrictions and capital controls, there may still be sizeable de facto financial inflows. While de jure restrictions on foreign direct investment may be somewhat more effective, Lane and Milesi-Ferretti (2007) found that there have been de facto significant increases in financial flows, and that there is a growing reliance on equity financing in emerging markets in contrast to the use of debt financing in industrial countries.[10]

Saudi Arabia

The Kingdom of Saudi Arabia (KSA) has a population of 25 million people. Of these, 35% are under the age of 15 and only 4% are over the age of 60, with a life expectancy of 71 years for men and 75 years for women. Seventy-two percent of employment is in the service sector, 21% is in industry (energy and related activities), while the remaining 7% is in agriculture. Unemployment during the past decade has run just under 5%. Similar to the United States, 97% of households have color television sets and 78% have cell phones, but only 14 people out of 100 have computers, compared to 76 in the United States and 47 in the European Union.[11]

Global Competitiveness In an annual survey of global competitiveness done by the International Institute for Management Development (IMD), Saudi Arabia ranked 35th out of 131 participating countries.[12] One of the most important factors contributing to this high ranking was macroeconomic stability, where it ranked third out of 131 countries. However, the sophistication of company operations and strategy and the quality of the national business environment ranked about 50th out of 127 countries (four countries did not report). The five major problems identified and ranked as issues for doing business in the Kingdom were:

- Inefficient government bureaucracy,
- Inadequately educated workforce,
- Restrictive labor regulations,
- Inadequate supply of infrastructure, and
- Lack of access to financing.

Consequently, a dependency on imported foreign workers has developed, resulting in anxiety among some of the local unemployed Saudi workers. As a result, the government put into place a program that required companies to hire Saudi nationals.

Saudi Arabia has launched a program to attract foreign investment into the country in support of its new "Economic Cities," which it is promoting strongly. Several changes were under way by the government to address some of the weaker aspects of its global competitiveness ranking. One of the most important of these improvement efforts was the centralization in one government ministry—the Saudi Arabian General Investment Authority (SAGIA)—of all of the various applications, rules, and regulations that had to be completed by a foreign company in order to start a business in Saudi Arabia. The government was making a concerted effort to significantly increase foreign investment coming into the country. In this respect, tax rates and tax regulations were ranked as one of the least problematic factors for doing business, along with a low-level burden of government regulation. Foreign investment is seen as a way to diversify the economy away from its concentration on energy, transfer new knowledge and technology into the country, and provide an alternative source of revenue for the Kingdom.

Foreign Investment Environment SAGIA combined three departments and nine ministries into one office at one location to assist foreign investors. In a statement by the governor of SAGIA, Amr bin Abdullah Al-Dabbagh,[13] he described SAGIA's role as, "… to attract sufficient investment to achieve sustainable rapid economic growth while capitalizing on the Kingdom's competitive strengths as the global capital of energy, and as a major hub between East and West."[14] SAGIA intended to position Saudi Arabia among the top ten most competitive nations by 2010 through the creation of a pro-business environment and a knowledge-based society while putting forth its best effort to make Saudi Arabia a favorable investment destination in the region and throughout world.

SAGIA's role was to provide comprehensive licensing and support services to foreign investors. In addition, SAGIA is working to become the investors' information clearinghouse, serving as a central repository of information regarding business in the country, including key economic news and indicator reports,

competitiveness studies, general statistics and economic research, and the country's laws and regulations. While they intended to provide services to investors in all sectors of the Saudi economy, SAGIA emphasizes three sectors: energy, transportation, and information and communications technology (ICT).

SAGIA cooperated with other government agencies and private sector organizations to improve the country's business laws and policies according to international best practices so that a healthy investment environment develops and continues in future years. An increasingly globalized economy required Saudi Arabia's business climate to be attractive and competitive. As a start, in August 2004, SAGIA (1) updated its list of policies and procedures that required revision, (2) compared the country's practices to its benchmarked countries, and (3) began cooperating with relevant government authorities on procedural improvements.

To maximize users' ease and efficiency, SAGIA's One-Step Shops (OSS) has centralized a wide range of critical services—all focused on making it as easy as possible to invest in or set up and operate a business in the Kingdom. A large number of government departments were represented in each OSS, providing investors with fast, hassle-free access to 128 business-related services, ranging from government licensing to telecommunications and banking services. As the government agency responsible for both promoting and licensing investments within the Kingdom, SAGIA is the sole contact point between investors and the Saudi Government, and would provide all government services through its OSS operations.[15] The SAGIA OSS service operations are listed below.

Government Procedures Licensing Conditions. The conditions for granting a Foreign Investment license by The Authority shall include the following:

1. The investment activity to be licensed should not be in the list of *Excluded Activities from Foreign Investment.*
2. The intended Product should comply with the *Kingdom's rules and regulations*, or the laws of the European Union or the United States of America in the absence of those laws, in terms of standards and specifications, raw materials and production processes.
3. The license applicant should be a natural or nominal person who has come to the Kingdom for investment.
4. The Foreign Investor should not have been convicted in the past for substantial violations of the provisions of The Act.
5. The Foreign Investor should not have been convicted in the past of financial or commercial violations whether in the Kingdom or in other countries.
6. The grant of a license shall not result in the breach of any international or regional agreement to which the Kingdom is a party.

Starting a Business Investment License. A foreign investor may obtain more than one license to practice the same activity or different activities. License application must be completed in full; all documentary requirements must be submitted in full; all of which must be signed by the applicant or his duly authorized representative.

Guides for Licensing a New Project. The required documents for governmental procedures are referenced here: Required Documents.

Business Visit Visas. Business Visit Visas are issued from the Saudi Arabian Embassies worldwide to facilitate the business community.

Commercial Registration. Companies operating in Saudi Arabia must register their businesses with the Ministry of Commerce and Industry and obtain a Commercial Registration (CR) number.

SAGIA provides examples of success stories in the area of telecommunications, summarized below.

Mobile Telephone—In 2004, United Arab Emirates operator Etisalat paid US$3.3 billion for the Kingdom's second GSM license. Etihad Etisalat has since gained 30% of the Saudi mobile market and offers a range of 3G services. The Kingdom's third mobile license was awarded to a Kuwaiti-led consortium, which made a US$6 billion bid against six other companies. Competition is propelling Saudi Arabia towards its goal of acquiring one of the region's most advanced and diversified telecommunications markets. Rapid growth is expected to continue due to still-low penetration rates across many fixed-line and mobile services. Newly appointed Saudi providers, the Bahrain Telecommunications Company (Batelco), Hong Kong-based PCCW, and U.S.-based Verizon Communications have formed consortia with local interests.

SAP—Many of the largest clients in SAP's portfolio are based in Saudi Arabia, including world-class players such as Saudi Aramco, Saudi Electricity Company, Saudi Arabian Airlines, Saudi Basic Industries Corporation, and the Saudi Arabian General Investment Authority. To accommodate its aggressive growth targets in the region, SAP announced in 2008 that it plans to locate 30% of its Middle East headcount in the Kingdom. In March 2008, Sergio Maccotta, managing director of SAP's MENA division, indicated that the majority of new Saudi-based staff would be local hires. "Saudi Arabia has always been one of our strongest countries in the Middle East, and we are continuing to reinforce our own presence there. Customers demand more local presence; we can't have only people from outside," he said. Following the acquisition of SAP Arabia, SAP now operates in Saudi Arabia as SAP KSA, with offices in Riyadh and Khobar.

Cisco—Cisco has signed agreements to design the information and communications (ICT) infrastructure for three of Saudi Arabia's planned Economic Cities. The scale of this Greenfield project provides a "blank slate" opportunity for Cisco to pioneer the most advanced innovations in communications infrastructure. Cisco plans to design the infrastructure for fully networked buildings and residences, linked together by a high-capacity fiber-optic backbone, along with ubiquitous wireless connectivity. These investments are integral to providing the Economic Cities with the most advanced basis for 21st century commerce, and will enable applications such as smart elevators, "invisible" security, RFID inventory tracking, and automated transportations systems. In addition, Cisco has announced plans to invest US$265 million in Saudi Arabia as part of the country's initiative to become a "connected Kingdom." Over the next five years, Cisco plans to: increase its workforce in the Kingdom from 70 to 600; provide leasing and other financial options to Cisco customers; create a Cisco technology and entrepreneurship innovation center; sponsor a Saudi technology and entrepreneurship institute; establish 100 networking training centers to provide joint technical programs with local universities; support provision of Internet connections to 2,000 underserved homes.

Cisco's NETVERSITY (Networking Academy program) has partnered with public education organizations to provide advanced business and technical training to Saudi students, and Cisco has hired 100% of the program's graduates. Cisco has operated in the Kingdom since 1998, with offices in Riyadh, Jeddah, and Khobar. In 2006, Cisco called Saudi Arabia the world's fastest growing region in terms of networking technology adoption. Cisco has worked on other "smart city" projects such as Dubai Internet City, Hong Kong's Cyberport, and Belgium's I-City. Its recent and planned investments in the Kingdom are examples of the large-scale opportunities provided by the Kingdom's expansive investment initiatives.

Sample Company Surveys and Interviews

Several companies were interviewed to discover what they considered to be the most important factors guiding their location in the Middle East. While the primary target industry was financial services, several other service industry companies were also interviewed to validate or reveal differences in the criteria considered. The results are organized along the following themes: strategic considerations (why invest?), location decision factors, ownership mode decisions (licensing vs. joint venture vs. wholly owned subsidiary), and the decision-making process.

Strategic Considerations

All companies interviewed invested in the region with a market-seeking purpose. In the case of financial services, the focus was primarily on sourcing of funds via the provision of private banking or wealth management services to the affluent. MENA markets are considered attractive with high-growth prospects. The financial services companies all found that it was increasingly inappropriate to service MENA clients from their

European base in the United Kingdom. Given an increasing aversion to suitcase bankers among clients and prospects, financial services companies decided to establish local bases to grow their business. Other companies interviewed had a global strategy and needed to be in all parts of the world as part of this strategy. This was particularly true for companies who needed to follow their clients across the globe (for example, logistics companies), who managed global relationships with the world's largest and most international companies. In such cases, investment in a particular national market might not be profitable on a standalone basis, but was necessary in order to support strategic, global client relationships.

Several companies also expressed elements of strategic asset-seeking considerations. This was the case, for example, for a logistics provider who invested in the UAE and Bahrain in order to perform hub functions for its global logistics network. Other companies investing in Dubai also did so in order to have a regional hub, which in several cases stretched farther in geographic scope than just the MENA region to encompass the whole of Africa or South Asia.

Natural resource-seeking or factor-seeking considerations were hardly mentioned as reasons to invest. This was to be expected, given the fact that all companies interviewed were service companies operating outside the energy sector. The availability of qualified staff and the possibility to attract staff into a particular location were mentioned as factors to decide for a particular location within the MENA region, but such considerations were not mentioned as reasons to support the investment decision in the MENA region overall.

Therefore, among the interviewees, market-seeking considerations were by far the most important motivation for the companies in the sample to be in the MENA region.

Location Choice Criteria

The main reasons for considering or choosing specific locations can be classified into the following categories:

1. **Market Potential**
   Since all companies in the sample were investing primarily for market-seeking purposes, market potential was clearly a major location decision criterion. Although Saudi Arabia is the largest market for many investors, most companies decided to set up operations first in countries other than Saudi Arabia. Especially Bahrain and the UAE, which are within close proximity of Saudi Arabia, were preferred based on the other location decision factors that are discussed below. Several companies subsequently started their own operations in Saudi Arabia as the market opportunity grew, Saudi Arabia's regulatory framework improved, and as investors gained familiarity with the region. Other MENA countries were entered in the same way, with a regional headquarters planning and coordinating entry into adjacent markets. In this sense, the findings are consistent with the Uppsala model of the company internationalization process (Johanson and Vahlne, 1977, 1990), whereby companies commit increasing amounts of resources to a market as their knowledge of foreign markets increases with experience.

2. **Regulatory Environment**
   The regulatory environment is a driver of both investment location decisions and operation mode decisions for all investors. The regulatory environment has changed significantly in many MENA countries in the last decade. As a result, several companies said they would have taken a different location and ownership mode decision in today's environment compared to the time that they made their original decision.

   Specifically, Bahrain attracted investment in the financial services industry because it was the first GCC country with a clear regulatory framework and the opportunity for foreigners to obtain 100% ownership. With the subsequent establishment of the Dubai International Financial Center (DIFC) in 2004, financial services companies had a choice of locations in which they could retain full ownership. More recently, Saudi Arabia also allowed foreign investors to obtain full ownership in certain sectors (including financial services) and Qatar established the Qatar Financial Center.

   Several financial services companies said that the fact that the DIFC regulations were modeled on UK regulations provided a major reason for establishing at the DIFC. In Dubai, the Dubai Financial Services Authority (DFSA) is the regulator for the DIFC. Its rules and ways of enforcing the rules are familiar to international bankers, particularly to those with experience in the UK and the United Sates. This consistency in regulation between the DIFC and other international financial centers made it easier for legal departments at headquarters to accept the DIFC as a location compared to other locations where the regulatory framework might be less familiar.

   Other regulatory factors mentioned included those from among the World Bank's Doing Business indicators and other rankings, such as ease

of setting up a business, the efficiency of the bureaucracy, and the level of corruption.

3. **Quality of Life**
   Quality of life for employees and their families is a major determinant for location decisions since new investments require new staff which may not be working in the region yet. Aspects of quality of life that were mentioned include:

   - The availability of good international schools
   - Community life and entertainment possibilities
   - Safety
   - The accessibility of the location by air

   Several respondents stressed the importance of this point in the context of the large proportion of time that staff spends traveling. Company management wants to make sure that their families are in an optimal environment when staff are away from home. These factors were mentioned as particularly important by companies that chose the UAE (specifically Dubai) as their hub.

4. **Physical Infrastructure**
   Infrastructure was mentioned as an important location decision factor by all respondents, particularly for those companies choosing their location for a regional hub. In these cases, the available international flight network was mentioned several times as a factor in favor of the UAE.

5. **Cost Considerations**
   Cost by itself was not mentioned frequently as a major driving factor for a location decision, indicating again the market-seeking motive rather than a resource-seeking motive for the companies in the sample. Every investment decision was typically supported by a business case which outlined the revenues, costs, investments, and risks associated with the investment proposal. Cost was therefore clearly one of the main factors driving the attractiveness of a project, but was not by itself a deciding factor for investors choosing one location over another or for companies investing in particular countries.

   A comment made by several companies was that Dubai's attractiveness as a location increased significantly since 2008 due to the large drop in rents for office and housing costs (housing for expatriate staff is usually paid for by the employer).

Quotes from Interviewees:

"We considered Bahrain and Dubai as locations for our first Middle East office. At the time, flight connections in and out of Bahrain were actually reducing due to the Gulf Air restructuring, while Emirates was rapidly expanding its network. This was an important factor in choosing for Dubai."

The Role of Environmental Risk

Environmental or political risk was considered in the investment decision-making process of all interviewees. The role that this risk factor played depended on the circumstances of the company and the investment decision. If the investment decision was a standalone project, then political risk influenced the decision-making process by increasing the discount rate that was used to evaluate a project's attractiveness. In this case, the hurdle rate for a project in a country with high political risk was increased and projects with relatively low profitability might be rejected in high-risk countries but accepted in low-risk countries.

If the project being considered had alternative locations (such as for a regional hub), then, ceteris paribus, the location with lower political risk was preferred. For example, Beirut was mentioned several times as a potential regional headquarters location for financial services firms, but political instability prevented companies from establishing their hub there.

The idea of threshold levels of risk was supported to some extent by the interviewees. If political risk was below a certain level, it had no impact on the discount rate used to evaluate the project. At higher levels of risk, the discount rate increased. Above a certain level of political risk, most companies concluded that it was not feasible to provide a service in the country. However, this threshold level of risk was high and seemed to be related specifically to security concerns rather than overall political considerations. No country in the MENA region seemed to be barred from consideration, and several respondents said they were actively considering investment in Iraq. For companies who needed to maintain control over key processes in their service delivery, the criterion to invest in a country was whether certain activities could be carried out by the company's own staff. If a company's own staff was not able to perform core functions because of security concerns, then the market was not entered. Only in one case was political risk found to affect the operation mode; if risk was high, the company was more likely to operate through a licensee rather than through a wholly owned subsidiary.

Political risk was typically a section in the company's business case document, enabling a structured discussion of political risk factors. There appeared to be little knowledge or use of publicly available political risk ratings among interviewees. Several companies

had their own risk rating methodology used by headquarters staff to evaluate and measure political risk. On the whole, it seemed that systematic political risk analysis was left to headquarters staff to ensure consistency of analysis methods across the company globally.

Quotes from Interviewees:

"Political risk is a structural feature of the region and needs to be accepted as an element of doing business."

"We did not carry out a specific political risk assessment, except for an analysis of the regulations specific to our business."

"Although political risk is an important consideration, it will not by itself cause us to abandon a project."

"We don't see joint ventures as a way to manage political risk."

Entry Modes and Operation Modes

The companies interviewed operated with a large variety of operation modes, including 100% ownership (either onshore or in free zones), joint ventures, and licensing agreements. In nearly all cases, the operation mode was the same as the entry mode, meaning that there were only few and minor changes to a company's ownership and control arrangements after the initial entry was made.

Nearly all companies demonstrated a strong preference for maximum ownership and control in all their markets in the MENA region. The reason that not all companies operated exclusively in their preferred ownership mode in practice was either due to regulatory factors, historical reasons, or a combination of both.

Regulatory factors inhibited companies from having full ownership in many MENA countries, although variations tended to exist by industry sector within a country. In all GCC countries except for Bahrain, an onshore presence could only be obtained in partnership with a local sponsor, whereby the sponsor must own a minimum of 51% in the venture. Several interviewees that operated under such an arrangement commented that they saw this not as a true joint venture but mostly an effective way to operate in a market under the regulations existing at the time of entry. Among companies interviewed, such joint venture arrangements often had a service contract in addition to the joint venture agreement, whereby the partner/sponsor provided visa processing and administrative services to the foreign investor for a fee. The actual profits from the business flowed entirely to the foreign investor. The local joint venture partner therefore did not take a risk by participating in the venture, got no share of the profits, and only received a fee for services rendered. In one case, the foreign investor did mention that the sponsor provided assistance in obtaining payment from a government entity.

In some cases, joint ventures existed because the government required part ownership of a business as part of a privatization effort, or because the government was a strategic participant in the company's parent.

In one case, a joint venture existed for historical reasons as it had been put in place by previous management who considered a joint venture as an effective way to obtain local market knowledge and access to decision makers. In this case, current management is continuing the existing arrangement, even though its preference would be for full control and ownership.

The forces of regulations and historical considerations come together in the sense that those companies that opened in the region before full ownership became possible were still operating as joint ventures through local sponsors, whereas several companies indicated they would prefer to set up in one of the free zones in order to benefit from full ownership and control. However, switching costs (including administrative costs, office moves, and increases in office rent), as well as a concern that the existing sponsor might respond negatively to the termination of the sponsorship agreement, were factors that inhibited a change in operation mode.

The reasons given by companies to prefer full ownership and to shy away from agency agreements or joint ventures showed a large degree of consistency among respondents, with the main theme being fears of opportunism among joint venture partners. In several cases, it was argued that the interests of joint venture partners might not be aligned. First, a local joint venture partner might be interested in local profitability, whereas the multinational company was managing for global profitability. This concern arose particularly in the treatment of strategic global customers. A second concern mentioned was that the joint venture partner might not be sufficiently interested in the profitability of the venture, as it might be just one of many business activities the partner engaged in. The partnership could be seen as a vehicle for prestige rather than profit. Third, foreign investors in knowledge-intensive industries were keen to protect their intellectual property, particularly in markets where intellectual property rights are not rigorously enforced. Fourth, companies with important operations in the U.S. all mentioned the importance

attached to full compliance with the Foreign Corrupt Practices Act (FCPA). This legislation, as well as equivalent legislation in the UK and other countries, places restrictions on the partners of multinational companies and their activities. Foreign investors wanted to ensure that communication with host governments was done by them directly in a way that complied with the FCPA rather than by a partner whose compliance with the FCPA was difficult to monitor in practice. Several companies said, "Only we can represent ourselves to foreign governments." Finally, several companies mentioned financial and reporting factors as reasons to prefer full or majority ownership. Majority ownership was required to be able to consolidate investments in the company's financial statements. Similarly, majority or full ownership was also mentioned as superior from a shareholder value-creation perspective, particularly if a company was quoted on the stock market.

Generally, the issue of dealing with host governments was seen as a reason to maintain full control over an investment rather than sharing ownership. In addition to the FCPA considerations mentioned, companies with operations in many countries (including emerging markets) considered dealing with host governments as one of their main competencies with which they required little outside help. Several of the companies indicated that when required, support was provided by the relevant Embassy or Consulate in the host country. If additional outside help was needed in this area, a company might use a consult for a fee, without any need to share ownership over the investment.

More generally, interviewees saw no major differences between the way the company operated in the MENA region compared to the home market in terms of how decisions were made on what should be done by the company itself and what could best be done by outsiders. If there were certain activities that were considered as not being core to the company, then these could be subcontracted or outsourced. The fact that the MENA operation was in a country other than the company's home base did not provide a reason by itself to enter into equity-sharing arrangements. Subcontracting and outsourcing were considered to provide greater flexibility to change partners when required.

The internationalization of the management base at multinational companies was an additional reason that local partnerships were not always viewed as necessary. The MENA operations of most of the companies interviewed were managed by staff from the region or had extensive experience in the region, combined with higher education and work experience in Europe or the United States. This internationalization of the multinationals' HR strategy helped reduce the liability of foreignness for these investors, and also reduced the need for local partners.

Therefore, most companies had a strong preference for maximum control and ownership of their operations.

Quotes from Interviewees:

"Local partners don't bring much to the table. They are not needed for financial strength and not for operational skills."

"The sponsor is not really needed to open doors in a country. This can be done just as well by local employees."

"If our name is on the venture, then we must have majority ownership."

"A joint venture is seen as risky, since it ties the company to one partner, who may later turn out to be the wrong partner."

"Our strategy is to have as much ownership share as the local regulations will allow."

"According to the FCPA regulations, we must avoid partnerships which can be seen as political partnerships."

The Decision-Making Process

Except for one acquisition, all market entries were made through greenfield investments. Nearly all companies considered several locations when they entered the MENA region for the first time, although several companies were able to narrow down the list of location options quickly.

In each case, a formal business case document was prepared and presented to the company's highest decision-making body, typically the Managing Board. The business case development process, the decision-making process, and its implementation were standardized to a high degree for the larger companies in the sample. Typically, the business case document itself was not completely standardized, even for the larger companies, but there was a clear expectation of the topics that should be covered in the document.

At the same time, the informal involvement of the company's senior management was seen as critical in obtaining subsequent approval of a business case. Such involvement typically consisted of visits of senior

management from company headquarters to proposed investment destinations in the MENA region.

The duration of the decision-making project varied between six months and several years.

Quotes from Interviewees

"Deciding on an office location is an iterative process. First, we serve customers from the country, we build up tacit knowledge, and then prepare a business case."

"Getting people from head office to visit the region helped a great deal in getting decisions made."

CASE DISCUSSION QUESTIONS

1. Discuss how laws and regulations regarding foreign direct investment (FDI) have changed over the years.
2. What are some of the major factors companies consider when investing in the countries discussed in the case? Do these companies consider one set of factors more important than others? Why?
3. What are some of the major challenges facing multinationals as they invest in countries such as Dubai or Saudi Arabia?
4. Why are most foreign multinationals unwilling to form joint ventures as they enter markets in Saudi Arabia and Dubai? Do you believe that these fears are justified?

CASE NOTES

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[3] M. Ayhan Kose, Eswar Prasad, Kenneth Rogoff, and Shang-Jin Wei, "Financial Globalization: A Reappraisal," *IMF Staff Papers*, Vol. 56, No. 1, 2009.

[4] Ibid.

[5] Ibid.

[6] This section is summarized from the IMF "Annual Report on Exchange Arrangements and Exchange Restrictions, 2010," Saudi Arabia, pp. 1208–1213.

[7] www.sama.gov.sa/en/insurance;www.cma.org.sa/cma_en/default.aspx.

[8] Information for this section is taken from the IMF "Annual Report on Exchange Arrangements and Exchange Restrictions, 2010," United Arab Emirates, pp. 1509–1513.

[9] Martin Schindler, "Measuring Financial Integration: A New Data Set," *IMF Staff Papers*, Vol. 56, No. 1, 2009.

[10] Philip R. Lane, and Gian Maria Milesi_Ferretti, "The External Wealth of Nations Mark II: Revised and Extended Estimates of Foreign Assets and Liabilities, 1970-2004," *Journal of International Economics*, Vol. 73, No. 2, 2007.

[11] IMD "World Competitiveness Yearbook, 2009."

[12] Ibid.

[13] His Excellency Mr. Amr Al-Dabbagh is the Governor and Chairman of the Board of the Saudi Arabian General Investment Authority (SAGIA), with the rank of Minister. In the years since assuming the position in March 2004, SAGIA has seen the value of investment licenses grow to 19 times the total since it was created in 2000 (from US$4.5 billion to US$80 billion). Al-Dabbagh has been lauded by government and private sector leaders for his visionary and highly ambitious leadership, which recently garnered several awards for him, including Man of Year from *Arabian Business Magazine*, Global Leader of Tomorrow from the Executive Board of the World Economic Forum and the Editorial Board of *Worldlink* magazine, and the Leadership Award of the 12th Arab Economic Forum. Since 2005, SAGIA has been the architect behind the launch of an entirely new global product called "Economic Cities." These super-high-tech, 100% privately held total living and investing environments will, by 2020, have added more than US$150 billion to the Saudi GDP, 1.5 million jobs, raised the per capital GDP from 13,000 to 33,500 riyals, and provided ultimate living destinations to more than 4.5 million people. Five of six cities have already been launched, with a total value of more than US$80 billion. These include King Abdullah Economic City in Rabigh, Prince Abdul Aziz Bin Mousaed Economic City in Hail, Knowledge Economic City in Madina, and Jizan Economic City in Jizan. [http://www.sagia.gov.sa/english/uploads/HEBio_2008October.pdf, downloaded 8/19/09]

[14] Information about SAGIA is taken from www.SAGIA.gov.sa.

[15] Web links to Saudi Arabia government procedures and licensing requirements: http://www.sagia.gov.sa/english/uploads/Government%20Procedures_%D9%90En_2.2.1.2.pdf; http://www.sagia.gov.sa/english/index.php?page=documents-downloads.